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THE TAXATION OF CORPORATE SURPLUS ACCUMULATIONS

THE APPLICATION AND EFFECT, REAL AND FEARED, OF SECTION 102 OF THE INTERNAL REVENUE CODE DEALING WITH UNREASONABLE ACCUMULATION OF CORPORATE PROFITS

STUDY PREPARED FOR THE JOINT COMMITTEE ON THE ECONOMIC REPORT

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JOINT COMMITTEE ON THE ECONOMIC REPORT

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LETTERS OF TRANSMITTAL

JANUARY 2, 1952.

To Members of the Joint Committee on the Economic Report:

For the information of members of the committee and others interested, there is transmitted herewith, without recommendation, a study: The Taxation of Corporate Surplus Accumulations. This study was made for the committee by Dr. James K. Hall, professor of economics, University of Washington, as the result of a recommendation of the Subcommittee of the Joint Committee which held hearings on investment two years ago. So much interest was displayed at that time in the application and effect of section 102 of the Internal Revenue Code, that the members of the subcommittee felt the study should be undertaken.

This monograph presented by Dr. Hall includes much original data obtained from replies to a committee questionnaire and information obtained from the Treasury Department, dealing with the operations and effects of section 102. The study is now submitted to members of the committee for consideration and such suggestions as they may wish to make for consideration by the full committee. It is understood, of course, that the materials, conclusions, and recommendations in no way reflect the views of the joint committee, its individual members, or its staff.

The committee expresses appreciation to Dr. Hall, whose services were without cost to the committee. The committee also is grateful to the University of Washington for cooperating in providing Dr. Hall with sabbatical leave to prepare this study.

It is hoped that this study will encourage similar studies of other parts of the tax structure by experts.

JOSEPH C. O'MAHONEY, *Chairman.*

JANUARY 2, 1952.

Hon. JOSEPH C. O'MAHONEY,
Chairman, Joint Committee on the Economic Report,
United States Senate, Washington, D. C.

DEAR SENATOR O'MAHONEY: Transmitted herewith is a study on the Taxation of Corporate Surplus Accumulations. It covers the application and effect, real and feared, of section 102 of the Internal Revenue Code dealing with the unreasonable accumulation of corporate profits. This study was prepared by Dr. James K. Hall, professor of economics, University of Washington, and grew out of one of the recommendations of the Subcommittee on Investment of the Joint Economic Committee and contained in its final report, Volume and Stability of Private Investment, Senate Document No. 149, Eighty-first Congress, Second session, transmitted to the Congress March 23, 1950. The subcommittee recommended:

> A thorough and complete study of the application and effect, real and feared, of section 102 of the Internal Revenue Code dealing with unreasonable accumulation of corporate profits.

In accordance with the subcommittee's wishes the committee staff arranged for Dr. Hall to make this study for the committee. In addition to available information on the subject, arrangements were made with the Secretary of the Treasury for the Bureau of Internal Revenue to provide original data on the administration of section 102 and a committee questionnaire was sent to selected corporations to ascertain the economic effects of this provision of the Internal Revenue Code.

Section 102 of the Internal Revenue Code is the statutory provision designed to prevent avoidance of the individual income tax by the unreasonable accumulation of profits within the corporation. An accumulation is regarded as unreasonable when such funds are not currently invested or are not distributed in dividends, and find no adequate justification in any bona fide corporate business use. When the purpose underlying such an accumulation of liquid surplus is to avoid the payment of the personal surtax the penalty tax under section 102 applies.

This provision of the code is intended to serve the following important objectives: (1) To protect the revenues of the personal income tax, and (2) to insure that the burden of the personal income tax is distributed among taxpayers as fairly as possible. Section 102 is the only statute of general application to prevent personal surtax avoidance through the corporate device. The penalty tax rates are 27½ percent on the first $100,000 and 38½ percent on all excess "undistributed section 102 net income."

The Subcommittee on Investment was concerned particularly with the possible undesirable effects of section 102 on small business and the availability of equity capital. The principal conclusions of Dr. Hall's study are:

1. While section 102 of the Internal Revenue Code is of concern to a limited number of vulnerable companies, and while it definitely forces affected corporations to direct profits to real investment or to dividends to avoid excessive liquid surplus accumulations, the study found no significant net unfavorable effect of the section on the national economy or on the volume and stability of private investment.

2. The present Federal tax structure imposes a corporate income tax on the profits of a corporation which are further taxed under the personal income tax upon distribution of earnings to stockholders, consequently, some provision such as section 102 of the Internal Revenue Code is necessary to prevent unreasonable accumulations (nondistribution) of corporate profits to avoid high personal surtaxes.

3. The substantial increase in income tax rates in recent years with their continued high levels probable for some time suggests that the Congress should call for an equalizing increase in the penalty surtax rates provided by section 102.

4. Administration of section 102 by the Bureau of Internal Revenue has been most cautious and conservative and its application generally limited to the very closely held and closely controlled corporations. With enforcement confined to this restricted area, the section is not fully serving its intended purpose. Many large public corporations are subject to the control of relatively small groups not unconscious of the substantial personal surtax savings which may result from corporate surplus accumulations. Consequently, these corporations may appropriately be brought within the purview of section 102. The study suggests that the Bureau consider expanding the corporate area

to which the section applies, even though an increased risk in litigation would be incurred.

5. In spite of the greater need for the section under present tax rates, a variety of proposals have been made for its modification which, if accepted by the Congress, would result in seriously weakening the section. Dr. Hall concludes that it would seem better to repeal the statute in its entirety than to reduce its effectiveness to a point where only the form is preserved.

6. The only complete answer to the problem of personal surtax avoidance, Dr. Hall concludes, lies in a complete integration of corporate and individual income taxes. Only if a satisfactory method for integration can be devised is there justification for dispensing with section 102. The mandatory partnership method, applicable to the great majority of private corporations, is offered as the most promising method of integration.

It occurs to the staff that the Joint Economic Committee should encourage similar, equally objective studies of other sections of the Internal Revenue Code by qualified students of public finance.

Respectfully submitted.

GROVER W. ENSLEY,
Staff Director.

PREFACE

One of the most mysterious parts of the Internal Revenue Code is section 102. No published information has been, or is, available as to the number of deficiency assessments, revenue collected, assessment impact on industrial groups, and the like. Because it is a penalty tax, perhaps some justification exists for the secrecy which has surrounded its operation. Until the Tax Institute and the Joint Committee on the Economic Report undertook their questionnaire investigations (both in 1949), no detailed cataloging of the reactions of the business community to the section had been attempted.

Businessmen and trade groups had the section under heavy attack, following the inclusion of the famous question 8 in the corporate income tax return for 1946. With the strengthening of the section by amendments in the 1938 Revenue Act and with the conclusion of the war, corporate officers and their tax attorneys and accountants anticipated that the Bureau of Internal Revenue, through section 102, would now place under serious review and vigorous prosecution personal surtax avoidance occurring through unreasonable accumulations of corporate surplus.

The build-up of high corporate liquidities from earnings during the war, and their maintenance after the war, provided grounds for corporate concern. During the same period the sharp increases in personal surtax rates, in contrast with the low maximum rate on long-term capital gains and the unchanged surtax rates of the section (since 1941), invited increased efforts of avoidance of personal tax. The situation posed a challenge to the Bureau for the employment of the section in a manner to provide as effective a prop as possible to the personal income tax so that tax burden distribution would not be seriously worsened and that current revenue flow to the Treasury would not be impaired. Under our nonintegrated income tax structure, the only tax instrument of general application preventative of surtax savings by corporate surplus accumulations is section 102. The revenue importance of the individual income tax is, within certain limits, a measure of the significance of the section.

Chapter III, which contains an analysis of the questionnaire of the Joint Committee on the Economic Report, directed to corporate officers in an endeavor to ascertain the economic effects of the section, and chapter V, which reviews Bureau administration over the period fiscal 1940–50, probably will have the greatest interest to readers.

The author's interest in the section was occasioned by his concern with surtax avoidance (through the corporate device) and its implications to the burden distribution of the personal income tax, the general secrecy which has attended the operation of the section, and the wide area of administrative discretion of the Bureau in its enforcement. It is his belief that in a democracy no tax should be clothed in mystery regardless of the enforcement cost.

In this study, the author has received the assistance of the Joint Committee on the Economic Report of the Congress. Without this assistance the study in its present outlines would not have been possible. The committee has been especially concerned with the investment effects of the section.

It should be made clear, however, that the Joint Economic Committee and its technical staff have no responsibility for the form and content of the study, the statements made therein, or the conclusions drawn. These are wholly the responsibility of the author.

This undertaking owes its completion to the full cooperation of many individuals both within and without Government. In particular, I should like to render grateful acknowledgement for the assistance and encouragement of Senator Joseph C. O'Mahoney, chairman of the Joint Committee on the Economic Report, and to the members of the committee as a whole; also to Dr. Grover W. Ensley, staff director of the Joint Economic Committee, who was unfailing in his interest, in his help, and in his support of the study. Mr. John W. Lehman, clerk of the committee, was helpful in every possible way.

The author's gratitude must be expressed for the cooperation received from the tax advisory staff of the Treasury, the staff of the Bureau of Internal Revenue and the technical staff, Joint Committee on Internal Revenue Taxation.

The assistance and counsel of Dr. Gene Oakes, formerly of the technical staff of the Joint Committee on Internal Revenue Taxation; Randolph Paul, attorney, Washington, D. C., and Rupert Warren, vice president, Trico Products Corp., Buffalo, N. Y., deserve special mention.

The manuscript was read by Dr. Douglas Eldridge, staff economist to Senator Ralph E. Flanders, Dr. Gerhard Colm, staff economist, Council of Economic Advisers, and Dr. William H. Moore, of the staff of the Joint Economic Committee, who gave me the benefit of their comments and criticisms.

My thanks go to Mrs. Eleanor F. Rabbitt, Mrs. Margaret Miller, Mrs. Frances Tillinghast, and Mrs. Marian T. Tracy who performed the tedious, but indispensable, tasks of typing and proofreading, and to Mrs. Virginia Dickmeyer who assisted in the statistical tabulations.

Throughout the preparation of the manuscript, Viola M. Hall, my wife, has given every possible assistance.

JAMES K. HALL.

SEATTLE, WASH., *December 5, 1951.*

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CHAPTER I

INTRODUCTION

The striking achievement of the Federal personal net income tax in its revenue response to rate and base adjustments during the war and postwar years has established it as the bulwark and chief taxing instrument of the Federal revenue system. The Special Tax Study Committee to the Ways and Means Committee of the House of Representatives emphasized the key position of the personal income tax by declaring that—

> For a long time to come the Federal Government must impose very heavy taxes. The income tax will, no doubt, be the core of the system. Since income taxes will have to be heavy, we must use great care to see that they are spread as fairly as possible over the income producers in our population.[1]

Also:

> Since the tax load now falls so heavily upon all classes of citizens, it is important that like incomes bear like burdens. No kind of income, nor any class of taxpayer, should be discriminated against or, by the same token should any class of taxpayer enjoy special advantages.[2]

For the individual income tax to serve as the chief source of revenue to the Federal Treasury, the base of the tax, of necessity, must be broad, i. e., relatively low individual exemptions, and the surtax rates high. Questions of equity in the application and administration of the tax become of pressing concern to a taxpaying public which is acutely conscious of the sharp reductions in disposable income which the tax occasions. High effective rates of tax induce taxpayers to search more intensively for opportunities for tax avoidance.[3] As the pecuniary

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[1] Revenue Revision, 1947–48, Reports of the Special Tax Study Committee to the Committee on Ways and Means, House of Representatives, 80th Cong., 2d Sess., H. Doc. 523 (Washington, D. C.: Government Printing Office, 1948), p. 2.

[2] Ibid., pp. 1–2.

[3] "Tax evasion" and "tax avoidance" are not infrequently employed as synonymous terms. However, in tax literature a distinction customarily is made. Tax evasion is used to connote illegal efforts to escape or to dodge taxes. Tax avoidance, on the other hand, refers to efforts to escape taxes which are not per se illegal or violative of the tax law. Taxpayers who take advantage of legal loopholes in taxing statutes to reduce their tax liabilities, or to minimize the impact of a tax, are within their legal rights (as to the letter of the law), even though on occasion they may be charged with violating the "intent" or the "spirit" of the law. Both evasion and avoidance are forms of escape from taxation.

Randolph Paul, in discussing tax evasion and avoidance, observes that—

"Once the line of legality is crossed, avoidance becomes evasion without protective coloring. Verbalists have struggled for years to draw the line which distinguishes tax avoidance from tax evasion. Both flourish when rates are high and people are resentful of what they consider 'confiscatory' taxation. But avoidance is essentially a sophisticated high-bracket game, while evasion is a crude method of tax dodging practiced in all economic strata." Taxation for Prosperity (New York: The Bobbs-Merrill Co., 1947), p. 285.

Harry Rudick defines tax avoidance as—

"* * * every conscious attempt, successful or unsuccessful, to prevent or reduce * * * tax liability by taking advantage of some provision or lack of provision in the law. This definition, which excludes fraud or concealment, presupposes the existence of alternatives, one of which will result in lesser tax than the other, or at least so it is hoped. The law

rewards of successful tax escape rise in correspondence with rising rates of tax, tax avoidance is stimulated. Insofar as the curve of tax avoidance and evasion follows the rising levels of surtax rates, congressional alertness becomes a sine qua non to a fair distribution of the tax burden.

Tax Equity and Undistributed Corporate Earnings

One of the major avenues of individual tax avoidance, and a troublesome problem from the inception of progressive rates on personal income, is the retention by corporations of their earnings. With the corporation as a recognized legal entity apart from the individual taxpayer, the corporation can be interposed between the source of income and its receipt by the individual owner. Partnerships and proprietorships, on the other hand, are subjected to the full impact of the progressive schedule of individual rates whether or not the earnings are retained within the business. To the extent that corporate earnings are retained rather than distributed, the beneficial owners pay no personal tax thereon, and the progressive schedule of personal rates (normal and surtax combined), currently ranging from 22.2 to 92 percent, is without force or effect for that increment of corporately saved income. The problem, of course, is to be found in the nonintegration of the corporate and individual income taxes. It is a difficulty which arises in "applying the personal income tax in a world thickly populated with fictitious personalities owned by non-fictitious persons." [4] It has been strongly urged that—

> If savings in general are to be included in the personal income tax base, there seems to be no escape from the conclusion that individual interests in corporate savings or undivided profits must somehow be brought to account. Otherwise the evasion and inequity becomes intolerable.[5]

Further:

> Undistributed profits of corporations constitute a significant element in the base of the personal income tax because, in the fundamental economic sense, they are savings, and savings form a part of the concept of taxable income that appeals to the conscience of the American people as the best measure of relative ability-to-pay taxes. The savings in question are, in the first instance, of course, the savings of an artificial person known as a corporation. Fundamentally, however, the savings of a corporation are the savings of the individuals who own the corporation. If savings in general are taxed as income, there should be no exemption of the savings of certain individuals whose investments take the legal form of shares in corporations that do not distribute their earnings promptly and completely. Moreover, corporate savings (undistributed profits) in this country are normally very large in amount. To exempt them would not only be grossly unfair to those using other forms of saving but would also provide a broad avenue for evasion, for the individual who desired to avoid a tax on his savings would only have to throw them into the form of corporate savings to accomplish his object.[6]

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openly countenances certain types of avoidance, e. g., investment in tax exempt securities; the mere investment makes exemption automatic. But the controversy with respect to such avoidance is one of policy, rather than of law; and, while we are concerned with it, there is not much of law to be discussed in connection with it." "The Problem of Personal Income Tax Avoidance," Law and Contemporary Problems, vol. VII, spring 1940, p. 245.

See Randolph E. Paul, Studies in Federal Taxation (Chicago: Callaghan & Co., 1937), pp. 9–157. For an enumeration of the more common methods of avoidance of income tax see pp. 19–27. Corporate retention of earnings, or surplus accumulation, is regarded by Randolph Paul as tax avoidance rather than tax evasion.

[4] Preliminary report of the Committee of the National Tax Association on Federal Taxation of Corporations, Proceedings, National Tax Association, 1938, p. 591.

[5] Ibid., p. 590.

[6] Final report of the Committee of the National Tax Association on Federal Taxation of Corporations, Proceedings, National Tax Association, 1939, pp. 539–540.

These statements by the Committee of the National Tax Association on Federal Taxation of Corporations leave little doubt that, if a full measure of equity is to be realized in personal income taxation, personal and corporate savings must be subjected to equivalent tax treatment. The committee is fully aware that no perfect solution to the problem of the taxation of undistributed corporate earnings is presently available. But, "as perhaps the most important in the whole field of federal corporate taxation," [7] it is a problem requiring serious and immediate consideration. The committee regarded the undistributed profits tax of 1936 with "sympathy" because its enactment was a recognition of the inequity in the tax treatment of undistributed corporate earnings, and an experiment in the integration of the corporate and individual taxes; but its demise in 1939 occasioned no regret on the part of the committee because of its crudities and imperfections.

Double Taxation of Distributed Corporate Earnings

The Federal corporate net income tax in its contemporary application may no longer be rationalized as a withholding tax (collection at source of the personal tax) in conjunction with the personal net income tax. For some years, i. e., since 1936, the tax on corporate income has been a full, separate, and impersonal levy on the corporation without reference to the tax status of the corporate owners. With dividend income to individual recipients subject to the full personal tax in 1936, complete separation of the corporate and personal taxes was achieved.

Early efforts in income taxation, as found in the income-tax acts of the Civil War period, were designed to avoid the imposition of a double tax on corporate income.[8] Corporate earnings, whether distributed or not, were taxed to the stockholders except in the case of certain specified corporations which were taxed directly. In the latter circumstance, stockholders were not required to include their share of such distributed corporate earnings in taxable income.[9]

The income tax of 1894, subsequently declared unconstitutional, likewise imposed only one levy on corporate earnings by excluding from personal taxable income dividend income previously taxed to the corporation.

With the adoption of the sixteenth amendment in 1913, Congress acted to impose the present individual income tax and to convert the Corporation Excise Tax of 1909 into a clear impost on corporate net income.[10] The 1-percent-tax rate on corporate net income was the same as the normal tax rate on individual income. Dividend income to the individual was deductible for purposes of the normal tax but

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[7] Ibid., p. 579.

[8] For an excellent brief description of Federal taxes on corporations, 1861 to 1938, inclusive, see appendix No. 2, Preliminary Report of the Committee of the National Tax Association on Federal Taxation of Corporations, op. cit., pp. 632–661.

[9] For an exception, see congressional joint resolution of July 4, 1864, 13 U. S. Stat. 417, imposing an additional income tax retroactively applicable to 1863.

The specified corporations (banks, insurance companies, trust companies, railroad, canal, and similar transportation companies) which were subjected to a direct tax at 5 percent (with such corporate interest and dividend payments excluded from personal taxable income to the recipients thereof) provided favorable tax treatment to their distributees with the rate graduation from 5 percent to 10 percent on personal net incomes in excess of $10,000. This favorable discrimination was removed in 1865 by requiring that such income be included in taxable income with a credit for the tax paid by the corporation.

[10] Tariff Act of 1913.

not for surtax (called additional tax). This identity between the corporate rate and the personal normal tax rate continued until 1917, although the rates were raised to 2 percent in 1916.[11] With the amendment to the 1916 Revenue Act, enacted in 1917, whereby the corporate rate was increased to 6 percent while the individual normal rate was increased to 4 percent only, rate equality was lost. Subsequent revenue acts continued the dissimilar rate treatment between the corporate tax rate and the individual normal tax rate, with corporate rates rising substantially above the individual rates from 1922 on, even though the dividend credit was continued until the Revenue Act of 1936. The character of the tax treatment accorded corporate income distributions from 1913 to the present is summarized in the following table:

TABLE 1.—*Federal income tax: Corporate and individual (normal) rates and dividend credits, 1913–51; individual surtax rates* [1]

Income years	Corporation rate	Individual normal rates against which dividend credit applies	Tax disparities with normal tax		Individual surtax rates
			Minimum	Maximum	
	Percent	*Percent*	*Percent*	*Percent*	*Percent*
1913–15	1	1	0	0	1–6
1916	2	2	0	0	1–13
1917	6	4	2	2	1–63
1918	12	6–12	0	6	1–65
1919–21	10	4–8	2	6	1–65
1922–23	12½	4–8	4½	8½	[2] 1–50
1924	12½	2–6	6½	10½	1–40
1925	13	1½–5	8	11½	1–20
1926–27	13½	1½–5	8½	12	1–20
1928	12	1½–5	7	10½	1–20
1929	11	½–4	7	10½	1–20
1930–31	12	1½–5	7	10½	1–20
1932–33	13¾	4–8	5¾	9¾	1–55
1934–35	13¾	4	9¾	9¾	4–59
1936–37 [3] [4]	8–15	([5])	8	15	4–75
1938–39 [4]	[6] 12½–19	([5])	12½	19	4–75
1940 [4]	14.85–24	([5])	14.85	24	[7] 4–75
1941 [4]	[8] 29–31	([5])	21	31	6–77
1942–45 [4]	[8] 25–40	([5])	25	40	[9] 13–82 (20–91)
1946–49 [4]	[8] 21–38	([5])	21	38	[10] 17–88
1950 [11]	[8] 23–42	([5])	23	42	[4] 17–88
1951 [12]	[8] 28¾–50¾	([5])	28¾	50¾	[4] 17. 4–88

[1] Adapted from table 1 in preliminary report of the Committee on the Federal Corporate Net Income Tax, Proceedings, National Tax Association, 1949, p. 440.
[2] Tax for 1923 reduced 25 percent by credit or refund under sec. 1200 (a), Revenue Act of 1924.
[3] Excludes surtax on undistributed profits.
[4] From 1936 to 1942 the normal rate of personal tax was 4 percent (defense tax excluded); for 1942 and 1943, 6 percent; for 1944 and 1945, 3 percent; for 1946 and 1947, 3 percent less 5 percent discount of total computed tax; for 1948 and 1949, 3 percent reduced by rates of discount ranging from 17 to 9.75 percent of total computed tax; for 1950, 3 percent reduced by 13 to 7.3 percent of total computed tax; for 1951, 3 percent.
[5] No dividend credit.
[6] Less a 2½-percent dividend-paid credit.
[7] Excludes defense tax.
[8] Includes surtax.
[9] Surtax rates ranging from 20 to 91 percent were applicable for years 1944 and 1945.
[10] For taxable years 1946 and 1947, a 5-percent discount from tentative surtax applies for taxable years 1948 and 1949, the tentative surtax is reduced by rates of discount ranging from 17 to 9.75 percent.
[11] Revenue Act of 1950.
[12] Revenue Act of 1951.

Sources: Annual reports of the Secretary of the Treasury for the fiscal years 1940 and 1944; Commerce Clearing House, Inc., Income Tax Regulations 111 (with amendments to Oct. 5, 1949).

[11] It should be noted in this connection that there was "under the 1913 and 1916 acts a minor differentiation in favor of the corporate form, in that the dividends subjected to individual surtax rates represented corporate earnings after deduction of the corporation tax while the distributive shares of partnership profits and the earnings of individuals were subjected to the surtax rates, without deduction of the normal rate paid on the profits." Preliminary report of the Committee of the National Tax Association on Federal Taxation of Corporations, op. cit., p. 577. This is, of course, an impairment of the "withholding principle."

The loss of rate equality between the corporate tax and the personal normal tax in 1917, in conjunction with the sharp increase in personal surtax rates, created a substantial inducement for the use of the corporation by persons of large income as a means of personal surtax avoidance by the accumulation of earnings rather than their distribution. In drafting the Tariff Act of 1913, Congress had anticipated this possibility for avoidance of individual surtax, even though surtax rates, by present standards, were nominal in amount, i. e., 1 to 6 percent.[12] Parity in the corporate and individual normal tax rates, with full dividend credit against normal tax, will not prevent efforts toward tax avoidance through accumulations of corporate surplus so long as there are individual surtax rates which apply to dividend income.[13]

Whether or not there is an advantage in the use of the corporation to minimize personal income tax depends upon the income status of the individual. When individual business or investment income is sufficiently small in amount as to result in a personal tax no greater than the corporate tax (if such income were funneled through and held in a corporation), the advantage taxwise lies in nonincorporation.[14] Such income becomes immediately disposable without further income tax. Income held within a corporation to be realizable and disposable to the stockholder, on the other hand, customarily requires either a partial or complete liquidation of the corporation or the sale of corporate shares, which results in capital gains taxation of the net increase in asset value. Consequently, if business income is not to be held indefinitely in the corporation, the relative tax advantage, in general, is to be found by a comparison of corporate tax plus the tax on long-term capital gains as against the individual tax.[15] If presently reinvested corporate earnings are later to eventuate in augmented dividend payments, then the corporation is used to postpone personal tax rather than to avoid it, assuming that the invested earnings are not lost through business reverses.[16] This, of course, is subject to certain qualifications.

First, the reinvested earnings of the corporation as earning assets are greater by the amount of the avoided personal tax to the shareholders. Thus the amount of the avoided tax becomes an earning asset yielding a future return. To illustrate, a shareholder in the present top surtax bracket with $100,000 of dividend income, if earnings are distributed by the corporation, would have available for reinvestment, after payment of personal tax, only $8,000.[17] If we assume a 6-percent return on invested funds (post corporate tax), the shareholder (by corporate reinvestment of the initial $100,000) has available $6,000 of additional income (pre-personal tax) the next year

[12] Tariff Act of 1913, sec. II (A) (2), 38 U. S. Stat. L. 166–167. This provision of the 1913 act is discussed in appendix 1.

[13] "Since the federal income tax system imposes higher rates on individuals than on corporations, individuals in high surtax brackets profit by interposing the corporate entity between their income and themselves. Through the withholding of dividends which would on distribution be taxable as personal income, profits mount in the form of corporate surplus subject only to the lighter corporate taxes." "Section 102 of the Internal Revenue Code: Surtax on Corporations Improperly Accumulating Surplus," 57 Yale Law Journal 474 (1948).

[14] It is recognized that there are advantages to the corporate form in business, i. e., limited liability, etc., which may counterbalance tax savings in the nonincorporation of business income.

[15] This disregards the offsetting of business losses against other income for unincorporated business earnings.

[16] See Carl Shoup, and others, Facing the Tax Problem (New York: Twentieth Century Fund, Inc., 1937), pp. 161–163.

[17] Effective rate of tax 92 percent.

either for corporate reinvestment or as a subsequent dividend flow (indefinitely in the future), while reinvestment of the $8,000 provides a future annual income of only $480 (pre-personal tax). The avoidance of personal tax by corporate retention and reinvestment of the $100,000 of earnings increases the shareholder's personal pre- and post-tax income by 1,150 percent.[18]

Second, should the corporately reinvested $100,000 later be realized by the stockholder as a long-term capital gain through corporate liquidation or sale of the stock, then the Treasury loses and the stockholder gains by the difference in the effective rate of tax on the long-term capital gain [19] as compared with the top rate of personal tax of 92 percent. This method of withdrawal of previously retained corporate earnings would obviously recommend itself to the taxpayer.[20]

Third, should the withheld $100,000 of corporate earnings subsequently be lost by reverses in the business, no present or future personal tax is paid by the stockholder on the retained earnings. By retention and reinvestment of earnings, such earnings are at risk not only so far as the corporation is concerned but to the Treasury as well in the amount of the avoided personal tax. In this sense, therefore, the Treasury becomes an involuntary participant in the hazards of business at the option of the corporate stockholders, through the corporate entity under a system of income taxation which establishes separability of income to the corporation as distinguished from the beneficial shareholders.

Fourth, should reinvestment of the $100,000 by the corporation result in later dividend distributions therefrom in a year or years in which (1) the stockholder is in a lower surtax bracket by reason of reduced income from other sources or (2) a congressional reduction in surtax rates, the shareholder will stand to gain. In the former instance, if the particular stockholder controls the corporation, dividend distributions can be more or less adjusted to income flow from other sources with a view of minimizing personal tax. In the latter case, however, Congress may adjust surtax rates up, as well as down. Congressional action in this respect is not within the control of the particular stockholder.

Fifth, should a stockholder in control of a corporation be in circumstances in which dividend distributions are not especially necessary or desirable, corporate earnings can be indefinitely reinvested and, at a shareholder's death, the corporate shares transferred to his heirs (or prior thereto by gift). During the shareholder's life no personal income tax (or capital gains tax) will be paid on the corporate earnings, with avoidance as to personal tax complete. To the extent that the value of the estate as found in the value of the corporate shares adequately reflects the capital value of the retained corporate earnings, a partial revenue compensation by death tax (or gift

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[18] The Treasury derives indirect gains through capital formation, based on reinvested corporate earnings, as found in the increase in taxable income to other persons and corporations.

No implications as to the relative productivity of private v. public investment should be drawn from this illustration.

[19] Effective maximum rate on long-term capital gains is 26 percent.

[20] Arthur H. Kent, observing the disparities between corporate and personal rates of tax 12 years ago, states that: "With surtax rates on other income running up to the present maximum of 75%, it is quite apparent that the preference in favor of capital gains under the existing law is such as to create a great incentive for tax avoidance through such transmutations of ordinary income into capital gain." "The Question of Taxing Capital Gains," Law and Contemporary Problems, vol. VII. No. 2 (spring, 1940), p. 203.

tax if transferred prior to death) for the avoided income tax will result.

Sixth, should the $100,000 of retained earnings by the corporation not be invested in the business but be loaned instead to the controlling stockholder, no personal tax on the $100,000 accrues, yet the stockholder has the current beneficial use of such funds. There are limits, of course, to this method of personal tax avoidance,[21] yet this has not been an uncommon means of escape from the individual tax. If there is intent to avoid personal tax, such loans take on the character of disguised dividend payments.

The advantages listed above to taxpayers in employing the corporate form are not exhaustive. Whether or not these and other tax advantages dictate taxpayer investment in corporations or taxpayer incorporation of income depends upon the aggregate income flow to the individual and the particular means of personal tax avoidance, or tax minimization, which meets his circumstances.[22]

It should be recognized, however, that the nondistribution of corporate earnings may be motivated by other than efforts toward tax avoidance. A highly important and an increasing source of corporate growth is through the retention of earnings. To small as well as to many medium-size corporations, external capital either may not be available or, if available, the cost may be prohibitive. Further, there may be a reluctance on the part of the owners of a corporation to dilute and weaken their control by the sale of corporate shares, even though feasible. From the point of view of some corporate managements (where management is divorced from the stockholding group, as found in many public corporations), dividends frequently seem to be regarded as a waste of corporate funds, which should be minimized as much as possible. Earnings retained constitute a "costless" source of capital for growth and a protection against the hazards and uncertainties of the future.

Insofar as the schedule of progressive rates on personal taxable income represents the public objective in the desired distribution of income tax among individuals, the policies of corporations in the distribution of corporate earnings become a matter of major concern; to the Treasury it affects current revenue yields;[23] to Congress and to the public it represents more distortion or less distortion in the desired pattern of tax spread among individuals of varying incomes.

Retention of Corporate Earnings To Avoid the Personal Surtax

For reasons of equity and revenue and as a prop for the progressive rates of personal surtax, Congress has endeavored to counter the pressure for tax avoidance through corporate retention of earnings. It is

[21] If carried to an extreme, and if the form of the loans is not carefully guarded, it may lead to the application of sec. 102 of the Internal Revenue Code.

[22] S. J. Graubard observes that: "Once the corporation has accumulated its surplus, a number of means are available to the stockholder to derive beneficial enjoyment from it without subjecting himself to the high rates of the surtax. He may simply wait until the tax rates are reduced, if ever. He may draw dividends in such years when income from other sources is unavailable, and thus be subject to a lower tax rate. He may find it advantageous to liquidate the corporation and pay a capital-gains tax on the proceeds. He may distribute it, in the form of shares, to his family or friends as a gift. Or, he may let the accumulation lie until he dies, when only the estate tax will be imposed." "Accumulation of Surplus To Evade Surtaxes," Pt. I, 10 Tax Magazine 415 (1932). See S. J. Sherman, "Taxation of Corporations Used To Avoid Taxes Upon Stockholders," 13 Tax Magazine 19 (1935).

[23] The "accumulation of corporate earnings by the postponement of the declaration and payment of dividends has long served as a convenient expedient for the avoidance of surtaxes on the part of stockholders, which in turn has deprived the Government of incalculable revenue." S. J. Sherman, op. cit., p. 20.

and has been the purpose of section 102 of the Internal Revenue Code and its predecessor statutes since 1913 to strike at what is deemed "improper accumulations" of corporate surplus which are representative of the use of the corporation to avoid personal surtax. Accumulation of corporate earnings for "legitimate" business purposes [24] is not, of course, within the prohibition. Instead, emphasis is placed, and the administration of the section proceeds, with reference to taxpayer *intent* or *motive* in forming or using a corporation as a means of personal surtax avoidance by causing or permitting corporations to accumulate rather than to distribute earnings.[25] As a penalty tax directing itself to the taxpayer motivation which lies behind the accumulation of the corporate surplus, section 102 (and its predecessor sections) not only has been and is subject to much taxpayer criticism but, in addition, poses difficult administrative problems to the Bureau of Internal Revenue. More will be said later with respect to these issues.

The importance of section 102 becomes clear when it is realized that *the only protection* [26] presently provided by the Internal Revenue Code against taxpayer avoidance of personal surtax by corporate retention of earnings is this section. The need for protection from this method of surtax avoidance has become especially acute because of (1) war and postwar increased rates of personal surtax, (2) high retention rates of corporate earnings during the war and postwar periods, and (3) high war and postwar corporate liquidities.

The high war and postwar combined normal and surtax rates on persons without dividend credit, in conjunction with increased corporate rates, served to create greater awareness of the advantage of personal surtax avoidance by nondistribution of corporate earnings. Except in the more or less special situations [27] where disincorporation could occur without significant disadvantage, passing business income through the corporation at the high rates of corporate tax, then subjecting the reduced income to the high personal-tax rates, left comparatively little disposable income from the corporate source for taxpayers in high marginal rates of surtax.

Since 1941 corporate retention of profits has been at a high continuing rate, exceeding the rate of the twenties. [28] In 1939 and 1940,

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[24] It should be said that there are differences of opinion between taxpayers and the Bureau of Internal Revenue as to what are "legitimate" business purposes for which surplus accumulations can be justified.

[25] With reference to corporate dividend policy and the tax factor, the Research Institute of America states:

"One of the important problems which they [corporations] face is how much, if any, of the earnings should be paid out as dividends.

"*Paying dividends is a tax waste.* The corporation gets no tax deduction for the dividends, while the stockholder must pay the full tax on the dividends received. There is only *one tax reason for paying dividends*—the necessity for avoiding the special 27½% and 38½% penalty corporate tax imposed on earnings [sec. 102, I. R. C.] which *are accumulated in order to save the stockholders from paying tax.*" (Italics ours.) Year-End Tax Planning, 1949, Analysis 68 (November 1949), p. 20.

[26] Except for the special code provisions which relate to personal holding companies and foreign personal holding companies.

[27] Disincorporation generally is an alternative available only to the small closely held corporation, not the so-called public corporation, and under the circumstance that the loss of limited liability is not a major disadvantage.

[28] "* * * the ratio of dividends to net earnings, which affects the level of retained profits, was lower in the postwar period than in the 1920's. This might conceivably indicate a greater reluctance by corporations to undertake new financing as a result of increased difficulties or expense, *or it may reflect an additional incentive to retain earnings in view of the much higher individual income-tax rates at present.*" (Italics ours.) Joint Committee on the Economic Report, Factors Affecting Volume and Stability of Private Investment (staff materials) (Washington, D. C.: Government Printing Office, 1949), p. 77.

The committee's staff noted "that for the stocks of large companies which are widely held, the ratio of dividends to net earnings is not much different currently from the average for

corporations withheld 24 percent and 37.5 percent, respectively, of current earnings after taxes. Beginning in 1941 the retention rate of corporate earnings has been in excess of 50 percent, except for the year 1945 when undistributed earnings were 44.7 percent of posttax corporate income. This high withholding rate of corporate profits was under circumstances of the largest volume of corporate net earnings [29] this country has experienced. The simultaneous forward movement of both posttax corporate profits and increased rates of retention during the war and postwar periods may be seen in the following table.

TABLE 2.—*Corporate profits posttax: Corporate profits retained and distributed* [1]

[Billions of dollars]

Year	Corporate income after Federal and State income and excess-profits taxes	Undistributed corporate income [1]	Percent corporate income retained	Corporate dividend payments [1]	Percent corporate income in dividend payments
1929	$8.4	$2.6	31.0	$5.8	69.0
1930	2.5	−3.0		5.5	
1931	−1.3	−5.4		4.1	
1932	−3.4	−6.0		2.6	
1933	−.4	−2.4		2.1	
1934	1.0	−1.6		2.6	
1935	2.3	−.6		2.9	
1936	4.3	−.3		4.6	
1937	4.7	[2]		4.7	
1938	2.3	−.9		3.2	
1939	5.0	1.2	24.0	3.8	76.0
1940	6.4	2.4	37.5	4.0	62.5
1941	9.4	4.9	52.1	4.5	47.9
1942	9.4	5.1	54.3	4.3	45.7
1943	10.6	6.2	57.5	4.5	42.5
1944	10.8	6.1	56.5	4.7	43.5
1945	8.5	3.8	44.7	4.7	55.3
1946	13.9	8.1	58.3	5.8	41.7
1947	18.5	12.0	[3] 64.9	6.6	[3] 35.7
1948	20.9	13.4	64.1	7.5	35.9
1949	17.0	9.2	54.1	7.8	45.9
1950 [4]	21.9	13.0	59.4	8.9	40.6

[1] Economic Report of the President, January 1951; table A–32, p. 202.
[2] Minus $8,000,000.
[3] Percentage total exceeds 100 percent because of rounding of data from which derived.
[4] Estimates based on incomplete data: third and fourth quarters by Council of Economic Advisers.

NOTE.—No allowance made for inventory valuation adjustment.

During the war period, uncertainties as to the war's duration, reconversion costs, plant and equipment replacement costs, availability of materials and supplies and their prices, war contract renegotiation, a possible postwar recession, and the like, apart from considerations of tax avoidance, strongly influenced corporations to retain rather than to distribute current earnings. At the same time it was generally believed that the Treasury, in recognition of the war's uncertainties,[30] would regard relatively large liquid corporate surplus accumulations with not too unsympathetic an attitude (particularly for corporations engaged in war production) and that the enforcement

the twenties" which suggests that the small- and medium-size corporations constituted the offset to the large corporations in establishing the lower ratio of dividends to net earnings of the present period as compared with the twenties. The tax factor consequently may have been of no small importance in the lower dividend ratios of the small- and medium-size corporations. Joint Committee on the Economic Report, ibid.

[29] Without adjustment for inadequate accruals to cover depreciation because of higher replacement costs.

[30] Certain national policy considerations related to low distribution ratios of corporate profits were (1) the minimization of consumption pressure against the reduced supply of civilian goods, (2) the private absorption of Government bonds (i. e., by corporations), and (3) the desirability of corporations establishing a strong liquid financial position to meet postwar industrial reconversion requirements.

of section 102 would be less vigorous.[31] The high war excess-profits tax appeared to provide some justification for the less vigorous enforcement of section 102 because it constituted some protection against rapid surplus accumulations by preventing corporations from retaining "excessive" profits.

However, in the years following the war, the low dividend ratio has continued, even though the excess-profits tax was repealed in 1945 and industrial reconversion was an accomplished fact several years ago. On the other hand, rising industrial plant, equipment, and inventory replacement costs, which have characterized the postwar period, combined with corporate preference for internal financing in the expansion of plant capacity, have been factors inducing corporations to retain high proportions of postwar earnings.

Although postwar retained earnings by corporations have been a major instrument in the expansion of industrial capacity, in augmenting needed additions to working capital, and in supplementing normal depreciation reserves (regarded as inadequate), the liquidity of corporations, in general, has not suffered, as is indicated below.[32]

TABLE 3.—*Corporate liquidity ratios, selected years, 1940–49* [1]

Year	Ratio to sales		Ratio to current liabilities	
	Liquid assets	Liquid assets less Federal income-tax liabilities	Liquid assets	Total current assets
	Percent	*Percent*		
1940	11.3	9.3	0.46	1.84
1941	10.0	5.8	.44	1.79
1945	17.9	13.5	.93	2.13
1946	14.1	10.9	.73	2.08
1947	11.2	7.9	.66	2.02
1948	9.8	6.6	.61	2.05
1949 (first half)	10.0	7.0	.64	2.10

[1] Excluding banks and insurance companies. Sales data are total for given period. Other data used to derive ratios are for end of period shown. This table has been reproduced from the study by the Joint Committee on the Economic Report, ibid., p. 81.

Source: U. S. Department of Commerce, based on data from Securities and Exchange Commission and Bureau of Internal Revenue.

[31] "* * * it has generally been said that Section 102 was less vigorously enforced during the war years. Probably any relaxation in administration was attributable to the high excess profits tax rate and, perhaps in greater measure, to the uncertainties which justified maintenance of large contingency reserves for the postwar transition. Certainly the emphasis of the Government was upon facilitating reconversion." William L. Cary, "Accumulations Beyond the Reasonable Needs of the Business: The Dilemma of Section 102 (c)," 60 Harvard Law Review 1287 (1947).

According to A. Allen Simon, the "activity of the Bureau with respect to the application of sec. 102 was naturally quiet during the war period for two very obvious reasons: (*a*) existence of the excess-profits tax; (*b*) the necessity of accumulating earnings for postwar reconversion." "Corporate Surplus and Section 102 in the Postwar Period," 14 The Controller 661 (1946).

Commerce Clearing House observes that—

"During the war years, it was assumed that enforcement of Sec. 102 surtax liability was somewhat less stringent than in ordinary times. Incidence of the excess profits tax, renegotiation of war contracts, and the necessity of preparing for extraordinary reconversion costs were among the factors underlying the assumption, which received added support from published reports of remarks attributed to Mr. Randolph Paul, then General Counsel for the Treasury Department, indicating that he believed the Bureau should take a generous attitude toward accumulation of profits in order to provide necessary postwar reserves. It is not surprising, therefore, to find that the decisions handed down by the courts during the past few years have without exception dealt with taxpayers not engaged in war production.

"However, it has also been stated that a return to closer examination of surplus accumulations, with a view to possible applicability of Sec. 102, could be expected from the Bureau with the conclusion of the war and reconversion period." 495 C. C. H. 11,633 (November 30, 1949).

See also E. B. George and R. J. Landry, The Shadow of 102 on Dividend Policies, A Supplement to Dun's Review (1947), p. 8.

[32] See Joint Committee on the Economic Report, Factors Affecting Volume and Stability of Private Investment, op. cit., pp. 72–73, for discussion of retained corporate profits as a source of capital for plant expansion and increased working capital.

The reduction in the highly liquid asset position of corporations, 1946 compared with 1945, is largely accounted for by the employment of liquid holdings for the expansion of plant capacity, inventory, and receivables following the war. Since 1946 percentage changes in the liquid assets of corporations have been comparatively minor, although in 1949 corporate liquidity increased, as compared with 1948, by some $2.5 billion.[33]

Corporate liquidity has a *peculiar* and *special* importance in the application of section 102. *In a fundamental sense, the problem of corporate liability under section 102 is a problem of liquidity.* The retention of corporate earnings, in whatever amount occurs, can always find justification under this section of the code if such earnings are directed to *real* investment[34] or serve a "legitimate" business need, i. e., necessary working capital. Corporate vulnerability to section 102 arises when retained earnings add unnecessarily[35] to existing corporate liquidity, i. e., idle funds at the disposal of the corporation. Under section 102, such "excess" liquidity becomes determinative of intent on the part of shareholders to avoid personal surtax. Section 102, as a penalty tax designed to strike at personal surtax avoidance by nondistribution of corporate earnings, is not intended to be a bar to capital formation or to the provision of such liquid reserves as find sanction in prudent business management, even though any retention of corporate earnings necessarily means current personal surtax avoidance. Congress and the Treasury, although recognizing the current surtax avoidance, are also aware that it is compensated therefor in the future by the increased power of the community to produce income arising from corporate investment of the retained profits. The question which always confronts the Bureau of Internal Revenue in the administration of section 102 in any case involving a possible deficiency assessment *is what measure of corporate liquidity*, in the particular case and under the particular circumstances, finds justification in "reasonable" business conduct and practice. Precision in the volumetric measurement of "proper" versus "improper" corporate liquidity is, of course, impossible of attainment. While all reasonable doubts may appropriately be resolved in favor of the taxpayer, nevertheless excessive liberality in the treatment of liquid corporate surplus accumulations only opens the door to more avoidance of personal surtax at the expense of tax equity.

Section 102 and the Tax on Undistributed Profits

In the absence of a comprehensive integration of the corporate and personal income taxes, Congress has endeavored to meet the undistributed profits tax problem in two ways:[36] First, enactment of section 102 and its predecessor sections. In substance, this approach has been to declare that corporate earnings may not remain idle—there must be either corporate use of such earnings if retained, or they must be distributed to stockholders for their employment. Personal

[33] Economic Report of the President, January 1950, pp. 51 and 182.
[34] This should be qualified in that investment in the assets or securities of an "unrelated" enterprise is interpreted as not a "legitimate" business purpose in the use of accumulated surplus.
[35] As interpreted by the Bureau of Internal Revenue.
[36] This excludes the code provisions applicable to personal holding companies and foreign personal holding companies.

surtax avoidance through the corporate device is recognized and countenanced so long as undistributed corporate earnings are put to a productive use. Section 102 is not an undistributed profits tax; it may, however, create the appearance of being an undistributed profits tax because of its application to undistributed income (tax base) when idle or unemployed surplus accumulations become unreasonable in amount. Because it is a penalty tax it necessarily operates negatively rather than positively. It is erratic and imprecise in its treatment of the prohibited surplus accumulations. Its erratic and imprecise character is a compound of the administrative discretion which determines its activation with reference to particular taxpayer corporations and the difficulties of applying any reasonably accurate standard of measurement to the liquid assets (resulting from surplus accumulation) for which alleged corporate use may or may not find justification. As a *penalty* tax, its purpose is not directly and of itself to produce revenue, but instead to "force" either corporate use of earnings, if retained, or their distribution in dividends. The personal and corporate income taxes are the taxing instruments the revenue yield of which will reflect the capabilities of section 102. As with any penalty device direct revenue yield is inverse to its effectiveness, assuming adequate administration.

The second method of meeting the undistributed profits problem was through a general positive levy on all retained corporate earnings at rates (1936) ranging from 7 percent to 27 percent (undistributed profits tax of 1936–39).[37] This surtax on undistributed profits was automatic in its application. It was intended to encourage the distribution of corporate earnings without reference to the business use to which such earnings could be put if retained by the corporation. In other words, there was no exemption from tax, even though the corporate profits were needed in the business, which profits, if retained and invested, would presumably give rise to increased profit flow and dividend distributions in the future. The only method of avoidance of this tax was by distributing the whole of the corporate net earnings. The progressive character of the tax rates operated to increase tax pressure cumulatively for distribution as the corporate earnings became larger. The undistributed profits tax was a step in the direction of integrating the corporate and personal taxes, and, to that extent, in the words of the committee of the National Tax Association on Federal Taxation of Corporations, "was of real significance in that it marked a recognition of the importance of the inequity involved in the failure to bring corporate savings fully and promptly to account for personal income tax purposes."[38] This tax experiment came to an end in 1939. Since then (as well as before), the only barrier to tax avoidance through corporate surplus accumulations is section 102.

Certain of the more important differences between section 102 and the undistributed profits tax of 1936 may be summarized as follows:

1. Section 102 is a penalty tax and thus negative in character; the undistributed profits tax was a general levy on all retained corporate earnings and thus was positive and automatic in its application.

[37] Except for a few classes of corporations specifically exempt, i. e., banks, insurance companies, etc.
[38] Final report, op. cit., p. 579.

2. Section 102 is directed only to the idle or unjustified surplus accumulations; the undistributed profits tax applied to the total of the undistributed earnings.[39]

3. Existing corporate liquidity is a factor of *large* importance in the determination as to whether or not section 102 is applicable; existing corporate liquidity was of no importance under the undistributed profits tax, because the tax applied to the annual corporate earnings remaining undistributed.

4. Section 102 is designed to "force" out as dividends only those corporate earnings which are not of active legitimate employment within the corporation; the undistributed profits tax was intended to apply tax compulsion toward the distribution of all profits.

5. Section 102 favors corporate savings if actively employed—the investment function; the undistributed profits tax penalized all corporate saving and favored the consumption function.

6. Section 102 should not be considered as performing an integrating function as to the corporate and personal taxes; the undistributed profits tax did provide a partial integration of the corporate and personal taxes.

7. Section 102 does not discriminate in general against the small and growing enterprise where growth is conditioned upon retaining and investing earnings;[40] the undistributed profits tax did discriminate against small and growing enterprises by taxing the retained, reinvested earnings.

8. Section 102, in comparison with the undistributed profits tax, favors—if not forces—secular growth of productive capacity,[41] and accentuates, in some measure, the amplitude of the business cycle; while the undistributed profits tax tended to retard secular growth of productive capacity, and to reduce probably the amplitude of the cycle.[42]

9. Section 102 does not apply to a corporation unless the Bureau of Internal Revenue initiates and makes a deficiency assessment under the section;[43] the undistributed profits tax was self-assessed by the corporation.

10. Section 102 tax rates under the Revenue Act of 1936 were 25 percent on the first $100,000 of net income subject to tax, and 35 percent on all excess net income for corporations not subject to the surtax on undistributed profits, otherwise 15 and 25 percent; the undistributed profits tax rates ranged from 7 to 27 percent.

Section 102—Future Prospects

Although there has been a growing volume of complaint from businessmen and trade organizations of section 102, there is every present indication that this section will remain a part of the code for some

[39] Except for a small specific credit which could not exceed $5,000 for corporations the adjusted net income of which was less than $50,000.

[40] If the proposed investment of the retained earnings, presently liquid, is nebulous as to time, form, and execution, then the Bureau of Internal Revenue may apply sec. 102.

[41] Assuming that the amount and availability of funds for investment will influence the level of investment.

[42] It has been argued that large and active corporate surpluses will lead to overexpansion of productive capacity and initiate a recession; it is also contended that corporate surpluses serve to cushion the shock of a depression and to assist in recovery. For a brief discussion of the undistributed profits tax in relation to the corporate surplus and cyclical aspects, see M. S. Kendrick, The Undistributed Profits Tax (Washington, D. C.: The Brookings Institution; 1937), pp. 41–64 and 86–91.

[43] There have been a few instances in which taxpayer corporations have voluntarily and on their own initiative assessed themselves a sec. 102 deficiency and remitted the tax to the Treasury.

time into the future. Since 1947, section 102 has presented a further complication to corporate directors and their managements, namely, the possibility of stockholders' suits against the directors to recover to the corporation the funds (of the corporation) lost by successful deficiency assessments under the section. To the extent that this possibility is realized, section 102 may become a more effective instrument to serve the purpose for which it is designed. Corporate directors may now be faced with two hostile groups when unjustified surplus accumulations occur, one the Bureau of Internal Revenue, the other the minority stockholders.

Continuation of high surtax rates under the personal tax, with large corporate surpluses and high corporate liquidity, directs increased attention to the possibilities of personal surtax avoidance which the corporation offers. Section 102, as the present sole means available to the Treasury to meet this problem, is worthy of some additional consideration. In the chapters to follow, an endeavor will be made to inquire into its operational effects as found in the influence of section 102 on corporate policy and the consequences thereof both to the corporation and the economy. In addition, the administration of this section by the Bureau of Internal Revenue will be reviewed.

CHAPTER II

CRITERIA IN THE APPLICATION OF SECTION 102

Basic Test of Liability

Corporate liability to the surtax under section 102 necessitates the conjuncture of two factors: There must be (1) an intent or purpose to prevent the imposition of the personal surtax on the stockholders of the corporation accumulating the surplus, or the stockholders of any other corporation, and (2) accomplishment of the purpose by the corporate retention of earnings. Failure of either of the two factors as, for example, the accumulation of earnings without any intent or purpose to avoid the personal surtax, or intent or purpose to avoid but without earnings to accumulate, means that section 102 does not apply. The basic issue of whether there is liability under the section arises only when corporations *do* accumulate earnings, with the question then to be faced as to whether the proscribed purpose is present—the intent to avoid personal tax. The purpose, the intent behind or influencing the corporate policy of accumulating earnings—avoidance of personal surtax—is the critical element in tax liability.[1] The prohibition is not of avoidance per se, nor of the effects, tax and otherwise, which result from the accumulation of earnings in the corporate till.

Section 102 establishes two presumptions concerning the intent or purpose behind the accumulation of corporate surplus: First, "the fact that any corporation is a mere holding or investment company shall be prima facie evidence of a purpose to avoid surtax upon shareholders"; and, second, "the fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid surtax upon shareholders unless the corporation by the clear preponderance of the evidence shall prove to the contrary."[2] As liability under the section is a function of *purpose* or *intent* (a state of mind) underlying the accumulation of earnings, these presumptions become the sine qua non of enforceability of the statute.[3] This is not to say that the prohibited purpose may not be shown by relevant evidence without the use of the statutory presumptions. However, as disclosed by the legislative history of the section, enforcement is largely dependent upon the presumptions which have the effect of compelling the taxpayer corporation to come forward and submit its proof that the interdicted purpose was not in fact present. The taxpayer corpora-

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[1] "The cases clearly establish the principle that the touchstone of liability is the purpose behind the accumulation of the income and not the consequences of the accumulation." Jacob Mertens, Jr., The Law of Federal Income Taxation, vol. 7 (Chicago: Callaghan & Co., 1943), pp. 348–9.

[2] Sec. 102 (b) and (c), Internal Revenue Code.

[3] A circuit court stated that "a statute which stands on the footing of the participants' state of mind may need the support of presumption, indeed be practically unenforceable without it, but the test remains the state of mind itself, and the presumpion does no more than make the taxpayer show his hand." *United Business Corporation of America* v. *Commissioner* (62 F. (2d) 755 (1933)).

tion, because of the statutory presumptions, is forced to prove a *negative* once the Commissioner finds as a fact that there is unreasonable accumulation of surplus.[4]

Influential stockholders and their corporate managements commonly are fully aware that dividend distributions will result in higher personal taxes; further, that earnings held within the corporate treasury will tend, in some measure, to increase the value of the corporate shares. Even though the price of the corporate stock does not rise in proportion to the retained earnings, stockholders, particularly those in high surtax brackets, nevertheless may find a substantial net advantage in surplus accumulation. Consequently, although avoidance of the personal tax frequently may not be the principal motivating factor in corporate surplus accumulation, it is likely to be one of the recognized and not unimportant considerations leading to the corporate decision either to distribute less income or none at all. Corporate decisions customarily reflect mixed influences and motivations. Moreover, it is not an easy or simple task to establish their relative importance, in combination, in shaping a particular corporate decision. In recognition of the difficulty of appraising the relative importance of the various considerations leading to a corporate decision (i. e., not to make an adequate distribution of earnings), the Tax Court insists that the thought or desire to avoid personal tax need not be the most important nor the compelling consideration in the retention of earnings. Instead, if the thought of personal surtax avoidance "played any part, no matter how small, in the determination of corporate policy,"[5] as evidenced by, or inferred from, the attendant circumstances, liability attaches; furthermore, "that the requirement for nonapplication is a complete lack of the condemned purpose."[6]

Corporate Liquidity

As stated in chapter I, the problem posed by section 102 in its application to taxpayer corporations is essentially a problem of corporate liquidity. A corporation having low liquidity[7] presumptively and in fact is providing *active* employment for its assets in the business.[8] Consequently, such a corporation does not come within the category of improper accumulation of surplus with its retention of earnings. Conversely, high corporate liquidity infers an inactive employment currently of a significant proportion of existing corporate

[4] See James J. Leahy, 70% Distribution of Profits Section 102 * * * Under Postwar Conditions (New York: Commerce Clearing House, Inc., 1949), pp. 94–100; J. K. Lasser and R. S. Holzman, Corporate Accumulations and Section 102 (New York: Matthew Bender & Co., 1949), pp. 66–69; Jacob Mertens, Jr., The Law of Federal Income Taxation, op. cit., pp. 350–359.

[5] *Trico Products Corporation* v. *Commissioner* (46 B. T. A. 346; aff'd 137 F. (2d) 424 (1943)). The reviewing court added: "Nor can we subscribe to the view that the prevention of the imposition of surtaxes must have been shown to have been the dominant factor behind the accumulation." (p. 426).

[6] Ibid. In *Trico Products Corporation* v. *McGowan* the corporation cited eight different business reasons for the accumulation of earnings—but lost the case (67 F. Supp. 311 (1946)).

[7] Corporate liquidity may be measured by the proportion of the net quick assets (excess of current assets over current liabilities) of the enterprise. Various ratios may be used to indicate relative liquidity; i. e., to total assets, to sales, to total current assets, to total current liabilities, etc.

Liquid assets, for some purposes, may be more narrowly defined as consisting simply of cash (currency and deposit credits) and Government securities.

[8] Assuming an absence of stockholder loans, investment in the securities of unrelated enterprises, and the like.

assets within the business.[9] In the latter situation, a corporation becomes suspect under section 102.[10] It is the inactive employment of earnings withheld from stockholders for purposes of the particular enterprise which comes within the prohibition of the section.

The actual or intended corporate use of retained earnings thus becomes a consideration of primary importance. The "command" of section 102 to those who own and control corporations is that corporate profits are (1) to be given "proper" employment within the business, or (2) to be distributed to shareholders. The "proper" employment of earnings held within the business is of crucial importance because some employment can always be found for retained earnings. Clearly, the corporate accumulation of earnings to finance loans to influential stockholders, or for speculative investment in unrelated securities by an operating company, is an employment of corporate funds, but hardly a necessary and legitimate use of funds for purposes of the business enterprise as such.

The reasonableness of the profits accumulation is to be gaged with reference to the bona fide needs of the *particular* business. The reasonable needs of the business find expression in terms of the type of enterprise; its methods of doing business; any expansion program and its financing; its contract obligations; its dividend policy; its replacement costs of capital; its inventory requirements; its hazards, competitive and otherwise; general price and production movements in the economy; and the like. However, because the needs of the business are of special and *particularized* interpretation to the individual enterprise, no general or set standard of measurement may be employed.

Although the courts and the Bureau of Internal Revenue apparently are neither rigid nor particularly restrictive in their interpretations of the needs of the business in profits accumulation, businessmen feel affronted that the judgment of management is not controlling, and that the revenue agent and the Bureau may make overriding decisions. Complaints are made that no revenue agent—an outsider—can have either the knowledge or the ability to judge properly the needs of the corporation in comparison with the corporate management—a group skilled and intimately acquainted with enterprise operations; also that section 102 confers on the Bureau power to make decisions of the highest importance to the corporation, but without any responsibility for the consequences. However, the courts have indicated appreciation of the fact that responsibility and discretion cannot be divorced, and have been hesitant to substitute their judgments for those of the corporate directors.[11] The latitude permitted corporate directors, however, is not without limits; their discretionary judgments must be within the bounds of "reasonableness."

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[9] A capital surplus with high corporate liquidity carries no implications of personal surtax avoidance.

[10] According to the Research Institute of America:

"Excessive Quick Assets Dangerous

"You may still be flirting with a penalty although you have neither stockholders' loans nor outside investments [unrelated to the business]. An excessive amount of quick assets—such as cash, receivables, United States and municipal bonds—may support a Treasury claim that your accumulation of earnings is too large. For example, a substantial increase in the ratio of quick assets to sales over past experience has been held evidence of unreasonable accumulation of earnings." Year-End Tax Planning, 1949, op. cit., p. 21.

See *United Block Co., Inc.* v. *Helvering* (123 F. (2d) 704 (1941)). In this case Judge Learned Hand stated that the "really important question is not how much capital of all sorts *but how much quick assets* it was reasonable to keep on hand for the business * * *." (p. 705). (Italics ours.)

[11] See *Lane Drug Company* v. *Commissioner*, Tax Court Memo. Op., Dkt. No. 1140 (April 26, 1944).

Indications of Improper Accumulation of Surplus

The courts, in dealing with section 102 cases, have distinguished particular circumstances which strongly suggest a purpose to avoid personal surtax through surplus accumulation. Among the more important factors, apparently persuasive to the courts and to the Bureau that a corporation may be engaging in the condemned act, are the following:[12]

1. *Loans to stockholders.*—Loans to shareholders (from earned surplus, i. e., when a corporation has an earned surplus) when proportioned to stock ownership, or made by a corporation to its only shareholder, especially when carrying no interest and remaining unpaid, establishes the presumption that the loans are simply a means of accomplishing profits distribution without payment of personal surtax. Loans to relatives of stockholders, or to persons not connected with the business, likewise are regarded as an improper use of surplus.

2. *Loans from one corporation to another when the identifiable interest is the stockholder (or stockholders) controlling both corporations.*—When the same stockholder (or stockholders) is in control of two or more corporations, the corporations for business purposes otherwise unrelated, and loans are made to one by the other from earned surplus, the presumption is strong that the lending corporation is being used to serve the personal advantage of the controlling stockholder (or stockholders) and for the avoidance of personal surtax.

3. *Investments unrelated to the business.*—Substantial investments in unrelated enterprises, property, or securities, except, i.e., as a temporary means of employing working capital or other funds currently in excess of business requirements, have been regarded as evidentiary of the prohibited purpose because such profits accumulation is not required to serve the reasonable needs of the business.

4. *Profits accumulation to provide unneeded reserves or reserves in excess of reasonable requirements.*—The accumulation of profits for assignment to reserves either not required, or which are substantially outsize with respect to the reasonable needs of the business, becomes presumptive of the proscribed act. Retention of profits to provide against generalized rather than specific and real hazards implies efforts of tax avoidance, for example, patent infringements when the patent has been previously sustained judicially, loss of business when such a hazard is either vague or the pecuniary loss inconsequential, and obsolescence when highly indefinite as to both time and amount. Earnings retention to provide working capital when the corporation is on an effective cash basis, or to provide a reserve for bad debts when the bad debts in contemplation are either unenforceable or there is no intention of collection, is without justification.

5. *Nondistribution of income tax-exempt to the corporation but taxable to the shareholders, if not distributed when substantial in amount.*—Sizable income to a corporation in the form of tax-exempt

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[12] These factors are to be viewed with reference to the corporations which establish a suspect status under sec. 102, namely, corporations closely held, with control residing in a few identifiable individuals, and which have accumulated relatively sizable earned surpluses.

For discussion of the cases involving the factors indicative of a purpose to avoid personal surtax, see Jacob Mertens, Jr., op. cit., pp. 357–379; J. K. Lasser and Robert S. Holzman. Corporate Accumulations and Section 102, op. cit., ch. 3; James J. Leahy, 70% Distribution of Profits Section 102 * * * Under Postwar Conditions, op. cit., ch. 3.

interest which is not distributed to the shareholders may be an important indication of a purpose to avoid personal surtax.

6. *Profits accumulation to provide corporate funds for the corporate purchase of the shares of a minority stockholder, or for the purchase of corporate liabilities when the corporation is under the close identifiable control of a particular stockholder (or stockholders).*—The accumulation of surplus and its use to satisfy the personal ambitions or interests of the controlling shareholder (or shareholders) is not regarded as serving a bona fide need of the corporation. The need for the retention of earnings must be that of the corporation itself.

7. *Accumulation of profits for purposes of business or plant expansion when (a) the proposed expansion could not be accomplished in the reasonable future, or (b) the cost of the projected expansion is substantially less than the surplus accumulation dedicated thereto.*—Surplus accumulations for purposes of corporate expansion not presently possible, with accomplishment indefinite as to a future time, is not defensible, especially when current profit rates are expected to continue and, at some later time when the projected expansion is imminent, to provide an accumulation adequate to meet its cost. The accumulation of earnings for a proposed expansion of plant may not be rationalized if the accumulation is substantially in excess of any possible cost thereof.

8. *Large personal surtax savings to the corporate stockholders through corporate retention of earnings, particularly when the benefiting stockholder (or stockholders) controls the corporation.*—When surtax savings to the controlling shareholders are large in amount, surplus accumulations become highly suspect, especially when the corporation is unusually liquid.

Indications of Proper Accumulation of Surplus

Among the more significant factors apparently recognized by the courts and the Bureau as justifying retention of corporate earnings for the needs of the business are the following:[13]

1. To make provision for bona fide expansion of plant or business, with such proposed expansion reasonably imminent and realizable.

2. To acquire the assets, or the bulk of the stock, of a reasonably related business enterprise.

3. For retirement of bona fide indebtedness.

4. For retirement of preferred stock (providing preferred stock is not held by shareholders in proportion to their holdings of common stock).

5. To make needed additions to working capital, i. e., inventories, accounts receivable, etc.

6. To establish or to enlarge needed reserves, i. e., reserves to assist in meeting higher replacement costs, for bad debts, for specific and proven business hazards and contingencies, for wartime contingencies and postwar reconversion, and the like.

7. To make provision for regularizing and equalizing dividend distributions.

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[13] See Jacob Mertens, Jr., op. cit., pp. 357–379; J. K. Lasser and Robert S. Holzman, op. cit., ch. 3; James J. Leahy, op. cit., ch. 2, for a discussion of factors justifying surplus accumulation as being in accordance with the reasonable needs of the business.

8. To offset fluctuations in wage scales, to provide continuous employment under conditions of sharp seasonal variations in the level of business activity, and the like.

9. To make loans or to extend financial assistance to business customers.

10. New corporate entries into business without an experience background, subject to competitive hazards not fully determined, and in a critical stage of development, may accumulate earnings as a necessary protection during the formative years.

Regulations 111, section 29.102–3, with reference to justifiable corporate accumulation of profits and the intent of section 102, is as follows:

It is not intended, however, to prevent accumulations of surplus for the reasonable needs of the business if the purpose is not to prevent the imposition of the surtax. No attempt is here made to enumerate all the ways in which earnings or profits of a corporation may be accumulated for the reasonable needs of the business. Undistributed income is properly accumulated if retained for working capital needed by the business; or if invested in additions to plant reasonably required by the business; or if in accordance with contract obligations placed to the credit of a sinking fund for the purpose of retiring bonds issued by the corporation. The nature of the investment of earnings or profits is immaterial if they are not in fact needed in the business. Among other things, the nature of the business, the financial condition of the corporation at the close of the taxable year, and the use of the undistributed earnings or profits will be considered in determining the reasonableness of the accumulations.

As to what constitutes the corporate business, the Regulations state:

The business of a corporation is not merely that which it has previously carried on, but includes in general any line of business which it may undertake. However, a radical change of business when a considerable surplus has been accumulated may afford evidence of a purpose to avoid the surtax. If one corporation owns the stock of another corporation in the same or a related line of business and in effect operates the other corporation, the business of the latter may be considered in substance although not in legal form the business of the first corporation. Earnings or profits of the first corporation put into the second through the purchase of stock or otherwise may, therefore, if a subsidiary relationship is established, constitute employment of the income in its own business. Investment by a corporation of its income in stock and securities of another corporation is not of itself to be regarded as employment of the income in its business. The business of one corporation may not be regarded as including the business of another unless the other corporation is a mere instrumentality of the first; to establish this it is ordinarily essential that the first corporation own all or substantially all of the stock of the second.

The Bureau and the courts are prepared to accept legitimate business needs (of the corporation itself) as an adequate justification of surplus accumulation, although more or less personal surtax avoidance thereby necessarily results. Consequently, so long as tax savings are incidental to or a byproduct of an accumulation of profits which is to serve a necessary business purpose, the corporation is not guilty of engaging in the prohibited act. In order to determine whether or not the condemned purpose is present, the Bureau and the courts find it necessary to scrutinize with care the reasons advanced by the corporation as ostensible justification for its earnings retention. In addition to the problem of the motivations which may underlie the corporate policy in surplus accumulation, the Bureau and the courts confront the question of the comparative reasonableness of the accumulation for the purpose or purposes which it is to serve. Profits accumulation which is clearly excessive in relation to the corporate need or needs may well create the inference that a motivation or pur-

pose to avoid personal surtax was present. Corporate defense against the application of section 102 requires, therefore, that there be a showing of a bona fide corporate need, that the corporation has the power of accomplishment of that need—i. e., that materials and equipment are available and can be purchased for plant expansion—that the corporate need is reasonably current in time—i. e., is not nebulous and uncertain as to a future time of implementation—and that the surplus accumulation is reasonable in its amount with reference to the proposed use.

Significance of Personal Surtax Savings Resulting From Corporate Accumulation

Although personal surtax savings to the corporate shareholders resulting from profits retention may be large, this fact, of itself, does not necessarily indicate that the corporation is being used for the interdicted purpose. This consequence (surtax savings) must be the result of an intent or purpose to avoid surtax as a necessary antecedent circumstance. However, the Bureau and the courts apparently view with no little suspicion a corporate surplus accumulation which results in large personal surtax savings to the shareholders. When such large tax savings occur, an inference as to the purpose or motivation in the corporate retention of earnings immediately arises. Conversely, when the personal surtax savings from corporate surplus accumulation are relatively small, the existence of the condemned purpose tends to be negated rather than supported.

Depreciation Reserves and Corporate Accumulation

Among the operating costs of a business which are deductible from gross income to arrive at net income for purposes of income tax is depreciation. The tax law recognizes and permits a reasonable allowance for depreciation (physical) and obsolescence when such factors are operative in the consumption of capital used in the enterprise. Property which ultimately finds retirement for reasons of obsolescence (functional depreciation) may have its annual decrease in value offset against current income, as in the case of physical depreciation, providing such obsolescence is "ordinary or normal."[14] To the extent that normal obsolescence causes the retirement of assets, it is allowed in the deduction for depreciation. Distinguishable from "normal" obsolescence is "special or extraordinary" obsolescence.[15] Because of the general unpredictability of this latter type of obsolescence in advance of its actual occurrence, its recognition as a deductible cost waits upon its existence as a current and predictable fact. Such obsolescence to have definite and specific consequences in the reduction of the useful life of the asset is to be grounded on fact and not on opinion, and the taxpayer must carry the burden of proof; i. e., must be able to establish by indisputable evidence the legitimacy of the deduction.

[14] Obsolescence which is foreseeable and predictable and which occurs without substantial variation over time.

[15] Special or extraordinary obsolescence arises by reason of unforeseen and unpredictable changes and developments, i. e., revolutionary inventions, drastic economic changes, etc., which force the premature retirement of property.

The amount of the deduction for depreciation is based, in general, on the cost of the depreciable property.[16] The use of cost as a basis for determining allowable depreciation deductions under income tax has been criticized as being seriously deficient in protecting the operating integrity of plant in a capacity sense. The productive capacity of an enterprise, it is said, may not be maintained when replacement of depreciable and retired assets is geared to a depreciation provision relating to historical costs of limited current significance. With dollars of diminished, and diminishing, buying power, less can be purchased in replacement capacity.[17] Further, reported dollar earnings tend to be overstated by reason of the inadequacy of the current charge to operating expense to cover depreciation. Earned surplus is thus overstated for some portion thereof represents the dollar inadequacy of the customary provision for depreciation.

In recognition of the insufficiency of the allowed deduction, i. e., based on the dollar cost, some corporations in the postwar period have supplemented the normal depreciation reserve by a "surplus reserve," e. g., United States Steel Corp. in 1947, or have employed "accelerated depreciation," e. g., Chrysler Corp.[18] Both the Chrysler and the initial Steel formulas reduce and restate current dollar income. The United States Steel Corp. shifted from its original formula for the fourth quarter of 1948, substituting therefor "accelerated depreciation on cost," and made this method retroactive to January 1, 1947. This change in method by United States Steel apparently was occasioned by the disapproval of its auditors and the disagreement of accountants, generally, who were of the opinion that the only appropriate method of measuring depreciation is one based on the cost of the depreciable assets.[19] The change in method (of itself) by United States Steel caused no particular alteration in the impact on current earnings.[20] The accelerated depreciation of Chrysler, Steel, and other corporations as a means of offsetting the decrease in the purchasing power of the dollar relative to plant replacements, i. e., amortizing excess cost of replacements over prewar price levels, is, of course, not deductible for Federal income tax purposes (corporate net income tax). Both Chrysler and United States Steel presumably, i. e., present stated intentions, will not accumulate through normal and accelerated depreciation an amount in excess of the original cost of the depreciable assets.[21] It is possible that these and other corporations are hoping that there will be a modification of the accounting principle of "depreciation on cost" prior to full cost amortization, which would then restrict further accumulations in the depreciation reserve.[22]

Although, as indicated above, the tax law does not permit the deduction of either accelerated depreciation (except for approved

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[16] For the basis upon which depreciation is to be computed see Bulletin "F", Bureau of Internal Revenue, U. S. Treasury Department (Washington, D. C.: Government Printing Office, 1948), especially appendixes A and B.

[17] In the absence of technological improvements which reduce the dollar cost per unit of capacity at a rate equivalent to the reduction in dollar purchasing power. For a discussion of depreciation tax policy and investment see Joint Committee on the Economic Report, Factors Affecting Volume and Stability of Private Investment, op. cit., ch. VII.

[18] See S. Y. McMullen, "Depreciation and High Costs: The Emerging Pattern," Journal of Accountancy, October 1949, p. 302.

[19] Ibid., p. 304.

[20] Ibid.

[21] Ibid.

[22] Ibid., pp. 304–305.

projects in the national defense) or the supplemental replacement cost as found in the surplus reserve as a business operating expense in the derivation of taxable net income under the corporate net income tax, the Bureau apparently recognizes the legitimacy of such a provision in its determination of reasonable surplus accumulations under section 102. Corporate accumulations of earned surplus, subject to test for improper accumulation, may undergo adjustment to exclude a surplus reserve to cover higher replacement costs (even though this involves departure from "depreciation on cost"), or increased allocations to the depreciation reserve under accelerated depreciation, if *reasonable* in amount and if specifically earmarked for this purpose. Earnings withheld and assigned to offset the difference between allowable depreciation and higher replacement costs, however, should be supported by competent and reliable estimates as evidentiary of the reasonableness of the amounts so allocated.

In *Syracuse Stamping Co.* v. *Commissioner*,[23] a section 102 case decided by the Tax Court in 1945, it was held that the taxpayer corporation had sustained the burden of proving that there was no unreasonable accumulation of profits in the taxable year and, consequently, was not liable for surtax under section 102, as the taxpayer, in financing its business out of earnings, had pursued a consistent policy of establishing reasonable reserves for growth and for increased volume of business. The evidence presented indicated that increases in business volume necessitated larger inventories and additional machinery and equipment; also that higher replacement costs of depreciable assets required increased replacement reserves. Profits retention to serve these purposes was found to be reasonable. In the words of the Court:

> Petitioner's president testified that increases in the volume of orders would require additional cash, over and above the $30,000 already mentioned, and that increases in business would also require increases in machinery and equipment, *and reserves for replacements which would cost more than equipment in use originally cost.* Such reasons as were given by petitioner's president for retaining the net profits of the taxable year are reasonable ones. * * * While its surplus appears to have been large and to have represented the result of accumulations over several years, it nevertheless represents physical plant and equipment by which petitioner has sustained and increased its business. (Italics ours.)

Public Versus Private Corporations and Section 102

Apart from having common legal characteristics, corporations are most heterogeneous as to types of business activities, financial size, numbers of stockholders, and the extent to which there is identity between corporate ownership and control. Section 102 has been directed particularly to the so-called private or close corporations,[24] namely, those corporations in which the shareholders are clearly in effective control of the business. In private corporations, the corporation, in substance, is the personality of the stockholders—their alter ego. The private corporation is a personal type of business enterprise

[23] Docket No. 4025, Memo. Op., year 1940; April 9, 1945.

[24] See A. A. Berle, Jr., and G. C. Means, The Modern Corporation and Private Property (New York: Commerce Clearing House, Inc., 1932), pp. 4–9. The classification of corporations into 2 groups, (1) public and (2) private, even though the classification becomes indistinct at the margin, is very useful for particular kinds of analyses.

See also Encyclopedia of the Social Sciences, vol. 2 (New York: The Macmillan Co., 1937), pp. 418–423.

which resembles, in many respects, the proprietorship or the partnership.

The public corporation, i. e., "quasi-public," on the other hand, is characterized by the separation of ownership and control, with shareholders in general remote and uninfluential in the determination of corporate policy. The public corporation is an entity separate and apart from the personalities and individual interests of the stockholders. The effective separation of mass ownership from control is regarded as the principal distinguishing feature of the public corporation. In public corporations, the decision and leadership functions are presumed to reside largely in the hands of salaried managements which have little or no concern with minimization of personal surtax of the individual shareholders. Dissatisfaction of particular stockholders with the policies of the salaried managements in the large public corporations highlights their impotency in that the only practical alternative is to dispose of stockholdings (other than to bear their displeasure).

Private corporations with relatively few shareholders apparently constitute the great majority of all corporations.[25] Of 374,950 corporate tax returns *with balance sheets* for 1945, 177,788, or 47 percent, had total assets under $50,000; 61,431, or 16 percent, had total assets $50,000 to $100,000; and 60,308, or 16 percent, had total assets $100,000 to $250,000.[26] As reported by the Securities and Exchange Commission, 2,128 issuers (corporations) had 3,544 security issues listed and registered on national securities exchanges subject to the Commission's control as of June 30, 1950.[27] Corporations not having their securities listed and registered on national securities exchanges are presumed to be private corporations (with few exceptions), typically small in size and very numerous.

In closely held private corporations an obvious opportunity exists for the corporate retention of earnings to the tax advantage of the owner or owners, even though not realized. Further, the character of such private corporations gives rise to the presumption that the affairs of the corporation are being run in a manner which serves the pecuniary interests of the principal owner or owners. A decision by a corporate official or officials to retain rather than to distribute earnings, with resultant surtax savings to these owner-officials, strongly suggests that the interdicted purpose may be present. Those public corporations in which salaried managements perform the entrepreneurial function, rather than the stockholders, on the whole avoid the suspicion that corporate dividend policy may be adjusted to the surtax advantage of the owners.

Although section 102 has been applied primarily to closely held and closely controlled private corporations of few shareholders, corporations having a comparatively wide distribution of shares, i. e., numerous stockholders, may be subject to the statute if the corporate-control group uses the corporation for the purpose of surtax savings. In the case of the Trico Products Corp.,[28] the Commissioner of In-

[25] J. L. McConnell, "Corporate Earnings by Size of Firm," Survey of Current Business, May 1945, p. 7.
[26] Statistics of Income for 1945, pt. 2, p. 12.
[27] Sixteenth Annual Report, 1950, p. 28.
[28] *Trico Products Corporation* v. *Commissioner* (46 B. T. A. 346 (1942)).

ternal Revenue in 1939 asserted deficiencies in income tax (sec. 102) for 1934 and 1935. The corporation had approximately 2,200 shareholders, but corporate control was in the hands of a small group of stockholders composed of John R. Oishei, who organized the corporation, and his close associates. Additional section 102 deficiencies were assessed for 1936 and 1937 [29]; also for 1938, 1939, and 1940, which were paid under protest; in addition, deficiency assessments were proposed (revenue agent in charge) for the years 1941 through 1945. The Board of Tax Appeals (1934 and 1935 assessments) and the United States district court (1936 and 1937 assessments) found for the deficiency assessments asserted by the Commissioner. These decisions were sustained upon appeal.

The Trico Products Corp., in defending against the deficiency assessments, contended that the accumulation of surplus was needed in order to increase asset values equivalent to the realized price on shares sold to the public, to provide for contingencies arising from patent expiration (which necessitated the development of substitute products), and to increase investment income in order to remove dividend restrictions on the deferred or restricted stock. These contentions were not persuasive.

Additional personal surtax liabilities of the three principal shareholders, J. R. Oishei, P. C. Cornell, and S. H. Evans, had there been full distribution of corporate earnings (including distribution by Trico Securities Corp.) for the years 1934–37, would have been some $2,549,262.24.[30] Deficiency assessments, plus interest, were paid by the corporation for the years 1934 to 1940, inclusive, in the amount of $7,303,238.20, although paid under protest for the years 1936 to 1940, inclusive; further, the revenue agent in charge proposed deficiency assessments for the years 1941 to 1945, inclusive, in the amount of $2,522,374.34.[31]

Although the control group in the case of the Trico Products Corp. held a majority of the shares—hence had undisputed control—effective control of a corporation does not necessarily require a majority stock interest. In general, the wider the distribution of stock the less will be needed for control. Many of our large public corporations with their thousands of shareholders are as effectively controlled by small groups of stockholders with a minority stock interest as are small private corporations with highly limited stock distributions when majority stock ownership is essential for control. Simply because a corporation is public in character, with wide distribution of its shares, does not mean that the entrepreneurial function has been abdicated by its owners and vested in a salaried group of officials with leadership and policy in its hands. It is possible for a small control group in a large public corporation to be as much interested in personal surtax savings—with adjustment of corporate accumulation policy in conformity therewith—as in the case of a few individuals

[29] *Trico Products Corporation* v. *McGowan* (67 F. Supp. 311 (1946)).

[30] Report of referee, Edward Weinfeld, in *Benjamin Mahler, Robert A. Klein, and Dorothy Kirschman, et al.*, v. *John R. Oishei, Charles H. Oshei, Peter C. Cornell, Stevenson H. Evans, William P. Haines, Paul A. Schoellkopf, R. John Oshei, et al.*, Supreme Court, State of New York, Index No. 28485–1947, p. 44.

[31] Ibid., p. 87.

in a small private corporation.[32] Consequently, it appears that our large public corporations should not necessarily be regarded as immune from the application of section 102. Further, the fact that the control is exercised indirectly through related and/or subsidiary corporations does not mean that it is any less effective than when exercised directly.

An illustration [33] of apparently highly effective small group (family) control of large public corporations is the du Pont family and the E. I. du Pont de Nemours & Co., the United States Rubber Co., and the General Motors Corp. The Attorney General of the United States filed a complaint [34] against the E. I. du Pont de Nemours & Co. et al., June 30, 1949, in which he charged that Pierre S. du Pont, Lammot du Pont, Irénée du Pont, and other members of the du Pont family related by blood or marriage to Pierre, Lammot, and Irénée du Pont,[35] established Christiana Securities Co. and the Delaware Realty & Investment Corp. as personal holding companies, and through these companies to control the E. I. du Pont de Nemours & Co.; and through this latter company to control General Motors Corp. The same individual defendants and other members of the du Pont family held directly, or indirectly through personal holding companies and trusts, approximately 300,000 (or 17 percent) of the outstanding common stock of the United States Rubber Co., which concentration of stock ownership permitted control.

As to the du Pont de Nemours & Co., the Attorney General said:

> The combined holdings of Christiana and Delaware in du Pont Company, together with the direct holdings of members of the du Pont family in that company, total at the present time approximately 36 percent of the outstanding common stock of du Pont Company.
>
> The remaining approximately 64 percent of the capital stock of the du Pont Company is diffused among approximately 73,000 stockholders whose average holdings amount to slightly over 100 shares apiece. The concentrated holdings of Christiana and Delaware alone, as contrasted to the wide distribution of the remaining shares of the stock among 73,000 stockholders scattered throughout the world, are sufficient to, and do, enable these personal holding companies to control the defendant du Pont Company and its policies.[36]

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[32] At the annual meeting, June 1, 1949, of Standard Oil Co. (New Jersey) a minority stockholder (Wolf) evidenced his dissatisfaction with the company's dividend distributions by stating, in part, that—

"It is quite possible for a small minority of stockholders, large individual holders, corporations, institutions, or other oil companies, holders of huge blocks of stock who may make their views on dividends known to the directors—and it is perfectly legitimate for directors to give weight to such views in proportion to the holdings of such owners—I say it is quite possible for such a small minority to wreak great hardship and injustice on the large body of small stockholders by favoring small dividends and huge withholdings of earnings.

"I make no direct accusation in this respect as regards Jersey, for I do not know if this is a fact, but it is quite possible that there may be many such large stockholders of Jersey who, indeed, prefer that dividends be kept small because of the large percentage of additional dividends they would have to give up in taxes, leaving hardly enough net to interest them. That is something we small stockholders may have to contend with, and one more reason why we should make our voices heard." Report (1949 annual meeting general discussion), pp. 24–25.

[33] It should be emphasized that no implication should be drawn as to vulnerability of the corporations under section 102 discussed below. These corporations are used solely to illustrate family control.

[34] Complaint filed in the United States District Court, Northern District of Illinois, Eastern Division, Civil Action No. 49C–1071, June 30, 1949.

[35] By members of the du Pont family is meant those persons who are lineal descendants of Pierre Samuel du Pont de Nemours and the wives and husbands of such lineal descendants.

[36] Complaint, op. cit., pp. 22–23.

"The du Pont Company also has a large number of either wholly or partially owned subsidiaries in this and other nations. It has a 50 per cent interest in The Old Hickory Chemical Co. which produces carbon bisulphide. It holds 51 per cent, and General Motors 49 per cent of the voting stock of Kinetic Chemicals, Inc., a manufacturer of refrigerants. Du Pont Company owns 16.7 per cent of the voting stock of International Freighting Corporation, Inc., which operates a steamship and general chartering business between the Atlantic Coast, Gulf Coast, and South American ports. The balance of the voting stock is held by General Motors." Ibid., p. 7.

Concerning General Motors Corp., the Attorney General declared that—

> Defendant du Pont Company has for many years past owned 10,000,000 shares (approximately 23 per cent) of the approximately 44,000,000 outstanding shares of General Motors common stock. The remaining shares of General Motors stock were, in 1947, held by over 436,000 stockholders located in the various States of the United States and in foreign countries. Ninety-two per cent of these stockholders owned no more than 100 shares. Sixty per cent owned no more than 25 shares. The concentrated block of 10,000,000 shares held by du Pont Company as contrasted to the wide distribution of the remaining 34,000,000 shares among hundred[s] of thousands of small shareholders has enabled defendants to control the selection of the directors of General Motors and to control the administration and policies of that corporation.[87]

As to the United States Rubber Co., the Attorney General asserted that—

> The common stock of United States Rubber, other than that held by defendant individuals and class defendants, is distributed among approximately 14,000 other stockholders who are located all over the United States, as well as in foreign countries. The concentrated stockholdings in United States Rubber of defendant individuals and the class defendants, as contrasted to the dispersed and small holdings of approximately 14,000 other stockholders, enables the defendant individuals and those class defendants who own United States Rubber stock to control the selection of members of the board of directors, the administration and the policies of United States Rubber.[88]

In consideration of the reasonable needs of the business in surplus accumulation, private corporations are heavily dependent on internal financing for growth, while public corporations have access to external sources of funds. The market position of private corporations because of size, in general, tends to be more tenuous and hazardous than for public corporations, thus affecting their requirements for reserves and liquidity. Risks in internal operations, as found in uncertainties in raw materials, labor, contingencies, and the like, have an impact on the liquidity requirements of private corporations.

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[87] Ibid., pp. 26–27.
"Since 1917 key officers and directors of the du Pont Company, including the individual defendants named herein, have been assigned by du Pont Company to serve as officers and directors of General Motors and on its principal committees. The du Pont Company has also determined what other persons should hold office as members of the Board of Directors of General Motors, and no person has been chosen for membership on such board contrary to the wishes of du Pont Company." Ibid., p. 28.

[88] Ibid., p. 56.

CHAPTER III

SPECIFIC ECONOMIC EFFECTS

Section 102 has been subject to extensive criticism which has not always been free of emotional content. The penalty character of the tax and its discretionary application by the Bureau of Internal Revenue doubtless are important factors contributing to the strong feelings of some of its critics. There has been a tendency toward some exaggeration of its faults, especially by those who express their condemnations in generalized and sweeping terms. Perhaps the fear that the tax has occasioned in the minds of some taxpayers, compounded in part of misunderstanding, has been influential in this respect. Moreover, these critics of section 102, while recognizing its real or alleged inadequacies and injustices, appear, in some instances, to overlook the important purpose the tax is designed to serve, namely, prevention of personal tax avoidance. Proposals for amendment, in general, seem directed toward weakening the section and undermining its effective administration rather than strengthening the section, or providing a more satisfactory alternative method of meeting the tax-avoidance problem.

Criticisms of Section 102

Some of the criticisms of the section finding expression before committees of the Congress have been to the effect that the statute "threatens only small business,"[1] that reprisals are feared by those who attempt "to accumulate working capital,"[2] that there is "undue pressure to pay out dividends,"[3] that the possible application of the section when profits are retained "stymies industrial growth,"[4] that it discriminates (competitively) in favor of "corporations which built up large reserves prior to the enactment"[5] of the statute, that it prevents the "accumulation of surpluses to withstand possible future economic recessions,"[6] and that it "tends to destroy incentive by preventing the accumulation of capital for constructive purposes."[7] Corporations, it is said, "cannot safely accumulate adequately for replacements, expansion, or otherwise under section 102."[8] Small corpora-

[1] Hearings, Joint Committee on the Economic Report, 81st Cong., 1st sess., Volume and Stability of Private Investment, pt. 2 (Washington, D. C.: Government Printing Office, 1950), p. 119.

[2] Ibid.

[3] Ibid., p. 620; see Revenue Revisions, 1947–48, hearings before the Committee on Ways and Means, House of Representatives, 80th Cong., 1st sess., on Proposed Revisions of the Internal Revenue Code, pt. 1 (Washington, D. C.: Government Printing Office, 1947), p. 73.

[4] Revenue Revisions, 1947–48, ibid., pt. 3, p. 1510.

[5] Ibid.

[6] Ibid.

[7] Ibid.

[8] Ibid., p. 1852.

Frank L. Andrews, representing the American Hotel Association:

"A final point: Treasury's increasingly diligent scrutiny of undistributed profits, under section 102 of the Revenue Code, must be realistic, or it could prove serious to the hotel industry, from a standpoint of excessive surtax. The hotels came out of the war with deferred maintenance growing out of accelerated depreciation, with equipment inventories depleted, and with heavy obsolescence. These factors, coupled with the need for substantial cash reserves, to carry a property over periods of low occupancy, frequently make necessary the retention of larger sums of undistributed profits than is required by many other types of business.

tions find that "risky expansion" is less attractive and that to obtain external capital "on satisfactory terms" is "much more difficult." [9] Undistributed corporate profits must be used for the "construction of new plants, or for the starting of new business operations within the corporation, or for the purchase of smaller independent businesses to be absorbed into the corporation" and may not be employed for "direct loans as mortgages to individuals" for home construction or for the purchase of "municipal bonds which might enable cities to carry on projects in slum clearance." [10]

The penal character of the section is condemned as being abhorrent and without justification.[11] It "induces the adoption of the partnership form of business" although the "corporate form would be far more desirable, and much more advisable from all other standpoints." [12] It is said to have caused "an epidemic of corporate dissolutions." [13] Rather than protecting the revenue "it creates it and does so by blackmail." [14] The statute has given rise to "uncertainty and confusion" [15] because of its vagueness and indefiniteness hanging over corporations "like the sword of Damocles." [16]

Criticisms of the section have not been limited to those placed directly before the Congress, such as those above. In illustration, section 102 has been described as an "illusory and almost impossible method of dealing in a proper manner with the problem of undistributed corporate earnings"; [17] also that it may be "least effective" in situations "where coercive pressure to declare dividends may be most needed." [18] It has been charged that the section "was conceived in error" and "ought to be repealed." [19] Of interest in this regard is the view expressed by the committee on the Federal corporate net income tax of the National Tax Association in its preliminary report.

The committee directed strong words of censure to the section.

> Section 102 imposes a special surtax on corporations "formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting earnings or profits to accumulate instead of being divided or distributed * * *" The section is one of the most unpopular features of our present corporate tax

"Mr. KEAN. Do you know of anybody in your industry who has been unfairly treated under 102?

"Mr. ANDREWS. I do not know just what you mean by 'unfairly.'

"Mr. KEAN. Have they brought up the case of 102?

"Mr. ANDREWS. I have no specific case.

"Mr. KEAN. If you know of a specific case, I would appreciate it if you would let me know about it.

"Mr. RYAN. There is no way for a lay group such as ours to challenge these things, or ascertain what the proper formula should be. In some instances the retention of reserves only equal to those that have been retained formerly have been questioned by the Commission; that is, not a greater reserve but the reserve they kept formerly.

"Mr. KEAN. Definitely you should be allowed to retain in many cases a good deal more than 70 percent. I have not heard of any cases where the Bureau has not been very intelligent and lenient in 102 cases. If you know of any case where they have not been, I would appreciate hearing about it so when we consider section 102 we can consider those cases.

"Mr. RYAN. I will have a number of those in your hands." Ibid., pp. 1445–1446.

[9] Ibid., pt. 5 (1948), p. 3321.

[10] Ibid., pt. 3 (1947), p. 1854.

[11] Ibid., pt. 5 (1948), p. 3241.

[12] Ibid., p. 3242.

[13] Ibid.

[14] Ibid.

[15] Revenue Revisions of 1950, hearings before the Committee on Finance, U. S. Senate, 81st Cong., 2d sess. (Washington, D. C.: Government Printing Office, 1950), p. 373.

[16] Revenue Revisions, 1947–48, pt. 5, op. cit., p. 3307.

[17] Arthur H. Kent, "Corporate Income Tax—Discussion," Proceedings, National Tax Association, 1947, p. 173.

[18] Arthur H. Kent, "The Legal Machinery of the Present Corporate Income Tax System," ibid., p. 76.

[19] George T. Altman, "Section 102 of the Internal Revenue Code," ibid., 1948, p. 557.

system, and it is the opinion of the committee that this unpopularity is well deserved. Section 102 is criticized because it fails to accomplish its purpose and because its definition in the law and regulations is so vague as to constitute a nuisance to business and provide a tax with a capricious incidence.

The truth is, of course, that all reinvestment is more or less with the motive of avoiding surtax, and the section is based upon the hypocrisy of denying this fact. Moreover, the operation of the section rests insecurely upon a judgment of men's motives. It is like the game of baseball, where it is wrong to pitch at the batter but all right to throw the ball "high and inside." Every umpire knows that under these circumstances he cannot draw a workable line. If he attempts to enforce the rule at all, he will catch some who are innocent and let many escape who are guilty. Much the same happens under Section 102.

It is easier to criticize Section 102 than to devise a substitute. As long as undistributed earnings are very substantially favored by the tax system, some device will be necessary to prevent unconscionable evasion. Even a partial removal of existing unneutralities, however, would remove some of the pressure that supports and warrants Sction 102. At present when Section 102 applies at all, it covers not only earnings that are wrongfully withheld but all earnings withheld. The law could at least be mitigated to eliminate this unnecessary harshness. Consideration may be given to the Canadian system, under which improperly accumulated surplus is taxed on a pro rata share to stockholders as though there had been a distribution. However, there is some feeling on the committee that the retention of penalties against unreasonable accumulation is essential.[20]

The final report of this committee contained a restatement of the committee's distaste of the section but an admission of its need.

As stated in our Preliminary Report, the majority of our Committee cherishes a cordial dislike for Section 102. Any action which would reduce the tax differentials between distributed and undistributed earnings would be a partial remedy for Section 102 in that this would relieve the pressure in the area of its application. But none of our members thinks that the partial dividend-paid credit here advocated would eliminate the need for Section 102 or that it would justify the weakening of an instrument already conspicuously feeble. In short, we accept the section as a necessary evil. We do think the statute might well be recast to make clear that the evidence to establish illegitimacy of reinvestment be confined to objective facts, eliminating the vagaries associated with subjective "intent" to avoid surtax.[21]

Recently, the Tax Institute gave careful consideration to section 102.[22] Examination of the section took the form of a questionnaire survey directed to a group of practitioners; a panel discussion designed to discover the economic effects of the section; and a panel discussion of policy with reference to the section.

Criticisms of section 102 developed by panel participants and questionnaire respondents were many and various as follows:

1. Discrimination against small business enterprises because (*a*) it is difficult for small businesses to obtain external capital funds; (*b*) irregularities in the flow of net earnings require a relatively larger retention of earnings, a relatively higher liquidity to protect against unknown contingencies and to take advantage of unexpected business opportunities; and (*c*) small-business men tend to be less well-informed tax wise, are less inclined to engage in legal defense of their actions, and are more susceptible to panic.

2. Application of the section has been especially against the closely held, closely controlled corporations; however, widely held corporations on occasion have felt concerned; also, in a few instances, fear of the section apparently has induced parent corporations to have subsidiary corporations declare and pay dividends.

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[20] Ibid., 1949, pp. 456–457.
[21] Ibid., 1950, p. 71.
[22] Economic Effects of Section 102 (Princeton, N. J.: Tax Institute, 1951).

3. Discrimination against corporations with high variability of earnings (regarded as being especially vulnerable under the section).

4. Fear and uncertainty created by the section, which some participants believed had their genesis in ignorance on the part of tax practitioners, as well as businessmen.

5. Forcing corporations to declare dividends which otherwise would not be done; also, inducing larger dividends than otherwise would have been paid.

6. Curtailment of growth, particularly by reason of the "immediacy" doctrine, by small closely held corporations; also, retardation of product development. On the other hand, the section, in many instances, was believed to have been an accelerating factor in plant expansion and in the acquisition of new machinery.

7. Increased borrowing caused by the forcing of dividends.

8. Curtailment of business operations.

9. Adequate financial provision for contingencies prevented.

10. Acceleration of capital formation which, in individual corporate cases, may not always have been wise.

11. Brought about conversion of corporations into partnerships and sole proprietorships.

12. Influenced debt reduction.

13. Caused preference for debt rather than equity financing.

14. Induced corporations to engage in practice of creating year-end balance sheet nonliquidity.

15. Caused resort to various business practices such as excessive inventory accumulation, deferral of collections, bonus and salary increases, corporate apathy to cost increases, pension and profit-sharing plans, holding funds in cash or in Government securities as an alternative to investment in securities of unrelated business enterprises, and the like.

16. Retards the funding of depreciation.

17. Fear of harmful publicity by corporate taxpayers if they resort to judicial determination of the validity of a deficiency assessment under the section.

18. Induces sales or liquidations of enterprises; also corporate mergers.

19. Factor influencing concentration of industry (*a*) by making it hazardous for small enterprises to accumulate adequate reserves, i. e., contingencies and expansion, and (*b*) by inducing sales, liquidations, and mergers of small businesses (sec. 102 in combination with other taxes).

20. Accentuates inflationary and deflationary trends within the economy by accelerating corporate expansion during periods of prosperity and, through restraint on corporate reserve accumulations, adversely affects the maintenance of employment and the payment of dividends during periods of recession and depression.

21. Difficulties created by administration of the section by the Bureau of Internal Revenue as found in—

(*a*) Its use as a coercive instrument by some Bureau agents to obtain concessions from taxpayers in other areas, i. e., depreciation, salaries, etc.

(*b*) Administration too mechanical; Bureau staff erects judgments without sufficient familiarity with business or with the

problems of the particular corporations under question for excessive accumulation of surplus.

(*c*) Possible changes in Bureau policy—unpredictable over time.

(*d*) Differences in attitudes of Bureau and particular revenue agents; also among revenue agents.

(*e*) Once subject to tax, the corporation thereafter is suspect.

(*f*) Delay in determination of section liability by the Bureau and final decision by Tax Court.

(*g*) Burden of proof on taxpayer—if on Commissioner greater uniformity in administration; also, the section could not then serve as an instrument of coercion by revenue agents.

22. Corporate directors may be subject to suit by minority stockholders subsequent to the successful assertion of section liability by Bureau.

Section 102 was defended by Tax Institute panel participants and questionnaire respondents in the following respects:

1. Statute a necessary feature of the law, providing for the taxation of income to prevent avoidance of personal income tax through use of the corporation as a personal "savings bank," i. e., corporate retention of profits. To the extent that the section is effective, the personal income tax distributes its burdens more equitably between and among taxpayers, safeguards the revenues from the personal income tax, and is a limiting influence on the use of the corporation as a tax avoidance device.

2. Protests and "cries of anguish" against the section are evidence that, in some measure, the section is accomplishing its purpose.

3. Bureau of Internal Revenue has intelligently administered the section in that its attitude has been fair and reasonable.

4. The more careful appraisal of the year-end position of the corporation and its future plans by the corporate directors, induced by the section, may well be of advantage in the long run.

5. Although the section may be of major importance to some corporations, its over-all effects on the economy, on balance, are not important.

6. Probably not more than 10 percent of corporations affected by the section under its present administration; these companies are small, family owned, debt-free enterprises.

7. The small amount of revenue collected directly by application of the penalty tax is no measure of its importance or of the extent to which the purpose of the section is accomplished. The purpose is to prevent improper accumulations of surplus from occurring, i. e., excessive corporate liquidities, rather than to penalize (collect revenue under the section) as such. It is a deterrent (a revenue protective device) not, of itself, a revenue measure.

8. The section has been given an importance beyond its deserts. Tax practitioners need further education regarding the section in order that the fears of businessmen will not be stimulated unnecessarily.

9. Real investment, on balance, apparently increased rather than decreased by the section.

Tax Institute Questionnaire

As a means of ascertaining certain of the economic effects of section 102, a questionnaire was sent to some 1,700 tax practitioners as of October 13, 1949. (See appendix 2, p. 230, for copy of questionnaire and accompanying letter.)

The respondent replies to the questionnaire:[23]

Number of "filled-in" questionnaires	153
Number of letters of brief comments	37
Total number of responses	190

All parts of the country were represented in the questionnaire returns. The Tax Institute was of the opinion that the "153 tax practitioners returning questionnaires represented approximately 10,000 corporations."[24]

Of the approximately 10,000 corporations, concern with section 102 was as follows:[25]

	Percent
No consideration	19
Casual consideration	25
Careful consideration	34
Intensive consideration	22

Some 56 percent of the represented corporations thus gave careful and/or serious thought to section 102.

Judging from questionnaire responses, the Tax Institute concluded that virtually all types of corporate business were affected by the section.[26] The listing of the various types of business undertakings by the respondent-practitioners was as follows:[27]

Type of business:	*Number of respondents listing*
Textile corporations	37
Personal service corporations	30
Manufacturing corporations	24
Merchandising corporations	17
Publishing corporations	12
Glass corporations	7
Auto dealer corporations	7
Paper products corporations	7
Lumber corporations	6
Steel and iron corporations	5

Other types of business reported by less than 5 respondents were dealers in securities, oil, finance, minerals, chemicals, food processing, automobiles, and furniture.[28] These data, of course, give no indication of the impact of the section by type of business, but only the kinds of corporate enterprise concerned therewith.

Types of business not affected by the section apparently were insurance companies, trust companies, railroads, and trade organizations.[29]

The principal impact of the section, as reported by respondents, was on closely held corporations with very few shareholders as indicated below.[30]

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[23] Ibid., p. 9.
[24] Ibid., p. 11.
[25] Ibid.
[26] Ibid., p. 12.
[27] Ibid., p. 13.
[28] Ibid.
[29] Ibid.
[30] Ibid., p. 14. These data were derived from replies of 141 respondents.

Number of corporate shareholders:	*Number of respondents reporting corporations affected*
Less than 5	89
5 to 10	71
10 to 25	49
25 to 100	37
Over 100	43

Corporations affected, according to corporate size as measured by net assets, were found to be as follows: [31]

Net assets:	*Number of respondents reporting corporations affected*
Less than $20,000	9
$20,000 to $50,000	22
$50,000 to $100,000	34
$100,000 to $250,000	58
$250,000 to $500,000	56
In excess of $500,000	92

The questionnaire did not provide for respondent reporting of the number of affected corporations by asset group.[32] However, if the number of respondents reporting (by asset group) is a general indication of the number of corporations affected (by asset group), corporations with net assets of $100,000 or more constitute the great majority of the corporations concerned with section 102. Comparatively few corporations with net assets of less than $100,000 are affected, apparently.

The effect of the section on dividend distributions for the average practitioner was as follows: [33]

Sec. 102 as influencing increased dividend distributions:	*Percent of his corporate clients*
Sole controlling factor	19
Major controlling factor	22
Contributing factor	18
Not considered	9
Incidental or inconsequential	32

For the average practitioner, therefore, section 102 was at least a contributing factor in increased dividend distributions for the majority of his corporate clients (59 percent); and for some 41 percent a sole or major factor causing increased profit distributions. These percentages should be construed as suggesting only the general order of magnitude in measuring the influence of the section on corporate dividend policy.

Certain effects from the forcing of dividends, by numbers of respondents reporting, were stated to be as follows: [34]

Consequences of forcing increased dividends	Frequent	Infrequent
Conversion of assets	15	32
Increased borrowing:		
From stockholders	10	22
From banks or other outside sources	13	33
Curtailment of operations	11	24
Additional stock issues	7	23

[31] Ibid. These data based on replies of 128 respondents.
[32] The number of corporations in each asset group could not be determined as a number of practitioners with a diversified clientele checked more than one asset group. Ibid.
[33] Ibid., p. 16.
[34] Ibid., p. 18.

Other economic effects observed by respondents, in rank order of number of reporting practitioners, were as follows: [35]

Economic effect	Number of respondents reporting effect	Effect one of—	
		Stimulation	Retardation
1. Expansion or rehabilitation of plant, or acquisition of new machinery	106	85	32
2. Acquisition of properties	93	77	23
3. Reduction of debt	67	43	30
4. Increase in inventories	65	52	17
5. Change from corporate to partnership or to sole proprietorship form	61	60	5
6. Debt financing in preference to equity financing	52	48	8
7. Pension and profit sharing plans	47	43	11
8. Development of a wholly new product (never produced before)	43	21	27
9. Mergers or sales of businesses	38	33	8
10. Complete liquidation and discontinuance of business in any form	35	31	7
11. Improvement, extension, or embellishment of a previous product	34	20	19
12. Resort to outside sources for financing by borrowing or issues of new stock	32	26	10

Respondent replies to the question relating to the effect of forcing dividends on corporate investments in a completely new product or an improvement of a previous product were as follows (See questions 5a and 5b in questionnaire, appendix 2, p. 231.): [36]

	Yes	No
Retarded investment in completely new product (5a)	22	58
Retarded investment in improvement of a previous product (5b)	23	51

Comments of practitioners on the questionnaire indicated that a number of corporate clients were in sufficient fear of section 102 to cause them to distribute earnings against the advice of the practitioner, that the Trico case created considerable uneasiness among corporate boards of directors, and that a "vicious" aspect of the section was its employment by revenue agents to coerce taxpayer corporations into agreeing to other adjustments.[37]

The Brookings Institution Questionnaire

In a study of Taxes and Economic Incentives,[38] Lewis H. Kimmel, of The Brookings Institution, used a questionnaire as a means of ascertaining the views of businessmen on a variety of tax problems. The

[35] Ibid., p. 19. The stimulative and retarding effects were further classified in the questionnaire as to frequency or infrequency of occurrence.
Some practitioners reported both stimulative and retarding effects (section causing diverse effects on clientele), consequently the total of reported effects exceeds the number of reporting respondents. See table, p. 20.
[36] Ibid., p. 21.
Various other effects of lesser importance and of occasional mention such as an increase in salaries and bonuses to corporate officers, reorganization, sale of stock, avoidance of any significant amount of liquid assets, some apathy to cost increases, advanced somewhat time of making replacements and improvements, forced expansion of plant as an alternative to dividends (dividends objectionable because of high individual surtax rates), and the like, were seen by respondents. See ibid., pp. 16–25.
One respondent stated that a corporate addition to plant in the form of a new building was called No. 102. Ibid., p. 24.
[37] Ibid., pp. 24–26.
[38] Washington, D. C.: The Brookings Institution, 1950.

questionnaire was sent to 1,000 manufacturing corporations in June 1948.[39]

One of the questions included in the questionnaire was as follows:

Has the provision (sec. 102) designed to prevent unreasonable accumulations of earnings affected the operations of your company? If so, please explain.[40]

Of the replies received to this question, 210 warranted a "yes" or "no" classification.[41] Some 51 replies (of the 210) of the corporate respondents gave affirmative answers to the question.[42] The replies, classified by industry, were as follows:[43]

Industry	Total replies	Corporate operations affected by sec. 102?		Percent affirmative replies
		Yes	No	
Metals and metal products	29	5	24	17.2
Machinery and accessories	47	8	39	17.0
Automobiles and accessories	7	1	6	14.3
Electrical equipment and appliances	16	3	13	18.8
Textiles	23	8	15	34.8
Chemicals and drugs	11	3	8	27.3
Building materials	8	3	5	37.5
Paper and paper products	14	3	11	21.4
Foods and beverages	18	3	15	16.7
Leather and leather products	7	4	3	57.1
Rubber	5	0	5	0
Glass	5	1	4	20.0
Miscellaneous	20	9	11	45.0
Total	210	51	159	24.3

Kimmel suggests that the comparatively small proportion, 24.3 percent of the respondent corporations reporting that section 102 affected their operations, can be misleading unless it is realized that only the closely held small and medium-sized corporations are concerned with the section—not the large public corporations.[44]

The affirmative responses, in most instances, revealed that the section had a forcing effect on profit distributions.[45] The forcing effect was attributed to the "uncertainty" in the application of the section. In addition, a number of respondents indicated that the section had induced expansion of plant as an alternative to earnings distribution.[46] One respondent corporation stated that it had derived an advantage thereby in that expansion plans were caused to become formalized.[47] The section was criticized as constituting an "unwarranted interference with corporate management";[48] the creation of a continuous potential contingent liability with the decision thereon in the hands of a third party, i. e., Bureau of Internal Revenue, which has no special concern with company operations or a solvent future for the corporation;[49] and the retrospective appraisal and judgment exercised by the Bureau of Internal Revenue on the decisions of corporate management.[50] Respondents also complained that corporate taxpayers are

[39] Lewis H. Kimmel, Taxes and Economic Incentives, ibid., p. 27.
[40] Ibid., p. 63.
[41] Ibid.
[42] Ibid.
[43] Ibid., p. 64.
[44] Ibid., p. 63.
[45] Ibid.
[46] Ibid., pp. 64–65.
[47] Ibid., p. 65.
[48] Ibid., p. 63.
[49] Ibid., pp. 63–64.
[50] Ibid., p. 64.

not on an equal "footing" with the Bureau under the section,[51] and that revenue agents generally have insufficient knowledge of corporate finance and of liquid reserve requirements to provide for growth.[52]

Kimmel regards the section as a contributory force to the inflationary pressure of the period 1946–48.[53] This effect was not only a function of currently induced real investment but of orders or contracts for future delivery of plant or equipment, even though subject to later change or cancellation.[54] Such orders or contracts served as a means of protecting the corporation from the possible application of the section in earnings accumulation by implementing future corporate expansion plans.[55]

The Questionnaire of the Joint Committee on the Economic Report of the Congress

The Joint Committee on the Economic Report of the Congress, in furtherance of its study of investment, directed a confidential questionnaire on section 102 to 254 corporations in December 1949.[56] Section 102 had been an object of severe and extensive complaint before congressional committees. Corporation executives and trade association representatives contended that the section "forced" investment and, on the contrary, "retarded" investment. There were conflicting opinions regarding the extent to which corporate directors "feared" the section, the corporations affected, its influence in compelling dividend distributions, and its effect on corporate liquidities. Answers to these questions, if obtainable, lay in the hands of those who direct corporate affairs. The purpose of the questionnaire was to derive information which might contribute to a better appraisal of the economic effects of the section.

The questionnaire was as follows:

DECEMBER 1949.

JOINT COMMITTEE ON THE ECONOMIC REPORT

(Created pursuant to sec. 5 (a) of Public Law 304, 79th Congress)

CONFIDENTIAL QUESTIONNAIRE ON SECTION 102, INTERNAL REVENUE CODE

Name of corporation_____

Nature of business_____ Number of stockholders_____

Total assets as of January 1, 1949_____

Total earned surplus as of January 1, 1949_____

Total liquid assets (cash, securities, and excess of current accounts receivable over current accounts payable), January 1, 1949_____

Ratio of current assets to current liabilities, January 1, 1949_____

	List Percentages in Order
Of your corporate voting stock, what is the percentage holding of the five largest stockholders:	_____
	_____
	_____
	_____
	_____

[51] Ibid.
[52] Ibid.
[53] Ibid., p. 65.
[54] Ibid.
[55] Ibid.
[56] Questionnaire prepared by author.

In each of the following questions it will be helpful to the Committee if you will cite specific evidence as to how your own corporate policy has been affected. If insufficient space is provided, use a separate sheet for your answer. YOUR ANSWERS WILL BE HELD CONFIDENTIAL.

1. Has Section 102 caused your corporation to distribute a larger proportion of current earnings in dividends than would otherwise have been done?

In 1946, Yes ___ No ___
In 1947, Yes ___ No ___
In 1948, Yes ___ No ___

	Total Net Income After Taxes (Including income tax)	*Net Income After Taxes Distributed*
1946		
1947		
1948		

2. Of corporate earnings after taxes during the past 3 years (1946–1948) *approximately* what percent was used for the following purposes:

	Percent
(*a*) Building up liquid reserves	
(*b*) Plant additions, betterments, and inventories	
(*c*) Purchase of other corporate stocks (common and preferred)	
(*d*) Purchase of assets of another corporation	
(*e*) Dividends	
(*f*) Debt retirement and retirement of preferred stock	
	100

3. During the past 3 years (1946–1948, inclusive), to what extent, if at all, has Section 102 adversely affected—

(*a*) Any contemplated program of corporate expansion?
Please explain _____

(*b*) The self-financed growth of your corporation?
Please explain _____

(*c*) The accumulation of a sufficiently large liquid earned surplus for prudent hedging against future contingencies?
Please explain _____

4. Has the possibility of Section 102 liability caused your corporation to buy other corporate securities or corporate assets which otherwise you would not have done during the past 3 years?
Please explain _____

5. During the past 3 years (1946–1948, inclusive), has Section 102 caused your corporation to make ill-timed investments in assets or to enter the market for equipment and supplies under unfavorable circumstances?
Please explain _____

6. Is your corporation (by reason of cost, unavailability, or corporate policy) completely dependent in fact on internal financing of fixed assets in corporate expansion?_____

If so, please state reason or reasons_____

7. Has the fact that the Treasury is permitted 3 years to make a final determination on your return as to the application of Section 102 affected the timing and amount of corporate investment or caused a larger dividend distribution than would have occurred if your return were subject to earlier closure?

Please explain_____

8. Do you believe there is any better way to prevent avoidance of personal surtax than by using Section 102 in its present form?

(If you believe that a change is desirable, please indicate the nature of the change or revision and your reason or reasons in support of it.)

9. Has your corporation been subjected to tax assessment under Section 102?
Yes_____ No_____
If so please give year or years_____; amount of Section 102 tax assessment_____; and amount of tax paid_____

Name of Respondent Officer *Title*

A covering letter accompanied the questionnaire, signed by the chairman of the Joint Committee on the Economic Report, Senator Joseph C. O'Mahoney. Its content was as follows:

CONGRESS OF THE UNITED STATES,
JOINT COMMITTEE ON THE ECONOMIC REPORT,
December 13, 1949.

By direction of Congress, the Joint Committee on the Economic Report has undertaken a survey of investment. The subcommittee appointed to conduct the study, among other things, is interested in obtaining information concerning the influence of section 102 of the Federal Revenue Code on corporation policy as to the retention or distribution of current earnings.

Your corporation has been selected as a possible source of information on the operation of the tax imposed under section 102. Your cooperation in filling out the attached questionnaire will be appreciated. The committee needs this information in order better to understand how this tax in our Federal tax system promotes or retards real investment. If possible, the questionnaire should be returned in the enclosed envelope before December 20. All replies to this questionnaire will be held strictly confidential.

Very truly yours,

JOSEPH C. O'MAHONEY, *Chairman.*

The questionnaire was directed to 204 industrial and manufacturing corporations and 50 finance companies, a total of 254 corporations.[57] It was believed desirable to contact corporate officers directly on the assumption that the opinions expressed would have greater reliability. Of the 254 corporations to which the questionnaire was sent, 140, or 55 percent, responded.[58]

[57] Corporations to which the questionnaire was addressed were divided into four groups as follows:

Group	Number of corporations	Asset limits	Type of corporation	Limitation on number of stockholders
A	50	$250,000-$5,000,000	Industrial	Not more than 1,000.
B	50	250,000-25,000,000	do	No limit.
C	104	250,000-25,000,000	do	Not more than 1,000.
D	50	250,000-25,000,000	Finance	No limit.

In determining the corporations to be contacted, it appeared desirable to exclude the very small corporations, assets less than $250,000, and the large public corporations, assets of $25,000,000 or more. Corporations in groups A and C were subject to a limitation of not having more than 1,000 stockholders; corporations in groups B and C were not restricted as to the number of stockholders. Within the limitations herein noted, corporations were of random selection from extensive lists. However, two corporations in C group, one with assets of $230,000 and one with assets of $162,704, did appear in sample.

The endeavor was to reach small and medium-sized corporations of a nonpublic character. This was on the assumption that the very small and probably very closely held and closely controlled corporations would have a recognized vulnerability and concern with section 102, being in the main incorporated sole proprietorships or partnerships; on the other hand, the large public corporations would view the section as not applicable to themselves and thus uninfluenced by it. The intention was to avoid these extremes in selecting the corporations to be contacted by the limitations on asset size.

[58] Responses by groups were as follows:

Group	Number contacted	Number responding	Percent response
A	50	25	50.0
B	50	30	60.0
C	104	64	61.5
D	50	21	42.0
Total	254	140	55.1

The number of stockholders in the corporation was indicated by 133 respondents of the 140 replying. The average (arithmetic) number of shareholders per corporation was 224; the median number, 77. The distribution of stockholders by corporation was as follows:

TABLE 4.—*Number of stockholders, by corporation, in 133 corporations*

Number of stockholders	Frequencies	Cumulative frequencies	
		More than—	Less than—
0 to but not including 20	37	133	37
20 to but not including 40	16	96	53
40 to but not including 60	5	80	58
60 to but not including 80	10	75	68
80 to but not including 100	5	65	73
100 to but not including 120	2	60	75
120 to but not including 140	5	58	80
140 to but not including 160	6	53	86
160 to but not including 180	2	47	88
180 to but not including 200	6	45	94
200 to but not including 220	3	39	97
220 to but not including 240	6	36	103
240 to but not including 260	1	30	104
260 to but not including 280	1	29	105
280 to but not including 300	3	28	108
300 to but not including 320	3	25	111
320 to but not including 340	1	22	112
340 to but not including 360	5	21	117
360 to but not including 380	0	16	117
380 to but not including 400	0	16	117
400 to but not including 420	2	16	119
420 to but not including 440	1	14	120
440 to but not including 460	1	13	121
460 to but not including 480	0	12	121
480 to but not including 500	0	12	121
500 and over	12	12	133
Total corporations	133		

Number of stockholders per corporation: Arithmetic average, 224; median, 77.

CHART 1

DISTRIBUTION OF NUMBER OF STOCKHOLDERS IN 133 CORPORATIONS.

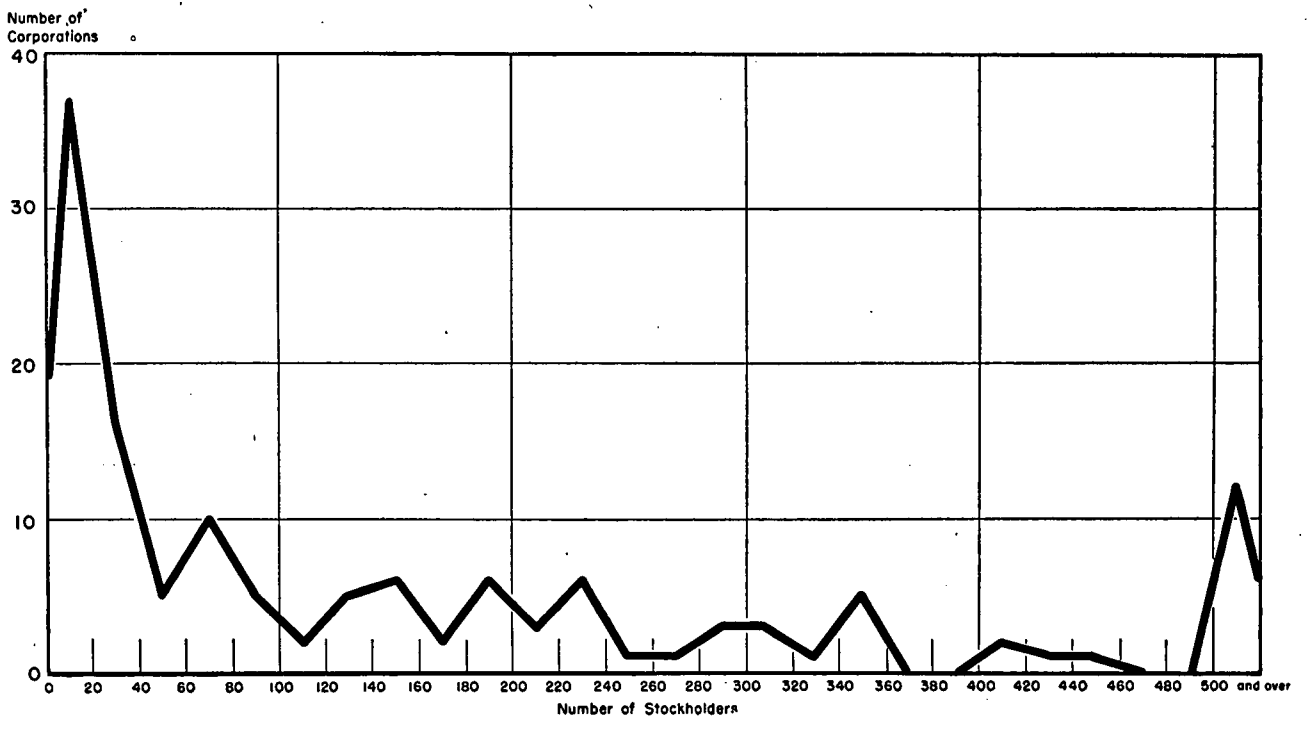
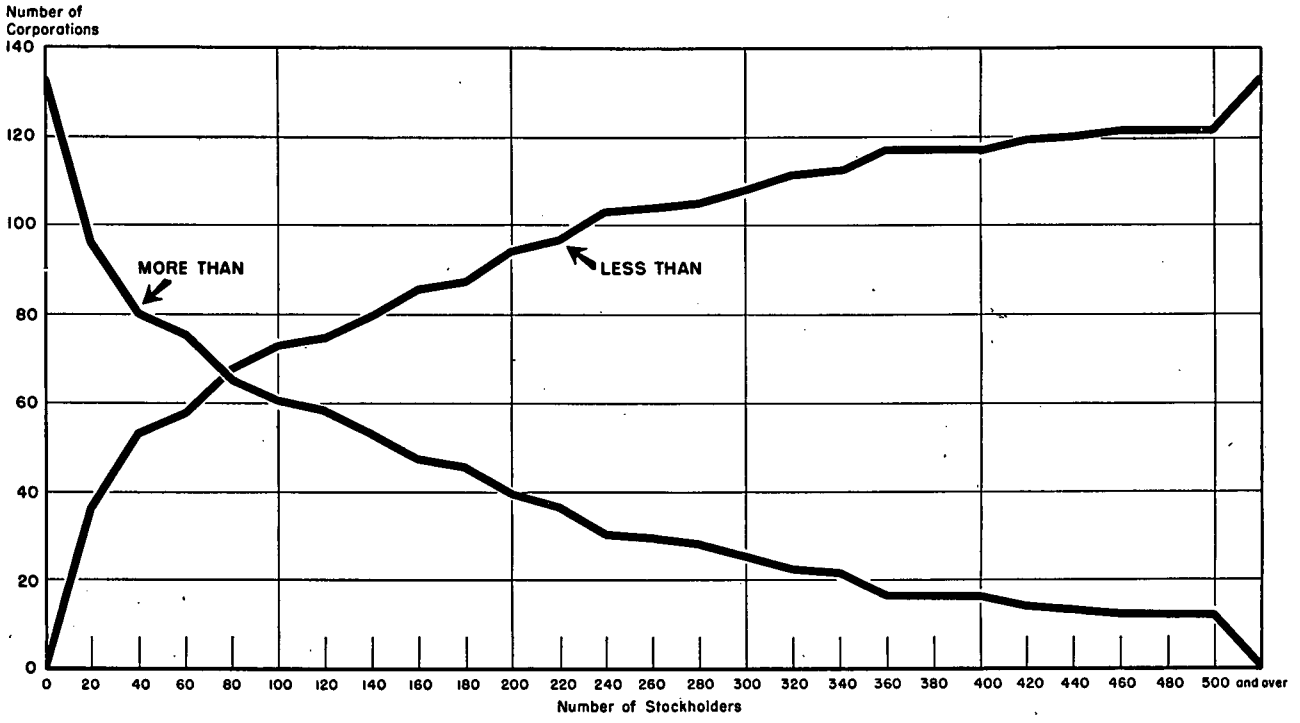


CHART 2

CUMULATIVE DISTRIBUTION OF NUMBER OF STOCKHOLDERS IN 133 CORPORATIONS.



Of the 133 corporations, 55 percent had less than 100 stockholders. The 12 corporations having 500 or more stockholders were distributed as follows:

	Number of stockholders		Number of stockholders
1	500	1	1,000
1	550	1	1,500
1	619	1	1,529
1	796	1	2,241
1	811	1	2,800
1	884	1	3,000

All but 12 of the corporations (139) providing information as to total assets and total earned surplus, as of January 1, 1949, had an earned surplus.[59] The median ratio of total earned surplus to total assets was 1 to 2.8; the average (arithmetic) ratio was 1 to 6.8. The great majority of the reporting corporations had substantial earned surpluses—indicative of relatively large earnings retention over time—as revealed by the fact that 100 of the 127 corporations had ratios of earned surplus to total assets of better than 1 to 5.0. Ratio distribution for the 127 corporations was as follows:

TABLE 5.—*Ratio of total earned surplus to total assets, distribution in 127 corporations*

	Frequencies	Cumulative frequencies	
		More than—	Less than—
0.0 to but not including 0.5	0	127	0
0.5 to but not including 1.0	0	127	0
1.0 to but not including 1.5	9	127	9
1.5 to but not including 2.0	20	118	29
2.0 to but not including 2.5	26	98	55
2.5 to but not including 3.0	14	72	69
3.0 to but not including 3.5	12	58	81
3.5 to but not including 4.0	8	46	89
4.0 to but not including 4.5	7	38	96
4.5 to but not including 5.0	4	31	100
5.0 to but not including 5.5	4	27	104
5.5 to but not including 6.0	2	23	106
6.0 to but not including 6.5	0	21	106
6.5 to but not including 7.0	2	21	108
7.0 to but not including 7.5	0	19	108
7.5 to but not including 8.0	3	19	111
8.0 to but not including 8.5	1	16	112
8.5 to but not including 9.0	3	15	115
9.0 to but not including 9.5	0	12	115
9.5 to but not including 10.0	0	12	115
10.0 and over	12	12	127
Total corporations	127		

Average per corporation: Arithmetic average, 1 to 6.8; median, 1 to 2.8.

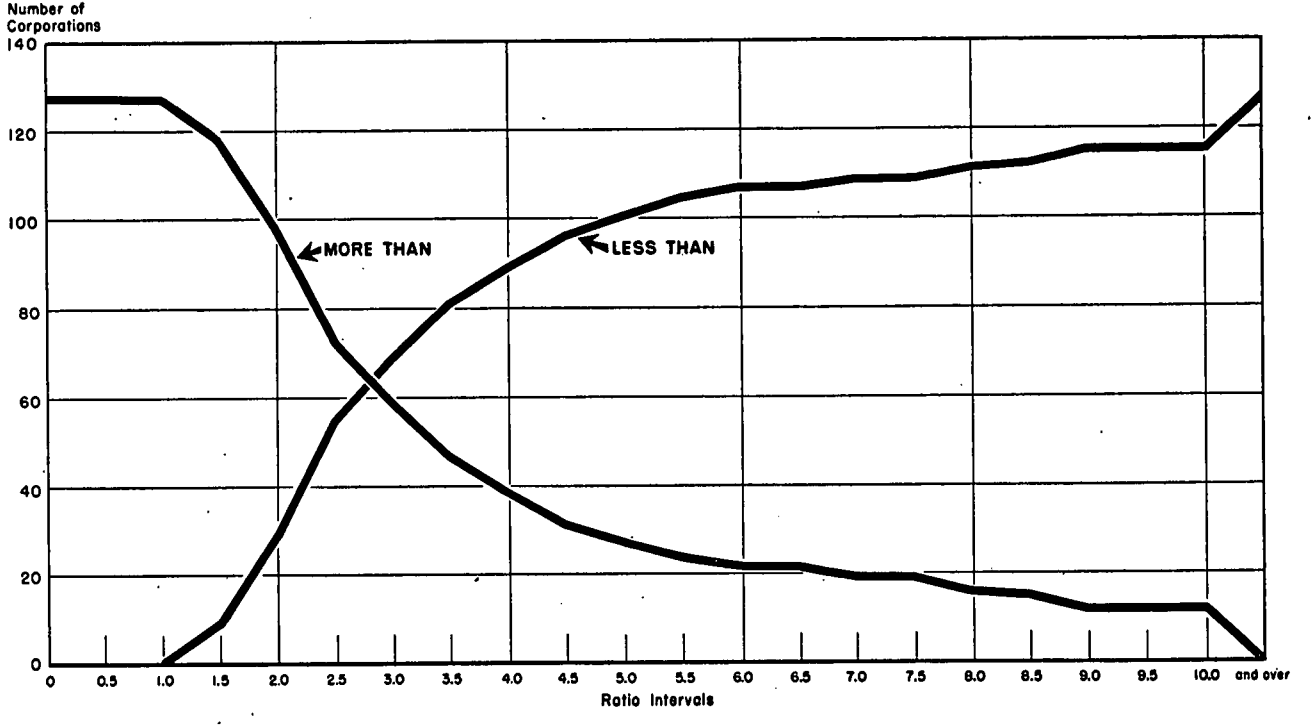
[59] The 12 corporations are excluded from the following table.

CHART 3

DISTRIBUTION OF THE RATIO OF TOTAL EARNED SURPLUS TO TOTAL ASSETS.

CHART 4

CUMULATIVE DISTRIBUTION OF THE RATIO OF TOTAL EARNED SURPLUS TO TOTAL ASSETS.



Ratios of current assets to current liabilities, as of January 1, 1949, were reported by 135 of the 140 respondents. An excess of current liabilities over current assets was indicated by three corporations. The median ratio of current assets to current liabilities was 2.8 to 1; the average (arithmetic) ratio was 3.6 to 1. The great majority of the corporations had very favorable ratios as found in the fact that 110 of the 135 companies had ratios of 2.0 to 1 or better, and 83 had ratios of 2.5 to 1 or better. Ratio distribution for the 135 corporations was as follows:

TABLE 6.—*Ratio of current assets to current liabilities, distribution in 135 corporations*

	Frequencies	Cumulative frequencies	
		More than—	Less than—
−2.5 to but not including −2.0	1	135	1
−2.0 to but not including −1.5	0	134	1
−1.5 to but not including −1.0	2	134	3
−1.0 to but not including −0.5	0	132	3
−0.5 to but not including 0.0	0	132	3
0.0 to but not including 0.5	1	132	4
0.5 to but not including 1.0	1	131	5
1.0 to but not including 1.5	9	130	14
1.5 to but not including 2.0	11	121	25
2.0 to but not including 2.5	27	110	52
2.5 to but not including 3.0	15	83	67
3.0 to but not including 3.5	14	68	81
3.5 to but not including 4.0	16	54	97
4.0 to but not including 4.5	14	38	111
4.5 to but not including 5.0	5	24	116
5.0 to but not including 5.5	2	19	118
5.5 to but not including 6.0	5	17	123
6.0 to but not including 6.5	1	12	124
6.5 to but not including 7.0	1	11	125
7.0 to but not including 7.5	1	10	126
7.5 to but not including 8.0	1	9	127
8.0 to but not including 8.5	0	8	127
8.5 to but not including 9.0	3	8	130
9.0 to but not including 9.5	2	5	132
9.5 to but not including 10.0	0	3	132
10.0 and over	3	3	135
Total corporations	135		

Average per corporation: Arithmetic average, 3.6 to 1; median, 2.8 to 1.

CHART 5

DISTRIBUTION OF THE RATIOS OF CURRENT ASSETS TO CURRENT LIABILITIES.

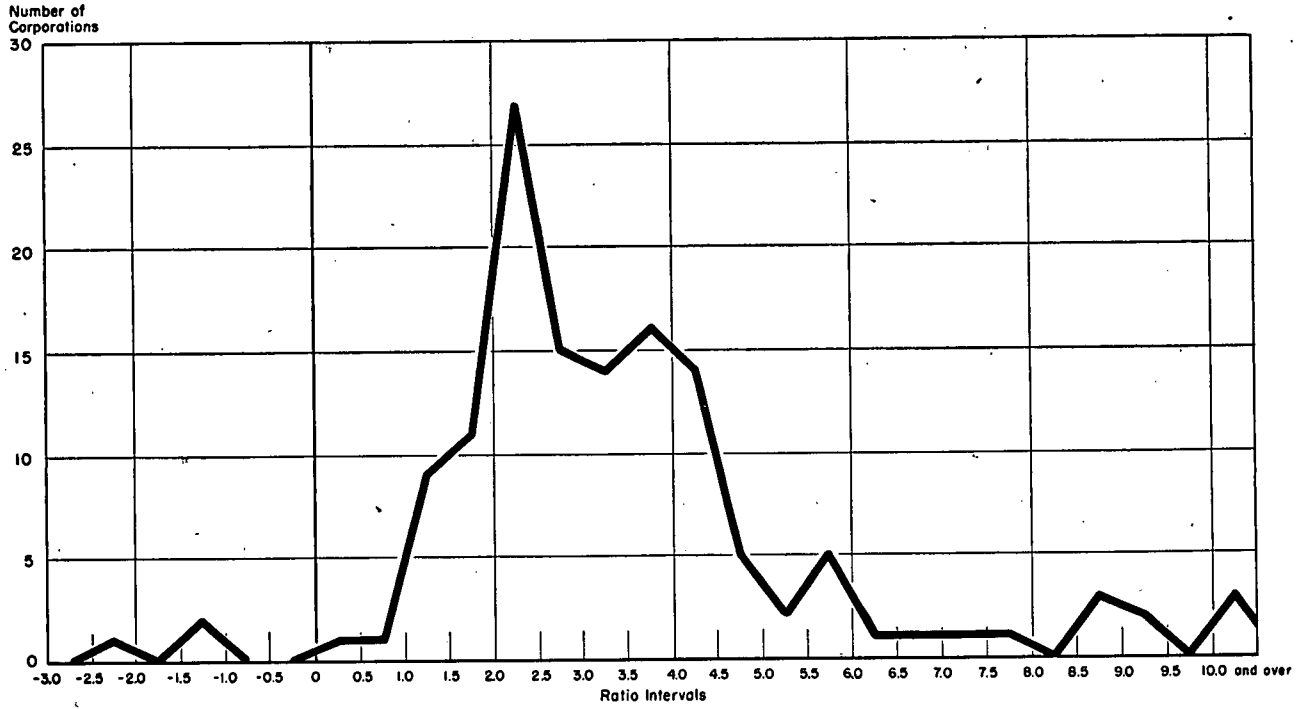
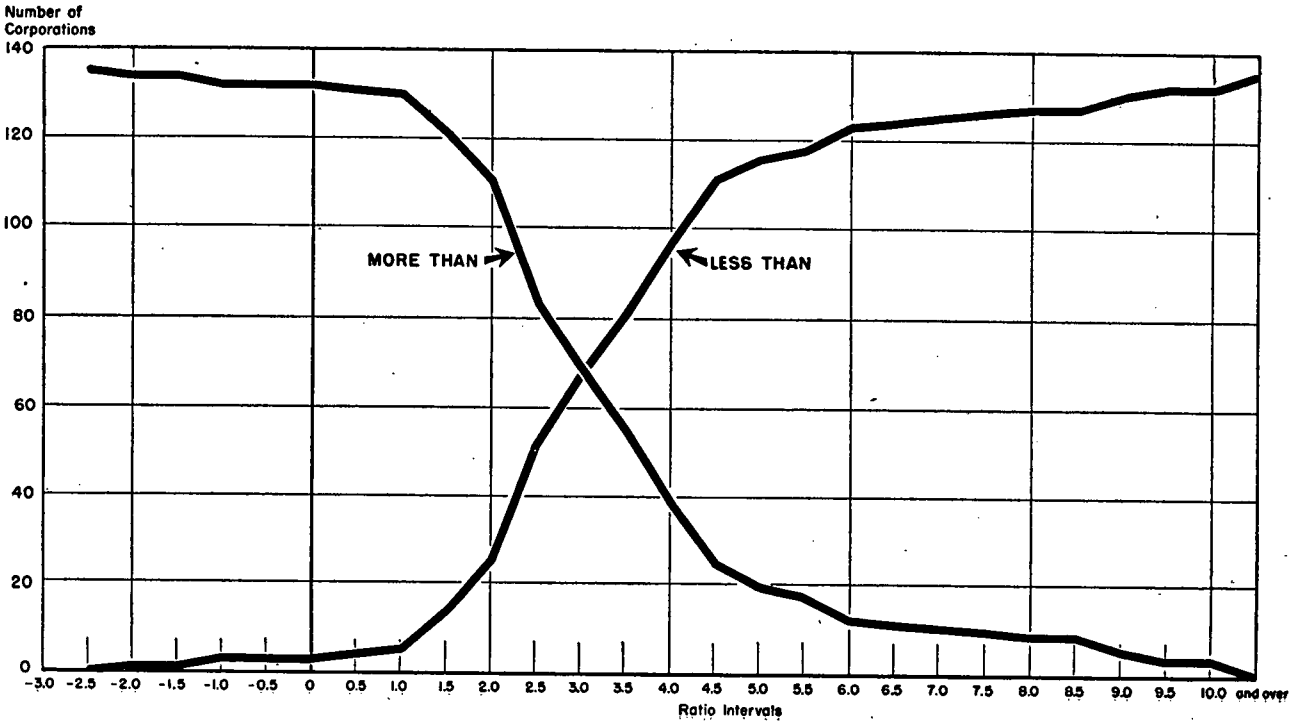


CHART 6

CUMULATIVE DISTRIBUTION OF THE RATIO OF CURRENT ASSETS TO CURRENT LIABILITIES.



Corporations receiving questionnaires were asked to report their total net liquid assets, defined for purposes of the questionnaire as the total of cash, securities, and the excess of current accounts receivable over current accounts payable. This was done by 131 of the 140 respondents. The median ratio of net quick (liquid) assets to total assets for the 131 corporations was 1 to 5.4; the average (arithmetic) was 1 to 10.4. A considerable number of the respondents had very high proportions of net quick assets to total assets; for example, 20 corporations had approximately 40 percent or more of their total assets in the form of net quick assets. On the other hand, 40 corporations had net quick assets of less than 10 percent of total assets. The following distribution of ratios of net quick assets to total assets was found for the corporations replying.

TABLE 7.—*Ratio of quick assets to total assets, distribution in 131 corporations*

	Frequencies	Cumulative frequencies	
		More than—	Less than—
0.0 to but not including 1.3	5	131	5
1.3 to but not including 2.6	15	126	20
2.6 to but not including 3.9	27	111	47
3.9 to but not including 5.2	15	84	62
5.2 to but not including 6.5	13	69	75
6.5 to but not including 7.8	7	56	82
7.8 to but not including 9.1	4	49	86
9.1 to but not including 10.4	5	45	91
10.4 to but not including 11.7	4	40	95
11.7 to but not including 13.0	6	36	101
13.0 to but not including 14.3	3	30	104
14.3 to but not including 15.6	2	27	106
15.6 to but not including 16.9	4	25	110
16.9 to but not including 18.2	0	21	110
18.2 to but not including 19.5	0	21	110
19.5 to but not including 20.8	2	21	112
20.8 to but not including 22.1	1	19	113
22.1 to but not including 23.4	1	18	114
23.4 to but not including 24.7	2	17	116
24.7 to but not including 26.0	0	15	116
26.0 to but not including 27.3	0	15	116
27.3 to but not including 28.6	0	15	116
28.6 to but not including 29.9	1	15	117
29.9 to but not including 31.2	0	14	117
31.2 to but not including 32.5	3	14	120
32.5 to but not including 33.8	1	11	121
33.8 and over	10	10	131
Total corporations	131		

Average per corporation: Arithmetic average, 1 to 10.4; median, 1 to 5.4.

CHART 7

DISTRIBUTION OF THE RATIOS OF QUICK ASSETS TO TOTAL ASSETS.

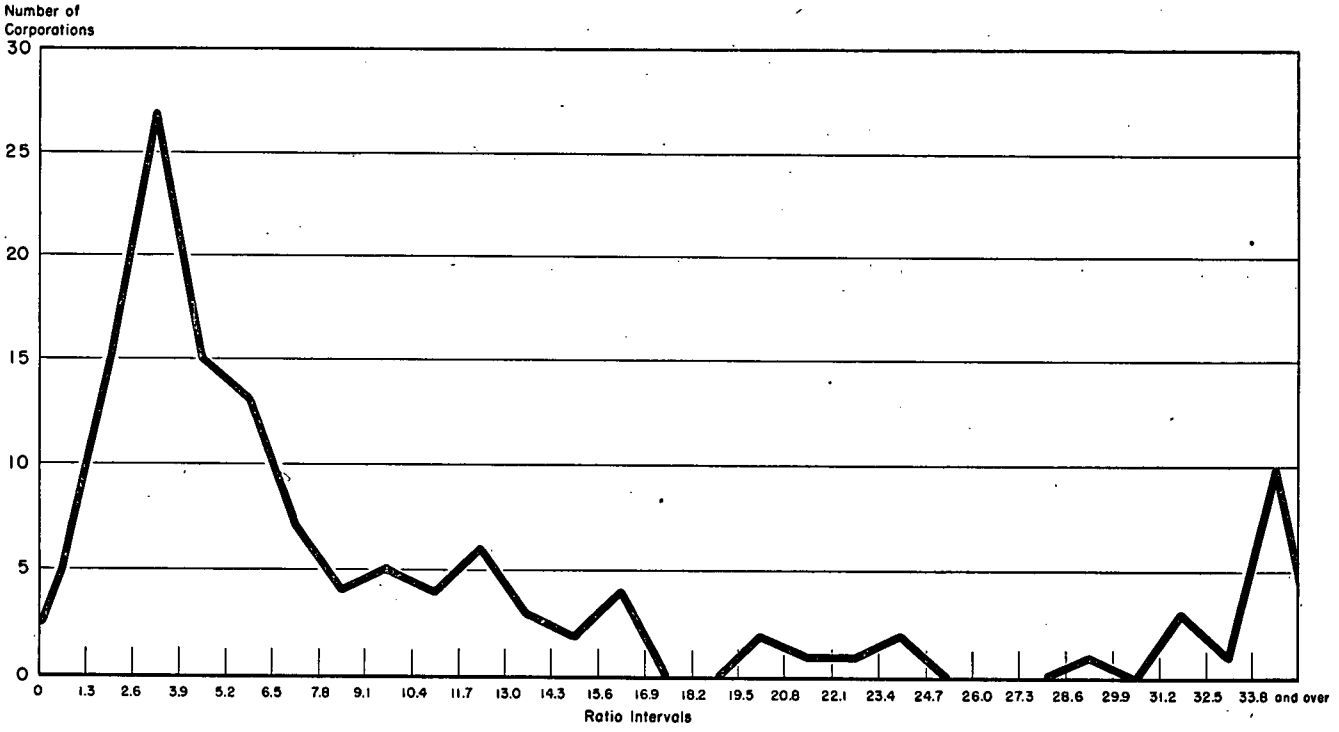
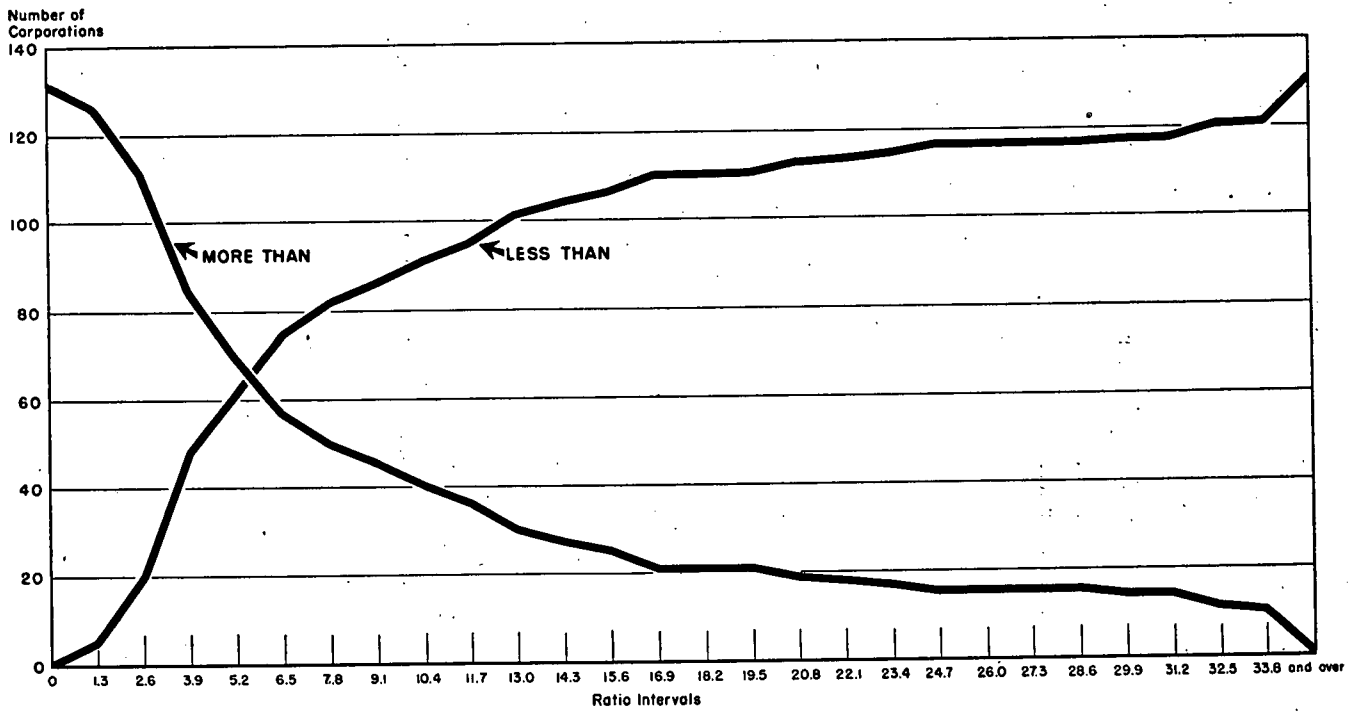


CHART 8

CUMULATIVE DISTRIBUTION OF THE RATIOS OF QUICK ASSETS TO TOTAL ASSETS.



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Of the 133 respondents reporting the percentage stockholding of the 5 largest stockholders, 90 corporations had 50 percent or more of the voting shares owned by 5 or less stockholders. In no instance did the 5 largest stockholders own less than 10 percent of the corporate voting stock. The median stockholding of voting stock of the 5 largest stockholders was 55.4 percent; the average (arithmetic) was 64.8 percent. High concentration in stockholder control thus characterized the respondent corporations. In view of the random sample, such concentration is difficult to explain. Whether this degree of concentration of stockholder control is characteristic of small- and medium-sized corporations as a class is not known. Of the 133 corporations, 22, or 17 percent, had complete voting-stock ownership in the hands of 5 or less stockholders.

TABLE 8.—*Corporations with 5 or less stockholders owning 100 percent of voting stock*

Corporation	Number of stockholders owning 100 percent of voting stock	Total assets	Ratio of quick assets to total assets	Ratio of earned surplus to total assets
B–1	5	$3,704,865.00	1 to 66.7	1 to 2.6
B–2	3	4,494,319.13	1 to 4.6	1 to 8.6
C–1	3	672,178.35	1 to 6.3	1 to 15.7
C–2	1	936,458.00	1 to 14.3	1 to 4.9
C–3	4	1,510,628.00	1 to 5.2	1 to 2.2
C–4	5	719,577.10	1 to 10.9	1 to 2.1
C–5	2	6,753,631.00	1 to 5.6	1 to 4.4
C–6	5	230,052.44	1 to 7.5	1 to 66.6
C–7	5	4,651,594.00	1 to 31.9	1 to 2.3
C–8	1	5,984,768.68	[1]	1 to 1.9
C–9	3	693,000.00	1 to 6.2	1 to 1.2
C–10	3	634,787.82	1 to 3.6	1 to 1.2
C–11	3	726,219.73	1 to 45.4	1 to 111.1
C–12	1	1,050,467.27	1 to 11.8	[1]
C–13	4	431,750.79	1 to 4.3	[1]
C–14	2	757,462.00	1 to 1.8	1 to 1.9
C–15	1	3,960,006.08	[1]	1 to 7.5
C–16	5	382,706.04	1 to 2.6	1 to 2.8
C–17	3	365,430.13	1 to 71.4	1 to 5.3
C–18	2	875,175.22	1 to 2.3	1 to 2.0
D–1	1	3,619,000.00	1 to 8.3	[1]
D–2	4	1,236,321.38	1 to 1.0	1 to 17.5

[1] Not reported or a negative ratio.

The distribution by corporations of the voting-stock ownership of the five largest stockholders is shown below.

TABLE 9.—*Percent stockholding of 5 largest stockholders, distribution in 133 corporations*

Percent intervals	Frequencies	Cumulative frequencies	
		More than—	Less than—
0 to but not including 10	0	133	0
10 to but not including 20	4	133	4
20 to but not including 30	7	129	11
30 to but not including 40	14	122	25
40 to but not including 50	18	108	43
50 to but not including 60	25	90	68
60 to but not including 70	7	65	75
7 to but not including 80	16	58	91
80 to but not including 90	5	42	96
90 to but not including 100	15	37	111
100 to but not including 110	22	22	133
Total corporations	133		

Average per corporation: Arithmetic average, 64.8; median, 55.4.

CHART 9

PERCENTAGE DISTRIBUTION OF VOTING STOCK OWNERSHIP OF FIVE LARGEST STOCKHOLDERS.

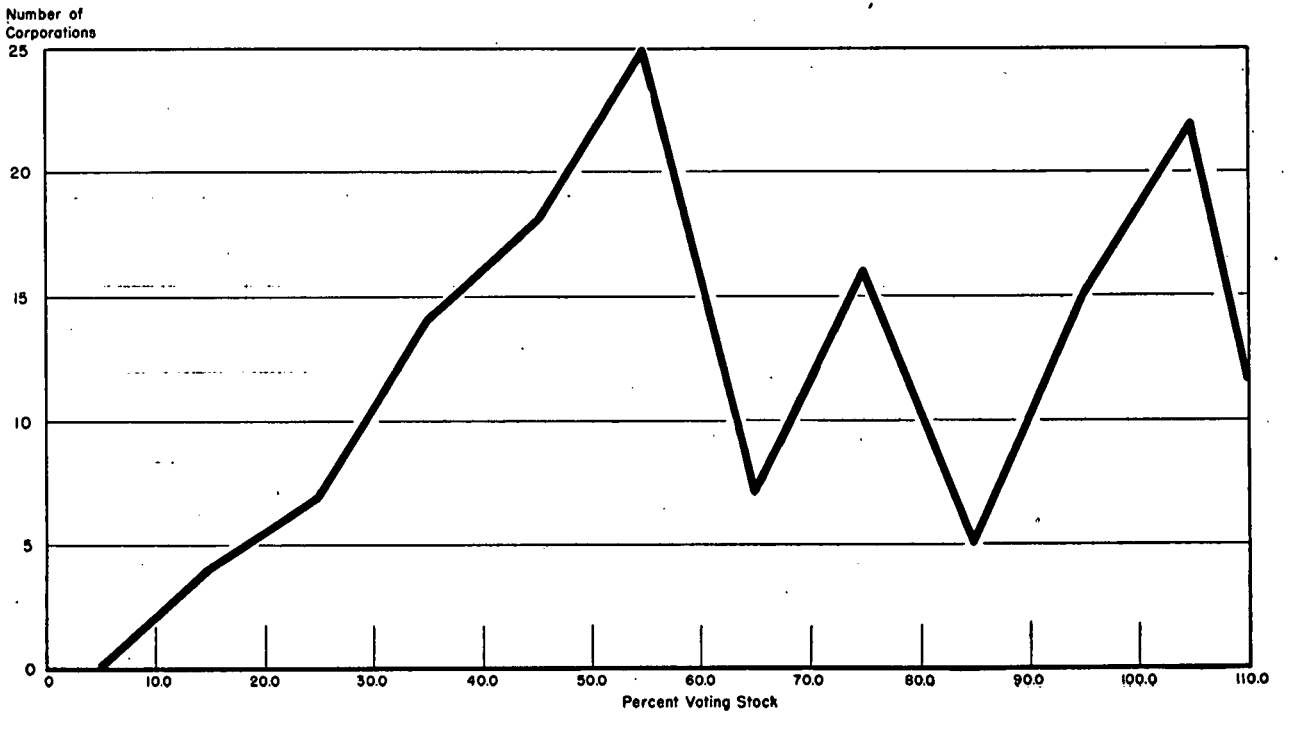
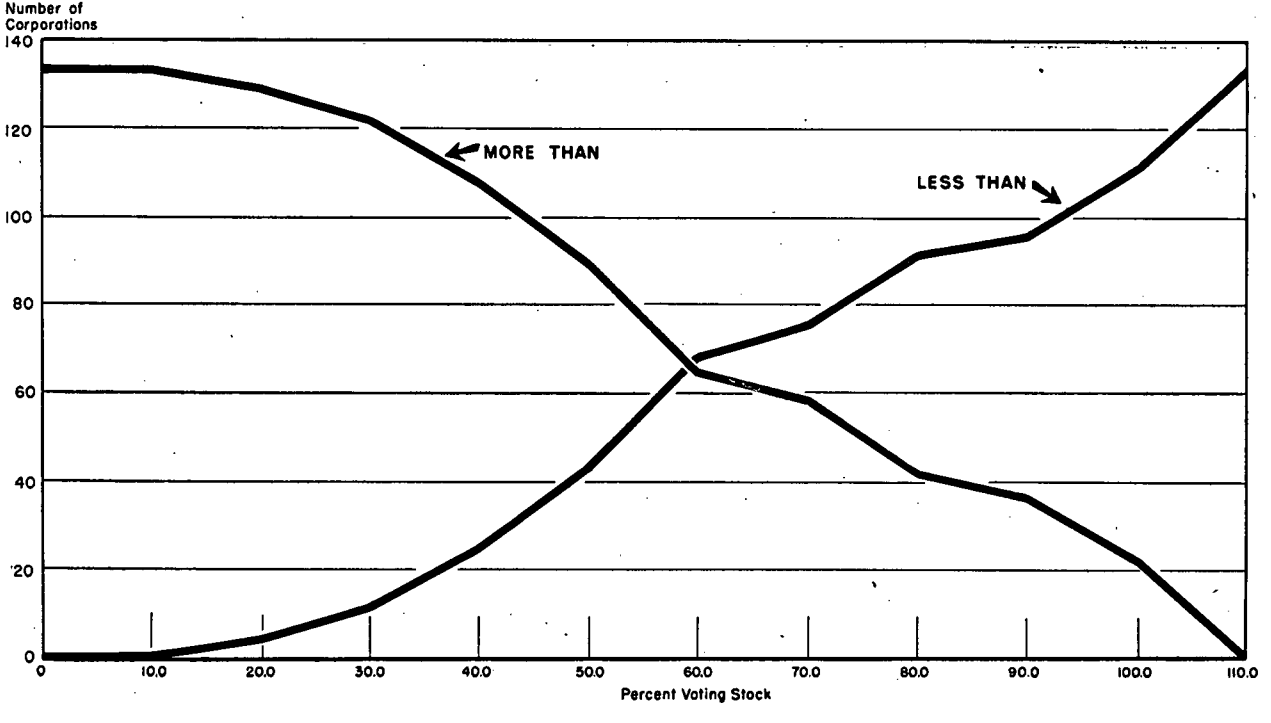


CHART 10

CUMULATIVE DISTRIBUTION OF VOTING STOCK OF FIVE LARGEST STOCKHOLDERS.



Corporations reporting the amount of posttax net income retained (and distributed) were 115 of the 140 respondents. Retention of net income was shown for the individual years 1946, 1947, and 1948. The average (arithmetic) retention of net income per corporation, averaged for the 3-year period, was 47.9 percent; the median, 46.2 percent. For these corporations, therefore, a little over half—i. e., average 52.1 percent and median 53.8 percent—of posttax net earnings was distributed in dividends on the average over the 3-year period. As noted in the table below, only 28 corporations retained on the average less than 30 percent of posttax net earnings, with 87 retaining 30 percent or more; 21 corporations retained 70 percent or more; and 3 corporations retained 100 percent. With 87, or 75.6 percent, of the respondents retaining 30 percent or more of posttax net income on the average, earnings retention for the group as a whole was substantial.

TABLE 10.—*Average percent of net income retained, distribution in 115 corporations*

Percent intervals	Frequencies	Cumulative frequencies	
		More than—	Less than—
0 to but not including 10	4	115	4
10 to but not including 20	10	111	14
20 to but not including 30	14	101	28
30 to but not including 40	19	87	47
40 to but not including 50	17	68	64
50 to but not including 60	10	51	74
60 to but not including 70	20	41	94
70 to but not including 80	10	21	104
80 to but not including 90	5	11	109
90 to but not including 100	3	6	112
100 to but not including 110	3	3	115
Total corporations	115		

Average per corporation: Arithmetic average, 47.9; median, 46.2.

CHART 11

DISTRIBUTION OF AVERAGE PERCENT OF NET INCOME RETAINED.

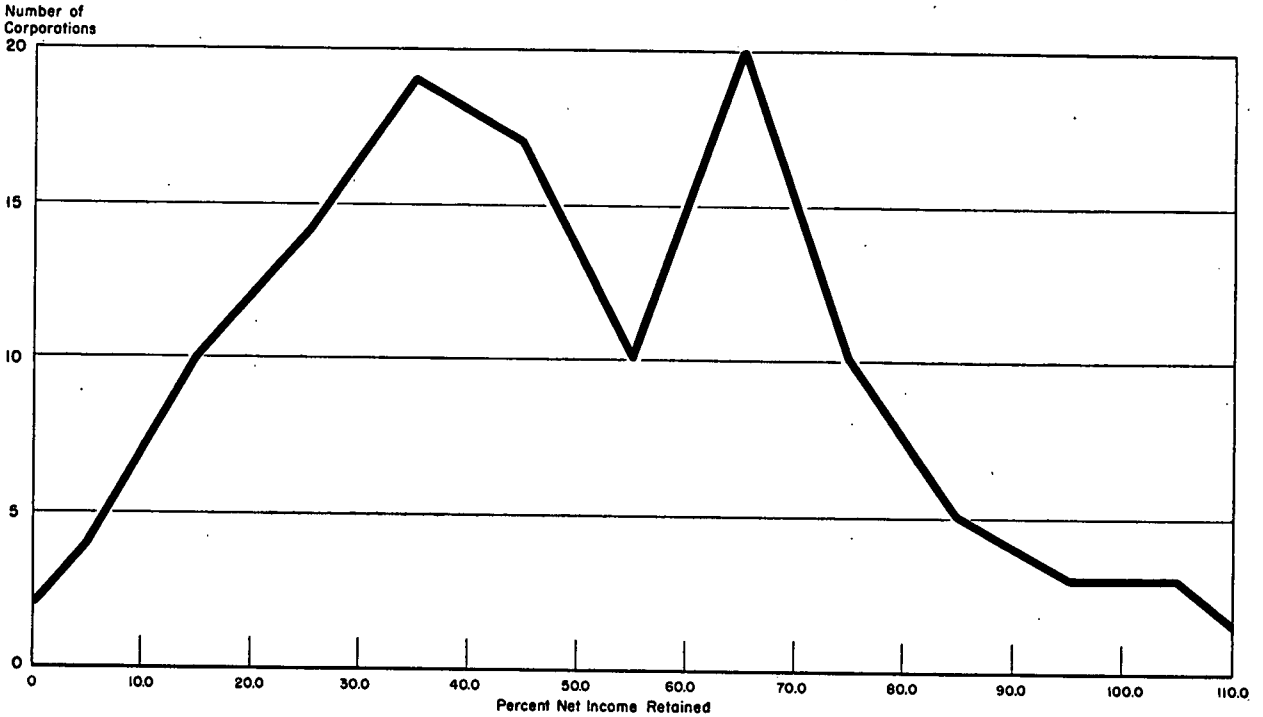
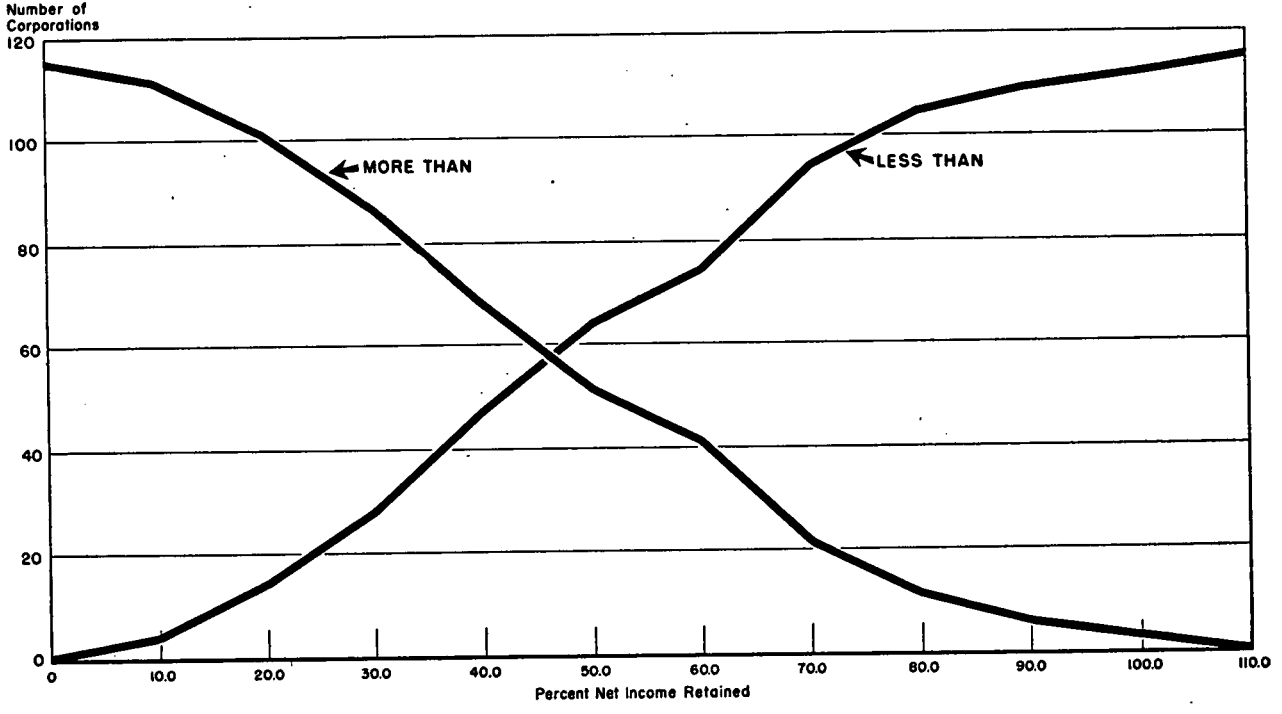


CHART 12

CUMULATIVE DISTRIBUTION OF AVERAGE PERCENT OF NET INCOME RETAINED.



Of the 140 corporations replying to the questionnaire, 139 answered the question:

Has section 102 caused your corporation to distribute a larger proportion of current earnings in dividends than would otherwise have been done?

The respondents were asked to give a "Yes" or "No" answer to the question for the years 1946, 1947, and 1948. The corporate response to the forcing effect of the section on corporate dividends was as follows:

Group	Number of respondents	1946		1947		1948	
		Yes	No	Yes	No	Yes	No
A	25	3	22	5	20	5	20
B	29	2	27	3	26	4	25
C	64	[1] 16	[1] 47	20	44	15	49
D	21	1	20	1	20	1	20
Total	139	22	116	29	110	25	114

[1] 1 respondent did not reply for 1946.

The total number of replies for the 3-year period was 416, of which 76, or 18 percent, were in the affirmative, and 340, or 82 percent, were in the negative. The forcing effect of section 102 dividendwise is thus of some significance when, on the basis of this sample, approximately one out of five corporations states that it is a factor directly causing the distribution of larger dividends than would otherwise have been paid. That section 102 has been given thoughtful consideration by many corporate officers in reaching decisions on dividend policies is further indicated by the differential impact by years of the section on the same corporation.

TABLE 11.—*Corporations differentially affected by sec. 102 re distribution of larger dividends*

Corporation	1946	1947	1948	Corporation	1946	1947	1948
A-1	No	Yes	Yes.	C-2	Yes	Yes	No.
A-2	No	Yes	Yes.	C-3	No	Yes	No.
B-1	No	Yes	No.	C-4	Yes	Yes	No.
B-2	No	No	Yes.	C-5	Yes	No	No.
B-3	No	Yes	Yes.	C-6	No	Yes	No.
B-4	No	No	Yes.	C-7	No	Yes	Yes.
B-5	Yes	No	No.	C-8	Yes	Yes	No.
C-1	No	Yes	Yes.	C-9	No	Yes	Yes.

Of these 16 corporations, 5 were influenced by the section to pay larger dividends in 1946, 11 not; 12 were so influenced in 1947, 4 not; and 8 were so affected in 1948, 8 not. Corporations which consistently paid larger dividends by reason of the section for each of the 3 years were 17 in number.

Question 2 was designed to obtain information regarding the corporate disposition of earnings. The question was as follows:

Of corporate earnings after taxes during the past 3 years (1946–48), approximately what percent was used for the following purposes: (*a*) building up liquid reserves, (*b*) plant additions, betterments, and inventories, (*c*) purchase of other corporate stocks (common and preferred), (*d*) purchase of assets of another corporation, (*e*) dividends, and (*f*) debt retirement and retirement of preferred stock?

The following disposition of earnings over the 3-year period was indicated by 139 respondents:

	Number of corporations		Total respondents
	Yes	No	
Disposition of earnings:			
(a) Building up liquid reserves	56	83	139
(b) Plant additions, betterments, and inventories	112	27	139
(c) Purchase of other corporate stocks (common and preferred)	13	126	139
(d) Purchase of assets of another corporation	8	131	139
(e) Dividends	109	30	139
(f) Debt retirement and retirement of preferred stock	50	89	139

The above uses of corporate earnings were not individually exclusive. As would be anticipated, posttax corporate earnings were split up among a number of end uses by the great majority of the respondents. The three-way combination of end uses in rank order were as follows:

1. Plant additions, betterments, and inventories plus dividends plus building up liquid reserves.
2. Plant additions, betterments, and inventories plus dividends plus debt retirement and retirement of preferred stock.
3. Plant additions, betterments, and inventories plus dividends plus purchase of other corporate stocks (common and preferred).
4. Plant additions, betterments, and inventories plus dividends plus purchase of assets of another corporation.

Twenty corporations adopted a four-way combination of end uses in employment of earnings, namely, plant additions, betterments, and inventories plus dividends plus building up liquid reserves plus debt retirement and retirement of preferred stock.

The two corporations splitting up corporate earnings among more than four end uses made the same selection of dispositions, namely (*a*), (*b*), (*c*), (*e*), and (*f*).

Corporate percentage distribution of earnings to the indicated end-uses varied widely, as would be expected.

End uses of corporate post tax earnings:	*Percent range corporations adopting end use (3-year period)*
(a) Building up liquid reserves	2.0– 73.8
(b) Plant additions, betterments, and inventories	1.8–100.0
(c) Purchase of other corporate stocks (common and preferred)	.2– 31.0
(d) Purchase of assets of another corporation	2.0– 70.0
(e) Dividends	1.0–100.0
(f) Debt retirement and retirement of preferred stock	2.6–100.0

Question 3 was as follows:

During the past 3 years (1946–48, inclusive) to what extent, if at all, has section 102 adversely affected: (*a*) Any contemplated program of corporate expansion; (*b*) the self-financed growth of your corporation; and (*c*) the accumulation of a sufficiently large liquid earned surplus for prudent hedging against future contingencies?

All respondent corporations (140) replied to this question. Those replying in the affirmative frequently had explanations or comments

indicating why or how they were affected. A tabular summary of responses to the question is presented below.

	Corporate responses		Total
	Yes	No	
Has sec. 102 adversely affected—			
(a) Any contemplated program of corporate expansion	20	120	140
(b) The self-financed growth of your corporation	24	116	140
(c) The accumulation of a sufficiently large liquid earned surplus for prudent hedging against future contingencies	33	107	140

Corporations affected by one or more of the above-noted adverse effects were, roughly, 1 out of 5. The total affirmative response was 18.3 percent. Adverse effects, in terms of the number of affirmative replies, were, first, as a barrier to the accumulation of a sufficiently large liquid earned surplus to protect against contingencies; second, as a restraint upon self-financed corporate growth; and, third, as a limiting factor on contemplated programs of corporate expansion.

Some of the more significant comments by corporate officers who reported that section 102 had interfered with "contemplated programs of corporate expansion" were as follows:

* * * indefinite and fearsome penalties under section 102 required such distributions.

High construction and equipment costs and the distribution of over one-third of earnings impelled in part by policy in view of possible penalty tax of section 102, has deferred proposed expansion.

In 1947 and 1948, we gave considerable thought to passing dividends and building up our cash for an expansion program. Several reasons deferred this action, among them was the effect of section 102.

Due to the fact that agent looks backward to see if plans are accomplished in the year earnings are retained, the company could not undertake a long-range program.

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* * * Section 102 has caused the directors to distribute out in dividends funds which otherwise could and would have been used for such purposes.

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* * * making it necessary to spend earnings each year instead of accumulating cash reserves to take on good development properties when offered.

Adversely affected the year 1946 because a larger dividend was paid than should have been in view of subsequent borrowings.

We have paid larger dividends thus reducing amount for expansion.

Section 102 has a tendency to hold down a corporation's cash reserve to a minimum.

The company had extensive plans for expansion but this section together with labor conditions has produced a psychological restiveness that has hampered intelligent planning.

* * * * * * *

I think you will find the consensus of opinion among smaller companies, if they will speak frankly, is that section 102 has disrupted and demoralized their future planning.

Although unexpanding in the years indicated, the company wanted to use earnings of those years to modernize and improve its machinery and equipment so as to maintain its position in the industry and to replace or renew machinery worn by continuous wartime operation. In part because of uncertainty of the status under section 102 of reserves for sincere but undetailed future programs, the company was not willing to set up such general reserves but ordered specific items at that time and set up reserves only for actual commitments. Under the escalator clauses existing in these contracts, the company was forced to pay higher prices and spend many thousands of dollars that could have been saved had we felt safe to wait for acquiring such new equipment under more stabilized conditions.

The presence of possible penalties provided in the law requiring immediate action in the matter of the distribution of funds, as against the inability to formulate and put into practice with like promptness the plans for which the funds might be used in corporate expansion, and the fact that these plans must have been contemplated at the end of the respective year, are conditions which militate against the accumulation of funds for any well-considered program of corporate expansion.

Present space inadequate for requirements. Contemplated constructing new building when materials available. Also replacing some equipment which it was not possible to do during war years. Therefore, would have paid less dividends, with the view of retaining larger percentage of earnings for contemplated expansion.

We felt we would be justified in paying less dividends to retain larger percentage of earnings for proposed expansion. However, as (due to conditions) we could not actually start expansion program, we did not know whether the Treasury Department would, in the event we reduced or eliminated dividends, correctly interpret our motive.

We would like to build a pattern shop, air-condition the office building, purchase a crane, and set up a pension plan for our employees.

We have limited our expenditures to needs for actual business. We considered it too hazardous to contemplate new fields of expansion.

We are in a very competitive market. To obtain maximum efficiency, the company has been talking of building a new plant. The additional dividends paid in 1947 and 1948 should have been retained for the new plant.

To be on the safe side, we never put any funds aside for expansion, only kept an estimated amount of earnings for increase of business.

Comments of respondents on section 102 as a curbing influence on self-financed corporate growth:

Precluded any addition of new departments.[60]

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[60] This respondent had been subject to a sec. 102 deficiency assessment for the years 1946 and 1947.

If we had decided to pass dividends and expand our plant, our financial position might have been jeopardized had we been assessed under section 102.

Section 102 caused investment in assets at inopportune time (1946) and borrowing in later years.

On several occasions the company has found itself unable to proceed with major capital transactions, since it did not feel justified in incurring large bank indebtedness for that purpose or resorting to other outside financing and was uncertain of its ability to finance such transactions out of earnings in view of section 102.

Through the limiting of oil exploration and development work to supply crude oil for the refinery.

Lack of operating capital has hindered the normal growth of the company in keeping with the current progress of the trade.

The management always has thoughts for elaborating of departments, building additions, replacing machinery, purchasing new dies, etc. These thoughts are for long-range expansion, and it has to consider section 102 in these cases.

There has been no inclination to invest one's personal funds with so much of Government control.

It has made necessary several moderate bank loans.

The replacement and expansion program has had to be timed based upon projected excess earnings over dividends augmented by current borrowing.

Slowed growth some, as we paid out some cash in dividends which would have been used for expansion when war scarcities ended.

Dividends disbursed in 1946 and 1947, as the result of section 102, were higher than our cash position could carry, necessitating long-term borrowing in 1947. We also considered at the time of the borrowing that it would not be possible in future years, in view of section 102, to increase our cash position to meet our requirements.

We have had to limit our growth to what we considered to be well within safe limits.

It was necessary to sell additional stock to the stockholders in order to finance the increased business and future expansion.

Respondents made the following comments regarding the accumulation of a sufficiently large liquid earned surplus for prudent hedging against future contingencies as restricted by section 102.

If earnings continue at same level as in the past few months of 1949, we will be unable to pay any dividend during 1950. It has been our policy to use earn-

ings accumulated during good years to pay dividends during poor years. Under section 102, we have been unable to retain sufficient earnings to pay dividends during poor years.

Please note the substantial decrease in liquid reserves indicated under item 2 (a), above. [Liquidity decreased equivalent to 41 percent of posttax earnings for 3-year period.]

We are comparatively a new company and have not been able to build a large cash reserve due to the impact of income taxes on our earnings. Section 102 did influence us in our decision to continue the payment of dividends.

(Except for sec. 102) believe the company would and should have retained a larger share of its earnings to provide for plant expansion, increasing costs, periods of lowered sales, and other contingencies.

While we do not believe that section 102 will apply to our company, there is always a tendency to pay more in dividends, on account of this section than might be warranted in considering the future prospects of our business which is subject to severe cycles.

Extra dividend was declared in 1946 when cash should have been retained to help finance later expansion and working capital requirements.

Have paid dividends when business prudence would have dictated conservation of earnings.

We would have had larger funds for our contemplated building expansion program, whereas, as we now stand, we must resort to borrowing.

One either spends earnings or pays dividends. Taxpayers dare not rely on the so-called 70 percent rule of thumb.

The company suffered an almost disastrous experience in the 1930 depression. It would like to become as liquid as possible as a contingency against a possible recurrence of such a condition. The fear of the application of section 102 tends to force the disbursement of greater dividends than prudent judgment would indicate.

The company has always felt that the influence of section 102 has caused it to reduce its liquid earned surplus below the level advisable for a business of its size, particularly in view of the ever-present threat of strikes, forest fires, pension-plan demands, and the wide variations in prices which are characteristic of the lumber industry.

As shown on the first page, we have a deficit in liquid assets. Since 1945 our sales volume has doubled, and for this reason it has been necessary to reinvest most of our earnings in the business. Our accounts receivable are abnormally low for the volume of business we do, because practically all our customers are able to discount their purchases at this time. Our company should liquidate most of its bank loans, or invest several hundred thousand dollars in marketable securities to provide for the receivables we will have to carry within the next few years. Because of the possibility that the taxing authorities would impose

section 102 we have been afraid to do this, and have felt that we must invest retained earnings in less liquid assets.

It has been necessary for the company to operate in a large measure on bank loans during this period. [Because of payment of overlarge dividends.]

Large dividends have reduced liquid assets.

Again in part because of uncertainty of the status under section 102 of reserves for indefinite but reoccurring cyclical trends in our industry, we felt it unwise to set up adequate reserves in 1946–48 for general contingencies. As a result, company has had to resort to short-term borrowings far in excess of any previous peacetime operation.

Funds that ordinary prudence would dictate retaining for eventual plant modernization have been paid out as dividends, despite actual and anticipated declines in earnings of succeeding years.

May have caused expansion in plant facilities and capital expenditures which might better have been retained for contingencies or longer-range planning. Only the future can determine if our judgment has been correct.

The company has not been able to maintain a large enough excess of current assets over current liabilities and at the same time pay reasonable dividends and pursue the necessary expansion program. This is evidenced in a closely operated company by the current ratio of 1.79 to 1. Present plans look toward the improvement of this ratio as we do not feel that we have enough liquid surplus for the size of the company.

Our business is of a nature that a reduction in production will show large losses. We would prefer to retain a larger share of profits to protect the firm against these losses.

Yes; an important contingency could occasion serious difficulties.

Don't think we have been prudent enough. The dividend payments have been too large for conservative management. These dividend payments made to avoid penalty under section 102.

A small amount of liquid surplus has been accumulated as a hedge against the future but this might have been larger (in 1949 especially) if section 102 had not existed.

The title insurance industry may be classified as one entirely dependent on the real estate market which follows definite cycles. To provide against lean years it is necessary to depend on net income reserved from more prosperous periods to tide over those which are below standard. Operations must continue even at a loss over long periods of time if the industry expects to remain in business. Our entire net income carried to surplus during the years 1946, 1947, and 1948 would be just about enough to meet our operating expense for one year. Had it not been for profits reserved during the years 1924, 1925, and 1926, this company

could not possibly have survived the depression of 1930 to 1934. Because of section 102 we were compelled to pay larger dividends during the years 1946, 1947, and 1948 than good business judgment dictated. We should have reserved larger sums during those years to carry us over the next cyclical depression.

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* * * many of our tenants under pressure of section 102 have negotiated purchases of their leaseholds. A business recession in the next few years will show that some of them have been imprudent in using their funds for this purpose.

Question 4 queried as follows:

Has the possibility of section 102 liability caused your corporation to buy other corporate securities or corporate assets which otherwise you would not have done during the past 3 years?

All 140 respondents replied to this question, of whom 138 said "No," with 2 "Yes." One, of the 2 replying in the affirmative, stated that machinery and equipment had been purchased; the other reported the acquisition of buildings and equipment. On the basis of these responses, the influence of section 102 in impelling the purchase of other corporate securities or assets appears negligible.

Question 5 was as follows:

During the past 3 years (1946 to 1948, inclusive), has section 102 caused your corporation to make ill-timed investments in assets or to enter the market for equipment and supplies under unfavorable circumstances?

The total number of respondents replying was 140, of whom 128 said "No" and 12 "Yes." Some of the comments of those replying affirmatively were as follows:

Portion of expansion program might have been delayed to such time as costs would be favorable.

Completed a plant improvement program in shorter period than good business judgment would have indicated.

We desired to expand after the war, but were afraid to retain cash and other liquid assets because of the threat of section 102. We therefore entered the market for capital assets in 1946, even though we were aware that prices were too high and other conditions such as labor supply, were extremely unfavorable. We opened three manufacturing plants and many stores. Had we been able to wait until 1948 to effect our expansion, we probably could have avoided heavy outside financing.

During the years 1946–48 our company spent $400,000 for buildings and equipment. We believe that costs will be lower within a few years, and many of these improvements could have been postponed. Since most of our earnings were retained, we believe that our defense against section 102 liability would be weak if this money had been invested in liquid assets such as cash or marketable securities. For this reason money was invested in high-cost buildings and equipment that we believed could be procured at lower cost in the near future.

Yes; some undeveloped leases were acquired and dry holes drilled thereon which might not have happened had it been possible to adequately investigate these properties before drilling and if not necessary to spend earnings in a given year.

Yes. Our business is women's full-fashioned hosiery. Since we could not get the full-fashioned equipment we wanted immediately after the war we tried women's seamless and took a 75-percent loss on $60,000.

Yes; this company felt obligated to spend money for improvements when market was excessive high in order to avoid penalty from section 102.

Possibly at too high prices.

We have increased our inventory in the last 3 years.

Yes. Postwar increased costs are effected.

With some 8.6 percent of the corporate respondents asserting that the section was instrumental in causing ill-timed investments to be made, the influence of section 102 in this respect is not unimportant.

Question 6 raised the following query:

Is your corporation (by reason of cost, unavailability, or corporate policy) completely dependent in fact on internal financing of fixed assets in corporate expansion?

Respondent replies to this question are summarized below:

Reasons for complete dependency on internal financing of fixed assets

No		60
Yes		79
Cost	3	
Unavailability	2	
Corporate policy	19	
Unclear or not stated	55	
Total replies		139

As will be noted above, a majority of the respondents, 56.8 percent, indicated a complete dependency on internal financing of fixed assets. Of the reasons cited, corporate policy, rather than cost or unavailability of external funds, was the most important. Considering the asset size of the corporate respondents, it is surprising that such a large proportion (43.2 percent) was admittedly able to finance fixed assets through procurement of external funds, and, presumably, did not find such financing objectionable from the point of view of cost and possible dilution of control (if resort were to equity financing).

Question 7 was as follows:

Has the fact that the Treasury is permitted 3 years to make a final determination on your return as to the application of section 102 affected the timing and amount of corporate investment or caused a larger dividend distribution than would have occurred if your return were subject to earlier closure?

Of the 140 respondents, 138 replied to the question. The replies were as follows:

No	108
Yes	30
No answer	2
Total respondents	140

The 3-year period permitted the Treasury to make a final decision (assuming no waiver of statute of limitations by subject corporation) apparently has a real influence on the timing and amount of corporate investment and/or dividend distribution judging from the replies of respondents. Of the 138 responses, 30, or 21.7 percent, were in the

affirmative. The time interval of statutorily permissable hindsight afforded the Treasury (apart from taxpayer waivers) is itself a factor adding to corporate fear and uncertainty, influencing, apparently, a greater degree of caution in the uses to which retained earnings are put—particularly tending to minimize the level of corporate liquidity.

Comments of respondents asserting that corporate policy was affected by 3-year interval:

In our case, the needs for capital investment have been so pressing as to force proceeding therewith and invading current position to finance the same and pay dividends. The uncertainties and delays surrounding possible imposition of section 102 taxes have caused considerable apprehension. We feel Congress would act most constructively in more clearly defining its intent rather than leaving application of section 102 to judgment or whim of Bureau officials.

It would have been helpful to have been able to know Treasury Department policy in respect to section 102 promptly in respect to dividend policy, and especially so in 1947 which year it will be noted there was an unusually large dividend distribution caused by lack of such knowledge.

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* * * extra dividend might have been passed or reduced.

Yes; our business ordinarily seasonal but following war production—profits abnormal. We had to guess how soon we would be back to normal. We guessed wrong.

Yes. We do not know our position in regard to section 102 promptly enough.

Directors of the corporation have to guess as to the future prospects to the best of their knowledge and belief. The Treasury has the advantage of hindsight when they examine the returns. There is no such thing as a 3-year limitation on examiner's returns. If the Treasury Department does not get around to examine the returns within the 3-year period, they ask for an extension of time and one is practically forced to give an extension or they put on an arbitrary assessment which must be paid. You then have to sue for a refund which would take several years. During the 3-year period, or any extension thereof, this section 102 hangs over the head of every corporation.

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* * * we felt that section 102 was an ever-present threat and the longer the period of determination permitted to the Treasury the greater the need to endeavor to keep pace with the dividend distribution requirements.

Here section 102 forced a corporation, such as we are, to follow through immediately with a contemplated expansion program, even though conditions become unfavorable, or to distribute those liquid assets previously reserved for expansion, rather than hold off for a more favorable year for expansion which might be more than 3 years hence.

Yes; particularly since it is a common Bureau practice to ask for extensions of the 3-year time limit on audits. In this company's case all years from and including 1945 are still open. The cumulative risk of section 102 is a serious deterrent to long-range corporate planning.

Earlier closure of possible 102 liability would be a big help but a reasonable time after finding of liability to make distribution without penalty would be more helpful.

The delay on the part of the Treasury definitely affected the year 1946 in that this question was put in the Federal tax return, and we did not know what the attitude of the Government would be.

More prompt examination of our records by the Treasury Department and of their thoughts on section 102 would tend to give the management a more definite program to follow.

Yes; our accountants have continually cautioned us and worried us about section 102.

Yes; other than dividend. Company has felt smaller corporations more seriously hurt by this section than larger companies, who have borrowing ability for payment of dividends which small companies can never have.

The 3-year limitation is just one more added disadvantage.

Yes; under section 102 management does not have benefit of hindsight.

Management must make its decisions currently in the light of current knowledge, and frequently without accurate information about the year's earnings. It must guess the future in evaluating "prudent hedging against future contingencies." Three years later the future has become history. At that point it is easy for the tax authorities to show when mistakes have been made. Motives are judged chiefly by results. Successful defense becomes practically impossible.

Yes; because we did not feel that we could take the chance of having some administrative official decide in his infinite wisdom that we should have distributed a larger percentage of our earnings than we did. Therefore, we tried to play safe, even if it required distributing a larger amount than we thought was proper.

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* * * Section 102 has caused us deep concern and we always face the possibility that the Commissioner of Internal Revenue will open the question on a past year. It is well known that section 102 acts as a deterrent to corporate growth and expansion.

Yes; we felt we would be justified in paying less dividends to retain larger percentage of earnings for proposed expansion. However, as due to conditions, we could not actually start expansion program; we did not know whether the Treasury Department would, in the event we reduced or eliminated dividends, correctly interpret our motive.

It takes us time to accumulate funds for future expansion of our plant. It would not be fair to let each year to stand by itself, because money is accumulated before it is spent for plant expansion.

Naturally this is a hazard which is constantly being considered. It is impossible, however, to cite any one example.

Yes; has caused larger distribution of dividends in order to avoid accumulated penalties under section 102.

Definitely. Our fixed assets (title plant) is valued at considerably in excess of replacement cost, but since such plants are not allowed depreciation or obsolescence, we are unable to reduce its book value to true value except by a direct charge to surplus which action would reduce that amount to a point we dare not risk. We are making moderate charge-offs each year but the amount is far too small. If section 102 had permitted, practically our entire net income, except for a moderate dividend, would have been applied to the reduction of plant.

* * * * * * *

We have just signed a waiver of examination of our 1946 tax return. In 1951 when it is examined there may be a new Commissioner with a different interpretation of the law and in the meantime we can only wait and hope that we have not violated the provisions of section 102.

Comments of respondents stating that corporate policy is uninfluenced by 3-year interval:

No; do not believe that it has. For your information, our tax returns have not been audited since 1943 so that, at this writing, we have 6 years of unaudited tax returns, with the resulting potential tax liability. We have given waivers postponing the tolling of the statute on the years 1944, 1945, 1946. In the year 1949, we suffered severe damage from the flood and, as a result, reported a loss for 1949, and have filed a "quicky claim" for a carry-back against profits in 1947. Our local agent has agreed to audit all back years.

No; earlier closure would not help unless determination could be made before the end of the year.

No; as our situation has been such that we did not feel S. 102 was applicable. We have been under constant pressure to expand plant facilities and clearly needed most of our earnings for expansion and working capital.

No; however, if some time in the future we were able to accumulate more working capital than we needed for the amount of business done, the judgment of the directors as to dividend policy, based on the facts then available, might appear wrong to a revenue agent after 3 years, when business conditions might be entirely different. It is always easier to evaluate the correctness of decisions after some years have passed than at the time they are made.

No; because the company has tried to make its dividend policy realistic and factual dependent upon its actual needs, and thoroughly believes that a reasonable department of the Government will understand a position of this kind in an independent company.

No; although we have taken some considered risks.

No * * * But, had we not been so clearly short of working funds for the continuance of our historic and immediate corporate purposes, it would have

had a real effect. While we might have felt justified in retaining earnings because of fear of another major depression, because we might wish to extend our activities to other sites or to other cities, or because we might have felt confident of securing a large volume of business from the large number of negotiations under way at the close of the year, we would not have dared to. We would have known that we were not prophets; that hindsight is better than foresight and that when the revenue agent looked at our return he would judge us in the light of what had actually happened during the next 5 (not 3) years that followed and not on what we thought was going to happen on December 31 of the year in question.

I would say "No" as to this, but if we had considered that section 102 had applicability to our operations in the years under review, I believe a corporate management might logically be inclined to try to follow a "safe" policy rather than a "sound" policy because of the possibility of being "hooked" under section 102.

Question 8 asked respondents:

Do you believe there is any better way to prevent avoidance of personal surtax than by using section 102 in its present form? (If you believe that a change is desirable, please indicate the nature of the change or revision and your reason or reasons in support of it.)

Answers to the question were as follows: Nineteen respondents said "No"; 68, "Yes." Respondents who stated they had "no opinion" numbered 14, and 39 failed to answer the question. Many, possibly all, of those not answering the question probably knew of no better way to prevent avoidance of personal surtax than continued use of section 102 in its present form; similarly, those who stated they had "no opinion." Should these respondents be included with those who answered "No," the negative responses would total 72 as against the 68 affirmative replies. On the other hand, if the positive responses only are taken, 68, or 78.1 percent, of the 87 replies were in the affirmative. One of the more significant and interesting aspects of the replies to the question was the unexpectedly large nonaffirmative response.

Of the 19 respondents replying in the negative, 1 commented upon the undesirability of the double taxation of dividends; 1 believed that section 102 was open to serious abuse by inexperienced or prejudiced internal revenue agents, although satisfactory if properly administered; and 1 thought the section was probably necessary to protect against excessive concentrations of capital. Comments of some of these respondents are reproduced in appendix 3.

All but one of the respondents giving an affirmative answer indicated the change or revision which, in their individual judgments, should be made with respect to section 102. The suggested changes or revisions in rank order were as follows:

Proposed change or revision of section 102

	Number of respondents
1. Total or partial exemption of dividends from individual tax which would render section 102 unnecessary and permit its elimination	15
2. Repeal of section 102 because it limits corporate growth and/or because intent to avoid surtax by corporate retention of profits is rare	12
3. Explicit expression of congressional intent re section 102 and the provision of specific standards in section application	5
4. Dividends paid deductible by corporation in computing corporate income tax	5
5. Shift burden of proof to Commissioner	4
6. Shift burden of proof to Commissioner; section 102 tax to apply only to that portion of retained earnings unreasonably accumulated	3

Proposed change or revision of section 102—Continued

	Number of respondents
7. Tax (corporate) paid by corporation on distributed earnings to be allowed as credit to individual on personal tax	2
8. Section 102 should be limited to closely held corporations where 1 stockholder owns 20 percent or more of voting stock and/or officers and directors 50 percent or more of voting stock	2
9. Exempt from section 102 surplus accumulations for 5 years	1
10. Shift burden of proof to Commissioner; apply section 102 only to companies where officers and directors own majority of voting stock	1
11. Application of section 102 should be restricted to closely held companies	1
12. Have a maximum tax of 25 percent on corporate dividends	1
13. Overhaul entire corporate tax program	1
14. Substitute an undistributed-profits tax for section 102	1
15. Administration of section 102 by Bureau objectionable; Bureau should render opinion and corporation should then be permitted to take steps to avoid the penalty tax	1
16. Burden of proof on Commissioner; 1 year statute of limitations; statutory immunity from section 102 if 50 to 60 percent of earnings distributed	1
17. Exclude all operating companies from section 102; allow 45 days after determination of section 102 surtax liability for payment of dividends without penalty; provide for payment of dividends of 50 percent from current earnings before application of section 102	1
18. Special consideration to small and growing corporations under section 102	1
19. Exempt from section 102 corporations with combined capital and surplus under $1,000,000	1
20. Make dividends taxable as a long-term capital gain	1
21. Shorten statutory period for section 102 deficiency assessment	1
22. Liberal interpretation by Bureau of section 102	1
23. Benefits of net loss carry-back and carry-over should be applicable to section 102 computation of surtax; also subsequent dividends within 90 days a credit in section 102 surtax computation	1
24. Section 102 should permit accumulation of earnings for reserves for future expansion, unprofitable years, and employee pension plans	1
25. Reduce Government expenditures—this would permit repeal of section 102	1
26. Exclude small operating companies from section 102	1
27. Permit application to Bureau for exemption from section 102 with prompt Bureau decision; section 102 should be implemented with specific rules	1
Total	67

The detailed suggestions of respondents as to the recommended change or revision of section 102 are found in appendix 3.

Question 9 was as follows:

Has your corporation been subjected to tax assessment under section 102? If so, please give year or years; amount of section 102 tax assessment; and amount of tax paid.

All respondents answered this question, with two stating that they had been subject to deficiency assessments under section 102.

Years of deficiency assessments	Respondents	Amount assessed	Amount paid
1946 and 1947	1	$15,694	$15,694
1935 and 1936	1	273,095	126,731

On the basis of the sampled corporations, section 102 has had a very limited impact as found in the number of corporations subject to the surtax application, i. e., 1.4 percent. Its importance, therefore,

as indicated by this sample, is not to be measured in terms of the number of corporations subject to deficiency assessments or the amount of revenue collected, but rather the extent to which corporations were influenced in number and in degree to pursue policies in the retention or distribution of earnings designed to forestall and prevent possible liability under the section.

The statements contained in the questionnaire came from the following corporate officers whose signatures appeared thereon.

Title of respondent corporate officer:	*Number*
Chairman, board of directors	1
President	42
Vice president	10
Secretary or assistant secretary	20
Treasurer or assistant treasurer	51
Controller	12
Auditor	1
Accountant	2
Attorney	1
Total	140

It appears that the respondent officers, judging from their corporate responsibilities, were, in the main, capable of appraising the influence of section 102 on corporate policy. The majority of such officers, in the small and medium-sized corporations included in the sample, probably had direct participation in corporate planning and policy formulation.

Summary

On the basis of respondent replies to the questionnaire of the Tax Institute, The Brookings Institution, and the Joint Committee on the Economic Report of the Congress, the following conclusions with respect to the impact of section 102 on taxpayer corporations appear to be warranted:

1. A significant proportion [61] of private profit-making corporations find section 102 a matter of serious concern, and have their dividend, real investment, and liquidity policies affected by it. The very small private corporations (assetwise) and, of course, small-profit, nonprofit, and debt-burdened corporations apparently have little or no interest in the section; this is likewise true of the large public corporations. Profitable corporations, small and medium-sized, which are very closely held and closely controlled are especially vulnerable and, hence, susceptible to its influence.
2. Corporations affected by the section cover virtually all types of business enterprise.
3. The forcing effect of the section comprehends real investment, as well as dividends, as alternatives to excessive corporate liquidity.
4. The section apparently stimulates more than it retards real investment.

[61] The Tax Institute questionnaire revealed that 56 percent of the represented corporations gave the section careful and/or intensive consideration. The Brookings Institution questionnaire indicated that 24.3 percent of the respondent corporations had their operations affected by the section; and the replies of respondents to the questionnaire of the Joint Economic Committee indicated that the section had a positive effect in forcing dividends for 18 percent of the reporting corporations, and, for 18.3 percent of the respondents, had adversely affected contemplated programs of corporate expansion, self-financed growth, and the provision of adequate contingency reserves.

5. The section appears to be a very limited though positive factor (for affected corporations) in business concentration (i. e., mergers and purchase of other corporate assets and corporate securities).

6. The section apparently influences corporations to reduce indebtedness (previously incurred), and to finance through debt rather than through equity (new financing).

7. Inventories, on balance, apparently are increased rather than decreased by the section.

8. The section has a positive forcing effect on corporate dividends as to timing and amount.

9. The section apparently has some influence in causing business enterprise to shift from the corporate form to a partnership or sole proprietorship.

10. The section tends to minimize corporate liquidities (the forcing effects on real investment and on dividends is largely at the expense of corporate liquidity).

11. The effect of the "immediacy" doctrine in the application of the section, on balance, seems rather to accelerate the formulation of corporate plans for expansion and their implementation than to retard corporate real investment.

12. The section has diverse (conflicting) effects on the corporations affected—it may induce plant expansion in one instance, retard it in another; cause one corporation to acquire the assets or securities of another, while preventing it in another instance.

13. The section is of importance in limiting in some degree the use of closely held and closely controlled profitable corporations as personal "savings banks" as a means of personal surtax avoidance. To the extent this purpose is accomplished, revenues from the individual income tax are protected, the burden of taxation is more equitably distributed (with reference to statutory intent), corporate real investment is stimulated and corporate hoarding is retarded, and disposable money incomes, i.e., dividend income, are somewhat greater than would otherwise be the case.

14. The section appears to be strongly cyclical in its effect in that, under the "immediacy" doctrine, it induces increased real investment and/or dividend distributions by the affected corporations during periods of economic recovery and prosperity, and, conversely, impairs corporate real investment and/or dividend payouts, because of reduced corporate liquidity, during periods of recession and depression.

15. Although the section is of vital concern to those corporations which are vulnerable, its net effect in raising the level of real investment and consumption for the economy as a whole, i.e., aggregate demand, appears to be of a minor order. Thus, it does not seem to exert an appreciable or an important inflationary and deflationary cyclical influence in its induced effects on the levels of aggregate demand.

CHAPTER IV

GENERAL ECONOMIC EFFECTS

The point of attack of section 102 is excessive corporate liquidity grounded in retained earnings. To the extent that the section is effective, liquidity, both for the particular corporation and corporations in general, is reduced. This repression of corporate liquidity compels corporate spending of funds on investment and/or on dividends beyond that which would otherwise occur in the current period. Although savings and investment for a past period are usually conceived as necessarily equal, they may not be in balance in the current period. Automatic adjustments in the level of the national income (money) accomplish an equating of savings to investment. If savings are currently redundant with respect to investment demand, the national income will decline; on the other hand, if investment demand exceeds the supply of savings derivable from the current level of national income and recourse is had to idle funds and/or bank credit, the national income will rise. Thus, although balance is achieved, the economy is subjected to the resulting deflationary or inflationary consequences attendant thereon.

The Level of Employment and National Income

Excessive current corporate liquidity represents more or less hoarding by the creation of idle balances, i. e., cash and securities, from the current income stream. Insofar as such corporate hoarding results from taxpayer efforts to avoid individual surtax, it comes under the purview of section 102. Excessive corporate liquidity arising from other than tax avoidance motivation, of course, is unaffected by the section. Judging from the past and current application of the section, it seems reasonable to conclude that its forcing effect is confined to a relatively small proportion of total corporate hoards or idle balances. Various reasons support this conclusion: First, the section has been applied almost exclusively to closely held and closely controlled corporations;[1] second, its enforcement by the Bureau apparently has varied over time and in its corporate coverage; and third, some vulnerable corporations apparently engage in open defiance of the section on the basis of a calculated risk, or in following the "sporting theory" of tax administration. Further, for individual taxpayers in the high surtax brackets, the combination of the penalty tax under the section plus the long-term capital gains tax results in a lower effective rate of tax than the effective marginal rate of personal surtax. Such taxpayers have everything to gain, except a short postponement in realization of income, in incurring section risk.[2]

[1] In terms of the corporations subject to deficiency assesments by the Bureau of Internal Revenue. See Chapter V.

[2] There is, of course, the possibility of a minority stockholders' suit, i. e., Trico case, in the event the corporation is subject to a deficiency assessment.

Although of minor importance, therefore, in reducing the aggregate volume of idle corporate savings, the effect of the section is beneficial nonetheless (except under conditions of inflation) in achieving a somewhat closer current balance between savings and investment. It should be recognized, however, that, for the individual corporation which has less liquidity than it would otherwise have because of section 102, this is cold comfort. Regardless of the motivation underlying the build-up in liquid savings by the corporation, such savings are an additional guaranty of solvency. The reduction in saving manifests itself in active corporate employment of such funds investmentwise if retained, or in reduced earnings retention. Increased dividend distributions add to the current total of individual disposable income. This increment of disposable income in part will go into consumption, in part into savings and investment. Insofar as such individual savings may become idle balances, there is no contribution currently to aggregate demand. However, the net effect of the section restriction on corporate liquidity is to increase both the investment and the consumption components of aggregate demand. In so doing, the current level of income and employment is higher than would otherwise be the case.

Corporate Solvency

Corporations affected by the section will either retain less of earnings or actively employ more of the earnings held within the corporation. More active employment of retained earnings means relatively less in the way of quick assets. The defense of corporate solvency against uninsured or uninsurable risks and contingencies resides largely in its quick asset position. For some individual corporations, it is possible that the section has induced a reduction in quick assets below that required for a minimum safeguard against reasonably imminent and definable business risks. Such situations probably are quite exceptional and, where they occur, are likely to be a product of excessive fear, bad advice, or ignorance.

Corporate insolvencies are a matter of common occurrence. Although the section has been criticized as impairing corporate financial strength, preventing the accumulation of adequate reserves for contingencies, and attacking the exercise of sound and conservative financial management, there is no convincing evidence available that it has been directly a principal, or even an important, contributing cause of corporate insolvency. Nonprofit and small-profit corporations, even though closely owned and closely controlled, have no concern with section 102, only the profitable enterprises. Of course, reduction of corporate liquidity, even though such liquidity is excessive by any reasonable standard, in a sense impairs the financial strength of a corporation, but this should not be construed as necessarily injurious nor as preventing the maintenance of a satisfactory ratio of quick assets. Restraint on the accumulation of reserves for undefinable and indefinite contingencies should not be interpreted as undermining corporate solvency, especially when the corporation has a profit-making history which may be expected to continue and to permit accruals for contingencies which subsequently are definable, real, and reasonably imminent. Sound and conservative financial management has a wide

range of expression as related to corporate liquidity, depending upon the individuals who exercise the judgment.

In general, the criticisms of the section involving allegations of impairment of corporate solvency do not appear to be of serious import. The Bureau of Internal Revenue appears to have been very cautious and conservative in the administration of the section. There is no present indication that the Bureau is likely to use the section as an instrument to reduce corporate liquidities (for the vulnerable corporations) to a level which would impair effective operation of a corporation and its solvency.

Corporate Investment Effects

The section poses two alternatives to corporate officers of vulnerable corporations in the disposition of profits—either invest the earnings or pay them out in dividends. Many corporate officers regard dividends as an unproductive use of corporate funds, with such funds lost forever to the corporation. Further, for closely held and closely controlled corporations the influential shareholders doubtless are aware that retention of earnings—accrual of surplus—is fully sanctioned by the section so long as the funds are given active employment—put to some legitimate business use. This involves investment. By investment of retained earnings, corporate assets can be increased and, at some later date, funds can be withdrawn subject only to the tax on capital gains (free of personal surtax) by corporate liquidation or sale. If the self-financed corporate undertakings have been successful, income is had, although subject to some delay in time.

There is no evidence to indicate that the desire of corporate officers to retain corporate earnings is any less strong because of section 102. In fact, the rising rates of personal surtax over the past decade probably have contributed to a strengthening of this desire, particularly in the case of closely held and closely controlled corporations whose shareholders are in the high-surtax brackets. Information is not available to indicate the relative and absolute retentions of earnings over the past decade for corporations which may be regarded as having particular vulnerability under the section. However, the high general profitability and heavy self-financed corporate investment flows, characteristic of the period, strongly suggest that affected corporations had higher absolute and, probably, higher relative retentions of earnings. The following table indicates that, for the period of 1934 to and including 1943, the smaller corporations retained a higher proportion of posttax net income than the larger corporations; also that the percentage of retained earnings for all corporations increased over the period.

With section 102 prohibition of excessive liquidity and under pressure of the "immediacy" doctrine to make early commitment of retained earnings, it seems that the section, on balance, has been a significant factor in increasing corporate investment flows of affected corporations; also that it has tended to reduce the time lag in the investment commitment of earnings which have been retained.

TABLE 12.—*Retained net earnings as a percentage of net income after taxes, corporations with net income, 1934–43* [1]

[Asset classes in thousands]

Year	Under $50	$50 to $100	$100 to $250	$250 to $500	$500 to $1,000	$1,000 to $5,000	$5,000 to $10,000	$10,000 to $50,000	$50,000 and over	All classes
1934	[2]8.1	57.1	52.6	45.5	34.9	25.8	28.5	3.5	13.9	19.7
1935	56.4	52.0	48.5	44.5	34.7	28.2	20.5	8.0	19.8	23.0
1936	35.8	28.4	23.8	22.7	25.8	25.9	22.3	15.6	4.9	15.1
1937	30.4	29.4	24.1	22.8	23.2	22.2	20.7	16.0	8.3	15.1
1938	50.6	54.8	48.3	39.3	37.8	29.5	23.7	16.8	7.3	19.2
1939	62.0	63.1	55.6	46.1	44.6	37.8	33.9	24.2	18.3	28.8
1940	62.2	59.2	56.4	51.2	50.1	44.3	39.0	30.1	22.3	33.2
1941	71.4	72.8	67.9	62.9	59.5	52.2	45.2	35.8	29.1	41.4
1942	78.7	76.4	71.5	66.3	62.8	58.9	56.6	51.4	49.5	54.6
1943	78.1	75.2	68.9	65.2	62.4	60.3	57.1	52.2	54.4	57.1

[1] From Revenue Revisions, 1947–48, op. cit., pt. 5, p. 3781. From Treasury Department, Division of Tax Research.

[2] The low percentage for this year is attributable mainly to heavy dividend payments by small financial corporations. The estimated retained net earnings for nonfinancial corporations in this class are approximately 45 percent of net income after taxes.

Source: Computed from Statistics of Income, annual volumes, 1932–42. Press release No. S–122 for 1943.

CYCLICAL IMPACT

As stated in chapter III, the economic effects of the section in inducing increased investment and dividend distributions of a cyclical character appear to be of minor importance. True, there is accentuation of aggregate demand in the prosperity phase of the cycle and, correspondingly, a more or less reduced contribution to aggregate demand in the depression phase of the cycle. However, the incremental addition to, or subtraction from, what would otherwise be the levels of aggregate demand during the course of the cycle probably is of very small proportions. This conclusion is supported by (1) the limited number of corporations affected or influenced by the section, and (2) apart from variation in the level of corporate net earnings, its effect, volumewise, in inducing an increased investment flow and/or dividends, is measured by the extent to which corporate liquidity is reduced over what it would otherwise be in the various phases of the cycle.

Insofar as corporate liquidity ratios would rise during the prosperity phase of the cycle at the expense of investment and dividends (in the absence of sec. 102), and would decline during the depression phase of the cycle in implementing investment and dividends, an ameliorating effect on the cycle would be introduced. Because of the section, affected corporations find that liquidity ratios no longer may be adjusted with full flexibility in anticipation of cyclical changes; also, that the timing in profits disposal now becomes a critical element in determining whether the liquidity ratio is reasonable or not. Consequently, profits must be quickly directed to their intended uses rather than find representation in liquid surplus. The liquidity ratio, which, for the profitable corporations, by its variability, frequently signaled changes in corporate plans in respect to the amount and timing of investment and/or dividends, in part, has lost this function. The section, for the affected corporations which depend heavily upon self-financing for growth and have an aversion to dividends, tends to

gear and synchronize investment more closely to profits both in amount and time. With investment (and/or dividends) a direct and immediate function of profits realization, and with profits rising with the recovery and prosperity phases of the cycle and falling with recession and depression, the effect is one of accentuating the inflationary and deflationary trends within the economy.

Corporate Distribution of Profits

The effectiveness of section 102 in inducing profit distribution as an alternative to earnings retention (no investment of earnings planned or contemplated if retained) varies with the applicable effective rate of personal surtax to the income if distributed in the hands of the shareholder or shareholders. In other words, the severity of the penalty tax under the section, assuming its imposition, declines as the marginal effective rate of personal surtax rises. As a result, individuals who are most strongly influenced toward efforts of surtax avoidance—those in the very high personal surtax brackets—are the least affected by the section. Thus, in those cases where the section should be the most effective, it is, in fact, the least effective. The Congress, perhaps, unwittingly, by increasing the bracket rates of personal surtax over the years, has, at the same time, correspondingly undermined section 102. The last rate adjustment in the surtax imposed by the section was in the Revenue Act of 1941 in which the rates were increased by 10 percent, i. e., from 25 percent to 27½ percent, from 35 percent to 38½ percent.

The comparative burdens of the individual tax (including normal tax and surtax) and the penalty tax under section 102, plus the capital-gains tax on long-term capital gains on posttax corporate income, are illustrated in the following table on the basis of the applicable rates to 1949 income; also to 1952 income. Various increments of posttax corporate income ranging from $10,000 to, and including, $200,000 are listed with the computed tax under the two alternatives; one, full dividend distribution of the income, the other, current retention of income by the corporation with subsequent distribution taxable as a long-term capital gain. In the latter alternative, it is assumed that the corporation is subject to section 102 tax on the undistributed earnings. The table is designed to show only effective rate interrelationships between the two tax alternatives.

For individuals who seek to establish their comparative advantage in these alternatives, the effective rate of personal surtax on the incremental addition to their income (assuming corporate distribution) is to be measured against the combined effective rates of the section 102 tax and the capital-gains tax applicable thereto. The comparative advantage to particular individuals, of course, will show wide variance, depending on individual income from other sources, deductions and exemptions, the share in the corporate income, and the like.

TABLE 13.—*Tax cost of corporate retention of earnings with assertion of sec. 102 deficiency and with subsequent capital gains taxation of retained earnings (dividend in partial or complete liquidation)*

EFFECTIVE TAX RATES, 1949 INCOME

Net income of corporation after Federal income tax [1]	Average effective income tax rate (normal and surtax) and computed tax on income in hands of stockholders [2]		Sec. 102 tax plus long-term capital gains tax (with income as dividend in partial or complete liquidation)				
	Effective surtax rate	Total computed tax	Sec. 102 surtax rate	Effective rate capital gains [3]	Average adjusted effective rate [4]	Total computed tax [5]	Advantage (+) or disadvantage (−) in dollars in corporate retention of earnings
	Percent		*Percent*	*Percent*	*Percent*		
$10,000	23.03	$2,303.20	27.50	8.92	33.97	$3,396.60	−$1,093.40
$20,000	31.84	6,368.80	27.50	10.39	35.03	7,006.80	−638.00
$30,000	38.71	11,613.60	27.50	11.93	36.15	10,845.80	+767.80
$40,000	43.38	17,351.20	27.50	13.57	37.34	14,935.60	+2,415.60
$50,000	47.16	23,581.60	27.50	15.16	38.49	19,244.30	+4,337.30
$100,000	59.22	59,221.60	27.50	20.88	42.64	42,635.80	+16,585.80
$150,000	65.77	98,647.55	31.17	23.88	47.60	71,404.10	+27,243.45
$200,000	69.63	139,260.05	33.00	25.00	49.75	99,500.00	+39,760.05
EFFECTIVE TAX RATES, 1952 INCOME (REVENUE ACT OF 1951)							
$10,000	29.56	$2,956.00	27.50	11.64	35.94	$3,593.75	−$637.75
$20,000	40.58	8,116.00	27.50	13.40	37.22	7,443.00	+673.00
$30,000	48.92	14,676.00	27.50	15.28	38.58	11,573.50	+3,102.50
$40,000	53.84	21,536.00	27.50	17.31	40.05	16,021.00	+5,515.00
$50,000	57.83	28,916.00	27.50	19.34	41.52	20,759.75	+8,156.25
$100,000	70.22	70,216.00	27.50	26.00	46.35	46,350.00	+23,866.00
$150,000	76.81	115,216.00	31.17	26.00	49.06	73,595.00	+41,621.00
$200,000	80.36	160,716.00	33.00	26.00	50.42	100,840.00	+59,876.00

[1] For purposes of this computation corporate net income after income tax is assumed to be undistributed sec. 102 net income for application of sec. 102 surtax.

[2] The income to which the effective rates are applied is assumed to be the marginal income to shareholders, i. e., taxable income after deductions and exemptions; individual rates used in calculation (not head of household).

[3] The capital gains tax applies to the residual income (distributed as a capital gain) after income in hands of corporation has been reduced by sec. 102 surtax.

[4] On total capital gain combined with sec. 102 surtax.

[5] Penalty interest on asserted deficiency assessment (sec. 102) not included.

On the basis of the above comparison of the two tax alternatives, it will be noted that (1) the tax advantage lies in the current corporate retention of earnings when the dollar increment of income approaches $30,000, 1949 effective rates, and $20,000, 1952 effective rates, rather than in current dividend distribution; (2) the effective penalty surtax rate under section 102, combined with the effective capital gains tax rate (not including penalty interest on section 102 deficiency assessment), is increasingly ineffective as the increment of income moves into the higher bracket rates of personal surtax; and (3) the increase in individual surtax rates under the 1951 Revenue Act, as would be expected, further increases the disparity between the tax alternatives. The maximum combined effective rate of section 102 tax and the tax on long-term capital gains on an increment of income is slightly less than 54½ percent, while the maximum bracket rate (normal and surtax) for individual tax is 92 percent (1951 Revenue Act).

Corporate Directors' Liability

Recently, the Bureau of Internal Revenue has been the recipient of unexpected assistance in bringing to the attention of vulnerable corporations the need to give careful consideration to section 102. Prior to this new development, the Bureau was forced to rely on such power of persuasion as might be exercized by the language of the statute and its own enforcement activities thereunder. For corporations not disposed to invest retained earnings and/or to pay dividends, this new instrument may have a considerable measure of effectiveness in causing a rephrasing of corporate policy.[3]

This unanticipated assistance comes from the minority stockholder. In general, minority stockholders favor relatively large dividend distributions and apply more or less pressure to that end. There are, of course, minority stockholders whose incomes, other than from dividends, place them in the high personal surtax brackets and who, consequently, may be interested in minimizing dividend distributions. Corporate officers have a full awareness of this pressure group and, if the "stock" arguments fail to dissuade minority stockholders from their dividend demands, the issue can be resolved by vote.

Directors of corporations have the legal responsibility of managing the corporate assets for the benefit and advantage of the shareholders, and, to this end, are to use their best skill and judgment. Directors may not use their positions of responsibility for personal advantage and profit at the expense of the corporation. They must act in good faith. The relationship of the directors to the corporate shareholders is essentially fiduciary, with the directors held to the exercise of ordinary prudence and diligence. Directors may not escape their basic responsibilities of supervision and policy decision, among which is the determination of dividend policy.[4]

For corporations which are very closely owned and controlled with substantial identity of interest among the stockholders and, consequently, agreement on corporate policy, the problem of the minority stockholder would not arise. However, when the corporate shares have sufficient distribution so that there are stockholders who are not identified with control and whose interests, dividendwise, are more or less in opposition thereto, the possibility of minority stockholder suits arises, in the event a deficiency assessment under section 102 is laid against the corporation. Implementation of this type of suit, therefore, requires (1) the existence of a dissident stockholder minority and (2) the imposition of the penalty surtax.

The penalty surtax, if imposed, is against the corporation. The question of personal liability on the part of the corporate directors to repay the corporation the financial loss occasioned by the tax arises out of possible abuse of their discretionary authority and of the trust reposed in them. The corporate directors are subject to challenge on the grounds of acting imprudently in permitting corporate liquidity to reach excessive proportions by nonpayment of dividends (thus inviting imposition of a deficiency assessment). Further, was the nonpayment of dividends to the personal advantage or profit of the

[3] J. K. Lasser and R. S. Holzman, "Personal Liability of Directors for Section 102 Surtaxes," The Controller, July 1948, p. 342.

[4] For a more complete discussion see J. K. Lasser and R. S. Holzman, Corporate Accumulations and Section 102 (New York: Matthew Bender & Co., 1949), pp. 201–206.

directors (avoidance of personal surtax)? The minority shareholders in such an action find support in the very basis upon which the section 102 deficiency assessment is made, namely, the existence of an improper accumulation of surplus, combined with the intent or motive on the part of the shareholders (controlling) to avoid payment of personal surtax. Minority shareholders, of course, must provide the necessary proof that the directors in accumulating surplus have done so in order to avoid personal surtax. In this the statutory presumptions available to the Commissioner of Internal Revenue will not be of assistance. On the other hand, the minority shareholders can assert that their case follows the same theory and rests on the same basis as that of the Government in the imposition of the penalty surtax. Also, even if it were admitted that the corporate directors acted in good faith (rather than for personal profit) in accumulating surplus, they are, nevertheless, guilty of negligence in subjecting the corporation to the deficiency assessment. However, corporate directors are given full latitude on matters of corporate policy and in the management of corporate assets. Although decisions of directors may prove to be unwise, they may not be questioned if made honestly and unselfishly in the general interests of the corporation.

Section 102 appears to create a *greater* vulnerability for directors from stockholders' suits than arise from other stockholder actions when mismanagement is alleged.[5] In stockholder suits contending director mismanagement by reason of a section 102 deficiency assessment, the loss to the corporation can be shown in specific and unmistakable terms (amount of the assessment plus penalty interest), and the personal benefit to the directors from avoidance of personal surtax is ascertainable and measurable.[6] If, as individuals, they have large holdings of stock or have sizable incomes from other sources, surtax savings may be substantial in amount. If a corporation concedes liability by paying the deficiency assessment, or unsuccessfully resists, with a consequent judicial decision supporting the validity of the assessment, it immediately causes the creation of a milieu unfavorable to the directors' defense from stockholders' suit. Because section 102 is a tax designed to penalize corporate wrongdoing,[7] its successful application by the Bureau establishes facts and circumstances favorable to stockholder suits (likewise grounded in an allegation of wrongdoing).

A recent, and apparently the first, instance of suit against corporate directors by minority stockholders seeking reimbursement to the corporation of funds lost by reason of a deficiency assessment under section 102 is the case of the Trico Products Corp. From March 1942 to and including April 1943 four stockholder actions were initiated against directors of the Trico Products Corp.[8] These separate actions were later consolidated (September 17, 1943) into a single suit. The plaintiffs' alleged causes of action in the original complaint covered the years 1934 through 1941; and later, by stipulation (September 22,

[5] J. K. Lasser and R. S. Holzman, "Personal Liability of Directors for Section 102 Surtaxes," op. cit., p. 344.

[6] Reports of revenue agents recommending deficiency assessments customarily contain a summarization of personal surtaxes which would have been paid had a dividend, or dividends, been declared.

[7] As defined in the section.

[8] These and other details relating to this case are drawn from the Report of Referee, Edward Weinfeld, referee, op. cit.

1947), were extended to include the years 1942 through 1946. Plaintiffs' general contention was that the directors had caused (1) the accumulation of earnings within the corporation far in excess of the reasonable requirements of the business, and (2) that such accumulations were not to serve the advantage of the corporation, but rather for the benefit of the controlling stockholder-directors who were thus saved from the payment of large additional personal surtaxes. It was pointed out that a very considerable portion of the accumulated surplus went to increase corporate liquidity—investment in Government and other securities—and not to build up operating assets.[9]

The history of deficiency assessments under section 102 against Trico Products Corp. is as follows:[10]

In 1939 deficiency assessments were asserted for the years 1934–35. Taxes and penalty interest paid were as follows:

Year	Tax	Interest	Total
1934	$403,714.21	$214,438.00	$618,152.21
1935	1,214,217.68	574,426.16	1,788,643.84
Total			2,406,796.05

Again, in 1943, deficiency assessments were levied for the years 1936 and 1937. Paid under protest were taxes and penalty interest as follows:[11]

Year	Tax	Interest	Total
1936	$532,468.00	$208,450.28	$740,918.28
1937	600,264.86	198,971.65	799,236.51
Total			1,540,154.79

In 1944 the Bureau asserted deficiency assessments for the years 1938, 1939, and 1940. The following taxes and penalty interest were paid under protest:

Year	Tax	Interest	Total
1938	$400,334.39	$139,102.49	$539,436.88
1939	976,727.38	280,775.67	1,257,503.05
1940	1,256,206.00	303,141.43	1,559,347.43
Total			3,356,287.36

In addition, in 1947 the revenue agent in charge proposed deficiency assessments for the following years:[12]

Year:	*Tax*
1941	$1,427,250.28
1942	244,954.28
1943	214,277.55
1944	256,450.47
1945	379,441.76
Total	2,522,374.34

[9] Ibid., p. 45.
[10] Ibid., pp. 43–44.
[11] In addition to the deficiency assessments under sec. 102, undistributed profits taxes of $364,532.93 in 1936 and $423,066.01 in 1937 were paid. Failure to distribute income in these years in dividends resulted in retained income being reduced by two profits levies—the undistributed profits tax and the penalty surtax under sec. 102.
[12] Until assessment and payment of taxes interest cannot be computed.

Three of the defendant directors of Trico Products Corp.—John R. Oishei, Peter C. Cornell, and Stevenson H. Evans, collectively—owned more than a majority of the outstanding shares of Trico Securities Corp., which, in turn, held more than a majority of Trico Products Corp. common stock during the period concerned in the stockholders' suit.[13] John R. Oishei served as president, general manager, and as a director of Trico Products Corp. from its beginning; Peter C. Cornell, as treasurer and director, and Stevenson H. Evans, secretary and director from 1927 on. The same individuals were directors of Trico Securities Corp., with John R. Oishei, president, Peter C. Cornell, vice president, and Stevenson H. Evans, secretary and treasurer.[14]

Stockholders in 1927 numbered 21; 1,200 in 1928; and approximately 2,200 in 1935.[15]

The net profits, dividends paid, and surplus accumulations of Trico Products Corp. are shown below.[16]

Year	Net profits	Dividends paid	Surplus accumulations
1927	$1,372,303.96	[1] $338,907.19	$434,957.69
1928	1,778,475.21	686,150.00	[2] 1,558,543.87
1929	2,249,947.97	833,531.59	[2] 2,953,231.86
1930	1,908,415.88	937,484.34	[2] 3,919,196.92
1931	1,762,550.76	937,484.20	4,744,263.48
1932	964,964.32	937,484.91	4,771,742.89
1933	1,418,277.21	937,485.11	5,252,534.99
1934	1,771,558.53	937,485.91	6,086,607.61
1935	3,567,404.42	919,447.17	[2] 8,762,708.19
1936	4,184,560.81	1,983,531.93	[2] 10,913,737.07
1937	3,792,244.62	1,960,768.77	12,745,212.92
1938	2,319,854.68	1,046,304.01	14,018,763.59
1939	3,540,669.29	1,042,827.52	16,516,605.36
1940	4,225,039.94	1,042,280.58	20,284,364.72
1941	3,882,221.04	1,094,424.77	[2] 23,032,160.99
1942	877,357.89	1,087,308.16	22,822,210.72
1943	951,426.75	1,077,705.39	[2] 19,622,417.98
1944	1,826,658.91	1,065,679.05	[2] 17,667,731.02
1945	2,141,750.21	1,046,125.01	18,763,356.22
1946	3,145,225.60	1,033,537.06	20,875,044.76

[1] Includes dividend payment on preferred and common stock; also charged against net profits for 1927 are various items incidental to recapitalization.

[2] After making the following additions (or subtractions) in respect of each of the years indicated: 1928 $31,260.97; 1929 ($21,728.39); 1930 ($4,966.48); 1935 $28,143.33; 1936 ($50,000); 1940 $585,000; 1941 ($40,000); 1943 ($3,073,514.10); 1944 ($2,715,666.82).

Investment of retained earnings by Trico Products Corp. in securities, in comparison with operating assets, was very large.[17]

[13] Report of Referee, op. cit., p. 41.
[14] Ibid., pp. 40–41.
[15] Ibid., p. 40.
[16] Ibid., p. 29.
[17] Ibid., p. 30.

Year	Amounts invested in operating assets	Amounts invested in United States, State, and municipal obligations	Amounts invested in stocks of domestic corporations (principally companies in allied industries)	Total invested in securities	Total investment income from stocks and bonds
1929	$5,229,805.72	$470,819.29	$626,752.11	$1,097,571.40	$8,281.69
1930	5,408,655.11	1,616,949.55	446,191.00	2,063,140.55	53,408.53
1931	5,492,549.73	2,422,799.36	361,054.90	2,783,854.26	86,632.07
1932	5,310,675.82	2,751,969.99	373,475.61	3,125,445.60	105,325.62
1933	5,172,849.74	3,817,580.28	209,372.10	4,026,952.38	122,355.72
1934	5,469,100.74	4,721,488.92	358,641.88	5,080,130.80	159,699.58
1935	7,271,068.05	6,482,828.51	376,239.45	6,859,067.96	207,127.39
1936	8,252,734.80	8,646,028.82	390,714.45	9,036,743.27	294,758.07
1937	8,914,844.62	8,125,237.70	2,067,577.77	10,192,815.47	376,634.39
1938	9,275,942.38	8,125,237.70	2,084,761.77	10,209,999.47	339,246.68
1939	10,838,740.72	9,234,839.58	2,118,939.52	11,353,779.10	427,325.61
1940	11,132,634.35	13,807,948.91	2,465,414.97	16,273,363.88	499,481.40
1941	11,880,660.39	16,127,681.46	2,822,202.42	18,949,883.88	614,064.59
1942	11,629,186.75	15,286,930.50	2,611,929.47	17,898,859.97	504,329.93
1943	11,820,980.28	15,689,499.65	2,598,750.27	18,288,249.92	499,429.15
1944	10,907,936.01	15,338,890.05	2,592,463.77	17,931,353.82	558,012.02
1945	13,391,084.57	15,194,732.46	2,594,391.53	17,789,123.99	529,838.12
1946	18,802,556.12	14,706,439.50	2,597,364.64	17,303,804.14	476,061.03

If Trico Products Corp., including Trico Securities Corp., had distributed all net income in dividends from 1934 through 1937, the added personal surtax liabilities of John R. Oishei, Peter C. Cornell, and S. H. Evans would have been as follows:[18]

	Additional surtax liability			
	1934	1935	1936	1937
Oishei, John R	$108,729.03	$356,734.85	$340,118.14	$310,839.52
Cornell, Peter C	97,924.94	322,260.16	309,262.51	289,272.95
Evans, S. H	35,166.41	134,599.02	128,347.02	116,007.69

Trico Products Corp. had its origin in an accident which occurred on a rainy night in Buffalo, N. Y., in 1917. John R. Oishei, a resident of the city, injured a pedestrian because the windshield of his car was obscured by rain. This accident directed Oishei's attention to the need for some device to clean automobile windshields. Upon investigation, he found that a John W. Jepson, also of Buffalo, had invented an instrument which, operating through slides in a slot, would clean windshields. Jepson was then employing three men, and production was in a barn, with market basket delivery. Oishei formed Tri-Continental Corp. to engage in the distribution of Jepson's windshield wiper. A Peter C. Cornell joined Oishei in this venture, and contributed some $10,000 of capital funds. Although Tri-Continental Corp. absorbed Jepson's entire output, it was soon evident that production was inadequate. At this juncture William P. Haines and Stevenson H. Evans joined Oishei and Cornell in the venture. Jepson's business, which then had eight employees, was purchased by Tri-Continental Corp.

Following the war, which caused a temporary stoppage of production, Oishei invented and patented a swinging type, manually operated windshield wiper known as the Crescent Cleaner. This wiper was

[18] Ibid., p. 44.

successfully introduced to the market, in consequence of which plant expansion was required. On April 26, 1920, Trico Products Corp. was formed and acquired the assets of Tri-Continental Corp. In order to obtain necessary capital to supplement stockholder contributions resort was had to bank loans on the personal notes of Oishei and Cornell. The years 1920 and 1921 were hazardous, with finances in a shaky condition and operations on a hand-to-mouth basis.

In 1921 Oishei invented an automatic vacuum type wiper which soon found market acceptance. This necessitated further expansion of plant. By 1927, after buying out competitors in the automatic wiper field, Trico Products Corp. became the sole producer of windshield wipers. The bulk of Trico's business was with General Motors, Ford, and Chrysler. In 1927, following judicial determination of the validity of Trico's patents on the vacuum wiper, the company was recapitalized. An important feature of the recapitalization, which later was urged in support of the directors' policy in heavy earnings retention, was the establishment, by agreement with stockholders, of a class of deferred or restricted common shares. Owners of the deferred shares were to waive dividends until a prior annual payment of dividends of $2.50 per share on the "free" stock could be made. Dividends were to be paid ratably on all shares, deferred and free, when in excess of $2.50 per share on the free stock. Of the issued common stock of 675,000 shares, 450,000 shares were deferred and 225,000 shares were free. The deferred shares were held originally in a voting trust which was replaced in 1929 by Trico Securities Corp. The agreement between the Trico Products Corp. and the stockholders further provided that the deferred shares could be exchanged for free shares and withdrawn from the voting trust as earnings increased.

Trico Products Corp., from the inception of the vacuum windshield wiper, has been active in the development of various types of vacuum operated devices for automotive equipment. There has been continuous research and experimentation. Among the marked items have been the Claireon horn (1931), a throttle guard (1932), the Venturi muffler (1933), an interior, windshield-moisture removing fan (1935), a windshield washer (1936), a vacuum pump for mounting on an oil pump of a car to produce vacuum (1938), the Electro-Vac, an electrically driven vacuum pump, and the Lift-O-Matic, a car window raising and lovering device.

The minority shareholders of Trico Products Corp., in the consolidated action against the corporation's directors,[19] asked for (1) recovery of damages sustained by Trico Products Corp. as a result of the imposition of the penalty surtax under section 102, (2) recovery of damages occasioned by the imposition of the undistributed profits tax in 1936 and 1937, which would not have occurred had there been full distribution of income in dividends, (3) recovery of legal and other expenditures incurred by the corporation in resisting the deficiency assessments under section 102, (4) recovery of profits and benefits obtained by defendant directors as a result of investing retained earnings of the corporation in securities the income from which increased corporate earnings and thus permitted the release of certain of the dividend restricted deferred stock, with such stock receiving the bene-

[19] Trico Securities Corp., which held a majority of the voting shares, was also a defendant in the suit.

fits of the free shares, and (5) intervention by the court to require defendant directors to declare a proper dividend from accumulated earnings—a dividend which would reflect the great accumulation of surplus and the reasonable requirements of the business.

In addition to denying that surplus had been accumulated in excess of the reasonable needs of the business, and that accumulations of earnings were motivated by reasons of personal surtax avoidance or to free the deferred shares from the dividend restriction to the personal advantage of the directors, the defendants pleaded (1) the agreement of reorganization and recapitalization of September 1, 1927, which allegedly justified and required the retention of earnings, (2) the unanimous approval of stockholders, at the annual meetings during this period, of the actions of the defendant officers and directors, and (3) the statute of limitations. The directors asserted that the policy of accumulating surplus was based on the "unusual character of the business" and the "unique problems arising therefrom."[20] Further, they declared

> that a policy of conservation of earnings was born of the trials and tribulations of the company in its early days and its hazardous beginning; that it was dictated by necessity and the very nature of the business; that with the growth and expansion of Trico the underlying reasons which led management to embark upon the original policy still remain. Generally, these reasons may be summarized as follows: a desire to avoid the experience in the pioneering days when the investment of stockholders had to be supplemented with borrowings from bankers on the personal guarantees of stockholders; the nature of the business, which required capital funds for expansion and exploitation of various patents and new products to avoid dependency upon a single item as the principal and almost sole source of earnings; the need for a strong and sound financial position in dealing with the powerful automotive industry to protect Trico in maintaining its position as the sole supplier of automatic windshield wipers and to avoid granting shop rights to automobile manufacturers; indemnity agreements required of Trico in connection with the patent; expensive litigation to protect its patent rights and to prosecute infringement suits; the need to preserve the cash value of its principal asset, the basic patent on the automatic windshield wiper which had a limited life; and, finally, but by no means least, as contended by the directors, the agreement with the bankers in 1927, which they claim obligated them to conserve the assets and plow earnings back so that the restricted shares could be released and also restricted the amount of dividends to $2.50.
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> In conclusion, the directors contend that the accumulations resulting from this policy represent the reasonable requirements of the business of the company, and moreover, they acted in good faith and in the exercise of a reasonable judgment.[21]

A stipulation of settlement, after a protracted period of negotiations, was entered into between the parties September 22, 1947, whereby the defendant directors personally were (1) to pay $2,390,000 to the Trico Products Corp., and (2) to provide for the payment of a dividend by the corporation in the amount of $5.50 per share on the outstanding stock, which was in addition to the regular dividend of $2.50 per share on the free stock. Costs of resisting the deficiency assessments under section 102, estimated at some $300,000, were to be borne by the corporation.

A referee, Edward Weinfeld, was appointed by the Supreme Court of the State of New York to inquire into the reasonableness of the proposed settlement. The referee recommended that the court approve

[20] Report of Referee, op. cit., p. 46.
[21] Ibid.

the proposed settlement in his report of November 12, 1947, finding it "fair, reasonable, and adequate." [22] The proposed settlement was approved by the court December 23, 1947, thus bringing to a conclusion the action of the minority shareholders.[23]

The Trico case clearly indicates that surplus accumulations which result in excessive corporate liquidity for closely controlled corporations carry a double hazard: First, a possible deficiency assessment under section 102; and, second, a minority stockholders' suit against the corporate directors based upon damages to the corporation as a result of the application of the penalty tax. Section 102, in a sense, thus becomes double-barreled—with the possibility that an explosion in one barrel will set off the other. Because of the settlement in the Trico case, there was no judicial definition of the liability of directors. Consequently, the relative vulnerability of corporate directors cannot be adequately assessed.

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[22] Ibid., p. 92.
[23] J. K. Lasser and R. S. Holzman, Corporate Accumulations and Section 102, op. cit., p. 217.

CHAPTER V

ADMINISTRATION

Prior to 1938 (and the strengthening of section 102 by the revenue act of that year), section 102 and its predecessor sections appear to have been largely ineffective in preventing personal surtax avoidance through corporate surplus accumulations. Individual and corporate taxpayers do not seem to have been generally aware of this tax statute, or, if aware, to have directed much attention to it prior to 1928.[1] Following this initial period of administrative inactivity in the enforcement of the statute, section 104 (1928) (previously section 220) became of increased enforcement concern to the Commissioner of Internal Revenue. An immediate response thereto was obtained in the way of increased taxpayer awareness and revenue yield.[2] Although sections 104 and 220 (predecessor sections to section 102) had been subject to some positive enforcement by the Commissioner of Internal Revenue since 1928, Congress had serious reservations [3] as to the administrative effectiveness of the section in accomplishing the purpose for which it had been designed. With tax avoidance by personal holding companies reaching a critical stage by 1934, Congress was of the opinion that other tax means must be employed to deal with this problem. Section 104 was admittedly unequal to the task. Consequently, Congress, in the Revenue Act of 1934, removed personal holding companies from the coverage of section 104, imposing thereon a special surtax under section 351 (title 1A). Congressional dissatisfaction with the ineffectiveness of section 102 continued and was

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[1] Seymour J. Graubard states:

"The lack of information about the statute may be attributed directly to the Treasury Department. Because of indolence or uncertainty of the law's constitutionality, it had enforced the collection of only $75,000 under the statute up to 1927. But then, at the instigation of Congress, the statute was more often invoked with the result that collections spurted to $5,679,475 by March 1, 1930." "Accumulation of Surplus To Evade Surtaxes," pt. II, 10 Tax Magazine 458 (1932).

See J. H. Landman, "Penalty for Improper Retention of Earnings," the Conference Board Business Record, vol. III, No. 2, February 1946, p. 86.

[2] In commenting on the incidence of increased enforcement, Warren W. Grimes observes that:

"In spite of the fact that an average of more than two millions of dollars a year is being collected by the Government in cases arising under Section 104 and the old Section 220, there are many who still refuse to believe the provision need be given serious consideration. Unfortunately, many tax counsel are of that opinion—some satisfied that in the end the provision will be held unconstitutional. It may as well be understood fully, that the Government is invoking Section 104, intends to invoke it vigorously, and has met so far with nothing but striking success—with prospects balanced heavily in its favor. Probably in tax history no statutory provision has been continued so long, so many cases considered and comparatively so much collected in cash and stowed away in the Treasury for all time, and yet never been construed by a single court!" "Surtax Rate Increase and Corporate Surplus Accumulations," 10 Tax Magazine 404 (1932).

[3] See appendix 1, particularly congressional discussion relating to section 104, Revenue Act of 1932 and Revenue Act of 1934.

Arthur H. Kent, Assistant General Counsel, U. S. Treasury, declared in 1937 that "sec. 102, which imposes a heavy surtax on corporations formed or availed of to evade surtax on shareholders by accumulating earnings, has proven largely ineffective through difficulties of enforcement and restrictive interpretation by judicial decision. It has been suggested that this problem of surtax escape might have been adequately solved through amendments which would have put more teeth into sec. 102. These possibilities were fully explored and considered but the conclusion was negative." "The Federal Revenue Act of 1936—Some Current Problems," 15 Tax Magazine 207 (1937).

influential in securing the enactment of the undistributed profits surtax of 1936 as an alternative tax approach to this problem. Section 102 remained, however, as an operative statute, with rates revised downward for corporations subject to the undistributed profits tax, and with section 102 becoming essentially supplemental and supporting thereto.

The general ineffectiveness of the Federal tax structure in preventing widespread tax avoidance and evasion was brought into sharp focus by the Presidential message to the Congress on June 1, 1937. Congress responded by the prompt creation of a Joint Committee on Tax Evasion and Avoidance. This committee made a detailed and thoroughgoing study of the many tax loopholes and inadequacies which characterized the tax structure, with recommendations to the Congress for appropriate remedial legislation. Section 102 was specifically recognized as difficult of enforcement and largely ineffective in its operation. Foreign personal holding companies were found to be an important means of tax escape, and, as section 102 was not effective in preventing this method of tax avoidance, the committee recommended that a special method of taxation be applied to them. Congress implemented the committee's recommendation by excluding foreign personal holding companies from section 102 and subjecting these companies to special taxation. The Joint Committee on Tax Evasion and Avoidance expressed the view that section 102 (and predecessor sections) had proved difficult of enforcement primarily because of the necessity of having "to prove a purpose to avoid the imposition of the surtax upon the shareholders" [4] through the accumulation of corporate surplus.

In the Revenue Act of 1938 Congress endeavored to remedy this weakness in the statute by providing (sec. 102, subsec. (c), Revenue Act of 1938) that corporate surplus accumulations "beyond the reasonable needs of the business shall be determinative of the purpose to avoid surtax upon shareholders unless the corporation by the clear preponderance of the evidence shall prove to the contrary." Further, with special reference to the ineffectiveness of section 102 in meeting the problem of closely held operating companies not within the personal holding company category, the Ways and Means Committee of the House in its report provided for a new surtax applicable thereto in title 1B. This was the so-called third-basket provision. This proposal failed of enactment by the House. The Senate Finance Committee expressed the belief that this class of corporation could be given appropriate tax treatment under a strengthened section 102.[5] Further, the committee was strongly of the opinion that section 102, strengthened in this fashion—

> will clearly shift the burden of proof to the taxpayer in such cases. The committee believes that substantial revenue will result from this change although no exact estimate of such revenue has been made by the Treasury Department. A reasonable enforcement of this revised section will reduce tax avoidance to a minimum and increase the revenues from sources where there is ability to pay.[6]

Since 1938 section 102, in its substantive character, has remained essentially unchanged, although certain technical alterations have

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[4] Joint Committee on Tax Evasion and Avoidance, Tax Evasion and Avoidance, letter and report, 75th Cong., 1st sess., H. Doc. 337 (Washington, D. C.: Government Printing Office, 1937), p. 7.
[5] Senate Finance Committee, 75th Cong., 3d sess., S. Rept. 1567, pp. 4–5.
[6] Ibid., p. 5.

been made. With the demise of the undistributed profits surtax in 1939, section 102 acquired an increased importance as the only taxing statute of general coverage directed to undistributed corporate profits, even though section 102 comprehends only improper accumulation of profits for purposes of tax avoidance and not undistributed profits per se. In the amendment of section 102 by the Revenue Act of 1938 through the addition of subsection (c), which had the statutory purpose of shifting the burden of proof to the taxpayer corporation[7] (once a finding has been made that the surplus accumulation is in excess of the reasonable needs of the business), it was the congressional hope and expectation that this section would become an effective taxing instrument and that the Bureau would no longer display hesitancy in its enforcement. To the end that section 102 and its predecessor sections would acquire a large measure of enforceability, Congress had endeavored to correct weaknesses in the section through various amendments thereto. The more important substantive changes have been as follows:

1. Deletion of the word "fraudulently," which was part of the language of the original section II (A) (2) of the Tariff Act of 1913, in the Revenue Act of 1918. Congress was of the opinion that this section had been ineffective because of the difficulty of procuring evidence to establish fraud where corporate earnings were improperly retained.

2. Transference of the impact of the tax from the corporate shareholders to the corporation in the Revenue Act of 1921. This was to avoid the possibility of unconstitutionality and, hence, unenforceability of the section as a result of the Supreme Court decision in *Eisner* v. *Macomber*.[8]

3. The removal of personal holding companies from the coverage of this section in the Revenue Act of 1934, also the reduction in rate of tax. Personal holding companies were regarded as presenting a special and a particularly acute problem in tax avoidance, and one which section 102 and its predecessor sections had been unable to meet in any effective fashion. The exclusion of personal holding companies from this section served to narrow somewhat the coverage of section 102. Bureau attention could now largely be directed to closely held operating corporations. In addition, the reduction in rate of tax from 50 percent to graduated surtax rates of 25 and 35 percent was viewed by Congress as a step in making the section more effective, as the 50-percent rate was believed to be too high for enforcement purposes.

4. The inclusion in section 102 of subsection (c) in the Revenue Act of 1938, which statutorily declared that unreasonable corporate accumulation is evidence determinative of the purpose to avoid surtax upon shareholders and is rebuttable only by a clear preponderance of the evidence. This, Congress believed, would permit effective enforcement of the tax by the Bureau.

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[7] "Although it is a fundamental principle of tax law generally that the burden of proof falls upon the taxpayer, sec. 102 adds even greater weight to the normal onus of demonstration. Since in its application the presumption of correctness attaches to the Commissioner's findings, the taxpayer is forced to prove a negative, always a difficult task." C. L. Turner, "Unreasonable Accumulation of Surplus * * * Section 102," 26 Taxes 843 (1948).

[8] 252 U. S. 189.

Effectiveness of a Penalty Tax

It should be reemphasized that section 102 is a penalty tax and that its effectiveness may not be accurately gaged by the number of deficiency assessments thereunder, the amount of revenue obtained therefrom, nor the volume of corporate protests and criticisms thereof. Basically, the effectiveness of the section should find expression in its influence on (1) corporate dividend policies, (2) corporate real investment flows, and (3) corporate liquidities.[9] The tax is intended to be preventative of unreasonable corporate accumulation of earnings as a means of personal surtax avoidance; to the extent that this penalty tax succeeds in accomplishing its purpose, corporate financial conduct will not be of the proscribed character. As in the case of any penalty—i. e., tax or fine—its effectiveness presumably would be inverse to revenue collected, assuming an adequate penalty with adequate enforcement. On the other hand, cursory and ineffective enforcement will not prevent the prohibited act nor give rise to any considerable amount of revenue. It should also be noted that a penalty tax may carry too low a rate or be insufficient in the amount of the financial penalty imposed. In this event it will not be of a prohibitory character to those taxpayers and their corporations who find that the advantage of surtax avoidance outweighs the penalty if invoked. Under this circumstance, it is possible to have vigorous enforcement and a sizable revenue in combination with extensive violation of the statute. If enforcement is limited and sporadic, with the tax imposing an inadequate penalty for those in the higher surtax brackets, taxpayers will be encouraged to engage in violation of the statute on the basis of a calculated risk. In addition, limited and sporadic enforcement is not conducive to widespread taxpayer awareness of the tax, with the result that unintentional and inadvertent violations may occur. No penalty tax is self-enforcing; for a penalty provision, tax or otherwise, to take on a meaningful character, there must be general public awareness combined with administrative willingness and alertness to enforce. Otherwise the penalty tax becomes an empty statutory threat.

Administration of Section 102 by the Bureau of Internal Revenue

Section 102 has been an administratively troublesome and difficult taxing statute for the Treasury and the Bureau of Internal Revenue. Apart from the fact that it is a penalty tax, thus inducing an adverse public reaction at the outset, the tax is not self-assessed by the corporation but requires administrative initiation and imposition on the suspect corporation.[10] In the process of the administrative imposition of the tax, a major discretionary judgment must be made—namely, that an unreasonable corporate accumulation of earnings in

[9] Further evidence of its relative effectiveness may be indicated by the extent to which there is tax-induced resort to means of avoidance as found, for example, in corporate reorganizations and liquidations.

[10] There are a few exceptions in this regard. The Bureau of Internal Revenue finds that five corporations (and there may be several more not presently tabulated) have voluntarily self-assessed the tax under sec. 102 and remitted the amount of the tax to the Treasury. This was without any deficiency assessment by the Bureau or any other administrative action or notice.

The voluntary payments of sec. 102 tax for two corporations covered tax years 1941–46, inclusive; two corporations covered tax years 1946–48, inclusive; one corporation covered tax year 1946.

fact exists—which, in turn, becomes statutorily determinative of the purpose to avoid surtaxes upon shareholders.

The enforcement efforts of the Bureau directed to section 102 and its predecessor sections from 1928 on caused increased taxpayer concern. Questions were raised as to Bureau attitude and enforcement policy. As a result, representatives of the Bureau from time to time have made public statements in answer to criticisms and in explanation of policy.[11]

In an early statement regarding Bureau administration (1935), Wright Mathews, Assistant to the Commissioner of Internal Revenue, declared:

> We hear some criticism of our administration of Section 104 of the Revenue Act of 1932 and corresponding sections of prior Acts. These sections provide for a high tax upon corporations formed or availed of to avoid the imposition of the individual surtax upon their shareholders through the medium of permitting gains and profits to accumulate instead of dividing or distributing them. The fact that a corporation is a mere holding or investment company, or that the gains and profits of any corporation are permitted to accumulate beyond the reasonable needs of the business is evidence of a purpose to avoid taxes. The Bureau intends to apply the Acts as they are written. It has no purpose to extend their application beyond the intent of Congress. Congress did not lay down a definite rule as to what is regarded as "reasonable needs of the business" in measuring corporate surplus. The Bureau of Internal Revenue is unable to state a definite rule except that the determination is dependent upon the facts and circumstances of each case. Corporations against which the higher taxes may be imposed are given full opportunity to present evidence to the Bureau to overcome any appearance of the purpose to avoid surtax and, of course, under the law have the right to have the issue settled by the Board of Tax Appeals and the courts. The cases are handled by trained Civil Service employees who are instructed that their responsibilities to the taxpayer and the Government are equal.
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> No operating corporation accumulating surplus and using it in the business in which it is engaged should be apprehensive. As an illustration, a manufacturing company setting up a reasonable surplus for the purpose of acquiring material, offsetting a fluctuation in wage scale, carrying the proper amounts to offset accounts payable, or accumulating a reasonable reserve to pay present indebtedness, would not be taxed under Section 104 of the law of 1932 for accumulating an unreasonable surplus. It would be an entirely different matter, however, if it accumulated these surpluses for the purpose of purchasing stocks, bonds, and securities of other corporations.
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> The following is a typical example where in the opinion of the Bureau taxes should be assessed under the provisions of Section 104 of the Revenue Act of 1932. A corporation was organized with a total capital stock of $200,000. Its earnings for two years were in excess of $5,000,000 and no dividends were declared during the two-year period. In this case the Bureau will, other things being equal, assess the company 50 per cent of the undistributed income under the provisions of Section 104.[12]

With the strengthening of section 102 by the inclusion of subsection (c) in the Revenue Act of 1938, the Bureau proceeded to alert its officers and employees to the section by the issuance of Treasury Decision No. 4914, dated July 26, 1939. This Treasury decision called specific attention to subsection (c), and instructed officers and employees to give close attention to the income-tax returns of the following classes of corporations:

> (1) Corporations which have not distributed at least 70 percent of their earnings as taxable dividends.

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[11] See appendix 3 for various public statements regarding Treasury and Bureau policy in the administration of sec. 102.

[12] Excerpt from address entitled "U. S. Tax Administration," before the Fifth Annual Economics Conference for Engineers at Johnsonburg, N. J., August 18, 1935. Reproduced in 13 Tax Magazine 575–577 (1935).

(2) Corporations which have invested earnings in securities or other properties unrelated to their normal business activities.

(3) Corporations which have advanced sums to officers or shareholders in the form of loans out of undistributed profits or surplus from which taxable dividends might have been declared.

(4) Corporations, a majority of whose stock is held by a family group or other small group of individuals, or by a trust or trusts for the benefit of such groups.

(5) Corporations the distributions of which, while exceeding 70 percent of their earnings, appear to be inadequate when considered in connection with the nature of the business or the financial position of the corporation or corporations with accumulations of cash or other quick assets which appear to be beyond the reasonable needs of the business.[13]

In addition, for corporate returns falling in classes (1), (2), (3), and (4) above, the Treasury decision provided that—

the examining officer's report in every instance shall contain a specific recommendation for the application or nonapplication of section 102.[14]

Further—

(*c*) Each internal revenue agent in charge and each head of a field division of the technical staff will designate a qualified employee in his office, whose responsibility it will be to pass personally upon each case in which a recommendation has been made by an examining or reviewing officer with respect to the application or nonapplication of section 102. The internal revenue agent in charge or head of the field division of the technical staff will advise the Commissioner of the names and titles of such employees.

(*d*) There will be maintained currently in Washington, D. C., detailed data regarding cases in which recommendations have been made with respect to the application or nonapplication of section 102, in order that the officers of the Department may be kept appropriately informed. To this end, there will be forwarded to this office by internal revenue agents in charge or heads of field divisions of the technical staff, as the case may be, immediately upon preparation thereof, a copy of each examining officer's report, revenue agent's report, field conference memorandum, or action memorandum in cases referred to in (1), (2), (3), and (4) of paragraph (*a*) of this section, in which a recommendation has been made with respect to the application or nonapplication of section 102, and a copy of each examining officers' report, revenue agent's report, field conference memorandum, or action memorandum in cases referred to in (5) or paragraph (*a*) of this section in which a recommendation has been made for the application of section 102.

(*e*) In the review of income tax cases by the Bureau, the returns of corporations of the classes enumerated in paragraph (*a*) of this section will be given special consideration to determine whether field officers have complied fully with these instructions.[15]

The general instructions to Bureau personnel in Treasury Decision 4914 were reinforced by supplemental directions[16] as to the manner in which corporate returns should be evaluated to determine liability under section 102; also, the data which the examining officer's report should contain. These supplemental directions stated that the—

purpose to avoid the imposition of the surtax upon the shareholders of a corporation can be determined only upon a careful study of the fiscal status of the corporation and other attendant circumstances. Among the circumstances requiring careful study or scrutiny are the purpose for which the corporation was formed; the dividend distribution history of the corporation; its dealings with its shareholders and advances or loans made to them in lieu of dividend distributions; and accumulations of surplus resulting from the retention of cash, securities, and other assets unrelated to and not essential to the normal business activities of the corporation.

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[13] Treasury Decisions Internal Revenue, vol. 35 (Washington, D. C.: Government Printing Office, 1941), pp. 137–138.
[14] Ibid., p. 138.
[15] Ibid., p. 138.
[16] Commissioner's Mimeograph Coll. No. 4943, R. A. No. 1005, dated July 31, 1939. See appendix 3, J. F. Addor, "Improper Accumulation of Surplus Section 102," address before convention of certified public accountants in Savannah, Ga., May 26, 1950, for a discussion of these directions.

Instances in which the utilization of the corporation for the purpose of avoiding surtaxes cannot be imputed (although none or a small percentage of the earnings have been distributed to the shareholders) may be determined from the circumstances that all or a large part of the earnings are necessary to acquire or finance additional working assets, such as larger inventories; that the distribution of the earnings to the shareholders would not have resulted in surtaxes because of individual losses or small individual incomes; that the stock is widely held in small blocks; and the reserves or additions thereto necessary for the retirement of bonded indebtedness incurred in the normal conduct of the business absorbs all or a large part of the earnings.[17]

Examining officers' reports were required to contain the following data when section 102 application was recommended:

(*a*) A history of the corporation from the date of its incorporation, fully setting forth the purpose for which it was formed, assets transferred thereto, capital stock issued in exchange for such assets, actual paid-in capital, and whether represented by par or no par stock, and if no par stock, the stated value, if any, ascribed thereto, reorganizations, if any, and kind of business in which engaged.

(*b*) Names and addresses of the principal or controlling stockholders and number of shares held by each at the close of the year involved.

(*c*) Names and titles of the officers of the corporation, stock ownership, and amount of compensation received, if such information is not contained in schedule C of the corporation return.

(*d*) A statement of substantial amounts, if any, withdrawn by the stockholders in the form of loans or advances and reflected in the asset accounts at the close of the year under examination.

(*e*) An analysis of the earned surplus account for the year under examination at at least the five preceding years, which will show in particular both taxable and nontaxable income, the amount of cash dividends paid during each of the respective years, and the amount and date of any cash dividends paid shortly after the close of the year under examination. If any distribution of dividends in reorganization was made, full details of such distribution should be stated.

(*f*) A statement showing the amount of surtaxes actually avoided by the principal stockholders through the failure of the corporation to distribute all of its earnings for the year under consideration.

(*g*) Comparative balance sheets at the beginning and end of the year or years under examination, and five prior years.

(*h*) Whether or not, in the opinion of the examining officer, the corporation is a mere holding or investment company and the basis for such conclusion, and why it does not qualify under title 1A.

(*i*) Any other facts and circumstances which may be deemed pertinent by the examining officer should be included in his report. The report should also contain a summary of the material facts upon which the recommendation of the examining officer with respect to the application of section 102 is based. If the proposed liability has been discussed with taxpayer corporation, the report should contain a summary of taxpayer's contention and examining officer's reaction.[18]

Should the examining officer recommended the nonapplication of section 102 for corporate returns requiring special attention as provided in section 22.1 (a), Treasury Decision 4914 (establishing the five classes of corporations to receive intensive scrutiny)—

a separate or collateral report containing only such information as is necessary to show clearly why section 102 does not apply, will be prepared and a copy thereof forwarded to Washington.[19]

Treasury Decision 4914 not only alerted Bureau personnel to section 102 but, in addition, placed taxpayer corporations on public notice [20]

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[17] Ibid., pp. 1–2.
[18] Ibid., pp. 2–3.
[19] Ibid., p. 3. This instruction was supplemented in Field Procedure Memorandum No. 35, November 8, 1939, Bureau of Internal Revenue.
[20] "On July 26, 1939, there was issued T. D. 4914 which, while addressed to the employees of the Bureau of Internal Revenue, was published in the weekly Internal Revenue Bulletin. The public release of this *Treasury Decision* had the effect, as undoubtedly was the intention, of placing the taxpaying public on notice that the Bureau was instituting a new drive on corporate taxpayers, and would attempt to impose the surtax on improper accumulations of surplus. * * * it necessarily follows that taxpayers are gravely concerned with the possible implications such a drive by the Bureau might entail." J. S. Halperin, "T. D. 4914 and the Surtax on Corporations Improperly Accumulating Surplus," 18 Taxes 72 (1940).

that the section presumably was to receive vigorous enforcement by the Bureau. The establishment of the five classes of corporations (particularly classes (1) to (4) inclusive), the returns of which were to receive careful examination, caused much apprehension on the part of corporations falling within these categories.[21] Tax attorneys and tax accountants rediscovered section 102, and were important participants in broadcasting the general alarm. Following the initial shock which had particular impact on that section of the taxpaying community especially vulnerable to the penalty tax, i. e., closely held corporations, a wait-and-see attitude developed. As deficiency assessments under section 102 did not take on a wholesale character, the fears of corporate taxpayers tended to subside. The Bureau did increase the volume of deficiency assessments during the period 1940–41 to 1942–43, inclusive, which, measured percentagewise by the number of corporate tax years of assessment, as compared with the earlier period, represents a large increase. However, the total number of deficiency assessments under section 102 was very small in absolute terms (and in comparison with the total number of corporations reporting net income), with the enforcement impact very limited. Deficiency assessments under the section, in terms of corporate tax years of assessment, reached their highest level in fiscal 1941–42, prior to the postwar period. Thereafter, a comparatively sharp decline occurred. This decline apparently had its genesis in the uncertainties and financial hazards of the war and the immediate postwar reconversion period, and which gave to corporations, if not bona fide, at least plausible arguments for their surplus accumulations. Bureau enforcement activity, as measured by the number of corporate tax years of assessment, remained at a comparatively low level until fiscal 1948–49 when a major increase occurred. This sharp increase suggests that the Bureau had returned to its peacetime standards in the application of section 102.

One of the questions which arose with the issuance of Treasury Decision 4914 was with reference to the adoption by the Bureau of 70 percent as the apparent breaking point in determining whether or not current corporate dividend distributions were adequate. Of the five classes of corporations distinguished in Treasury Decision 4914 as corporations to be given close attention for section 102 liability, the 70 percent standard was employed in class (1) as a means of segregating corporate returns. Corporations distributing less than 70 percent of their current earnings in dividends would find themselves scheduled for close inspection; where current dividend distributions were in excess of 70 percent of earnings, corporations would be excluded from class (1). However, it was still possible for a corporation with a current dividend distribution record in excess of 70 percent to qualify for close examination under class (5), providing this dividend distribution appeared inadequate by reason of the nature of its business or the existence of excessive liquidity.

The Bureau has explained its adoption and use of the so-called 70 percent rule by indicating that it is used as one of the means of selecting cases for examination[22] and, of itself, has no bearing in

[21] See J. H. Landman, "Penalty for Improper Retention of Earnings," op. cit., p. 84.
[22] Statement of W. A. Gallahan, Bureau of Internal Revenue, before the National Industrial Conference Board, New York City, May 28, 1947, appendix 3.

determining whether section 102 applies;[23] further, that the case must be, and is, decided on all the facts which show whether the failure to distribute was for the purpose of avoiding surtax.[24] This explanation may represent questionable reassurance to taxpayers (and their corporations) who strongly prefer not to have their tax returns under close scrutiny by the Bureau, and who have a suspicion that, if this occurs, section 102 liability may attach. Many taxpayers have uneasy consciences, and have no desire to invite the hazard of close Bureau examination. Others, although submitting returns which represent corporate financial conduct to them rational and defensible, i. e., high and increasing liquidity, nevertheless feel that the Bureau is capable of arbitrary judgments and has an unfair advantage under section 102 (c). In addition, they are aware of the high cost of litigation which, when resorted to, is at best a negative advantage only. Consequently, through Treasury Decision 4914, particularly with reference to class (1) and the 70 percent rule, the Bureau has exerted real pressure toward a 70 percent current dividend distribution on the part of those taxpayers who are unwilling to risk the hazard, and who, therefore, do not subscribe to the sporting theory[25] in dealing with tax administration. Many taxpayers, on the other hand, are willing to take a calculated risk, or to regard noncompliance with the section 102 prohibition as a tax gamble which is worth taking.

The selection of 70 percent as the bench mark by the Bureau, rather than some other percentage, apparently was based on an average of cash dividend pay-outs to the adjusted net income of corporations for a period of prior years, and before the undistributed profits tax became effective in 1936.[26]

Treasury Decision 5398[27] was issued on August 12, 1944, as an amendment to Treasury Decision 4914. An examining officer's report *in every instance* was now to contain a specific recommendation for the application or nonapplication of section 102. Under Treasury Decision 4914, examining officers' reports must include specific recommendations for or against the application of section 102 only as to returns falling in classes (1) to (4) inclusive. In addition, subsection (d) of section 22.1 of Treasury Decision 4914, which provided for the maintenance of detailed data, i. e., record file in Washington, D. C., as to cases on which recommendations had been made regarding the application or nonapplication of section 102, was struck out.[28] This amendment thus caused a discontinuance of the Washington record file. However, since Treasury Decision 5398, records, in general, have

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[23] Ibid. See also Treasury Department release of December 5, 1947, containing a statement by George J. Schoeneman, Commissioner of Internal Revenue, regarding the use of the 70-percent figure, appendix 3.

[24] Ibid.

[25] Randolph Paul observes that many taxpayers "learned the doctrine that the power to tax is not necessarily, as Chief Justice Marshall said, the power to destroy, while the Supreme Court sits; that distinctions in tax law, as in other fields of modern law, are distinctions of degree; that taxing statutes place cases on one side or the other of an arbitrary mathematical line; that taxpayers may go intentionally as close to this line as they can, if they do not pass it. The line may shift, and the taxpayer may, to his sorrow, misconceive its exact position, in which case he must pay the penalty. But the line is 'hazy,' and there is a fair gamble where the tax structure is complicated, where the question is one of degree upon which 'reasonable men may differ widely as to the place where the line should fall,' and where this difference of opinion is one of feelings rather than processes of articulate reason. Sometimes one wins, and sometimes one loses. The game is, in the opinion of many taxpayers, worth the candle." "The Background of the Revenue Act of 1937." 5 University of Chicago Law Review 45 (1937).

[26] See J. F. Addor, op. cit., appendix 3.

[27] Treasury Department, Internal Revenue Bulletin, Cumulative Bulletin 1944 (Washington, D. C.: Government Printing Office, 1945), p. 194.

[28] See Appendix 8.

been maintained in Washington as to cases involving recommendations *for* the application of section 102.

With the war's end, the Bureau decided to include in the 1946 corporate tax return a question which required corporations to indicate whether they had distributed 70 percent of their current earnings to stockholders; if not, to state the reasons for the retention of such earnings or profits. This was the famous (or infamous) question 8 on the 1946 corporate return, and was as follows:

8. If the total of line 1 of schedule M, page 4, is less than 70 percent of the earnings and profits for the taxable year, state reasons for retention of such earnings and profits. (See instruction J.)

Instruction J:[29]

J. Surtax on improperly accumulated surplus.—In order to prevent accumulation of earnings or profits for the purpose of enabling shareholders to avoid the surtax on individuals, section 102 provides an additional tax upon the net income of corporations formed or utilized for the purpose of such tax avoidance. This additional tax is equal to the sum of the following:

Twenty-seven and one-half percent of the amount of the undistributed section 102 net income not in excess of $100,000, plus 38½ percent of the undistributed section 102 net income in excess of $100,000. (For definition of "undistributed sec. 102 net income," etc., see sec. 102.)

This tax is not to be applied to the accumulations of earnings for the reasonable needs of the business if the purpose of such accumulations is not to prevent the imposition of surtax upon the shareholders. *The information required in response to question 8, page 3, Form 1120, is designed to afford the taxpayer retaining a substantial portion of its earnings the opportunity to indicate the business needs, legal requirements, or other reason for the retention of such earnings.* (Italics ours.)

The amount of the earnings available for dividends is generally the taxable net income plus the nontaxable income reduced by the unallowed deductions. For the purpose of answering question 8, the amount of earnings and profits available for dividends may be determined by subtracting from the total of lines 18 and 19, schedule M, page 4, the total of lines 2 to 12, inclusive, of that schedule.[30]

The inclusion of question 8 in the 1946 corporate income tax return served several important purposes: First, as the Bureau explained to irate taxpayers, it permitted the easy segregation of corporate tax returns which should be subjected to further (and close) examination for section 102 liability; second, it constituted a general public notice that section 102 presumably would receive the enforcement attention of the Bureau;[31] and third, taxpayer corporations were required to state their reasons for distributing less than 70 percent of current earnings.[32] These reasons would be of Bureau record, and,

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[29] Instructions, Form 1120, United States Corporation Income Tax Return, 1946.

[30] Schedule M, Form 1120, 1946, is the "Reconciliation of net income and analysis of earned surplus and undivided profits."

[31] With the end of the war, but prior to the distribution of the 1946 corporate income tax return with its question 8, "there is already a great deal of talk (off the record) in the Bureau offices with respect to increased attention to the applicability of sec. 102 with respect to tax years, starting with 1946." A. Allen Simon, "Corporate Surplus and Section 102 in the Postwar Period," 14 The Controller 661 (1946).

[32] Edward I. McLarney, Deputy Commissioner, Bureau of Internal Revenue, on November 20, 1946, stated that "in order to afford such a corporation [a corporation distributing less than 70 percent of current earnings] an opportunity to state its business needs, legal requirements, or other reasons for retaining its earnings in the business, the corporation income tax return, Form 1120, for 1946 will include a question as to whether the total dividends to stockholders during the taxable year 1946 were less than 70 percent of the earnings and profits for the year." He cautioned "don't be disturbed when you see this question—its only purpose is to make easy the presentation to the Bureau of appropriate evidence in cases where the answer is 'Yes,' and thus avoid, if possible, the expense and inconvenience to both the taxpayer and the Bureau of further development of the subject. So if you answer 'Yes,' you should give the reasons why your corporation retained the profits instead of distributing them to its stockholders." See appendix 3, address entitled "Recent Progress in Federal Income Tax Administration" before the Tax Executives Institute, Los Angeles, Calif. It is not difficult to see how the above words of caution would serve principally to induce higher blood pressure on the part of taxpayers.

consequently, taxpayers could not later second-guess or rationalize on the basis of hindsight. Also, the Bureau, in subsequent years,[33] could check to see whether the reasons advanced for the accumulation of surplus had been, or were being, implemented.

Taxpayer reaction to question 8 initially was one of excitement and alarm, apparently.[34] There was suspicion that the question was indicative of a Bureau enforcement drive, in response to the large wartime growth in corporate surplus accumulations and liquidities;[35] further, that section 102 possibly was to be extended to the so-called public corporations. In commenting on the existing state of taxpayer apprehension, Clarence L. Turner said:

> Obviously, opinions vary as to the new import of "102"; and it is enigmatic that each theory bears the germ of truth.
>
> Many regard conciliatory official pronouncements with suspicion, and "view with alarm" the vast implication of the improper administration of "102." They see this section as the traditional "blunt instrument" being used by the Treasury to recoup losses from the repeal of the excess-profits tax, reduction of the corporate income tax to thirty-eight per cent and generous Congressional allowances for reconversion. Still others believe present rumblings presage an eruption in the form of a new undistributed profits tax.
>
> The calm reaction toward this medley of fact and fancy is that the importance of Section 102 is overemphasized; that nervous taxpayers, not yet recovered from the annual impact of the excess profits tax, have given way to morbid imaginings, and are inclined to see a tax collector lurking behind every tree.[36]

The incorporation in the 1946 return of an information question, i. e., question 8, was not a current innovation in Bureau thinking. It had been suggested, for example, in Congress on previous occasions.[37] The Bureau acted within its administrative discretion in its inclusion. There is support for Bureau use of this method of obtaining information. W. L. Cary contends that "the principle of requiring the taxpayer to explain the retention of profits appears to be a sound method of simplifying the Bureau's administrative problem. It aids in sifting out the clearest potential violators."[38] Robert S. Holzman expresses the view that "accountants in general will actually welcome this question. No more will they have to wrestle with the problem as to why dividends were small or nonexistent at some date three years

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[33] In the absence of fraud, the Bureau has 3 years for the examination of returns, i. e., statutory period of limitation for assessment of income and profits taxes is 3 years after filing of the return.

[34] To inquiries as to the content of a "Yes" answer to question 8, the Bureau indicated that it should be in detail—which did not serve to decrease the concern of taxpayers. In illustration, the following telegraph ruling:

MARCH 4, 1947.

To GUSTAVE SIMONS,
60 East 42d St., New York, N. Y.:

Reference telegram 3d question 8 on form 1120 should be answered in detail as to business needs, legal requirements, or other reasons for retention of earnings to aid examining officer of Bureau in more accurately determining whether provisions of section 102 have or have not been violated.

E. I. MCLARNEY,
Bureau of Internal Revenue.

Reactions as to detail in explanation of a "Yes" answer were stated to be as follows: "One school of thought advocates a statement of reasons for retention of earnings that is as accurate and convincing as possible, so that the revenue agent will have something specific to hang his hat on, while the opposite school prefers to couch the answer in extremely vague language, so that whatever circumstances prove to have materialized in three years (or whenever the return is audited) may be seized upon as *the* intended reason 'that's precisely what our answer had tried to set forth.' The writer doubts whether this second method will be found acceptable by the revenue agent * * *." Robert S. Holzman, "What's New in 102?" 25 Taxes 102 (1947).

[35] See O. D. Westfall, "Integrating Federal Income Taxes on Corporations and Their Shareholders," 27 Taxes 244 (1949).

[36] "Unreasonable Accumulation of Surplus * * * Sec. 102." op. cit., p. 842.

[37] William L. Cary, "Accumulations Beyond the Reasonable Needs of the Business: The Dilemma of Section 102 (c)," 60 Harvard Law Review 1288 (1947).

[38] Ibid.

ago—a task which now must be faced when the revenue agent asks his question. The accountant will be pleased to be relieved of this *a posteriori* rationalization; for the problem is now being thrown back squarely where it belongs—with management." [39]

The Bureau decided not to include question 8 in the 1947 and later returns. As stated by Edward I. McLarney, Deputy Commissioner, this question "having served its purpose, it will not be necessary to repeat the statement in the return for 1947," but, he added, "I can assure you that there has been no change in the long-established policy of the Bureau on this subject, either in inserting the statement in the 1946 return or in omitting it from the 1947 return." [40] The public interpretation of the omission of this question from the 1947 return apparently was that it has "been abandoned under pressure," [41] and that "protest against Question 8 has been so vigorous that the Bureau has now felt obliged to retreat." [42] That the Bureau has a certain sensitiveness to public criticism and pressure must, of course, be accepted; for that matter, the Bureau is not alone in this respect. Governmental departments and institutions generally, as well as private enterprises and institutions, constantly demonstrate an awareness of public opinion and an adjustableness with reference thereto.

The task of the Bureau of Internal Revenue is one of the most difficult in Government. In order that tax administration be of manageable proportions, the Bureau properly recognizes the need, in fact the necessity, of public acceptance of its practices and procedures. To separate taxpayers from their income with some reasonable regard for relative equities, with basic dependence on taxpayer self-assessment, and to do it with effectiveness, requires a tax administration which, among its other virtures, displays courage, tact, and a sensitiveness to the public it is serving.

It is not unlikely that Bureau abandonment of question 8 in the 1947 and later returns was strongly influenced by the public criticism which the question invoked. The language of criticism was strong, involving allegations of witch hunting and corporate hamstringing. It is possible that the Bureau was reasonably convinced that the question had "served its purpose" in creating a public awareness of section 102 during the one year of inclusion.[43] To the extent that question 8 was to serve the further purpose of permitting easy administrative segregation of those corporate returns requiring close examination for section 102 liability, the purpose obviously had not been served, with this need being continuous. Furthermore, the rational and limited use of the questionnaire principle, in conjunction with the corporate-tax return, hardly seems to require defense. The flow of

[39] "What's New in 102?," op. cit.
[40] See appendix 3, address entitled "Some Income Tax Reflections."
[41] William L. Cary, op. cit.
[42] Ibid., p. 1283.
J. H. Landman points out that E. I. McLarney's statement to the effect that the question had served its purpose "is not quite borne out by the facts; the national corporate dividend policy was more conservative for 1946 than for 1945 * * *." "Concepts of Section 102," 26 Taxes 23 (1948).
On the other hand, it is possible that corporate dividend policy would have been even more conservative for 1946 had it not been for question 8. On balance, it would seem that the insertion of this question in the 1946 return probably had some significant "forcing effect" on dividend distributions, as well as on real investment. Certainly, if the volume of clamor and criticism raised against question 8 (and sec. 102) is any criterion of its effectiveness, then some forcing effect was had.
[43] General corporate awareness of section 102 is not likely to be of a lasting character on the basis of a "1-shot" approach. It is induced and maintained by intensive cultivation which is continuous over time.

essential facts and information to the Bureau should be made as automatic as possible in the interest of effective and equitable taxation.

Bureau Procedure Upon Assertion of Corporate Liability

The internal revenue agent who examines the corporate tax return is the person initially responsible for a proposed deficiency assessment under section 102. This proposed deficiency results from an investigation which presumably establishes the relevant facts in accordance with Bureau policy and instructions. The internal revenue agent in charge then issues a preliminary letter (perhaps better known as a 30-day letter)[44] and provides the taxpayer corporation with a copy of the report of the examining officer. The taxpayer is then allowed 30 days in which to protest against the proposed action in writing, should he be in disagreement, and to file a brief submitting therewith the necessary evidence to support the protest. Thereupon, the taxpayer may appear for an oral hearing before a representative of the conference staff of the field office should he wish. Should an agreement be reached in the case, the appropriate forms[45] are executed by which the taxpayer formally consents to an immediate assessment and collection of the proposed deficiency in taxes. The field office then forwards the case record to the appropriate Audit Review Division of the Income Tax Unit in Washington, D. C., for postreview. In the event there is disapproval of the field closing action (to which the taxpayer has agreed) by the Audit Review Division, with the taxpayer subsequently unable to agree on the issue with the internal revenue agent in charge, a hearing may be had (at taxpayer option) before a representative of the Income Tax Unit in Washington in the office of the internal revenue agent in charge. If this hearing results in agreement and the taxpayer formally submits to the assessment and collection of the tax deficiency (with interest), the internal revenue agent in charge sends the case to the appropriate collector who then lists the deficiency (tax and interest) for assessment.

If the preliminary notice (30-day letter) has been sent to a taxpayer indicating a proposed deficiency upon which no agreement subsequently was reached (between the taxpayer and the internal revenue agent in charge), a statutory notice of deficiency (90-day letter)[46] is then sent the taxpayer by registered mail by the internal revenue agent in charge, acting under a delegation of authority of the Commissioner of Internal Revenue. This statutory notice of deficiency must be transmitted to the taxpayer, and 90 days must elapse before the Commissioner is empowered to assess the deficiency and enforce its collection. However, if the taxpayer files a petition with the Tax Court within the 90-day period for a redetermination of the deficiency, the Commissioner may not assess the deficiency until the Tax Court has rendered its decision. An alternative available to the taxpayer, prior to the issuance of the statutory notice of deficiency by the internal revenue agent in charge, is to request that the case be transferred to the appropriate field division of the technical staff for consideration. Even though the statutory notice of deficiency has been issued, and

[44] See Form 1200–A (1951), appendix 3.
[45] See Form 870 (1951), appendix 3.
[46] See Form 1230–A (1951), appendix 3.

the case is in 90-day status, the taxpayer may still submit a request for transfer of the case to the technical staff.[47] Once the case is in the hands of the technical staff, the internal revenue agent in charge is subject to technical staff direction in any further action on the case. Should the case fail of settlement, following proceedings before the technical staff, it is returned to the internal revenue agent in charge, with direction for appropriate action in the case. In the event of agreement, the taxpayer formally assents to the assessment of such deficiency as has been determined (upon which he has agreed). Customarily, cases settled by the technical staff, which are not pending before the Tax Court, require the taxpayer (as contingent to settlement) to execute an agreement for prompt payment of the deficiency with interest thereon, not to file an offer of compromise relative to the agreed tax liability, and to execute a final closing agreement when requested by the Commissioner. If the case is pending before the Tax Court at the time an agreed settlement is effected by the technical staff, a stipulation to that effect (agreed deficiency or overassessment) is filed with the Tax Court. The Tax Court then enters an order in conformity therewith.

Another alternative to which the taxpayer may have resort is that of paying the asserted deficiency, once the statutory notice of deficiency has been issued, and entering a suit for refund on the basis of alleged overassessment in a Federal district court or court of claims. In order to get the case tried on its merits in a Federal district court, advance payment of the tax must be made. This is not required, i. e., advance payment of deficiency, in the event of an appeal to the Tax Court for a redetermination of the proposed deficiency.

Taxpayer Consent to Waiver of Statute of Limitations

Under the statute of limitations (in the absence of fraud), the Bureau has three years in which to examine corporate income tax returns and to assert deficiency assessments thereon. In illustration, a corporate tax return covering the calendar year 1946, and filed on or before March 15, 1947, may be subject to a possible deficiency assessment until March 15, 1950. Because of staff inadequacies in the face of the large volume of corporate returns requiring examination, the Bureau is unable to examine, substantively, corporate returns the year filed. The time lag in return examination frequently means that a corporation subject to a deficiency assessment under section 102 will find that the deficiency assessment will be for a return filed 2 or 3 years previously. Further, it is not unusual for the Bureau to request the taxpayer corporation to sign a waiver[48] of the statute of limitations for the return of a particular tax year (or years) if it is about to be outlawed by the statute. Taxpayer corporations, apparently, rarely refuse to sign waivers upon Bureau request, as to do so may be construed as evidence of a lack of cooperation by the Bureau and, possibly, as feared by the taxpayer, may lead to a more rigorous examination of present and future returns. From the point of view of the taxpayer, a particular corporate return is in jeopardy (re possible deficiency assessment) for at least 3 years and possibly

[47] He may, in fact, be invited to do so.
[48] See Form 872, appendix 3.

longer, depending upon whether he has agreed to an extension of the statutory time by a waiver or waivers.[49] However, it should be said that waivers to extend the statutory period of assessment are not confined to section 102, but may be for any type of deficiency under income and profits taxes. Furthermore, the extension of time, by waiver, may be to the taxpayer's advantage, as well as his disadvantage, in permitting a more thorough investigation. Taxpayers generally regard a time extension of the statute of limitations as disadvantageous because a more thorough examination is likely to lead to a deficiency assessment in that the Bureau, in making the request for waiver, presumably was suspicious of the return following a preliminary examination. Further, the longer in time their corporate returns are at hazard, with a possible additional liability attaching thereto of unknown amount, the greater is the present feeling of corporate insecurity.

Of major concern, with particular reference to section 102, is the fact that the pattern of corporate policy as expressed in the retention of corporate earnings is likely to be fairly consistent over time. Consequently, a deficiency assessment under section 102 for a prior tax year, i. e., four or five years back, may well lead to deficiency assessments for the next several years subsequent thereto. To illustrate, if in 1950 the taxpayer's return for the tax year 1946 is under examination (and subject to assessment because of waiver), and a deficiency assessment is subsequently imposed, the taxpayer corporation may have good reason to expect deficiency assessments for the tax years 1947, 1948, and 1949, assuming the same policy in surplus accumulation was followed in those years as in 1946. Therefore, taxpayer corporations do not have at hazard the one tax year only, i. e., the 1947 return in 1950 (if no waiver has been given on a prior year or years), but all later returns as well. As would be expected, once the Bureau finds that a corporation has been guilty of the proscribed act (accumulation of surplus to avoid the surtax on shareholders) for a particular tax year, the corporation becomes suspect for later tax years, with close examination of its returns a natural consequence.

Taxpayer corporations have charged that the time lag in the examination of corporate returns, further extended in the event of waivers, permits the Bureau to "back guess" on corporate returns and the financial policies found therein. This, it is said, gives the Bureau an unfair advantage. It must be admitted that this time lag is to the disadvantage of corporations, and does place in jeopardy the returns for two or more tax years; also, that it is to be hoped that the examination of corporate returns will be established on a more current basis for the determination of all income tax deficiencies, including section 102. On the other hand, "directors of companies generally know when they are skirting the fringes of liability under Section 102, and in determining dividend policies, weigh the possible penalty against the individual tax saved by non-distribution."[50] Further, according to Cary, "there appear to be few instances in which the Section 102 penalty has been asserted by the Commissioner when there were insubstantial grounds for the Government's claim."[51] In addition, "by and large, it may be

[49] It has been reported to the writer that one corporation had its 1935 corporate return still at hazard in 1949 by reason of waivers signed by the taxpayer at the request of the Bureau.

[50] H. J. Rudick, "Section 102 and Personal Holding Company Provisions of the Internal Revenue Code," 49 Yale Law Journal 194 (1939).

[51] "Accumulations Beyond the Reasonable Needs of the Business," op. cit.

concluded that the courts have given sympathetic consideration to the taxpayers' claims of need for the profits retained." [52]

Enforcement of Section 102 by the Bureau of Internal Revenue, Fiscal 1940–50

Although section 102 and its predecessor sections have been part of the Federal tax structure since 1913, statistical information relating to the detailed administration of the statute heretofore has not been compiled. In order that these data be available for this study, the chairman [53] of the Joint Committee on the Economic Report of the Congress directed a request to the Secretary of the Treasury.[54] The Bureau of Internal Revenue thereupon prepared the statistical data which are discussed below.[55]

The statistical information requested was for the period fiscal 1939–40 to and including the first 6 months of fiscal 1949–50 (July 26, 1939–December 31, 1949). This period includes assessable tax years (corporate) 1938 to and including 1948. In illustration, the Bureau in fiscal 1940–41 may have imposed section 102 deficiency assessments on a corporation for tax years (calendar) 1938 and 1939.

The reasons for the selection of the period fiscal 1939–40 to and including the first half of fiscal 1949–50 were as follows:

1. It was not until 1939, with the issuance of Treasury Decision 4914, following the strengthening of section 102 by the Revenue Act of 1938, that Bureau agents were provided with working rules to assist in the screening of returns for suspect corporations; also that a central record file for section 102 cases was established in Washington.

2. With the inclusion of subsection (c) in the Revenue Act of 1938, which placed upon the taxpayer corporation the carrying forward of the burden of proof to the extent that it must be shown by a clear preponderance of all the evidence that the interdicted purpose was not present (if there is an unreasonable accumulation of surplus), the Bureau was in a stronger position in the enforcement of section 102.

3. Many of the cases prior to 1934 involved personal holding companies which, since then, are taxed under a separate section; also, the undistributed profits surtax of 1936–39 apparently was an influential factor in minimizing, in some degree, the need for enforcement of section 102 during its life.

4. Corporate liquidities have never been at higher levels than during the period under review.

5. With the abandonment of undistributed profits taxation in 1939, the Bureau was impelled to direct more attention to section 102 enforcementwise.

6. It is believed that the period fiscal 1940–50 not only provides some historical perspective as to section 102 enforcement, but is a period of sufficient duration to permit some reasonable contemporary appraisal of Bureau administration and policy.

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[52] Ibid.
[53] Senator Joseph C. O'Mahoney.
[54] To the Honorable John W. Snyder.
[55] With the case files of section 102 complicated and involved, the task of case analysis to abstract the required information items was tedious and exacting, and required the use of members of the auditing staff.
The author is responsible for the kind of data requested from the Bureau and its tabular organization.

The tabulated deficiency assessments under section 102 for fiscal 1940–50 (tax years 1938–48) involved 514 corporations and 919 assessable corporate tax years. Although the Income Tax Unit of the Bureau during this period had proposed deficiency assessments totaling 1,033 tax years, 114 tax years were subsequently declared nonassessable upon review by the technical staff and the courts.

The number of corporations, the total of assessable and nonassessable tax years, and the aggregate (dollar volume) of deficiency assessments, included in the following tables, do not comprise all cases handled by the Bureau during this period. The Washington file from which these cases were drawn for analysis is believed by the Bureau to be about 75 percent complete in respect to which recommendations have been made by the Income Tax Unit for section 102 deficiency assessments. The 919 corporate-tax years of assessment available for inclusion in the tables represent 90 percent of the total of 1,025 assessable tax years of record in the Bureau.[56] On the assumption that the Washington file contains some 75 percent of the section 102 cases (remainder in field offices), with 90 percent of the cases included herein, the tables represent a sample of 67.5 percent of all the cases (i.e., assessable tax years) of the period. This is a large, comprehensive, and representative sample.

The administrative file in Washington from which the cases were taken for analysis was brought into existence on July 26, 1939, by Treasury Decision 4914. The central record file, which was established in conformity with this Treasury decision, included each case in which a recommendation was made for a deficiency assessment. The central record file was discontinued following the issuance of Treasury Decision 5398 (August 12, 1944). Since then, according to the Bureau, there has been, in general, a recording of cases involving proposed deficiency assessments under section 102 in Washington.

It should be emphasized with reference to the number of deficiency assessments under section 102, as well as deficiencies with respect to income and profits taxes in general, that only a portion of the total corporate income tax returns in any one year is subject to intensive field examination by agents of the Bureau. While screening and classification procedures have been employed by the Bureau as a means of selecting the more productive cases, i. e., in terms of tax deficiencies, much yet remains to be done because present procedures are not adequately selective. The total number of corporations against which deficiency assessments could, or should, be made with respect to income and profits taxes, including section 102, is not indicated, of course, by the total of *actual* deficiency assessments.

From the totals of deficiency assessments under section 102 listed above (even when the totals are adjusted), the comparative unimportance, measured in an aggregative sense, of section 102 in the over-all enforcement activities of the Bureau can be seen. However, several modifying factors must be recognized in the interpretation of these figures. With the exception of the several corporations which have self-assessed section 102 deficiencies, enforcement of the section in the individual cases requires an intensive field examination of the return and the attention of the most highly trained and experienced revenue

[56] The 919 assessable tax years included in the study represent $16,560,012 of assessments, plus interest, which is 78 percent of the total of deficiency assessments, plus interest, of the entire Bureau file (1,025 tax years) in Washington.

TABLE 14.—*Deficiency assessments; income and profits tax, and sec. 102*

Tax year	Total number of corporation returns with net income	Fiscal year of deficiency assessment [1]	Income and profits tax deficiency assessments	
			Total	Total sec. 102 [2]
1938	169,884	1939–40	50,898	30
1939	199,479	1940–41	53,601	106
1940	220,977	1941–42	53,235	128
1941	264,268	1942–43	63,684	100
1942	269,942	1943–44	69,650	76
1943	283,735	1944–45	74,279	68
1944	288,904	1945–46	74,549	59
1945	303,019	1946–47	95,682	81
1946	359,310	1947–48	107,921	66
1947	[3] 382,538	1948–49	101,039	133
1948	[4]	[5] 1949–50	[5] 41,877	[5] 72

[1] Fiscal year of deficiency assessment will include (in total deficiencies) deficiencies against corporate returns for the current tax year as well as prior tax years.
[2] This includes only the tabulated sec. 102 cases estimated at 67.5 percent of total.
[3] Preliminary.
[4] Not available.
[5] First 6 months.

Source: Bureau of Internal Revenue.

agents, of which the Bureau has all too few. Further, because of the large area within which the discretion and judgment of corporate managements must be permitted to operate with reference to justifiable corporate liquidities, a zone of tolerance is found in its enforcement which serves, apparently, to exclude all but the more clear-cut cases. In addition, of the some 21 percent to 25 percent of the total of corporate returns (income years) which in the last several years have been subject to field examination under income and profits taxation, the Bureau tends to concentrate its attention principally upon the larger returns as measured by reported income. In illustration, the so-called "automatics" (returns automatically sent to the field for examination) fall within two classes: Returns reporting net income, when the reported total income (item 15 in the net income computation) is $75,000 or more; and returns reporting a loss, when the reported total income is $125,000 and above.[57] It is probable that a small proportion only of the closely held or family-owned corporations, as distinguished from the so-called public corporations, will have returns which will be included in the "automatics." Consequently, it is likely that corporations to which section 102 is a matter of concern [58] may receive less than a proportionate amount of attention, i. e., field examination (in numerical terms). These reasons, among others, may account in some measure for the relatively small volume of cases under the section.

For fiscal years of assessment 1940 to and including the first 6 months of 1950, the number of deficiency assessments (percent of total additional assessments) under section 102 to total income and profits tax deficiency assessments ranged from a low of 0.06 percent in fiscal years 1940 and 1948 to a high of 0.24 percent in fiscal 1942. This represents a deviation from the mean of 60 percent over the 11-year

[57] Revenue agents are permitted to use their discretion (except where returns have been recommended for examination) in the selection of the "automatics" to be examined.
[58] Closely held corporations.

period.[59] For the same period, the deviation from the mean for total deficiency assessments (in number) for income and profits tax, including section 102 assessments, is some 35 percent.

The deviation from the mean in the number of section 102 assessments, which ranged from a low of 30 in fiscal 1940 to a high of 133 in fiscal 1949, is some 63 percent.

TABLE 15.—*Percent sec. 102 deficiency assessments to total deficiency assessments*

[Money figures in thousands of dollars]

Fiscal year of assessment	Total additional income and profits tax assessments		Assessments with respect to improper accumulation of surplus		Assessments with respect to improper accumulation of surplus as a percent of total additional assessments	
	Number	*Amount*	*Number*	*Amount*	*Number*	*Amount*
1940	50,898	$128,754	30	$130	0.06	0.10
1941	53,601	119,208	106	832	.20	.70
1942	53,235	120,813	128	929	.24	.77
1943	63,684	225,506	100	949	.16	.42
1944	69,650	272,907	76	959	.11	.35
1945	74,279	353,855	68	1,028	.09	.29
1946	74,549	588,236	59	1,775	.08	.30
1947	95,682	872,801	81	800	.08	.09
1948	107,921	735,207	66	845	.06	.11
1949	101,039	679,174	133	3,943	.13	.58
1950 (first 6 months)	41,877	279,238	72	2,066	.17	.74
Total	786,415	4,375,699	919	14,255	.12	.33

NOTE.—This includes the tabulated sec. 102 cases only, estimated at 67.5 percent of total.

Source: Bureau of Internal Revenue.

The annual amounts of the deficiencies assessed under section 102 are found to vary from a low of 0.09 percent in fiscal 1947 to a high of 0.77 percent in fiscal 1942 as a percentage of total income and profits tax assessments. This is a deviation from the mean of 79 percent. Total annual assessments for income and profits tax, including section 102, show a deviation from the mean of 76 percent, which is in close correspondence thereto.

Section 102 assessments, of themselves, display a deviation from the mean over the period of some 94 percent, with the assessments varying from a low of $130,000 in fiscal 1940 to a high of $3,943,000 in fiscal 1949.

In the amounts of the deficiency assessments, as well as in the number of assessments, section 102 has been relatively unimportant, with total assessments less than 1 percent of total income and profits tax assessments, with the maximum annual percentage assessment standing at 0.77 percent in fiscal 1942.

However, in absolute terms, the assessments acquire a somewhat larger meaning because, in 4 of the 11 years, assessments have exceeded a million dollars, with a total of $3,943,000 in fiscal 1949, and $2,066,000 for the first 6 months of fiscal 1950.

In the following table, the relative significance of section 102 is indicated with respect to the number of proposed deficiency assessments to the total number of corporate returns with net income by tax years; the amount of corporate posttax net income of corporations subject to section 102 assessments, in comparison with posttax net income of

[59] The statistical measure (deviation from the mean) herein used is for ease of summarizing data variabilities. Any interpretation of the statistical summaries of the sec. 102 data should recognize the very small and highly variable aggregates involved.

all corporations with net income; and the total assets of corporations incurring deficiency assessments to the total assets of all corporations with net income.

In relation to all corporations with net income, it will be observed that the number against which section 102 deficiency assessments were proposed ranges from a low of 0.01 per cent in 1947 to a high of 0.12 percent for tax year 1938. The decline in this proportion since 1938 is largely accounted for by the time gap in Bureau assessment of tax.

TABLE 16.—*Corporations against which sec. 102 deficiency assessments proposed by Income Tax Unit, posttax net income and assets*

[Money figures in millions of dollars]

Tax year	Total number of corporation returns with net income	Sec. 102 deficiencies proposed by Income Tax Unit		Net income after taxes			Total assets		
				All corporations with net income	Corporations against which sec. 102 deficiencies were proposed by Income Tax Unit		All corporations with net income	Corporations against which sec. 102 deficiencies were proposed by Income Tax Unit	
		Number	Percent of total		Amount	Percent of total		Amount	Percent of total
1938	169,884	199	0.12	$5,666	$14	0.25	$181,059	$202	0.11
1939	199,479	167	.08	7,594	17	.22	206,671	202	.10
1940	220,977	148	.07	8,655	17	.20	228,659	171	.07
1941	264,628	110	.04	10,943	17	.16	263,522	189	.07
1942	269,942	72	.03	11,796	8	.07	321,424	113	.04
1943	283,735	75	.03	12,792	6	.05	363,495	98	.03
1944	288,904	80	.03	12,240	7	.06	399,674	98	.02
1945	303,019	72	.02	11,370	6	.05	415,860	75	.02
1946	359,310	70	.02	18,310	8	.04	416,844	70	.02
1947	[1] 382,538	37	.01	[1] 22,374	5	.02	[2]	40	
1948	[2]	3		[2]	1		[2]	3	

[1] Preliminary.
[2] Not available.

NOTE.—This includes only the tabulated sec. 102 cases, estimated at 67.5 percent of total.
Source: Bureau of Internal Revenue.

In comparison with all corporate posttax net income (for all corporations with net income), the posttax net income of corporations subject to deficiency assessments ranged from a low of 0.02 percent in 1947 to a high of 0.25 percent in tax year 1938. This substantially higher proportion of net income, as compared with the proportion of assessments to total corporate returns (with net income), indicates that, on the average, corporations against which section 102 assessments were asserted had approximately twice the amount of posttax net income as corporations in general.

The relative asset position of corporations subject to assessment, as compared with total assets of all corporations (with net income), ranges from a low of 0.02 percent for 1944, 1945, and 1946 to a high of 0.11 percent for the tax year 1938. The relative amount of assets of corporations subject to section 102 assessments is in approximately the same proportion as the number of corporate tax years of assessment to total corporate returns (with net income). This suggests that the average amount of assets per corporation assessed was comparable to the average of assets of corporations in general. The relationship of income to assets of assessed corporations indicates that income yield per dollar of assets was about twice as high as for all corporations (with net income).

Asserted deficiency assessments were few in number of corporate tax years, and the corporations assessed represent a relatively insignificant proportion of total corporate assets and of total posttax corporate income. It should be cautioned, however, that the above measurements of Bureau enforcement activity in regard to section 102 are not to be taken as indicating the *real* importance of this section because it is penal in nature; the effects induced in corporate dividend and investment policies constitute the basic indicators of its significance.

Table 17 is a summary by tax years (1938–48) of the deficiency assessments initially recommended by the Income Tax Unit, Bureau of Internal Revenue, under section 102.[60] Also included are the number of 90-day letters issued, the number of corporate tax years for which waivers were requested of taxpayers, the total tax proposed, and the total tax assessed as finally determined by the Income Tax Unit, the technical staff, or the courts (i. e., Tax Court, or other courts).

TABLE 17.—*Assessable and nonassessable tax years combined by tax years: Total number of tax years, number of 90-day letters issued, number of waivers requested, total tax proposed, and tax assessed*

[Corporation income-tax returns involving deficiencies proposed by the Income Tax Unit with respect to improper accumulation of surplus for taxable years ending after Dec. 31, 1937, closed in the period July 26, 1939, through Dec. 31, 1949]

Tax years	Total number of tax years	Number of 90-day letters issued [1]	Number of tax years for which waivers were requested of taxpayers [2]	Total tax proposed [3]	Tax assessed
1938	199	42	15	$2,803,337	$1,368,215
1939	167	44	13	2,989,456	1,279,516
1940	148	30	21	3,950,514	1,848,075
1941	110	12	21	4,054,750	2,199,318
1942	72	4	24	1,757,669	1,091,895
1943	75	2	26	1,110,678	901,061
1944	80	5	26	1,520,081	1,324,104
1945	72	2	14	1,164,772	970,590
1946	70	1	1	1,984,910	1,824,146
1947	37	----------	----------	1,452,677	1,322.251
1948	3	----------	----------	125,958	125,958
Total	1,033	142	161	22,914,802	14,255,129

For footnotes, see table 26 (p. 132).

NOTE.—Table prepared by the Bureau of Internal Revenue.

It will be noted that the total of 1,033 corporate tax years of proposed deficiencies (as initially recommended by the Income Tax Unit) represents a very uneven impact by tax years. The number of corporate tax years of proposed assessment declines sharply and consistently, with the exception of 1942 and 1943, over the period under review. This is explained by the time lag between the tax years and the fiscal year of assessment. The number of 90-day letters issued by the Bureau, as would be expected, largely follows the same pattern of

[60] The data included in tables 17–26 are estimated to include some 67.5 percent of the total assessable corporate tax years for fiscal years of assessment 1940–50 (first 6 months) under sec. 102; on the basis of this estimate, assessable tax years for the period would total some 1,361.

Corporate tax years of recommended assessment in 1948 are incomplete because 1948 returns are subject to examination primarily in fiscal 1950 and later years; returns for tax year 1947 are open for examination, without waivers, to March 15, 1951 (calendar year taxpayers).

decline. The number of tax years for which waivers were requested, on the other hand, reaches its maximum during 1943 and 1944, and thereafter decreases. The increase in the number of waivers requested during the war years possibly may find explanation in Bureau manpower shortage, which may have retarded the processing of section 102 cases. Total tax proposed, as well as tax assessed, is at its highest level for tax year 1941.

The total number of 90-day letters issued is 13.7 percent of the total number of tax years of initially recommended assessments. The number of waivers requested exceeds somewhat the number of 90-day letters, and is 15.6 percent of tax years of recommended assessment; or, 1 out of each 6 corporate tax years, on the average, was subject to a request for waiver. For tax years 1942, 1943, and 1944, requests for waivers were at an average ratio of 1 to 3. Of the tax proposed, some 62 percent was ultimately assessed.

In table 18 are shown the number of assessable tax years by fiscal year of assessment, fiscal 1940–50 (first 6 months), the total of nonassessable tax years, and the closing of the deficiency assessments, both as to number and as to amount of the initially recommended assessments by the Income Tax Unit, the technical staff, and the courts.

Of the 1,033 initially recommended corporate tax years of assessment by the Income Tax Unit, 114, or 11 percent, were subsequently found to be nonassessable by the technical staff and the courts. The technical staff accounted for the larger number, 83 corporate tax years, or 73 percent, of the total of nonassessable tax years, while the courts closed 31 corporate tax years, or 27 percent, as nonassessable. The 114 nonassessable tax years represent $2,841,801 of recommended tax, or $24,928 per corporate tax year.

The Income Tax Unit closed 726 of the 919 assessable corporate tax years, or 79 percent, the technical staff 173 assessable corporate tax years, or 19 percent, and the courts 20 assessable tax years, or 2 percent.

In the closure of assessable corporate tax years, the Income Tax Unit assessed 78 percent of the tax initially proposed, the technical staff 54 percent of the proposed tax in cases closed under its jurisdiction, and the courts 86 percent.

Fiscal 1949 has been the year of Bureau assessment of the largest number of assessable corporate tax years over the period—133 tax years. However, it is possible that fiscal 1950 may show a larger total because the first 6 months of the year resulted in 72 corporate tax years of assessment. Fiscal 1941, 1942, and 1943 also were years of a relatively large number of corporate years of assessment. Total tax assessed, as well as total tax proposed, reaches the highest level in fiscal 1949. Fiscal 1950 (in the first 6 months) is next highest in total tax assessed; and by the end of the year it may exceed fiscal 1949. Enforcement activity, as measured by total tax assessed, has been increasing since fiscal 1947, with a sharp step-up in fiscal 1949 and 1950 as compared with earlier years.

The number of assessable and nonassessable corporate tax years segregated by tax years 1938–48, in contrast with fiscal years of assessment as shown in table 18, can be seen in table 19. This arrangement of the data indicates the character of the time lag between the tax years of corporate assessment and the fiscal year of Bureau imposition or assessment of the tax.

TABLE 18.—*Assessable tax years by fiscal year of assessment and by stage of closing, and nonassessable tax years in total by stage of closing: Number of tax years, tax proposed, and tax assessed*

[Corporation income-tax returns involving deficiencies proposed by the Income Tax Unit with respect to improper accumulation of surplus for taxable years ending after Dec. 31, 1937, closed in the period July 26, 1939, through Dec. 31, 1949]

	Total			Closed by Income Tax Unit			Closed by technical staff			Closed by Tax Court or other court		
	Number of tax years	Tax proposed [3]	Tax assessed [4]	Number of tax years	Tax proposed [3]	Tax assessed [4]	Number of tax years	Tax proposed [3]	Tax assessed [4]	Number of tax years	Tax proposed [3]	Tax assessed [4]
Assessable tax years [5] by fiscal year of assessment:												
1939–40	30	$200,810	$129,786	25	$168,584	$119,127	5	$32,226	$10,659			
1940–41	106	1,209,237	832,037	87	786,377	508,114	18	402,305	317,923	1	$20,555	$6,000
1941–42	128	1,424,292	928,978	85	873,288	554,683	43	551,004	374,295			
1942–43	100	1,836,431	949,378	62	807,629	481,338	35	897,992	387,319	3	130,810	80,721
1943–44	76	1,947,676	958,755	43	870,026	410,581	28	881,765	353,623	5	195,885	194,551
1944–45	68	1,227,490	1,027,588	44	829,470	716,427	17	297,315	210,456	7	100,705	100,705
1945–46	59	2,391,233	1,774,978	50	2,255,152	1,667,332	7	125,111	96,676	2	10,970	10,970
1946–47	81	965,161	799,827	74	734,721	650,075	7	230,440	149,752			
1947–48	66	1,052,067	844,670	62	900,846	701,200	4	151,221	143,470			
1948–49	133	5,617,677	3,943,036	122	3,135,201	2,693,546	9	2,476,624	1,243,638	2	5,852	5,852
1949–50 (first 6 months)	72	2,200,927	2,066,096	72	2,200,927	2,066,096						
Total	919	20,073,001	14,255,129	726	13,562,221	10,568,519	173	6,046,003	3,287,811	20	464,777	398,799
Nonassessable tax years,[5] total	114	2,841,801					83	2,249,342		31	592,459	
Grand total	1,033	22,914,802	14,255,129	726	13,562,221	10,568,519	256	8,295,345	3,287,811	51	1,057,236	398,799

For footnotes, see table 26 (p. 132).

NOTE.—Table prepared by the Bureau of Internal Revenue.

TABLE 19.—*Assessable and nonassessable tax years by stage of closing and by tax year: Number of tax years, tax proposed, and tax assessed*

[Corporation income-tax returns involving deficiencies proposed by the Income Tax Unit with respect to improper accumulation of surplus for taxable years ending after Dec. 31, 1937, closed in the period July 26, 1939, through Dec. 31, 1949]

Tax years	Total			Closed by Income Tax Unit			Closed by technical staff			Closed by Tax Court or other court		
	Number of tax years	Tax proposed [3]	Tax assessed [4]	Number of tax years	Tax proposed [3]	Tax assessed [4]	Number of tax years	Tax proposed [3]	Tax assessed [4]	Number of tax years	Tax proposed [3]	Tax assessed [4]
Assessable tax years: [6]												
1938	169	$2,334,406	$1,368,215	104	$1,149,673	$678,571	59	$1,012,793	$545,297	6	$171,940	$144,347
1939	136	2,120,992	1,279,516	85	929,782	598,892	45	1,032,787	559,252	6	158,423	121,372
1940	121	3,298,028	1,848,075	83	1,284,580	811,252	35	1,934,683	959,392	3	78,765	77,431
1941	99	3,479,642	2,199,318	81	1,706,481	1,218,798	16	1,726,406	933,765	2	46,755	46,755
1942	65	1,540,164	1,091,895	58	1,499,791	1,065,451	5	34,554	20,625	2	5,819	5,819
1943	73	1,103,225	901,061	67	972,088	789,283	5	128,062	108,703	1	3,075	3,075
1944	76	1,487,281	1,324,104	71	1,335,295	1,182,135	5	151,986	141,969			
1945	71	1,153,990	970,590	69	1,141,107	957,707	2	12,883	12,883			
1946	69	1,976,638	1,824,146	68	1,964,789	1,818,221	1	11,849	5,925			
1947	37	1,452,677	1,322,251	37	1,452,677	1,322,251						
1948	3	125,958	125,958	3	125,958	125,958						
Total	919	20,073,001	14,255,129	726	13,562,221	10,568,519	173	6,046,003	3,287,811	20	464,777	398,799
Nonassessable tax years: [5]												
1938	30	468,931					19	267,776		11	201,155	
1939	31	868,464					20	617,346		11	251,118	
1940	27	652,486					21	579,521		6	72,965	
1941	11	575,108					9	517,338		2	57,770	
1942	7	217,505					6	208,054		1	9,451	
1943	2	7,453					2	7,453				
1944	4	32,800					4	32,800				
1945	1	10,782					1	10,782				
1946	1	8,272					1	8,272				
1947												
1948												
Total	114	2,841,801					83	2,249,342		31	592,459	
Grand total	1,033	22,914,802	14,255,129	726	13,562,221	10,568,519	256	8,295,345	3,287,811	51	1,057,236	398,799

For footnotes, see table 26 (p. 132).

NOTE.—Table prepared by the Bureau of Internal Revenue.

It will be observed that relatively large numbers of deficiency assessments (tax years) made by the Bureau in fiscal 1949 and 1950 (see table 18) are not reflected in the number of corporate tax years of assessment of 1947 and 1948 (see table 17, p. 111). This indicates that a large proportion of the assessments made in those fiscal years are for corporate tax years prior to 1947. Correspondingly, it may be anticipated that the number of corporate tax years of assessment for 1947 and 1948, respectively 37 and 3, will be substantially increased over the next several fiscal years as more corporate returns (for these years) are examined, and returns presently under examination are subject to assessments.

A frequency distribution, with reference to the number of individuals owning voting stock in corporations to which section 102 deficiency assessments have been proposed, is found in table 20. The frequency distribution is by corporate tax years of assessment.

Of 919 assessable corporate tax years, 1938–48, the number of individuals owning voting stock was available for 857. This is 93 percent of the assessable tax years. Ownership of assessed corporations is found to be highly concentrated [61] with—

- 79 percent of the corporations (tax years of assessment) having less than 5 shareholders per corporation
- 14 percent of the corporations (tax years of assessment) having 5 to 10 shareholders per corporation
- 3 percent of the corporations (tax years of assessment) having 10 to 15 shareholders per corporation
- 2 percent of the corporations (tax years of assessment) having 15 to 25 shareholders per corporation
- 0.8 percent of the corporations (tax years of assessment) having 25 to 50 shareholders per corporation
- 0.4 percent of the corporations (tax years of assessment) having 50 to 100 shareholders per corporation

[61] Percentages have been rounded.

TABLE 20.—*Assessable and nonassessable tax years by distribution of individuals owning voting stock by tax years: Number of tax years*

[Corporation income-tax returns involving deficiencies proposed by the Income Tax Unit with respect to improper accumulation of surplus for taxable years ending after Dec. 31, 1937, closed in the period July 26, 1939, through Dec. 31, 1949]

Tax years	Number of tax years	Number of individuals owning voting stock							
		Not reported	Under 5	5 under 10	10 under 15	15 under 25	25 under 50	50 under 100	100 under 150
ASSESSABLE TAX YEARS [5]									
1938	169	3	121	31	12	1	1		
1939	136	6	96	19	8	4	1	2	
1940	121	4	93	14	6	3		1	
1941	99	5	76	14	2	2			
1942	65	6	51	7		1			
1943	73	9	53	9		1	1		
1944	76	10	56	8		1	1		
1945	71	8	54	6	1	2			
1946	69	7	53	4		3	2		
1947	37	4	26	4		2	1		
1948	3		2			1			
Total	919	62	681	116	29	21	7	3	
NONASSESSABLE TAX YEARS [5]									
1938	30	1	15	10	1	1	1		1
1939	31	2	18	9			1		1
1940	27	2	16	5		1	1	1	1
1941	11	1	3	4	1	1		1	
1942	7		4	2	1				
1943	2		2						
1944	4		4						
1945	1		1						
1946	1		1						
1947									
1948									
Total	114	6	64	30	3	3	3	2	3
Grand total	1,033	68	745	146	32	24	10	5	3

For footnotes, see table 26 (p. 132).

NOTE.—Table prepared by the Bureau of Internal Revenue.

These data fully support the contention commonly made that section 102 has been applied by the Bureau almost exclusively to corporations *very* closely held—so closely held, in fact, that virtually a prima facie case exists for a finding of direct corporate control by particular individuals whose circumstances would indicate a financial advantage, or interest, in personal surtax avoidance. The so-called public corporation (with a wide distribution of voting stock) is conspicuously absent from the list of the corporations which have been subject to section 102 assessments, even though in the case of many of the public corporations control is vested in a particular family group or a few identifiable individuals. It appears that the Bureau, in its application of the section, has directed its principal attention to what may be regarded as the *extreme* cases of concentrated corporate control; and with concentration of control interpreted primarily in terms of the total number of shareholders, rather than the existence of control in fact in the hands of a few individuals or family group, although there may be many thousands of shareholders. However, from the point of view of the enforcement of the section, its application to corporations with a very limited number of shareholders doubtless is rendered less difficult. It should be pointed out in this connection that because of the very

conservative attitude displayed by the courts in section 102 litigation an expansion of the area of enforcement by the Bureau would be attended with considerable risk. The Government has received adverse decisions in 50 percent of the litigated cases under the section to January 1, 1950 (see ch. VI). However, to limit section application only to the more extreme cases of concentrated corporate ownership and control is greatly to reduce its effectiveness. To serve its intended purpose with reasonable adequacy the area of its application should be broadened, even though it entails an enlarged litigation risk.

For corporations initially subject to a deficiency assessment by the Income Tax Unit and later found to be nonassessable, the same concentration of control is found. A frequency distribution of individuals owning voting stock for 108 nonassessable corporate tax years of a total of 114 is shown. This is 86 percent of the total nonassessable tax years. The frequency distribution is as follows: [62]

59 percent of the corporations (tax years of recommended assessment) had less than 5 shareholders per corporation
28 percent of the corporations (tax years of recommended assessment) had 5 to 10 shareholders per corporation
3 percent of the corporations (tax years of recommended assessment) had 10 to 15 shareholders per corporation
3 percent of the corporations (tax years of recommended assessment) had 15 to 25 shareholders per corporation
3 percent of the corporations (tax years of recommended assessment) had 25 to 50 shareholders per corporation
2 percent of the corporations (tax years of recommended assessment) had 50 to 100 shareholders per corporation
3 percent of the corporations (tax years of recommended assessment) had 100 to 150 shareholders per corporation

The data in table 21 further emphasize the extreme character of the concentration of corporate control in the hands of a few shareholders for corporations assessed under the section. The numbers of corporations by assessable and nonassessable tax years, in which a single shareholder or 2 shareholders own more than 50 percent of the voting stock, are summarized for tax years 1938–48. The 856 assessable tax years for which information as to the amount of stock ownership was available is 93 percent of the total of 919 assessable tax years.

It will be noted that, in 576 corporate tax years of assessment of the total of 856, the corporations herein assessed had, individually, a single stockholder owning more than 50 percent of the voting stock. This is 67 percent of the total. Corporations in 244 assessable tax years had more than 50 percent of their voting stock owned by 2 shareholders, or 29 percent (28.5) of the total. Corporations having *more* than 2 shareholders owning more than 50 percent of the voting stock are found in only 36, i. e., 4 percent of the 856 assessable tax years. Thus, in 96 percent of the assessable tax years, corporate control was so highly concentrated and so complete, i. e., either 1 or 2 shareholders owning more than 50 percent of the voting stock, that no legitimate question could be raised as to where the corporate control resided.

[62] Percentages have been rounded.

The pattern of high concentration of corporate control for the nonassessable tax years is the same as for the assessable tax years. In only 5 percent (4.5) of the 111 nonassessable years did the corporations therein assessed have *more* than two stockholders owning more than 50 percent of the voting shares. Thus, with few exceptions, corporations assessed under section 102 have had a very limited distribution of the voting stock (few stockholders), with the majority of the voting shares concentrated in the hands of one or two persons. From the standpoint of corporate control in the application of the section, it is clear that the Bureau has directed its principal enforcement attention to that class of corporations in which the extremes of fewness of shareholders and concentration in voting share ownership are found in combination.

TABLE 21.—*Assessable and nonassessable tax years by tax years: Total number of tax years, and concentration of holders of more than 50 percent of voting stock*

[Corporation income-tax returns involving deficiencies proposed by the Income Tax Unit with respect to improper accumulation of surplus for taxable years ending after Dec. 31, 1937, closed in the period July 26, 1939, through Dec. 31, 1949]

Tax years	Total number of assessable tax years [6]	Assessable tax years [5]			
		Corporations in which 1 stockholder owns more than 50 percent of voting stock		Corporations in which 2 stockholders own more than 50 percent of voting stock	
		Number	Percent of total	Number	Percent of total
1938	167	111	66.5	50	29.9
1939	131	91	69.5	34	26.0
1940	116	85	73.3	26	22.4
1941	94	64	68.1	26	27.7
1942	60	42	70.0	17	28.3
1943	63	37	58.7	22	34.9
1944	67	46	68.7	19	28.4
1945	62	41	66.1	18	29.0
1946	61	36	59.0	22	36.1
1947	32	21	65.6	10	31.3
1948	3	2	66.7		
Total	856	576	67.3	244	28.5
		Nonassessable tax years [5]			
1938	29	18	62.1	10	34.5
1939	30	20	66.7	9	30.0
1940	26	20	76.9	4	15.4
1941	11	7	63.6	3	27.3
1942	7	6	85.7	1	14.3
1943	2	1	50.0	1	50.0
1944	4	2	50.0	2	50.0
1945	1	1	100.0		
1946	1	1	100.0		
1947					
1948					
Total	111	76	68.5	30	27.0
Grand total	967	652	67.4	274	28.3

For footnotes, see table 26 (p. 132).

NOTE.—Table prepared by the Bureau of Internal Revenue.

Table 22 presents detail as to the assets, earned surplus, liquid assets, the ratio of current assets to current liabilities, the proportion of posttax net income retained, the total number of stockholders, tax proposed, tax assessed, and interest on tax for corporations incurring

deficiency assessments for tax years 1938–48; also by fiscal years of assessment fiscal 1940–50 (first 6 months).

For corporations against which the tax was assessed, grouped by tax year of assessment, the following will be observed:

1. That earned surplus was in excess of 50 percent of total assets for each year of the 11-year period.
2. That liquid assets were in excess of total earned surplus for each year of the 11-year period.
3. That the ratios of current assets to current liabilities ranged from a low of 5.3 to 1 (tax year 1945) to a high of 8.5 to 1 (tax year 1938) over the 11-year period.
4. That the proportion of posttax net income retained ranged from a low of 61.4 percent (tax year 1939) to a high of 93.2 percent (tax year 1945) over the 11-year period.

TABLE 22.—*Assessable tax years by fiscal year of assessment and tax year, nonassessable tax years by tax year: Number of tax years, total assets, earned surplus, liquid assets, ratio of current assets to current liabilities, percent of net income after taxes retained, number of stockholders, tax proposed, and amount assessed*

[Corporation income-tax returns involving deficiencies proposed by the Income Tax Unit with respect to improper accumulation of surplus for taxable years ending after Dec 31, 1937, closed in the period July 26, 1939, through Dec. 31, 1949]

	Number of tax years	Total assets	Earned surplus	Liquid assets [7]	Ratio of current assets to current liabilities	Percent of net income after taxes retained	Total number of stockholders [8]	Tax proposed [9]	Amount assessed		
									Tax [4]	Interest	Total
ASSESSABLE TAX YEARS [5]											
Total assessable tax years: [6]											
Tax year:											
1938	169	$175,380,515	$95,648,807	$118,471,347	8.5	68.8	665	$2,334,406	$1,368,215	$233,210	$1,601,425
1939	136	164,994,545	97,811,081	104,852,382	8.4	61.4	696	2,120,992	1,279,516	175,130	1,454,648
1940	121	142,039,088	75,814,139	85,667,440	8.4	73.6	505	3,298,028	1,848,075	441,995	2,290,071
1941	99	159,900,714	85,585,819	92,841,838	7.7	78.0	309	3,479,642	2,199,318	509,587	2,708,905
1942	65	89,050,278	45,526,711	58,791,601	7.3	79.1	157	1,540,164	1,091,895	190,834	1,282,729
1943	73	97,955,471	56,537,413	67,481,092	7.7	78.3	211	1,103,225	901,061	131,531	1,032,592
1944	76	95,394,577	54,394,371	71,179,079	6.5	89.7	202	1,487,281	1,324,104	207,922	1,532,027
1945	71	72,719,259	41,430,539	53,962,884	5.3	93.2	201	1,153,990	970,590	118,040	1,088,633
1946	69	69,451,191	36,291,671	52,739,477	6.2	89.4	260	1,976,638	1,824,146	194,164	2,018,314
1947	37	39,747,732	23,486,762	28,641,226	5.8	87.5	152	1,452,677	1,322,251	98,920	1,421,172
1948	3	2,798,095	1,962,729	2,099,206	5.4	67.5	27	125,958	125,958	3,538	129,496
Fiscal year of assessment 1939–40:											
Tax year:											
1938	29	21,968,352	10,759,878	12,207,663	7.2	64.7	155	192,029	121,005	6,486	127,491
1939	1	248,920	149,634	212,397	9.3	100.0	1	9,781	8,781	----------	8,781
Fiscal year of assessment 1940–41:											
Tax year:											
1938	66	61,993,225	41,724,470	41,006,419	11.0	63.9	208	678,720	398,426	41,481	439,907
1939	40	46,296,837	33,205,074	34,698,804	9.8	63.0	220	530,517	433,611	27,876	461,487
Fiscal year of assessment 1941–42:											
Tax year:											
1938	45	27,341,565	16,024,446	17,973,339	9.0	65.2	196	392,817	198,613	29,486	228,099
1939	50	52,651,900	27,581,726	33,719,510	8.1	49.4	221	519,066	328,483	28,794	357,278
1940	33	30,914,692	19,732,052	22,851,513	9.2	57.8	213	512,409	401,882	24,879	426,761
Fiscal year of assessment 1942–43:											
Tax year:											
1938	19	34,167,101	14,249,057	23,337,921	5.2	69.2	77	619,619	315,596	59,617	375,213
1939	25	24,508,745	13,403,375	12,819,137	7.3	58.0	129	389,874	173,041	28,423	201,465
1940	36	25,998,214	12,483,114	14,454,952	5.2	68.8	119	593,836	254,227	27,656	281,884
1941	20	19,031,208	11,321,801	7,069,474	10.6	60.2	51	233,102	206,514	11,692	218,206
Fiscal year of assessment 1943–44:											
Tax year:											
1938	4	7,126,206	5,042,516	5,971,978	10.0	100.0	5	64,967	55,939	16,648	72,587

1939	9	15,535,049	8,280,648	8,003,520	5.0	84.6	60	363,920	162,427	35,973	198,400
1940	27	27,750,850	14,401,964	15,877,846	7.3	79.9	103	667,776	325,821	46,365	372,186
1941	29	41,295,573	28,074,560	26,952,426	7.1	76.7	113	758,559	362,108	28,479	390,587
1942	6	1,985,051	1,128,120	1,707,779	4.1	97.5	9	91,026	51,032	3,447	54,479
1943	1	120,597	61,557	95,576	9.8	52.7	6	1,428	1,428	46	1,474
Fiscal year of assessment 1944–45:											
Tax year:											
1938	3	14,370,376	5,242,066	11,831,162	34.4	88.4	8	322,658	244,576	66,372	310,948
1939	5	6,875,582	4,007,848	3,732,491	14.8	73.3	16	47,525	45,806	13,319	59,125
1940	14	17,052,857	11,290,659	9,641,312	15.2	74.2	35	160,105	135,354	31,245	166,599
1941	22	31,469,506	18,035,726	19,761,645	8.4	72.8	60	437,825	359,478	54,978	414,456
1942	19	23,288,861	12,793,231	13,913,281	11.5	59.8	55	228,078	212,967	25,280	238,247
1943	5	3,105,963	1,664,719	2,189,471	10.9	78.4	11	31,298	29,407	2,111	31,518
Fiscal year of assessment 1945–46:											
Tax year:											
1938	1	7,134,403	1,639,431	5,595,724	7.6	100.0	12	59,071	29,535	11,725	41,260
1939	3	12,898,550	6,355,768	8,964,195	31.0	68.6	38	163,669	92,443	29,891	122,334
1940	6	10,709,869	9,603,198	7,981,733	13.9	77.0	30	145,639	106,102	23,869	129,971
1941	16	29,125,198	14,920,494	20,281,648	12.2	79.9	60	643,796	531,567	103,079	634,646
1942	16	33,228,390	15,503,637	22,996,970	9.8	88.5	39	842,349	585,040	98,423	683,463
1943	14	26,671,820	16,524,260	19,119,613	14.5	89.5	33	451,607	345,189	41,417	386,606
1944	2	6,963,674	6,335,102	5,487,488	1,139.1	100.0	2	64,155	64,155	3,093	67,248
1945	1	1,771,916	340,768	1,370,463	13.2	100.0	1	20,947	20,947	----------	20,947
Fiscal year of assessment 1946–47:											
Tax year:											
1938	2	1,279,287	966,943	547,141	3.3	100.0	4	4,525	4,525	1,395	5,920
1939	2	5,579,849	4,608,533	2,371,877	4.3	100.0	6	89,316	26,600	10,654	37,254
1940	2	4,315,581	2,717,317	1,416,221	9.5	70.1	1	39,950	33,358	11,316	44,674
1941	7	7,921,466	4,084,546	3,551,738	3.9	76.3	16	127,519	89,866	24,659	114,525
1942	11	6,977,988	2,647,520	4,380,695	6.5	80.2	22	71,942	54,789	11,817	66,606
1943	25	27,443,868	15,037,006	19,296,513	5.4	79.0	94	296,031	257,484	27,829	285,313
1944	23	23,674,709	14,249,572	17,592,032	9.0	84.6	48	234,344	233,006	12,702	245,709
1945	7	5,634,207	2,502,265	2,883,749	7.6	99.3	12	66,271	64,936	1,378	66,315
1946	2	2,389,743	738,191	1,892,522	10.9	100.0	2	35,263	35,263	----------	35,263
Fiscal year of assessment 1947–48:											
Tax year:											
1941	1	1,044,095	432,211	605,386	2.6	41.8	4	19,629	19,629	6,617	26,246
1942	6	19,278,320	11,625,463	12,317,405	5.7	75.3	22	259,014	159,583	42,360	201,943
1943	14	26,530,209	17,290,280	16,183,349	8.2	67.3	39	189,585	158,114	31,485	189,599
1944	24	28,554,162	15,656,173	20,527,459	7.7	82.7	75	365,357	291,283	36,213	327,496
1945	13	13,204,978	7,937,392	10,219,464	7.8	84.9	35	133,253	130,832	12,761	143,593
1946	7	1,963,248	1,100,731	1,019,500	4.0	96.4	11	58,972	58,972	3,393	62,366
1947	1	1,874,686	487,079	1,402,322	23.6	100.0	1	26,257	26,257	----------	26,257

For footnotes, see table 26 (p. 132).

TABLE 22.—*Assessable tax years by fiscal year of assessment and tax year, nonassessable tax years by tax year: Number of tax years, total assets, earned surplus, liquid assets, ratio of current assets to current liabilities, percent of net income after taxes retained, number of stockholders, tax proposed, and amount assessed*—Continued

[Corporation income-tax returns involving deficiencies proposed by the Income Tax Unit with respect to improper accumulation of surplus for taxable years ending after Dec. 31, 1937, closed in the period July 26, 1939, through Dec. 31, 1949]

	Number of tax years	Total assets	Earned surplus	Liquid assets [7]	Ratio of current assets to current liabilities	Percent of net income after taxes retained	Total number of stockholders [8]	Tax proposed [3]	Amount assessed		
									Tax [4]	Interest	Total
Fiscal year of assessment 1948–49:											
Tax year:											
1939	1	$399,113	$218,475	$330,451	(9)	40.0	5	$8,324	$8,324	$200	$8,524
1940	3	25,297,025	5,585,835	13,443,863	10.2	88.2	4	1,178,312	591,331	276,665	867,996
1941	4	30,013,668	8,716,481	14,619,521	6.5	89.3	5	1,259,212	630,156	280,083	910,239
1942	6	2,667,136	1,266,657	2,239,916	4.1	98.6	8	43,361	24,188	8,007	32,195
1943	11	11,453,326	5,149,264	8,488,495	6.8	68.1	26	107,728	86,891	22,059	108,950
1944	21	25,922,809	14,248,473	20,807,513	9.3	96.1	74	709,011	621,310	126,527	747,837
1945	34	37,011,172	23,029,113	29,855,414	5.9	93.1	115	797,367	617,788	77,458	695,248
1946	35	35,863,296	17,934,663	29,255,879	6.0	89.9	142	1,037,867	950,305	88,750	1,039,057
1947	18	15,517,794	8,976,746	11,130,303	5.3	80.3	78	476,495	412,743	22,247	434,991
Fiscal year of assessment 1949–50 (first 6 months):											
Tax year:											
1942	1	1,624,532	562,083	1,235,555	1.6	95.9	2	4,394	4,296	1,500	5,796
1943	3	2,629,688	810,327	2,108,075	4.8	88.9	2	25,548	22,548	6,584	29,132
1944	6	10,279,223	3,905,051	6,764,587	1.8	94.6	3	114,414	114,350	29,387	143,737
1945	16	15,096,986	7,621,001	9,633,794	3.1	95.2	38	136,152	136,087	26,443	162,530
1946	25	29,234,904	16,518,086	20,571,576	6.3	87.8	105	844,536	779,606	102,021	881,628
1947	18	22,355,252	14,022,937	16,108,601	5.9	91.6	73	949,925	883,251	76,673	959,924
1948	3	2,798,095	1,962,729	2,099,206	5.4	67.5	27	125,958	125,958	3,538	129,496
NONASSESSABLE TAX YEARS [5]											
Tax year:											
1938	30	26,660,868	15,448,742	14,138,711	6.9	76.1	294	468,931			
1939	31	36,823,130	17,999,177	21,368,281	4.9	65.8	246	868,464			
1940	27	28,910,277	16,594,016	14,897,271	6.3	63.2	307	652,486			
1941	11	29,534,736	18,146,518	16,295,124	7.6	46.6	145	575,108			
1942	7	23,985,003	15,848,704	14,972,918	10.3	47.3	33	217,505			
1943	2	252,274	117,250	195,610	4.4	100.0	5	7,453			
1944	4	3,060,693	1,511,273	2,050,983	2.9	99.4	13	32,800			
1945	1	2,028,428	1,136,762	1,570,821	(9)	29.2	3	10,782			
1946	1	81,107	28,006	61,998	1.9	100.0	2	8,272			

For footnotes, see table 26 (p.132).

NOTE.—Table prepared by the Bureau of Internal Revenue.

These data sharply emphasize the conclusion that the corporations (collectively) assessed under the section had very large earned surpluses (heavy prior accumulations of earnings), extraordinarily high liquidities, unusually high ratios of current assets to current liabilities, and were retaining very large proportions of their current earnings.

The most striking aspect of the financial behavior of these assessed corporations is the extremely high liquidities which have been achieved. This, of course, is reflected in the very high ratios of current assets to current liabilities. The ratios of liquid assets to total assets are as follows:

Tax year:	*Ratio liquid assets to total assets*	Tax year—Con.	*Ratio liquid assets to total assets*
1938	0.68	1944	0.75
1939	.64	1945	.74
1940	.60	1946	.76
1941	.58	1947	.72
1942	.66	1948	.75
1943	.69		

The ratio of liquid assets to total assets for all assessed corporations for the 11 tax years, 1938–48, is 0.66.

Variations in ratios of earned surplus to total assets, in liquid assets to total assets, in current assets to current liabilities, and in the proportion of posttax net income retained are somewhat better seen by taking the fiscal years of assessment with the smaller groupings of the assessed corporations. Certain striking situations may be noted. In fiscal 1946, the six assessable tax years for 1940 (of six corporations) show a ratio of earned surplus to total assets of 0.90, a ratio of liquid assets to total assets of 0.75, a ratio of current assets to current liabilities of 13.9 to 1, with 77 percent of posttax net income retained. The stockholders of the assessed corporations were 30 in number.

An extreme, and very unusual, set of ratios may be observed with respect to two corporations—one large and one small—for fiscal 1946 and assessable tax year 1944. The ratio of earned surplus to total assets was 0.91; of liquid assets to total assets 0.79; of current assets to current liabilities 1,139.1 to 1; and with 100 percent of posttax net earnings retained.

In fiscal 1950, a corporation assessed for tax year 1942, although showing a comparatively low ratio of current assets to current liabilities, i. e., 1.6 to 1, for a section 102 deficiency, nevertheless had a ratio of liquid assets to total assets of 0.76; a ratio of earned surplus to total assets of 0.35; and a current retention of posttax net income of 95.9 percent. A similar situation may be noted for fiscal 1950 assessments for tax year 1944 involving six corporations. The combined ratio of current assets to current liabilities was 1.8 to 1; however, the ratio of liquid assets to total assets was 0.66; of earned surplus to total assets 0.38; and 94.6 percent of posttax net income retained.

This strongly suggests that the critical factor in section 102 assessments by the Bureau, assuming the corporation is closely held and subject to control by a limited number of persons, is corporate liquidity (unless justifiable). The ratio of earned surplus to total assets is not, per se, significant because a high ratio of earned surplus may simply represent a long previous plough-back of earnings into real investment—which is a legitimate reason for the retention of earnings. A very favorable ratio of current assets to current liabili-

ties, likewise, may simply represent a small amount of current liabilities—rather than excessive liquidity. Similarly, a high percentage of posttax net income currently retained by the corporation may be fully and completely excusable, if employed for the implementation of additional real investment, or if it does not cause the corporation to establish a position of excessive liquidity.

The nonassessable corporate tax years, 114 in number, involve corporations which show ratios, on the whole, about as favorable as for the tax years of assessments:

Tax year	Ratio of earned surplus to total assets	Ratio of liquid assets to total assets	Ratio of current assets to current liabilities	Percent of posttax net income retained
1938	0.58	0.53	6.9	76.1
1939	.49	.58	4.9	65.8
1940	.57	.52	6.3	63.2
1941	.61	.55	7.6	46.6
1942	.66	.62	10.3	47.3
1943	.46	.78	4.4	100.0
1944	.49	.67	2.9	99.4
1945	.56	.77		29.2
1946	.35	.76	1.9	100.0

The comparatively high liquidities for the nonassessable tax years apparently were satisfactorily explained, with their existence justified by the corporations concerned to the Income Tax Unit, the technical staff, or to the courts—whichever agency closed the case.

Table 23 indicates the impact of Bureau enforcement of the section with reference to industry groupings. The standard industrial classification is used, with major subclasses, and corporations incurring deficiency assessments are classified therein in accordance with the particular activity responsible for the largest proportion of total money receipts.

TABLE 23.—*Assessable tax years by fiscal year of assessment (tax years in total) by industrial classification: Number of corporations, number of tax years, tax proposed, and tax assessed*

[Corporation income-tax returns involving deficiencies proposed by the Income Tax Unit with respect to improper accumulation of surplus for taxable years ending after Dec. 31, 1937, closed in the period July 26, 1939, through Dec. 31, 1949]

Industrial classification [10]	Assessable tax years [6]																																			
	Total				Fiscal year of assessment 1939–40				Fiscal year of assessment 1940–41				Fiscal year of assessment 1941–42				Fiscal year of assessment 1942–43				Fiscal year of assessment 1943–44				Fiscal year of assessment 1944–45				Fiscal year of assessment 1945–46				Fiscal year of assessment 1946–47				Fiscal year of assessment 1947–48				Fiscal year of assessment 1948–49				Fiscal year of assessment 1949–50			
	Number of corporations	Number of assessable tax years	Tax proposed [8]	Tax assessed [4]	Number of corporations	Number of assessable tax years	Tax proposed [8]	Tax assessed [4]	Number of corporations	Number of assessable tax years	Tax proposed [8]	Tax assessed [4]	Number of corporations	Number of assessable tax years	Tax proposed [8]	Tax assessed [4]	Number of corporations	Number of assessable tax years	Tax proposed [8]	Tax assessed [4]	Number of corporations	Number of assessable tax years	Tax proposed [8]	Tax assessed [4]	Number of corporations	Number of assessable tax years	Tax proposed [8]	Tax assessed [4]	Number of corporations	Number of assessable tax years	Tax proposed [8]	Tax assessed [4]	Number of corporations	Number of assessable tax years	Tax proposed [8]	Tax assessed [4]	Number of corporations	Number of assessable tax years	Tax proposed [8]	Tax assessed [4]	Number of corporations	Number of assessable tax years	Tax proposed [8]	Tax assessed [4]
All industrial groups	514	919	$20,073,001	$14,255,129	30	30	$200,810	$129,786	88	106	$1,209,237	$832,037	98	128	$1,424,292	$928,978	79	100	$1,836,431	$949,378	61	76	$1,947,676	$958,755	40	68	$1,227,490	$1,027,588	35	59	$2,391,233	$1,774,978	45	81	$965,161	$799,827	43	66	$1,052,067	$844,670	79	133	$5,617,677	$3,943,036	43	72	$2,200,927	$2,066,096
Manufacturing	202	355	11,037,085	7,667,599	8	8	81,999	32,267	35	40	606,725	441,345	45	55	819,227	551,452	33	41	1,059,250	460,491	34	40	771,716	307,026	13	22	374,515	369,620	16	23	886,666	635,968	12	22	209,243	246,342	16	22	246,596	232,586	29	52	4,607,335	3,106,192	18	30	1,313,813	1,284,310
Food and kindred products, beverages	28	42	1,412,220	966,503	2	2	9,585	6,410	8	9	47,630	35,280	2	2	25,231	11,041	7	8	327,725	104,975	1	1	29,768	12,500	3	5	147,219	147,219					3	4	38,985	28,465	1	1	12,854	12,854	5	9	681,943	516,479	1	1	91,280	91,280
Tobacco manufactures																																															
Textile-mill products	8	14	177,683	134,894					1	1	17,119	17,119	1	1	33,695	33,695	1	1	6,114	3,000	4	4	69,788	34,661									2	2	17,832	13,384	1	2	15,967	15,967	1	1	9,540	9,540	1	2	7,628	7,628
Apparel and other finished products made from fabrics	11	19	395,213	367,136					2	2	7,694	3,847	5	5	48,739	36,242													1	1	16,252	12,189					1	3	38,346	30,676	2	3	134,893	134,893	3	5	149,289	149,289
Lumber and timber products	7	11	614,452	596,877	1	1	3,684	2,137													1	1	10,758	3,870	1	3	8,116	8,116	1	1	18,280	9,140					1	1	[26,142	26,142	1	3	542,281	542,281	1	1	5,191	5,191
Furniture and finished lumber products	11	21	292,477	193,279					1	1	8,575	8,575	3	3	70,388	35,476	1	1	3,800	2,098	5	6	54,090	30,717	1	1	8,691	8,691	1	2	52,216	52,216	1	2	14,389	6,749	1	2	9,636	9,636	1	1	19,371	19,371	1	2	51,321	24,750
Paper and allied products	12	33	1,220,812	977,318					4	5	178,036	169,262	4	5	108,802	100,520	1	2	4,244	4,244	2	4	265,589	41,271	1	4	79,001	79,001	2	4	90,355	88,235	1	1	22,965	22,965	1	1	19,947	19,947	3	5	40,672	40,672	1	2	411,201	411,201
Printing, publishing, and allied industries	28	53	969,813	808,794	2	2	31,223	18,693	6	7	114,280	89,905	7	11	188,934	172,040	3	7	194,856	106,196	2	2	4,453	3,061	1	1	11,473	10,616	6	8	61,403	49,623	2	5	66,164	66,164	5	5	45,632	44,033	1	1	7,847	7,847	2	4	243,548	240,616
Chemicals and allied products	14	21	313,855	157,722					3	3	21,517	3,104	3	3	13,087	12,295	3	3	157,828	52,250	3	3	13,558	10,782					1	1	40,924	22,279					2	4	32,077	32,077	1	4	34,864	24,935				
Petroleum and coal products																																															
Rubber products	2	4	18,498	14,581													1	1	3,016	3,016																					1	5	36,464	9,625				
Leather and products	2	7	59,891	23,590													2	2	23,427	13,965																												
Stone, clay, and glass products	3	6	96,580	56,946																													1	3	27,736	27,736										
Iron, steel, and products	19	37	928,574	750,468	1	1	14,843	500	1	2	69,206	39,999	3	3	24,978	22,396	3	3	23,701	21,222	3	4	80,659	46,763	3	4	95,742	91,704	1	2	26,024	21,229	1	2	77,071	76,778	2	2	16,254	16,254	7	11	441,694	355,221	2	3	58,402	58,402
Nonferrous metals and their products	7	10	175,940	70,318					1	1	59,259	10,000	1	2	17,796	8,898	1	1	40,051	12,000	3	3	25,188	14,774	1	2	19,146	10,146																	1	1	5,500	5,500
Machinery, except transportation equipment and electrical	20	36	3,373,351	1,890,576	1	1	12,391	3,500	3	3	56,437	41,882	8	9	178,760	80,837	5	6	93,697	35,284	5	5	162,898	79,106	1	1	338	338	1	1	198,572	198,572	1	3	4,101	4,101	1	1	29,741	25,000	1	2	2,418,920	1,209,460	2	4	212,496	212,496
Electrical machinery and equipment	7	10	67,044	36,210					2	3	14,536	9,936	1	2	14,064	3,001	2	2	22,788	16,337	1	1	11,694	2,924																			1	2	3,962	3,962				
Transportation equipment, except automobiles	2	2	17,231	11,494													1	1	6,315	578																					1	1	10,916	10,916				
Automobiles and equipment, except electrical	2	2	19,518	4,108	1	1	10,273	1,027									1	1	9,245	3,081																												
Miscellaneous manufacturing industries	19	27	883,933	601,785					3	3	12,436	12,436	4	6	68,310	18,030	3	3	94,565	74,176	2	2	19,268	10,922	1	1	4,789	4,789	2	3[7]	382,640	182,485									3	4	223,968	220,990	3	5	77,957	77,957
Agriculture, forestry, and fishery	8	17	213,626	203,695	1	1	5,727	5,727	1	1	11,071	11,071	1	1	21,587	21,587	1	1	4,176	4,176	1	1	34,031	25,000					1	2	8,658	8,658	2	2	17,244	17,244	1	1	13,862	13,862	3	6	80,355	80,355	1	1	16,015	16,015
Mining and quarrying	12	22	1,058,177	923,394	2	2	10,793	10,793	1	1	2,104	400	2	2	31,766	12,531	1	1	18,357	5,500	2	2	14,920	13,586	2	3	316,181	227,408	1	4	523,727	523,725	1	2	10,428	10,428	2	4	117,586	106,708	1	1	12,315	12,315				
Metal mining																																															
Coal mining	2	2	5,288	3,534	1	1	3,184	3,184	1	1	2,104	400																																				
Crude petroleum and natural gas production	6	13	497,309	377,089									2	2	31,766	12,531					1	1	9,033	7,699	2	3	316,181	227,408					1	2	10,428	10,428	2	4	117,586	106,708	1	1	12,315	12,315				
Nonmetallic mining and quarrying	4	7	555,580	542,721	1	1	7,609	7,609									1	1	18,357	5,500	1	1	5,887	5,887					1	4	523,727	523,725																
Construction	13	32	459,610	376,970					3	5	40,204	8,859					2	2	9,172	4,030	3	5	30,300	15,293					2	4	173,951	158,141	1	2	12,466	12,466	3	6	41,126	41,126	3	5	69,399	54,123	1	3	82,992	82,932
Wholesale and retail trade	144	234	4,451,988	2,799,071	8	8	31,121	22,513	25	28	148,509	109,713	19	26	196,334	116,039	22	27	511,861	320,523	12	13	851,773	357,408	12	16	153,006	132,566	13	22	773,090	423,345	13	21	178,474	143,983	14	19	530,138	350,868	27	40	637,894	488,953	10	14	439,788	335,160
Wholesale trade	72	121	2,497,390	1,315,454	6	6	27,771	20,252	11	12	64,793	43,738	11	14	82,240	44,557	11	16	242,715	129,187	5	6	480,096	162,904	6	9	70,176	52,253	9	17	738,406	394,315	6	10	81,589	50,112	5	7	285,906	152,409	15	19	385,431	234,633	3	5	38,267	31,064
Retail trade	56	98	1,500,796	1,101,081	1	1	2,089	1,000	10	11	55,415	43,045	7	11	112,080	70,038	10	10	235,232	176,336	4	4	285,196	148,424	5	6	76,311	73,794	4	5	34,684	29,030	7	11	96,855	93,871	7	9	223,320	183,992	8	15	104,877	104,877	4	5	274,078	176,553
Trade not allocable	16	25	453,802	382,556	1	1	1,261	1,261	4	5	28,301	22,929	1	1	1,414	1,414	1	1	33,894	15,000	3	3	86,481	46,080	1	1	6,519	6,519									2	3	20,903	14,467	4	6	147,586	147,443	3	4	127,443	127,443
Finance, insurance, and real estate	59	118	1,161,567	981,435	7	7	59,161	48,904	6	8	73,814	31,663	13	21	115,621	98,822	6	8	89,152	47,341	2	3	35,946	35,946	7	15	160,916	137,323	1	3	22,714	22,714	8	18	237,123	191,897	4	7	87,388	87,388	7	14	73,018	73,018	8	14	206,714	206,419
Banking and credit agencies	1	1	5,500	5,500													1	1	5,500	5,500																												
Investment trusts and investment holding companies	2	4	11,283	11,283																																					1	3	7,387	7,387	1	1	3,896	3,896
Other finance	6	8	176,731	176,059	1	1	414	414																									1	1	3,297	3,066	1	2	28,442	28,442	1	1	6,032	6,032	1	2	137,224	137,224
Insurance	8	19	120,741	90,115	2	2	6,319	2,072									2	3	18,691	9,602	1	2	42,290	25,000	1	2	26,243	26,243	1	4	5,582	5,582					1	1	3,836	3,836					1	5	17,780	17,780				
Real estate, including lessors of real property	42	86	847,312	698,478	4	4	52,428	46,418	6	8	73,814	31,663	9	16	90,108	82,839	5	6	46,862	22,341	1	1	9,703	9,703	6	11	155,334	131,741	1	3	22,714	22,714	6	16	229,990	184,995	3	5	58,946	58,946	4	5	41,819	41,819	6	11	65,594	65,299
Transportation, communication, and other public utilities	25	41	526,620	389,204					3	4	118,999	102,543	11	14	193,796	107,777	5	7	56,312	34,898					1	1	3,861	1,250	1	1	2,427	2,427					2	6	11,920	8,681	3	4	26,154	23,477	2	4	103,151	103,161
Service	47	91	1,079,992	834,780	1	1	1,719	1,719	14	19	207,811	126,443	6	7	35,890	15,699	8	12	83,460	70,656	6	11	207,058	203,464	5	11	219,011	159,421					8	14	240,183	177,467	1	1	3,451	3,451	5	9	47,955	43,351	3	6	33,454	33,109
Hotels and other lodging places																																															
Business service	9	13	65,192	41,714					4	5	33,438	19,417	2	3	28,405	12,542	1	1	1,678	1,678	2	4	11,671	8,077																	3	7	35,894	35,894	1	3	17,270	17,270
Motion pictures	13	36	159,762	152,358					5	9	30,992	28,014					4	7	32,529	28,103	1	2	5,065	5,065									4	8	38,012	38,012										
Amusement, except motion pictures	4	6	150,812	42,154	1	1	53,129	9,133	1	1	500	500	1	1	4,600	2,654	1	2	4,867	4,867													1	1	87,716	25,000										
Other services	21	36	704,226	598,554	1	1	1,719	1,719	4	4	100,252	69,379	3	3	6,985	2,657	2	3	44,653	38,221	3	5	190,520	190,520	4	9	213,946	154,356					3	5	114,455	114,455	1	1	3,451	3,451	2	2	12,061	7,457	2	3	16,184	15,839
Nature of business not allocable	4	9	84,336	78,981	3	3	10,290	7,863					1	2	5,071	5,071	1	1	1,691	1,763	1	1	1,032	1,032																	1	[9] 2	63,252	63,252				

For footnotes, see table 26 (p. 132).

NOTE.—Table prepared by the Bureau of Internal Revenue.

The number of corporations assessed, the number of assessable years, the tax proposed, and the tax assessed are shown by fiscal year of assessment 1940–50 (first 6 months) on the basis of the industrial class of the assessed corporations.

The enforcement of section 102 has had the following distributional impact, measured by the number of corporations assessed, the total number of tax years assessed, and the amount of tax assessed:

Industrial class	Number of corporations [1]	Total tax years assessed	Tax assessed	Percent total tax assessed [2]
Manufacturing	202	355	$7,667,599	54
Wholesale and retail trade	144	234	2,799,071	18
Finance, insurance, real estate	59	118	981,435	7
Mining and quarrying	12	22	923,394	6
Service industries	47	91	834,780	6
Transportation, communication, and other public utilities	25	41	389,204	3
Construction	13	32	376,970	3
Agriculture, forestry, fishery	8	17	203,695	1
Other corporations not classifiable	4	9	78,981	0.5
Total	514	919	14,255,129	

[1] The total of corporations by fiscal years of assessment is 641 (instead of 514). This is a result of the assessment of the same corporations in different fiscal years for other (nonduplicating) tax years. To illustrate, a corporation may be assessed in fiscal 1942 for tax years 1939 and 1940: again in fiscal 1949 the same corporation may be assessed for tax years 1946 and 1947. Consequently, this corporation would be listed twice in the total of corporations assessed by fiscal years of assessment. The number of corporations (514) herein used excludes duplications, and is the total of separate and distinct corporations which have been subject to 1 or more tax years of assessment under sec. 102.

[2] Percentages have been rounded.

It will be observed that manufacturing corporations, as an industrial class, have received the largest number of deficiency assessments, accounting for 39 percent of the total of corporations assessed, 39 percent of the total of assessable tax years, and 54 percent of the total tax assessed. Wholesale and retail trade corporations are next in relative importance, with this industrial class having 28 percent of the total number of corporations assessed, 25 percent of the total tax years assessed, and 18 percent of the total tax assessed. Collectively, corporations in manufacturing and in wholesale and retail trade were subject to 72 percent of total tax, 64 percent of total assessable tax years, and 67 percent of the total of assessed corporations.

Finance, insurance, and real-estate corporations comprised 11 percent of the corporations assessed, 13 percent of the tax years assessed, and 7 percent of the assessed tax. Corporations in the mining and quarrying industry accounted for only 2 percent of the assessed corporations and 2 percent of the assessed years, yet received 6 percent of the total tax assessed.

Service corporations were 9 percent of the corporations assessed, and had 10 percent of the tax years assessed. They were subject to 6 percent of the total tax assessed. Transportation, communication, and other public utility companies constituted 5 percent of the number of assessed corporations, 4 percent of the assessed tax years, and 3 percent of the assessed tax. Construction companies represented 3 percent of assessed corporations, 3 percent of assessed tax years, and 3 percent of the assessed tax.

Corporations engaged in agriculture, forestry, and fisheries were the least important of the classified industrial groups, as they were only 2 percent of the corporations assessed, 2 percent of the assessed tax years, and 1 percent of the assessed tax.

Some four corporations could not be classified by reason of the nature of their business, which did not permit assignment. These unallocated corporations represent 1 percent of the assessed corporations, 1 percent of the assessed tax years, and five-tenths of 1 percent of the assessed tax.

A wide range exists among the industrial classes as to tax assessed per corporation and tax assessed per tax year, with the ratio of tax years assessed per corporation showing significant although less extreme variation:

Industrial class	Tax assessed per corporation	Tax assessed per tax year	Average number of tax years assessed per corporation
Manufacturing	$37,958	$21,599	1.8
Wholesale and retail trade	19,438	11,962	1.6
Finance, insurance, and real estate	16,634	8,317	2.0
Mining and quarrying	76,949	41,972	1.8
Service industries	17,761	9,173	1.9
Transportation, communication, and other public utilities	15,568	9,493	1.6
Construction	28,998	11,780	2.5
Agriculture, forestry, and fishery	25,462	11,982	2.1
Other corporations not classifiable	19,745	8,776	2.3

Corporations engaged in mining and quarrying had an average assessed tax of $76,949—the highest of any of the industrial classes. Transportation, communication, and other public-utility companies had the lowest average assessed tax per corporation of $15,568. This range represents a deviation from the mean of 59 percent. The mining and quarrying industry likewise ranks first, with respect to the average tax per corporate tax year, with a tax in the amount of $41,972. Finance, insurance, and real-estate companies are lowest, with an average tax per corporate tax year of $8,317. This range is a deviation from the mean of 67 percent. Significant dispersion in the ratios of average tax years assessed per corporation exists for the various industrial groups. The construction industry has the highest ratio of 2.5 assessed tax years per corporation, with the public utility and wholesale and retail trade industries lowest with 1.6 assessed tax years. This is a deviation from the mean of 22 percent.

Industrial vulnerability, as found in the number of corporations assessed, in section 102 enforcement by the Bureau, is found to be highest for industrial subclasses as follows:

Industry	Subclasses	Number of corporations assessed
Manufacturing	Food and kindred products, beverages	28
	Printing, publishing, and allied industries	28
Mining and quarrying	Crude petroleum and natural gas production.	6
Wholesale and retail trade	Wholesale trade	72
Finance, insurance, and real estate	Real estate, including lessors of real property.	42
Service	Motion pictures [1]	13

[1] Excluding residual and miscellaneous services which had 21 corporations subject to assessment.

Enforcement impact, in terms of the number of corporations assessed by industry groups, displays, on the whole, a rather remarkable

consistency by fiscal years of assessment.[63] In fiscal 1947 the wholesale and retail trade industry exceeded manufacturing in corporations assessed—13 as against 12; the only year in the period in which this occurred. The finance, insurance, and real-estate industry was third highest in the number of corporations assessed except for fiscal years 1941, 1943, and 1944 when exceeded by the service industry,[64] and in fiscal 1946 by the construction industry. The number of corporations assessed by fiscal years and the interindustry patterns of assessments for the 11-year period are shown below:

Fiscal year of assessment	Manufacturing	Wholesale and retail trade	Finance, insurance, and real estate	Service	Transportation, communication, and other public utilities	Construction	Mining and quarrying	Agriculture, forestry, and fishery	Others, not classified	Total
1940	8	8	7	1			2	1	3	30
1941	35	25	6	14	3	3	1	1		88
1942	45	19	13	6	11		2	1	1	98
1943	33	22	6	8	5	2	1	1	1	79
1944	34	12	2	6		3	2	1	1	61
1945	13	12	7	5	1		2			40
1946	16	13	1		1	2	1	1		35
1947	12	13	8	8		1	1	2		45
1948	16	14	4	1	2	3	2	1		43
1949	29	27	7	5	3	3	1	3	1	79
1950 [1]	18	10	8	3	2	1		1		43
Total	259	175	69	57	28	18	15	13	7	641

[1] First 6 months.

The distribution of assessable corporate tax years, by class of industry, by fiscal year of assessment for the period fiscal 1940–50, follows. Over the period there is a tendency for the number of assessed tax years to increase per corporation assessed. This increase is noticeable, particularly, since fiscal 1944. This suggests that the Bureau may be directing, in general, more attention to the returns of a corporation for prior, as well as subsequent, years, once the corporation is assessed.

Fiscal year of assessment	Manufacturing	Wholesale and retail trade	Finance, insurance, and real estate	Service	Transportation, communication, and other public utilities	Construction	Mining and quarrying	Agriculture, forestry, fishery	Others, not classified	Total	Tax years assessed per corporation
1940	8	8	7	1			2	1	3	30	1.0
1941	40	28	8	19	4	5	1	1		106	1.2
1942	55	26	21	7	14		2	1	2	128	1.3
1943	41	27	8	12	7	2	1	1	1	100	1.3
1944	40	13	3	11		5	2	1	1	76	1.2
1945	22	16	15	11	1		3			68	1.7
1946	23	22	3		1	4	4	2		59	1.7
1947	22	21	18	14		2	2	2		81	1.8
1948	22	19	7	1	6	6	4	1		66	1.5
1949	52	40	14	9	4	5	1	6	2	133	1.7
1950 [1]	30	14	14	6	4	3		1		72	1.7
Total	355	234	118	91	41	32	22	17	9	919	[2] 1.4

[1] First 6 months.
[2] Average.

[63] Certain corporations may be assessed in two or more fiscal years for different tax years. Consequently, the total of corporations assessed by fiscal years is greater than the number of corporations individually subject to one or more years of assessment.
[64] In fiscal 1947 these industries had the same number of corporations subject to assessment.

Nonassessable tax years classified by industrial groups, with the number of corporations and proposed tax, are listed in table 24 for fiscal years of assessment 1940–50.

TABLE 24.—*Nonassessable tax years in total by industrial classification: Number of corporations, number of tax years, tax proposed, and tax assessed*

[Corporation income-tax returns involving deficiencies proposed by the Income Tax Unit with respect to improper accumulation of surplus for taxable years ending after Dec. 31, 1937, closed in the period July 26, 1939, through Dec. 31, 1949]

Industrial classification [10]	Nonassessable tax years [9]		
	Number of corporations	Number of nonassessable tax years	Tax proposed [8]
All industrial groups	78	114	$2,841,801
Manufacturing	40	54	1,933,336
Food and kindred products, beverages	3	6	429,548
Tobacco manufactures			
Textile-mill products	2	2	15,210
Apparel and other finished products made from fabrics	4	5	63,890
Lumber and timber basic products	1	1	25,277
Furniture and finished lumber products	1	1	8,568
Paper and allied products			
Printing, publishing, and allied industries	4	5	76,030
Chemicals and allied products	8	11	400,496
Petroleum and coal products			
Rubber products	1	1	8,429
Leather and products			
Stone, clay, and glass products			
Iron, steel, and products	3	3	85,882
Nonferrous metals and their products	4	5	190,124
Machinery, except transportation equipment and electrical	1	1	27,353
Electrical machinery and equipment	2	3	59,209
Transportation equipment, except automobiles	1	1	15,726
Automobiles and equipment, except electrical	1	2	221,127
Miscellaneous manufacturing industries	4	7	306,467
Agriculture, forestry, and fishery	2	3	17,205
Mining and quarrying	1	1	31,073
Metal mining			
Coal mining			
Crude petroleum and natural gas production	1	1	31,073
Nonmetallic mining and quarrying			
Construction	3	3	46,525
Wholesale and retail trade	17	30	544,552
Wholesale trade	8	13	198,907
Retail trade	7	14	310,245
Trade not allocable	2	3	35,400
Finance, insurance, and real estate	4	6	55,611
Banking and credit agencies			
Investment trusts and investment holding companies			
Other finance			
Insurance	1	2	12,032
Real estate, including lessors of real property	3	4	43,579
Transportation, communication, and other public utilities	7	11	177,891
Service	4	6	35,608
Hotels and other lodging places			
Business service	2	4	18,127
Motion pictures			
Amusement, except motion pictures			
Other services	2	2	17,481
Nature of business not allocable			

For footnotes, see table 26 (p. 132).

NOTE.—Table prepared by the Bureau of Internal Revenue.

The total number of nonassessable tax years is 114; of corporations involved therein, 78; and the amount of the proposed tax, $2,841,801. Nonassessable tax years are found for all industrial groups, with manufacturing and wholesale and retail trade accounting for the majority of the nonassessable tax years, corporations, and proposed tax. Collectively, these two industries represent 73 percent of the total number of corporations, 73 percent of the nonassessable tax years, and 87 percent of the total proposed tax. Nonassessable tax years ranged from a low of 1 per corporation for the construction and mining and quarrying industries to a high of 1.8 per corporation for the wholesale and retail trade industry.

Industry	Number of corporations	Percent of total corporations [1]	Number of nonassessable tax years	Percent of total nonassessable tax years [1]	Tax proposed	Percent of total tax proposed [1]	Nonassessable tax years per corporation
Manufacturing	40	51	54	47	$1,933,336	68	1.4
Wholesale and retail trade	17	22	30	26	544,552	19	1.8
Transportation, communication, and other public utilities	7	9	11	10	177,891	6	1.6
Finance, insurance, and real estate	4	5	6	5	55,611	2	1.5
Construction	3	4	3	3	46,525	2	1.0
Service	4	5	6	5	35,608	1	1.5
Mining and quarrying	1	1	1	1	31,073	1	1.0
Agriculture, forestry, and fishery	2	3	3	3	17,205	1	1.5
Total	78	100	114	100	2,841,801	100	[2] 1.5

[1] Percentages have been rounded.
[2] Average.

For this period, fiscal 1940–50 (tax years 1938–48), nonassessable tax years represent 11 percent of total tax years of proposed tax (assessable and nonassessable tax years).

A frequency distribution of corporations by asset size, by assessable and nonassessable tax years, is found in table 25. This table indicates the range, as well as the principal points of concentration, of tax impact with reference to the financial size of corporations subject to proposed assessments for tax years 1938–48.

TABLE 25.—*Assessable and nonassessable tax years by size of total assets: Number of tax years*

[Corporation income-tax returns involving deficiencies proposed by the Income Tax Unit with respect to improper accumulation of surplus for taxable years ending after Dec. 31, 1937, closed in the period July 26, 1939, through Dec. 31, 1949]

Tax years	Total number of tax years	Size of total assets (thousands of dollars)									
		Not shown	Under 50	50 under 100	100 under 250	250 under 500	500 under 1,000	1,000 under 5,000	5,000 under 10,000	10,000 under 50,000	50,000 and over
ASSESSABLE TAX YEARS [1]											
1938	169	1	4	13	33	39	39	33	5	2	
1939	136		4	9	21	29	33	32	7	1	
1940	121		5	13	18	21	27	32	4	1	
1941	99		6	9	17	15	21	22	6	3	
1942	65		4	3	11	14	11	17	4	1	
1943	73		1	3	15	13	14	22	4	1	
1944	76		1	7	12	19	14	17	6		
1945	71			3	18	13	14	21	2		
1946	69		1	2	18	11	15	21	1		
1947	37	1		1	5	6	8	16			
1948	3					2		1			
Total	919	2	26	63	168	182	196	234	39	9	
NONASSESSABLE TAX YEARS [1]											
1938	30			2	5	4	9	10			
1939	31			1	5	8	7	8	2		
1940	27	1			8	3	5	9	1		
1941	11					2	2	5	1	1	
1942	7				1	1		3	1	1	
1943	2			1	1						
1944	4			1	1		1	1			
1945	1							1			
1946	1			1							
1947											
1948											
Total	114	1		6	21	18	24	37	5	2	
Grand total	1,033	3	26	69	189	200	220	271	44	11	

For footnote, see table 26 (p. 132).

NOTE.—Table prepared by the Bureau of Internal Revenue.

For corporations with assessable tax years, the largest number of tax years of assessment is found to concentrate on corporations with assets (individually) in the $1,000,000 to $5,000,000 class. This group of corporations accounts for 25 percent of the total number of assessable tax years. The rank order of frequency distribution is as follows:

Corporations with total assets of—	Number of assessable tax years	Percent of total assessable tax years [1]
$1,000,000 to $5,000,000	234	25
$500,000 to $1,000,000	196	21
$250,000 to $500,000	182	20
$100,000 to $250,000	168	18
$50,000 to $100,000	63	7
$5,000,000 to $10,000,000	39	4
Under $50,000	26	3
$10,000,000 to $50,000,000	9	1
(Corporations total assets not shown)	2	
Total	919	

[1] Percentages have been rounded.

Corporations with assets $500,000 and above were subject to 51 percent of the total of assessed tax years. With only a nominal proportion of the assessable tax years applicable to corporations with assets $10,000,000 and above (1 percent), section 102 in terms of the number of deficiency assessments has had its impact almost exclusively on corporations of lesser asset size (less than $10,000,000). No corporation with assets of $10,000,000 or more has had assessable tax years subsequent to 1943. This is further evidence of Bureau concern, in the enforcement of the section, with the smaller closely held corporations. The comparatively small number of assessable tax years for corporations of asset size of under $100,000 may find explanation, in part, in the noninclusion of these corporate returns in the so-called automatics for field examination, as well as the defense the smaller corporations can make for higher liquidity ratios resulting from retention of earnings. In numerical terms, the closely held corporations, controlled by a very limited number of stockholders, have high concentration in the smaller asset size groups.

For the nonassessable tax years a similar distributional pattern will be observed (as for the assessable tax years) with corporations of asset size $1,000,000 to $5,000,000 having 32 percent of the nonassessable tax years, and corporations $500,000 to $1,000,000, 21 percent. Together these two asset-size classes account for 53 percent of the total of nonassessable tax years. However, corporations with assets under $50,000 have no nonassessable tax years, although subject to 26, or 3 percent, of the assessable tax years.

Table 26 provides a frequency distribution of undistributed corporate net income as a percentage of posttax net income, by tax years 1938–48, for assessable and nonassessable tax years. This table summarizes corporate conduct as to the retention of earnings (surplus accumulation) for corporations against which section 102 assessments have been proposed.

TABLE 26.—*Assessable and nonassessable tax years by tax years: Frequency distribution of undistributed net income as a percent of net income after taxes*

[Corporation income-tax returns involving deficiencies proposed by the Income Tax Unit with respect to improper accumulation of surplus for taxable years ending after Dec. 31, 1937, closed in the period July 26, 1939, through Dec. 31, 1949]

Tax year	Total number of tax years	Undistributed net income as a percent of net income after taxes						
		25 and under	Over 25, not over 50	Over 50, not over 75	Over 75, not over 90	Over 90, not over 95	Over 95, and under 100	100
Assessable tax years: [5]								
1938	169	3	23	33	8	3	4	95
1939	136	6	29	21	9	7	-------	64
1940	121	2	16	18	18	5	1	61
1941	99	-------	14	25	12	1	-------	47
1942	65	2	3	9	8	1	1	41
1943	73	1	7	10	6	-------	2	47
1944	76	1	1	6	4	2	5	57
1945	71	-------	2	11	4	5	4	45
1946	69	1	-------	8	10	2	2	46
1947	37	-------	1	5	4	3	1	23
1948	3	-------	-------	1	2	-------	-------	-------
Total	919	16	96	147	85	29	20	526
Nonassessable tax years: [5]								
1938	30	1	3	6	8	-------	-------	12
1939	31	1	3	7	8	1	-------	11
1940	27	1	3	7	2	2	1	11
1941	11	1	2	3	1	2	-------	2
1942	7	-------	1	3	2	-------	-------	1
1943	2	-------	-------	-------	-------	-------	-------	2
1944	4	-------	-------	-------	1	-------	-------	3
1945	1	-------	1	-------	-------	-------	-------	-------
1946	1	-------	-------	-------	-------	-------	-------	1
Total	114	4	13	26	22	5	1	43
Grand total	1,033	20	109	173	107	34	21	569

[1] If, in the case of any taxpayer, the Commissioner determines that there is a deficiency in respect of the tax imposed by ch. 1 of the Internal Revenue Code, the Commissioner is authorized to send notice of such deficiency to the taxpayer by registered mail. Within 90 days after such notice is mailed, the taxpayer may file a petition with the Tax Court for a redetermination of the deficiency. No assessment of a deficiency in respect of the tax imposed by ch. 1 and no distraint or proceeding in court for its collection shall be made, begun, or prosecuted until such notice has been mailed to the taxpayer, nor until the expiration of such 90-day period, nor, if a petition has been filed with the Court, until the decision of the Court has become final.

[2] The amount of income taxes imposed by ch. 1 of the Internal Revenue Code shall be assessed within 3 years after the return is filed and no proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of such period.

Where, before the expiration of the time prescribed for the assessment of the tax, both the Commissioner and the taxpayer have consented to its assessment after such time, the tax may be assessed at any time prior to the expiration of the period agreed upon. The period so agreed upon may be extended by subsequent agreements in writing made before the expiration of the period previously agreed upon.

[3] Tax proposed is the amount computed under sec. 102 of the Internal Revenue Code as initially recommended by the Income Tax Unit.

[4] Tax assessed is the amount of tax under sec. 102 of the Internal Revenue Code as finally determined by the Income Tax Unit, the technical staff, or the Tax Court or other court.

[5] Assessable tax years are those income-tax years for which a tax was assessed under sec. 102 of the Internal Revenue Code. Conversely, the nonassessable tax years are those income-tax years for which a tax was proposed, under sec. 102, but not assessed.

[6] Reports for 63 assessable tax years and 3 nonassessable tax years do not show the least number of stockholders owning more than 50 percent of the voting stock.

[7] Liquid assets comprise cash, net notes and accounts receivable, Government obligations, and other investments.

[8] Total number of stockholders is not reported for every return. The number of returns not reporting the total number of stockholders is shown in table 20 (p. 116).

[9] No current liabilities reported.

[10] Standard industrial classification as modified by the Bureau of Internal Revenue by which a corporation is classified according to the type of activity producing the greatest amount of total receipts.

NOTE.—Table prepared by the Bureau of Internal Revenue.

It will be noted that corporations incurring 526 assessable tax years of a total of 919 retained 100 percent of posttax net income. This is 57 percent of total assessable tax years. The frequency distribution is erratic, however, with reference to expectation, namely, that the

number of assessable tax years will tend to increase as the percentage of corporate posttax net income retained increases. Assessable tax years increase with a rising proportion of corporate earnings retained to 75 percent retention of earnings, but thereafter decline sharply until 100 percent of posttax net income is retained.

The frequency distribution, by rank order, is as follows:

Proportion of posttax net income retained (percent)	Number of assessable tax years	Percent of total assessable tax years [1]
100	526	57
Over 50, not over 75	147	16
Over 25, not over 50	96	10
Over 75, not over 90	85	9
Over 90, not over 95	29	3
Over 95 and under 100	20	2
25 and under	16	2
Total	919	

[1] Percentages have been rounded.

It is interesting to note that corporations distributing up to 50 percent of posttax net income had 112, or 12 percent, of the total of assessable tax years; also, that corporations distributing up to 75 percent of posttax net income had 16 assessable years, or 2 percent, of the total.

These data suggest that the Bureau's admonition to taxpayer corporations to the effect that a 70 percent distribution of current earnings to stockholders (re question 8, 1946 corporate return) will not necessarily absolve the corporation from a section 102 assessment has been given force and effect. As would be expected, and as found, the number of assessments would be relatively few with such relatively large distributions of net income.

Further, these data indicate (negatively) that corporations may and do retain high proportions of their posttax net income, i. e., see decline in number of assessable years with percentage retention of earnings from 75 to 100 percent, and yet escape the application of the section. The proportion of current earnings retained, therefore, is not the critical factor because the rising corporate liquidities so generated may find adequate justification in the investment destination of these accruals both as to time and place.

As would be anticipated, the great majority of the assessable tax years are for corporations either not distributing current earnings, or distributing small proportions thereof. In illustration, 72 percent of the assessable tax years applies to corporations in which undistributed net income is over 75 percent of total posttax net income.

Nonassessable tax years, for tax years 1938–46, display a similar frequency distribution. Although initially recommended for assessment by the Income Tax Unit, 71 tax years, or 62 percent of total nonassessable tax years, were closed as nonassessable, even though the corporations in question had retained over 75 percent of current earnings. Relief from proposed assessments does not concentrate with respect to the corporations having the larger proportions of earning distributions, because only 17 of the 114 nonassessable tax years, i. e., 15 percent, apply to corporations distributing up to 50 percent of posttax net income.

Conclusion

Although section 102 and its predecessor sections have been in existence since 1913, the first thoroughgoing and comprehensive effort to apply the penalty tax by the Bureau of Internal Revenue was not until 1939 with the issuance of Treasury Decision 4914, which followed the strengthening of the section by the inclusion of subsection (c) in the Revenue Act of 1938. This Treasury decision was designed to direct the attention of the officers and employees of the Bureau to the existence of the section, to indicate to the field offices that the section was to receive enforcement attention, and to provide detailed instructions for the screening of corporate returns in the interest of more effective enforcement. Each internal revenue agent in charge, and each head of a field division of the technical staff, were required to designate a qualified employee to review personally every case in which an examining officer had recommended the application, as well as the nonapplication, of section 102. In support of this program of intensified field activity, a central record file for all cases under the section (recommended application and nonapplication) was established and maintained in Washington, D. C. This was to permit officers of the Bureau to observe both the extent and the kind of performance of revenue agents to the instructions of Treasury Decision 4914.

Taxpayer corporations were put on public notice by this Treasury decision that section 102 was no longer largely moribund, and that the Bureau was initiating a serious and, presumably, sustained effort in enforcement. Corporations which were especially vulnerable under section 102 (closely held) were in a state of alarm. Taxpayer tension, however, subsided when it was observed that deficiency assessments were not of a wholesale character, even though an increase in the number of assessments did occur. From the cases going to the courts for adjudication taxpayers and tax practitioners concluded, apparently, that the section was applied in only the more flagrant instances of surplus accumulation, and under circumstances of corporate liquidities so high as to make very difficult any plausible rationalization of their existence. Also, it was noted that not only must a corporation be closely held but, in addition, share ownership must be heavily concentrated in very few hands.

The largest number of tax years of assessment, prior to the postwar period, was reached in fiscal 1941–42, with a sharp decline thereafter occurring. This decline in Bureau enforcement activity during the war and the immediate postwar period, i. e., from fiscal 1942 to 1949, had its origin in the financial uncertainties and hazards of the war and postwar reconversion, which rationalized large corporate surplus accumulations and high liquidities. It was not until fiscal 1948–49 that the Bureau sharply advanced the level of its enforcement of the section, which has continued during the first half of fiscal 1950.

Treasury Decision 5398 was issued in 1944 as an amendment to Treasury Decision 4914. It provided that an examining officer's report in every instance must contain a specific recommendation for the application or nonapplication of section 102; also the discontinuance of the central record file in Washington (which the Bureau subsequently indicated had served its purpose). Treasury Decision 5398 served to strengthen the enforcement of the section insofar as an examining agent was required to recommend for or against the appli-

cation of the tax in regard to each corporate return examined. However, the discontinuance of the Washington central record file probably was not to the advantage of section 102 enforcement, as it indicated to the revenue agents a lessened interest by officers of the Bureau in the field handling of the cases under the section; also, the officers of the Bureau would be in a less satisfactory position to evaluate carefully enforcement operations in each of the 39 field divisions of the Income Tax Unit. Records, since 1944, have, in general, been maintained in Washington in cases involving recommendations for the application of section 102 (not for the nonapplication of the section). These records are believed to be about 75 percent complete. Reestablishment of the central record file would appear to be desirable, being in the interest of more adequate and uniform enforcement.

The substantial increase in personal surtax rates in 1942, without a corresponding adjustment in section 102 surtax rates, decreased the relative effectiveness of the penalty tax. Taxpayers in the higher surtax brackets, interested in surtax avoidance (minimization of tax), were encouraged, in consequence, to accumulate corporate surpluses and to view section 102 as a "calculated" tax risk. If subject to a deficiency assessment thereunder, they were still better off than if the corporate earnings were currently distributed. The Bureau has had to confront, therefore, the tendency toward greater disregard of the tax by reason of the reduction in its relative "cost" from 1942 on. As a penalty surtax, which is intended by its existence in the Internal Revenue Code to be prohibitory of corporate surplus accumulations for the purpose of personal surtax avoidance, the rates of tax under section 102 should be adjusted upward to where the "opportunity costs," in general, are in better balance as between the higher bracket rates of personal surtax on the one hand and section 102 on the other. Such an adjustment would remove the incentive, as found in the lower rate of tax, to regard the penalty tax, if imposed, as still representing a lesser tax charge against current income than if the income is offered for application of personal surtax. No penalty can have any real measure of effectiveness if the cost of engaging (unsuccessfully) in the prohibited act is less than the cost of observance of the law.[65]

The decision of the Bureau to incorporate the famous question 8 in the 1946 corporate return, following the war, was justified in that the response to this question would assist in the process of screening corporate returns with a better directed enforcement effort—examination of returns. It is unfortunate that the question was withdrawn after 1946 because a useful purpose would have been served by its retention. Further, taxpayers interpreted the subsequent omission of the question as an indication of Bureau weakness—a hasty retreat in response to taxpayer clamor and criticism. The inclusion of the question in the return served to put taxpayers on notice that the Bureau had not forgotten this section of the Code; further, it carried the strong implication that returns would be scrutinized with section 102 in mind. Also, taxpayers, in stating their reasons for failure to distribute less than 70 percent of current earnings, were on record—with reasons which could later be checked against the actual corporate use

[65] A somewhat analogous situation would be the imposition of a 50-cent charge for parking a car in a prohibited zone while, at the same time, the minimum charge is $1 for off-street parking.

of the surplus accumulation. The dropping of question 8 probably decreased the effectiveness of the section in its influence on taxpayer corporations to avoid large retentions of earnings and excessive liquidities.

Section 102 deficiency assessments have been relatively few in number (an estimated total of 1,361 as compared with 786,415 total income and profits tax assessments) for the period fiscal 1940–50, and show a wide variance. Income and profits tax assessments show a deviation from the mean of 35 percent over the period under review (including sec. 102), while section 102 assessments have a deviation from the mean of 60 percent. It is to be expected that section 102 assessments, apart from shifts in administrative enforcement policy, would be more erratic over time because of the nature of the tax than would assessments generally under income and profits tax. Corporate liquidities generated by the war and rationalized in terms of war hazards and postwar reconversion largely explain, apparently, the reduced level of Bureau enforcement activity with respect to section 102 following fiscal 1943 to fiscal 1949.

From the point of view of revenue yield per deficiency assessment, section 102 is highly productive. In fiscal 1949, the yield per assessment under income and profits tax (including sec. 102) is $6,722, while section 102 produced $29,647 per deficiency assessment. For the period fiscal 1940–50 (first 6 months), the yield per assessment under income and profits tax averaged $5,564; section 102 averaged $15,522 per assessment.

The Income Tax Unit in the closing of proposed assessments has assessed 78 percent of the tax initially recommended; the technical staff in closing cases coming under its jurisdiction has averaged 54 percent of the tax proposed; and the courts have closed their cases on the basis of 86 percent of the proposed tax. These proportions refer to corporate tax years for which assessments have been made.

Corporations assessed under section 102 display a very high concentration of ownership, with 93 percent of the corporations, in terms of corporate tax years of assessment, having less than 10 shareholders per corporation. In combination with this concentration in ownership is found an extremely high concentration of corporate control, with corporations in 96 percent of the assessable tax years having either one or two shareholders owning more than 50 percent of the voting stock. These data indicate that the Bureau has applied the section in the extreme cases of concentrated corporate ownership and control. So-called public corporations have not been subject to assessments under this section even though many such corporations are controlled by particular family groups or a few identifiable persons. From the point of view of selecting cases in which section application was most clearly indicated, a better choice could hardly be made. A broader enforcement policy by the Bureau, even though accompanied by somewhat greater administrative hazards and litigation risks, would appear to be thoroughly justified. Surplus accumulation, with the purpose of avoiding personal surtax, is by no means confined to the extreme cases of concentrated corporate ownership and control which have characterized Bureau enforcement during the period under review.

For the limited class of corporations which has received the impact of section 102 enforcement, vulnerability under the section does not

arise unless corporate liquidities generated out of surplus accumulations reach extreme proportions. For corporations assessed, fiscal 1940–50, the ratio of liquid assets to total assets was 0.66. The ratio of earned surplus to total assets was very high, as was the ratio of current assets to current liabilities, with a large proportion of current earnings being retained.

The critical factor in vulnerability under the section appears to be the liquidity ratio. The ratios of earned surplus to total assets and current assets to current liabilities do not appear to be significant, per se, because a large earned surplus may be representative of real assets, and a very favorable ratio of current assets to current liabilities may be an expression of a very small amount of current liabilities. Retention of a large proportion of current earnings may not cause the corporation to become excessively liquid—and, hence, vulnerable. To avoid section 102, however, the corporation must be able to explain satisfactorily to the Bureau its high liquidity—which is the danger signal.

Corporations engaged in manufacturing have been subject to the largest number of tax years of assessment and the largest proportion of total tax assessed, with wholesale and retail trade corporations second, and corporations in the finance, insurance, and real-estate business third. The proportions of assessed tax of each of these industrial classes to total tax assessed are 54 percent, 18 percent, and 7 percent, respectively.

The largest tax per corporation and per tax year assessed was for the mining and quarrying industry, with an assessment of $76,949 per corporation, and an assessment per tax year of $41,972.

It is important to note that there is a distinct tendency for the number of assessed tax years to increase per corporation assessed over the 11-year period. This suggests that the Bureau may be increasingly concerned with the corporation's returns for prior and subsequent years, once the corporation is subject to assessment.

Corporations assessed under section 102 show high concentration, by asset size, in the $100,000 to $5,000,000 range. Relatively few corporations were assessed with assets under $100,000 and $5,000,000 and above, i. e., 15 percent in terms of assessable tax years. The comparatively small number of corporations assessed with assets under $100,000 may, in part, be explained by the field examination procedure of the Bureau, because these corporations, with very few exceptions, would not have their returns in the group of "automatics"; also, the Bureau may regard relatively high liquidities for these small corporations as more defensible by reason of competitive risks, limited credit, and irregularities over time in forming capital. It is to be expected that few corporations would be assessed with assets of $10,000,000 and above, because the very size of these corporations customarily necessitates more or less public distribution of their securities. Consequently, a high concentration of stock ownership (few stockholders), with a majority of the voting shares in the hands of one or two persons, is not commonly found. Thus, these corporations find, in general, administrative exemption (in effect) from the section.

The majority of the corporations, in terms of assessable corporate tax years, i. e., 57 percent, retained all posttax net income for the tax years of assessment. The number of assessable tax years of corporations increases with an increase in the proportion of earnings retained to 75 percent posttax net income retained. However, from 75 to 100 percent earnings retention, the number of assessable tax years declines

sharply. Comparatively few corporations were subject to assessment where less than 25 percent of earnings were held within the corporation. However, there were enough assessments, i. e., 16 assessable tax years, with this low proportion of earnings retained, to support the Bureau's pronouncement that the distribution of 70 percent or more of current earnings will not, necessarily, free the corporation of liability under section 102.

From this review of the administration of section 102 by the Bureau of Internal Revenue for fiscal 1940–50, on the basis of the data herein treated, the following observations may be made:

1. The Bureau has displayed a very conservative and cautious attitude in the enforcement of the section. It will be recalled that each corporate income tax return is subject to examination by agents of the Bureau of Internal Revenue and that the total of assessments represents the results of this screening process. Only a limited number of very closely held, individually controlled corporations (1 or 2 shareholders) have been subject to assessment. These vulnerable corporations take on the character of "personal operating companies."

2. The Bureau might appropriately expand the corporate area within which the section has enforcement meaning. This would more adequately serve the purpose for which the statute is presumably designed. Admittedly, litigation risks would be increased.

3. The section will have little influence in preventing taxpayers from engaging in the interdicted purpose unless backed by an enforcement program which is reasonably comprehensive and vigorous.

4. The rates of surtax of section 102 were not adjusted upward to conform to the increased personal surtax rates of 1942 on. This discrepancy in rates should be removed; otherwise, the inadequate penalty serves as an invitation to taxpayers to engage in the proscribed act on the least-cost principle.

5. The Bureau might appropriately consider for reintroduction in present and future corporate returns a question similar to question 8 in the 1946 return, because several useful purposes can be served thereby, particularly if supported by a more comprehensive enforcement policy.

6. A central record file in Washington, D. C., for section 102 cases might properly be reestablished; such a file would permit officials of the Bureau to be informed, in necessary detail, of revenue agent recommendations for nonapplication, as well as application, of section 102.

7. So long as income siphoned through a corporation is subject to a double tax if distributed—corporate tax and personal tax—section 102 stands as an important guardian of efforts to achieve equity in the application of progressive rates of personal surtax as between recipients of wage, salary, and noncorporate business income and those who are routing their incomes through corporations. The present high rates of personal surtax strongly suggest the need of a reappraisal by the Bureau of its enforcement policy and efforts under section 102.

8. The real significance of section 102—a penal tax—is not indicated by the tax revenue collected from the assessed corporations; rather by the effects which are induced by the section in regard to corporate real investment and dividend policies (and the avoidance of excessive liquidities). Consequently, section 102, not designed to raise revenue directly, should not be compared with taxes which have a direct revenue-raising function.

CHAPTER VI

JUDICIAL ENFORCEMENT

During the period 1913 to January 1, 1950, 101 cases have been litigated under section 102 and its predecessor sections. The first litigated case appeared in the trial court, i. e., Board of Tax Appeals, in fiscal 1929–30.[1] This involved the United Business Corp. of America[2] and an assessment for the taxable year 1921 under section 220 (Revenue Act of 1921). This indicates a considerable lag between the enactment of the first statute in 1913,[3] which was prohibitory of unreasonable accumulation of surplus, and the appearance of litigation. The taxpayer corporation in this case contended that the statute was too indefinite and challenged its constitutionality.

The United Business Corp. of America was a corporation organized by Burns Smith under the laws of the State of Washington. He was a son of L. C. Smith who had been one of the leading figures in the typewriter industry. The corporation was vested with the ownership of valuable real estate in Seattle, Wash., of which the most valuable parcel consisted of the L. C. Smith Building, as well as stocks, bonds, cash, and other assets, which had been transferred to the corporation from April 1, 1920, on. Burns Smith borrowed from the corporation, with indebtedness thereto, in the amount of $599,394.90 at the end of 1921;[4] he was also a creditor of the corporation with indebtedness in the amount of $189,000 at the close of 1921.[5] No dividends were declared by the corporation during 1921, or for the years 1922 and 1923. The first dividend was not declared until 1924. The book value of assets as of December 31, 1921, was $4,213,689.07. Corporate net income for 1921 was $133,539.88 (except for Federal income and profits taxes). The corporate balance sheet as of December 31, 1921, reported earned surplus of $212,222.43. Burns Smith received no salary from the corporation during the period 1920–25.

The Board of Tax Appeals held that the corporation was not a mere holding company, and was not formed for the purpose of preventing the imposition of personal surtax upon its shareholders. The question, therefore, was whether the corporation had been availed of for the interdicted purpose. This the court found to be the case because there had been transferred to the corporation shares of stock aggregating a large value the dividends from which were taxable while the shares had been held by Smith, but nontaxable when received by the corporation. In addition, Smith had borrowed large sums from the corporation—so large, in fact, as to require the corporation to increase its notes payable in order to provide the funds for the loans. Such man-

[1] Decision, B. T. A., April 30, 1930.
[2] 19 B. T. A. 809; affirmed, 62 F. (2d) 754; cert. denied, 290 U. S. 635.
[3] Tariff Act of 1913, sec. II (A) (2).
[4] Notes and open account.
[5] Excludes additional liability of corporation on its notes endorsed by Burns Smith in the amount of $50,000.

ipulations (i. e., loans), in the view of the court, were intended to permit the evasion of personal surtax.

Upon appeal,[6] Judge Learned Hand, speaking for the court, declared:

> These loans are incompatible with a purpose to strengthen the financial position of the petitioner, but entirely accord with a desire to get the equivalent of his dividends under another guise.[7]

Further:

> Ordinarily it will indeed be difficult to prove the forbidden purpose, unless the accumulations are too large for the fair needs of the business. But it may not be impossible to do so, even though the profits arise out of normal business, as they did not here. * * * A sudden change of policy, coincident with large increases in the surtax rates, might in that situation betray a purpose to accumulate against a season more propitious for distribution. Or the officers might unguardedly disclose a scheme to avoid surtaxes, though the other evidence was not enough. A statute which stands on the footing of the participants' state of mind may need the support of presumption, indeed be practically unenforceable without it, but the test remains the state of mind itself, and the presumption does no more than make the taxpayer show his hand.[8]

As to constitutionality:

> The intent being plain, the only question is whether Congress expressed its will certainly enough to be enforced, and whether any other constitutional obstacle is in the way. The argument is that the standard set is too vague for execution; that it is impossible definitely to say when the purpose of those who use the corporation to accumulate its profits is to exonerate its shareholders. Purpose is indeed not often a factor in legal transactions, though at times it is; but intent is often material, and whatever the difficulties of proof, the issue is concrete enough. Nothing is more frequent in human relations than the effort to learn what goes on in others' minds. The presumption is indeed less definite, and it is this especially that the petitioner attacks * * *. Standards of conduct, fixed no more definitely, are common in the law; the whole of torts is pervaded by them; much of its commands are that a man must act as the occasion demands, the standard being available to all.[9]

Further:

> the reasonable needs of a business * * * is immediately within the ken of the managers, the suppositious standard, though indeed objective, being as accessible as those for example of the prudent driving of a motor car, or of the diligence required in making a ship seaworthy, or of the extent of proper inquiry into the solvency of a debtor. Moreover, * * * the result of the presumption is at most no more than to compel the taxpayer to disclose the facts, and * * * the tax itself is definitely enough determined.[10]

The court did not find objectionable the fact that the tax imposed under section 220 bore no relation to the surtaxes on the shareholders; also, the tax was declared not to encroach upon the powers reserved to the States. Companies were free, said the court, to "accumulate what profits they please so long as they do not do so to defeat the fiscal policies of the United States."[11] And, though the regulation of their business "is wholly for the states,"[12] this does not prohibit Congress from preventing the "manipulation of dividends to avoid taxes."[13] Congress, to provide for the revenue, "has incidental power to defeat obstructions to that incidence of taxes which it chooses to impose."[14]

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[6] 62 F. (2d) 754 (1933).
[7] Ibid., p. 755.
[8] Ibid.
[9] Ibid., pp. 755–756.
[10] Ibid., p. 756.
[11] Ibid.
[12] Ibid.
[13] Ibid.
[14] Ibid.

The retroactive aspect of section 220, Revenue Act of 1921, likewise was found unobjectionable.

The tax assessed against the United Business Corp. of America was in the amount of $19,710.

It was not until 1938, following 16 litigated cases, that the United States Supreme Court passed upon the constitutional aspects of the statute—section 104 of the Revenue Act of 1928—in *Helvering* v. *National Grocery Co.*[15] In all previous cases appealed, the Supreme Court had denied certiorari.

The National Grocery Co., a concern operating chain stores, was assessed for the corporation's fiscal year ending January 31, 1931. The Board of Tax Appeals had sustained the deficiency assessment,[16] but, in turn, had been reversed by the circuit court of appeals.[17] The Supreme Court reversed the circuit court of appeals and held that the deficiency assessment of $477,360.68, imposed by the Commissioner of Internal Revenue, and sustained by the Board of Tax Appeals, must stand. The opinion of the Court was delivered by Mr. Justice Brandeis who reviewed, and discarded as unsound, the five reasons advanced by the corporation as to why section 104 should be held unconstitutional in its application to an operating, or "legitimate business," corporation. The reasons urged by the corporation were:

1. The statute violates the tenth amendment by interfering with the corporate right (conferred upon the corporation by the State) to withhold or to declare dividends.

The Court said:

The statute in no way limits the powers of the corporation. It merely lays the tax upon corporations which use their powers to prevent imposition upon their stockholders of the federal surtaxes.[18]

2. The statute is unconstitutional because it imposes not a tax on income *per se* but a penalty with the purpose of compelling corporations to declare dividends which would become a basis for taxation in the hands of the shareholders.

The Court declared:

If the business had been carried on by Kohl individually all the year's profits would have been taxable to him. If, having a partner, the business had been carried on as a partnership, all the year's profits would have been taxable to the partners individually, although these had been retained by the partnership undistributed. * * * Kohl, the sole owner of the business, could not by conducting it as a corporation, prevent Congress, if it chose to do so, from laying on him individually the tax on the year's profits. If it preferred, Congress could lay the tax upon the corporation, as was done * * *. The penal nature of the imposition does not prevent its being valid, as the tax was otherwise permissible under the Constitution.[19]

3. The statute is unconstitutional because the liability accrues as a result of the mere purpose to avoid personal surtaxes, and not upon its accomplishment as such. Thus, it is a "direct tax on the state of mind." [20]

The Court stated:

But this is not so. The tax is laid "upon the net income of such corporation." The existence of the defined purpose is a condition precedent to the imposition

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[15] 304 U. S. 282 (1938).
[16] 35 B. T. A. 163.
[17] 92 F. (2d) 931.
[18] 304 U. S. 286.
[19] Ibid., pp. 288–289.
[20] Ibid., p. 289.

of the tax liability, but this does not prevent it from being a true income tax within the meaning of the Sixteenth Amendment. The instances are many in which purpose or state of mind determines the incidence of an income tax.[21]

4. The statute is unconstitutional because it deprived the corporation of its property without due process of law, as applied; that, lacking a standard or formula to guide the Commission in making assessments or the corporate directors in avoidance of the tax, the section is unreasonable, arbitrary, and capricious; that it is of retroactive assessment; and that nonassenting minority stockholders are treated unfairly by it.

The Court answered:

The prescribed standard is not too vague.[22]

Further:

Clearly, retroactive assessment is no more objectionable here than in the case of penalties for fraud or negligence. * * * And since no minority stockholders are here involved, the last objection need not be considered.[23]

5. The statute is unconstitutional because it delegates legislative power to the Commissioner.

The Court replied:

The statute provides that if the corporation is availed of for the forbidden purpose, the tax "shall be levied, collected, and paid"; and certain facts are made prima facie evidence of the existence of this purpose. No power is delegated to the Commissioner save that of finding facts upon evidence.[24]

With this decision, the constitutionality of section 104 and its successor section 102 was firmly established. Since then, the United States Supreme Court has denied certiorari when cases have been appealed, except for the *Chicago Stock Yards Company case* (318 U. S. 693 (1943)), in which it reversed the circuit court of appeals to support a deficiency assessment approved by the Board of Tax Appeals.

The National Grocery Co., an operating concern, by accumulation of surplus, had saved Henry Kohl, the beneficial owner of all the capital stock, surtax for the 9 years preceding the year of assessment (1930–31), $1,240,852.30.[25] In addition, if the profits going to surplus in 1930–31 had been distributed, surtax in the further amount of $90,744.56, as a minimum, would have been incurred.[26] Although drawing a salary of $104,000 a year, Kohl required additional funds which he took from the corporation in the form of loans. His total indebtedness to the corporation, as of January 31, 1931, covering 7 years of borrowings, was $610,000.[27] The corporation (January 31, 1931) had

Total assets	$9,108,437
Earned surplus	7,938,965
Liquid assets	5,000,000

Ratio of current assets to current liabilities 8 to 1.

In this case, the Supreme Court reprimanded the circuit court of appeals for making an independent determination of the matters which had been in issue and had been ruled on by the Board of Tax Appeals. The proper function of the circuit court of appeals, as

[21] Ibid.
[22] Ibid., p. 290.
[23] Ibid.
[24] Ibid.
[25] Ibid., p. 292.
[26] Ibid.
[27] Ibid., p. 293.

pointed out by the Supreme Court, was to limit its review of the case to determining whether the evidence was sufficient to sustain the findings and decision of the Board of Tax Appeals. It is difficult, in the light of the facts, to see how the circuit court of appeals, in this case, reached a decision adverse to the lower court.

Some Recent Cases

Whether or not a surplus accumulation is unreasonable is a question of fact in the individual case and is to be determined with reference to the relevant circumstances and conditions relating thereto. It is in the judicial sifting and appraisal of the facts germane to the individual case and in the reasoning by which the particular conclusions are reached that the attitude of the courts in the enforcement of section 102 finds expression. The reasoning of the courts in some of the more important recent cases, as well as the considerations establishing the reasonableness or unreasonableness of the particular surplus accumulation, is briefly reviewed below.

Reasonable Surplus Accumulations.

Gus Blass Company v. *Commissioner of Internal Revenue* (9 T. C. 15 (1947); 168 F. (2d) 833 (1948)).

The Gus Blass Company, a corporation of the State of Arkansas, owned a retail department store in Little Rock, Arkansas. Its fiscal year ended on January 31, and it filed its Federal corporate tax returns on this basis. Fifty-one percent of the stock of the corporation was owned by the lineal descendants of Gus Blass who founded the company, namely, Noland Blass, his sister, and the two surviving children of Julian Blass, a deceased brother, in the fiscal year ending January 31, 1941, the year in which the Commissioner asserted a section 102 deficiency of $89,921.81.

In a directors' meeting held January 4, 1941, it was decided to revert to a former practice (before fiscal 1937) of not paying dividends prior to a final report of its auditors which would not be received until after the close of the corporation's fiscal year.

For the fiscal year ending January 31, 1941, the company's net profit (post income tax) was $240,134.70. On March 12, 1941, a dividend of $239,690 was declared and the dividend was paid on April 20, 1941. Of the dividend of $239,690, Noland Blass and 28 persons related to him owning collectively 94 percent of the company's stock received $224,592.50. These individuals reported this dividend distribution in their taxable income and paid tax thereon for the calendar year 1941 (being on a calendar year basis). The record does not disclose the accounting period for which taxable income was reported by the other 12 owners of stock who received 6 percent of the distribution.

The company's earned surplus as of January 31, 1941, was $1,359,449.62, with an excess of current assets over total liabilities, other than capital, of $840,099.52. In addition, Federal, State, and municipal bonds and corporate stocks amounted to $1,140,004.70 (40 percent of total assets) which had been acquired out of retained earnings. Net quick assets were more than sufficient to finance a possible $750,000 building project—were it to prove necessary—without any retention of earnings in fiscal 1941 as had been the case. The court consequently held that earnings had been permitted to accumulate beyond the reasonable needs of the business.

This holding established the presumption (sec. 102 (c)) that the purpose of the accumulation was to avoid personal surtax upon the shareholders for the year ending January 31, 1941. However, the court noted that this presumption could be overcome by a clear preponderance of the evidence to the contrary. Inasmuch as the distribution of dividends by the company (April 20, 1941), following the close of its fiscal year, was included in the income of the shareholders for the calendar year 1941, which would have been the case had the distribution occurred within the company's fiscal year, i. e., January, 1941, no personal surtax was avoided by the distribution after the close of the fiscal year. Further, virtually all of the net earnings (except for $444.70) were distributed, which refuted any purpose of surtax avoidance.

Upon appeal to the Circuit Court of Appeals the case was dismissed on motion of the petitioner and with the consent of respondent (168 F. (2d) 833 (1948)).

William C. Atwater and Company, Incorporated v. *Commissioner of Internal Revenue* (10 T. C. 218 (1948)).

William C. Atwater and Company, incorporated in the State of New York in 1909, was engaged in the business of selling coal on commission for various coal mines. Some income was derived from mine management, trading in coal, dividends and interest. Its corporate income tax returns were on a calendar year basis. A substantial majority of the stock of the company was owned by members of the Atwater family, the heirs of William C. Atwater, Sr.

The Commissioner of Internal Revenue imposed a deficiency assessment under section 102 for tax years 1942 and 1943 in the amounts of $42,261.96 and $24,155.91 respectively.

The court found that the company had no net income for 1943, consequently no assessment could be imposed for that year. In 1942 reported net income was in the amount of $169,898.65; and surplus was $5,219.83. As of December 31, 1942, the company held $304,753.79 in cash which was not regarded as excessive because the working capital requirements (monthly settlements with coal mines) were large. Frequent borrowings from banks were necessary to provide additional working capital. The court was of the opinion that the corporate directors acted in good faith in the retention of the earnings in 1942 in the belief that they were needed in the business, particularly in view of pending litigation, and that the directors could not lawfully pay a dividend under the laws of New York because of the inadequacy of the company's earned surplus. For these reasons the court held that there was no improper accumulation of surplus.

J. L. Goodman Furniture Co. v. *Commissioner of Internal Revenue* (11 T. C. 530 (1948)).

The J. L. Goodman Furniture Co., a corporation, was engaged in the retail furniture business in Cleveland, Ohio. Julius E. Goodman, the son of the founder of the business, his mother, and two others related by blood or marriage owned 90 percent of the stock of the company in 1942 and 1943. In 1935 Julius E. Goodman, the president, decided that one or two branch stores should be opened in the newer residential districts of the city. Various circumstances, including the business recession of 1937–1938 and the war, caused postponement of the proposed expansion. It was not until 1947 that a lot was purchased for the erection of a new store.

The Commissioner asserted section 102 deficiencies for 1942 of $9,119.24 and for 1943 of $8,921.21.

The company's retail sales were largely on the installment basis, i. e., about 90 percent. Dividends in the amount of $36,000 were paid in 1942; also in 1943. Taxable net income was $127,098.88 in 1942 and $130,112.96 in 1943.

	1941	1942 [1]	1943 [1]
Cash	$211,180.09	$234,794.41	$312,237.40
Government securities	342,160.74	436,841.35	499,428.46
Other securities	87,303.22	87,303.22	87,303.22
Total	640,644.05	758,938.98	898,969.08
Receivables	151,167.62	82,220.48	56,283.84
Inventories	103,189.47	132,799.93	91,594.09
Total	254,357.09	215,020.41	147,877.93
Earned surplus	811,179.62	854,357.43	922,389.51

[1] As of Dec. 31.

The court was of the opinion that the company was using about $500,000 of its earned surplus as working capital in the business. This figure was reached by adding together (a) annual operating expenses, (b) the average amount of accounts receivable, and (c) the average current inventory. The court also found persuasive the company's contention that bona fide plans for expansion had been and were being made during the years 1942 and 1943, even though it was not until 1947 that a lot was purchased. Goodman's claim that $500,000 was necessary for the proposed expansion was allowed by the court as being reasonable. Goodman further claimed that additional funds were necessary to meet working capital requirements by reason of an anticipated large increase in sales at the end of the war. With this the court agreed and was of the opinion that a few hundred thousand dollars of surplus accumulation for this purpose was not unreasonable.

The court observed that additional dividends would have increased the personal surtaxes of the shareholders, but Goodman's testimony that the retained earnings were without purpose of surtax avoidance was persuasive. In addition, the court was favorably impressed with the prior dividend record of the company. Allowance was made for tax uncertainties and the unresolved profit from installment sales. The court concluded that the company had sustained its burden of proof and that no improper accumulation was present.

The decision in this case is difficult to understand. Customarily, the courts are adverse to the corporate accumulation of large amounts of liquid funds when an expansion program is nebulous in its conception and highly uncertain as to time of implementation. In the instant case, the court conceded that expansion plans would not be effectuated until some time after the war—the duration of which was uncertain, and that the cost of the expansion program was indeterminate because of its indefiniteness. The court noted that the company had been highly profitable over its many years of operation. This carries the presumption that its profit making operations would continue and, in so doing, would permit the financing of the expansion program at a future time when it became formalized and certain—

thus making unnecessary earnings accumulations in 1942 and 1943. This consideration did not appear in the reasoning of the court. The fact is that working capital requirements for inventories and accounts receivable had declined since 1941 and could be expected to be relatively low during the war period. Highly liquid assets as found in cash and Government securities increased substantially, reflecting the decrease in accounts receivable and inventories and the continuing buildup of liquid surplus from retained earnings. This growth in liquid assets for which there was no current employment in the business, with future employment highly uncertain and indefinite, does not lend support for a judicial holding that further earnings accumulation was justified. It appears that the Commissioner had good grounds for the assertion of deficiency assessment for tax years 1942 and 1943.

Walkup Drayage and Warehouse Co. and Merchants Express Corp. (T. C. M., Dkt. No.'s 3271–3272; tax year 1940; year 1945).

The Walkup Drayage and Warehouse Co., a California corporation, provided a drayage and warehousing service in the City and County of San Francisco, California. All the common stock of the company was owned by Ward G. Walkup. The Merchants Express Corporation was engaged in the express, drayage, and warehousing business in the East Bay district, which included Oakland, Berkeley, and other cities. All the stock of the Merchants Express Corporation was owned by the Walkup Drayage and Warehouse Co. The Walkup Company was organized in 1937 by Ward G. Walkup, who held all its stock, for the purpose of holding real property and improvements thereon which it leased to the Walkup Drayage and Warehouse Co. and the Merchants Express Corporation for their business operations.

A deficiency assessment under section 102 was asserted against the Walkup Drayage and Warehouse Co. for tax year 1940 by the Commissioner of Internal Revenue.

The court found as follows:

(1) The company had grown rapidly, particularly since 1928, until it became the largest business of this type in San Francisco. This growth created a need for additional capital which was provided by retained earnings and bank loans.

(2) Earned surplus increased from $278,524 on December 31, 1939 to $333,468 on December 31, 1940, an increase of $54,944. On December 31, 1940, current assets were less than current liabilities for the company as well as the Merchants Express Corporation. The cash working capital needs of the company were in the amount of $100,000 to $150,000, with the company having $101,890 in cash on December 31, 1940. Liquid assets were not excessive—instead they appeared inadequate.

(3) The investment of the company's surplus and/or the proceeds of bank loans in the stock of the Merchants Express Corporation, in the notes receivable of the Walkup Company, and in an advance to the Vallejo, Napa and Calistoga Transport Company was justified because these enterprises were reasonably related to the company's business.

(4) The company was under no compulsion from section 102 to borrow funds from a bank in order to provide cash for the payment of a dividend. The statute was not intended to force earn-

ings distributions when such earnings are necessary in the proper conduct of the business.

Lion Clothing Company v. *Commissioner of Internal Revenue* (8 T. C. 1181 (1947)).

The Lion Clothing Company, a California corporation, was a retailer of clothing, the third oldest mercantile firm in San Diego, California. John H. Fox, the son of the founder of the business, became president of the firm in 1939 on the death of his father. For the period 1940–1942 inclusive, John H. Fox, his sister, Lillian Gaynes, and A. F. Gaynes, her husband, owned all of the 2,000 shares of stock outstanding.

Deficiency assessments were asserted by the Commissioner for tax years 1940, 1941, and 1942 under section 102 against the company.

	Earned surplus [1]	Net quick assets	Net to surplus	Dividends paid
1939	$163,934.85		$30,106.13	None
1940	199,419.58	$67,774.72	35,610.81	$11,000
1941	251,716.11	91,584.29	52,467.96	15,000
1942	305,025.48	188,785.62	45,992.30	20,000

[1] As of Dec. 31.

If there had been distribution of all income after payment of the corporate taxes for the years 1940, 1941, and 1942, additional personal surtaxes would have been as follows:

John H. Fox	$33,120.94
Lillian Gaynes	26,598.28
A. F. Gaynes	193.77
Total	59,912.99

The court found that:

(1) In accordance with a policy adopted by the company's directors in 1938, a part of the net profits were added to surplus each year to provide funds for expansion and as a protection against an unforeseen depression (the company had suffered losses during the period 1930–1932 inclusive, and had been in trouble with the banks because of outstanding loans).

(2) Funds were needed for expansion of the business as found in physical improvements to the store building (i. e., $90,000), in the purchase of interests of store concessionaires (i.e., $100,000), and in the retirement of mortgage indebtness against the store building (i.e., $145,000 as of December 31, 1940).

(3) The accumulation of some cash reserves was justifiable to meet the risks of the war and postwar period; also as a protection against future depressions.

(4) The estimate of the company of an additional working capital requirement of $100,000 for inventory increase as clothing became more available, and $50,000 for an increased volume of accounts receivable was not unreasonable.

(5) Net quick assets and the accruals to surplus were reasonable in amount because they were dedicated to legitimate business needs.

Unreasonable Surplus Accumulations.

World Publishing Co. v. *United States* (72 F. Supp. 886 (1947); 169 F. (2d) 186 (1948); 335 U. S. 911 (1949)).

The World Publishing Company, a corporation engaged in the publication of the Tulsa World, a daily newspaper of general circulation in Tulsa, Oklahoma, was organized in 1906 with a capital of $25,000. As of December 31, 1943, the authorized and issued capital stock was in the amount of $1,000,000, which was represented by 10,000 shares of which Eugene Lorton, the president, owned 9,997 shares. His salary as president was $50,000 per year.

The Commissioner of Internal Revenue imposed deficiency assessments under section 102 for the corporation's taxable years of 1942 and 1943 in the amounts of $22,118.41 and $19,524.30 respectively. The taxpayer corporation paid the deficiency assessments with interest and then sued for a refund.

It was the practice of the taxpayer corporation to finance its growth from the earnings of the company. The substantial growth of the company is indicated by the increase in the week-day subscriptions from 7,000 in 1910 to 70,000 in 1945. The need for a new press and associated equipment, including a suitable building, caused the directors, by resolution, to set aside funds for the acquisition of these facilities. In 1939 a reserve was established in the amount of $250,000. This was increased to $500,000 in 1941. Although there had been some negotiations for the purchase of a new press in 1942 and thereafter, a contract was not entered into until 1945. The estimated minimum cost of the new press and associated equipment at the end of 1942 was $350,000; the cost of the building $150,000. One-half the cost of the new press and accessory equipment was to be borne by the Tulsa Tribune. This latter newspaper was to make no contribution to the cost of the building.

The financial status of the World Publishing Company for the years 1942 and 1943 was as follows (Circuit Court of Appeals):

Year	Net earnings (after corporate income tax)	Earned surplus	Gross quick assets [1]	Net quick assets [2]
1942	$80,540.28	$643,062.26	$631,252.57	$563,651.79
1943	96,564.21	739,626.47	859,099.53	671,261.60

[1] Consisting of cash, stocks, and bonds.
[2] Gross quick assets less current liabilities.

Dividends were paid in the years 1934 to and including 1941, and in 1944 and 1945. No dividends were paid during 1942 and 1943 because earnings were retained for the expansion program.

Had the company distributed in full its net earnings in dividends in 1942 and 1943, additional personal surtax in the amount of $69,520.35 would have been paid by Eugene Lorton.

The trial court (Federal District Court) found that:

(1) Net quick assets were in the amount of $427,287.39 as of December 31, 1941, $496,168.65 on December 31, 1942 (book value), and $645,878.61 on December 31, 1943 (fair market value).

(2) Net quick assets were in sufficient amount to provide for the expansion program—thus making unnecessary the retention

of earnings in 1942 and 1943. Judicial notice was taken of the fact that the Tulsa Tribune was to bear half the cost of the new press and accessory equipment (estimated 1942 in the amount of $175,000). With deduction of the cost to be borne by the Tulsa Tribune, the cost to the World Publishing Company of the proposed expansion was $325,000, including the building.

(3) The testimony that several hundred thousand dollars in the form of working capital was necessary in the business was unreasonable and without merit; the only working capital that was required was a nominal amount to maintain the editorial staff of the paper.

(4) The taxpayer's reserve for depreciation may not be deducted from surplus to determine the amount available for the expansion program.

(5) There was little or no possibility of profit diminution because of the war. Consequently, retention of corporate profits (accrual of surplus) in 1942 and 1943 could not be rationalized on this ground.

(6) The expansion program contemplated by the company could not be effectuated until after the war—which was recognized by the directors in December, 1942; also in January, 1944 (minutes of meetings).

(7) The expansion program, when implemented, would find distribution of its cost over a considerable period of time, and would not require a cash outlay equal to its full cost on the contract date.

(8) The taxpayer failed to overcome by a preponderance of the evidence the finding of the Commissioner (i. e., improper accumulation) because both the amount of the surplus accrual and the volume of liquid assets thereby represented prior to 1942 were adequate for the expansion program, apart from the necessary remoteness of the proposed expansion.

(9) The proposed venture in the business of radio broadcasting, likewise remote in time, was not sufficiently related to the taxpayer's business to make the financial needs of the former a part of the requirements of the latter.

Upon appeal from the adverse decision of the Federal District Court, the Circuit Court of Appeals (169 F. (2d) 186 (1948)) affirmed the judgment of the trial court. Attention was directed to the taxpayer's record of net earnings and accumulated earned surplus, which were found to be highly satisfactory with reference to the contemplated expansion program; in addition, the court noted that the World Publishing Company was a "one-man" corporation, that there was no indication from the facts that profits would not continue or increase, and that the expansion program was necessarily indefinite and remote because of the war. Further, the court declared that personal surtax avoidance in surplus accumulation need not be the sole or exclusive purpose—that it need be only one of the factors behind the accumulation.

The dissenting judge in the Circuit Court of Appeals was of the opinion that the accumulated quick assets—which represented the means of financing the expansion program, not accumulated earned surplus per se—were not in excess of the reasonable cost of the expan-

sion program, with the estimated cost of the press and accessory equipment increasing to $636,489.38 by May, 1945, and the building to $301,600 by August, 1945. The trial court was challenged as being in error in giving consideration to the taxpayer's earned surplus—rather than quick assets—as the taxpayer's capabilities of financing the expansion program rested upon its quick assets, not earned surplus. In this respect the dissenting judge appears to have overlooked the review and emphasis attached by the trial court to the quick asset position of the taxpayer. The difference of opinion of the trial court and the dissenting opinion of the Circuit Court of Appeals is that the trial court set the quick assets against the estimated cost of the expansion program as estimated at the end of 1942, finding them adequate, while the dissenting judge of the Circuit Court measured quick assets against the cost of the expansion program as estimated in 1945 (after costs had increased), and thus finding them to be not unreasonable in amount.

Certiorari was denied upon appeal to the United States Supreme Court (335 U. S. 911 (1949)).

Eastern Railway and Lumber Company v. *Commissioner of Internal Revenue* (12 T. C. 869 (1949)).

The Eastern Railway and Lumber Company was incorporated in 1903 under the laws of the State of Washington. The vice president and majority stockholder was S. A. Agnew who had acquired 99½ percent of the company's stock by December 31, 1943.

The company became inactive following 1939, renting its mill and equipment and selling its timber property to S. A. Agnew. No dividends had been paid by the company after 1920.

The Commissioner imposed a deficiency assessment under section 102 for the taxable year 1943 in the amount of $26,827.98 on the ground that the company had been availed of to prevent the imposition of personal surtax upon its shareholders.

The financial status of the company at the beginning and end of 1943 was as follows:

	Earned surplus	Gross quick assets	Net quick assets	Cash on hand
Beginning of taxable year 1943	$115,497.69	$156,929.84	$90,844.76	$126,747.85
End of taxable year 1943	172,185.19	334,008.81	251,879.17	206,411.77

The court found that:

(1) The taxpayer corporation had no activity except the holding of its property and the collection of the income therefrom.

(2) The accumulation of earnings in 1943 was unnecessary as no financial need existed. Its limited business activities could not justify the heavy accumulation of quick assets.

(3) The company's earnings were used by Agnew for his personal operations and advantage, although such earnings were not distributed as dividends. This he was able to accomplish because he owned virtually all the stock.

(4) The contention of the taxpayer corporation that its accumulations of earnings were necessary to permit reentrance into the logging and lumber activities at a future time as it had planned, which would require $1,500,000 to effectuate this purpose,

was unreasonable. In rejecting this contention the court stated that there had been no showing of any reasonably immediate need for the corporate retention of earnings in 1943.

Whitney Chain and Mfg. Company v. *Commissioner of Internal Revenue* (3 T. C. 1109 (1944); 149 F. (2d) 936 (1945)).

The Whitney Chain and Mfg. Company, a corporation of the State of Connecticut, was subject to a deficiency assessment under section 102 for taxable year 1939 in the amount of $17,611.81. The company was engaged in the manufacture of chains and sprockets for power transmission, and keys and cutters for metal-working operations.

The company's outstanding stock of 15,000 shares (par value $100) in 1939 was distributed as follows:

Held in corporate treasury—3,693 shares
Wife and children of C. E. Whitney (five persons)—all remaining shares except the directors' qualifying shares

Dividends were paid in the amount of $67,842.00, with $70,447.23 of the current earnings retained in 1939. As of December 31, 1939, earned surplus was $1,668,102.04; current assets, $1,310,102.00; current liabilities, $108,865.05; and net quick assets, $1,201,236.95, of which $218,501.61 was in cash. In addition, $381,867.51 was invested in the stock of the Hanson-Whitney Machine Company, which represented a 75 percent stock interest. The Hanson-Whitney Machine Company had leased certain plant facilities owned by the Whitney Chain and Mfg. Company.

Noninterest bearing loans to stockholders were in the amount of $347,768.54, which the court found had no relationship to the business activities of the company.

By the nondistribution of the $70,447.23 of earnings in 1939, personal surtax savings of $12,042.28 accrued to the principal shareholders.

The court declared that:

(1) The accumulated surplus was greatly in excess of the needs of the business.

(2) The investment of $381,867.51 in the stock of the Hanson-Whitney Machine Company was an investment of surplus in an unrelated business; also that the noninterest bearing loans to the stockholders served no business purpose and represented idle funds. Employment of accumulated surplus in the above investments was surplus accumulated in excess of the reasonable needs of the business because no useful purpose was served thereby.

(3) If the $70,447.23 of retained earnings in 1939 were, in fact, needed in the business for purposes of expansion as the taxpayer contended, a distribution could have been effectuated without the company foregoing the use of the funds by a dividend in kind payable by stockholder debt cancellation in the above amount, by a cash dividend of this amount conditioned upon a corresponding reduction in the debts of the shareholders held by the company, or by a dividend of this amount in the shares of the Hanson-Whitney Machine Company.

Upon appeal the Circuit Court of Appeals (149 F. (2d) 936 (1945)) held with the trial court that methods were available to the directors to effectuate a distribution of earnings without any diminution of the

company's quick assets available for use in the business, and that these methods could be expected to be known by directors of the calibre of the taxpayer as the trial court had observed.

Christmann Veneer and Lumber Company (T. C. M., Dkt. No. 4916; tax year 1941; year 1945).

The Christmann Veneer and Lumber Company, a Missouri corporation, was engaged in the lumber, veneer, and plywood business in St. Louis, Missouri. The company was owned by Fred G. and Wm. E. A. Christmann and Martin Beckemeier, with each having a one-third interest.

The company was subjected to a deficiency assessment under section 102 for tax year 1941 by the Commissioner of Internal Revenue in the amount of $7,928.34.

The finances of the company were as follows:

	Posttax net income	Dividends paid	Net to surplus	Total earned surplus (net)
1941	$42, 580. 31	$13, 750. 00	$28, 830. 31	$160, 081. 40

On December 24, 1941, the company loaned $36,000, in individual amounts of $12,000, to each of its three shareholders. The proceeds of the loan to Wm. Christmann were used to purchase a farm. The loans to the other two shareholders were to equalize the distribution and to provide the same benefits to them as to Wm. Christmann. The loans were formalized in interest bearing notes at 2 percent interest. Although the shareholders had borrowed from the company prior to 1941, the loans had all been repaid.

Prior to the above loan transaction, the company's cash and Government bonds totaled $96,934.80. The only liabilities consisted of $2,893.23 in accounts payable and $32,828.93 in accrued income and excess-profits taxes not yet due.

The court found that:

(1) More than the amount of the net undistributed income was transferred to the shareholders in amounts corresponding to their stock interests, i. e., $36,000 in loans with undistributed income in the amount of $28,830.31, with the distribution accomplished by loans rather than dividends.

(2) The shareholders received the benefits of the corporate profits without incurring personal surtax thereon. Had the $28,830.31 been distributed as a dividend to the shareholders, additional personal surtaxes in the amount of $12,529.32 would have accrued.

(3) No purpose other than personal income tax avoidance was served by the loan operation.

(4) The claim of the company that the profits retained in 1941 were needed in the business is negatived by the fact that the company did not retain the earnings but, instead, placed the shareholders in possession. The company could not expect payment of the loans on demand. Further, the investment in a farm of the proceeds of the loan by one shareholder did not comport with the company's desire for liquidity. If the company had been seriously concerned with the preservation of its liquidity, the retained earn-

ings could have been invested in Government bonds with which it was familiar and which paid approximately the same interest as the shareholder loans.

Southland Industries, Inc. (T. C. M., Dkt. No. 3387; tax year 1940; year 1946).

Southland Industries, Inc., a Texas corporation, operated a commercial broadcasting station, known as WOAI, in San Antonio, Texas. The company had the largest transmitter, i. e., 50 KW, and the only A–1 classification in San Antonio. The income of the company was derived from the sale of advertising, with cash payment therefor on a monthly basis. All the stock of the company was owned by G. A. C. Halff. The company's operations had been very profitable.

A deficiency assessment under section 102 was asserted by the Commissioner of Internal Revenue for the fiscal year ending July 31, 1940, in the amount of $21,731.37.

Investments had been made by Southland Industries, Inc., in other enterprises unrelated to the broadcasting business as follows (as of July 31, 1940):

Ratcliffe-Payne Motor Co	$22,100.00	(common stock) (52 percent stock interest)
Dittmar Properties Co	41,000.00	(bonds) (G. A. C. Halff owned some 35 percent of the stock of this company)
Blanco Oil Co	377,200.00	(notes receivable) (G. A. C. Halff was the sole owner of this company)
Central P. and L. Corp	960.00	(6 percent pfd. stock)
Street Widening Certificates	3,654.00	
Other stocks and bonds	1,810.00	
Loans to G. A. C. Halff	13,356.26	
Other loans	16,651.73	

Loans to the Blanco Oil Co. were increased in the net amount of $64,000 in the taxable year ending July 31, 1940. Accrued interest on the loans outstanding to the Blanco Oil Co. was $103,188.31.

The financial condition of Southland Industries, Inc., as of July 31, 1940, was as follows:

Earned surplus	$226,938.40
Cash	118,550.82
Excess of current assets over current liabilities (surplus not included)	662,179.00

For fiscal 1940:

Posttax net earnings	$161,925.46
Net to surplus	86,925.46
Dividends paid	75,000.00

If all the company's earnings had been distributed for fiscal year 1940, G. A. C. Halff would have paid $43,476.22 in additional personal surtaxes.

The court found that:

(1) Of total assets of $913,470.93 only $153,293.33 were net fixed assets (after deduction of reserve for depreciation) relating to the broadcasting business; total nonoperating capital (assets not directly related to broadcasting business) was $714,761.04.

(2) A large working capital was not needed because the business was operated on a cash basis (collections were monthly).

(3) The accumulation of a large earned surplus was unjustified because of the company's cash basis of operations and its high past and current profitability.

(4) Liquid assets were greatly in excess of requirements.

(5) The claim of the company that a large surplus accumulation and a large amount of nonoperating capital were needed in the business because of plans for expansion and modernization was not persuasive. Evidence indicated that the suggested need for a more imposing building had not led to the formulation of any plans or a decision thereon; that Halff's intention to invest assets of the company in a merchandising business had no relationship to the needs of the broadcasting business; that the installation of a more powerful transmitter (in excess of 50 KW) could not be accomplished because the Federal Communications Commission had publicly announced that no power in excess of 50 KW would be licensed; that frequency modulation was in the experimental stage in 1940, and the company could not claim it was a necessary installation that year because it did not apply for an FM license until 1944; and that the need for installation of television or facsimile transmission facilities was rebutted by the fact that the company had never applied for a license for these types of transmission. The proposed complete modernization of the existing transmitting equipment, at an estimated cost of $125,000, was substantially less than the accrued surplus of $226,938.40. The court noted that the proposed, and presumably needed, modernization had not been accomplished by the time of the trial (1946).

(6) To justify surplus accumulation the business needs to be served must be immediate—not remote nor indefinite.

(7) The Southland Industries, Inc., and the Blanco Oil Co. were simply the alter egos of G. A. C. Halff who used the assets of the former company to expand the operations of the latter, solely to the personal advantage of Halff.

(8) The Southland Industries, Inc., having no need or use of its accumulated earnings, had directed them to unrelated enterprises, particularly to the Blanco Oil Co. the investments in which totaled $480,388.31 (principal and interest), or over half the company's total assets. These loans (and investments) negatived the need to strengthen financially the company, and evidenced the desire on the part of Halff to obtain, free of surtax, a dividend equivalent. The court noted that the company's loans ($64,000) to the Blanco Oil Co. in the taxable year could have been paid to Halff as a dividend.

Summary of Litigated Cases

A review of the litigated cases under section 102 and predecessor sections reveals that the following disposition has been made of the 101 cases (table 27).

Cases heard and decided favorably to the Government total 42 (42 percent of total cases), and represent 67 percent of the total proposed tax (tax proposed in cases going to the courts for adjudication).

Heard and decided adversely to the Government were 50 cases (50 percent of total cases), involving, however, only 23 percent of the total proposed tax.

In three cases (3 percent of total), a trial court decision favorable to the Government was appealed to the circuit court of appeals and dismissed without decision on stipulation of the parties. These cases account for 8 percent of total proposed tax.

TABLE 27.—*Summary of cases litigated under sec. 102 of the Internal Revenue Code or under similar provisions in prior revenue acts, 1913 to Jan. 1, 1950*

	Number of cases	Tax proposed
Heard and decided favorably to Government	42	$12,612,084
Heard and decided adversely to Government	50	4,256,271
Trial court decision favorable to Government; appeal to circuit court of appeals dismissed without decision on stipulation of parties	3	1,485,222
Trial court decision adverse to Government; appeal to circuit court of appeals dismissed without decision on stipulation of parties	3	108,280
Trial court decision partly in favor of Government; appeal to circuit court of appeals dismissed without decision on stipulation of parties	1	183,127
Trial court decision favorable to Government; on appeal remanded without decision pursuant to stipulation of no deficiency or remanded on other grounds without discussion of applicability of sec. 102	2	104,162
Total closed	101	18,749,146

NOTE.—Table prepared by the Bureau of Internal Revenue.

In another three cases (3 percent of total), the trial court decision was adverse to the Government. Upon appeal to the circuit court of appeals, the cases were dismissed without decision on stipulation of the parties. Only 0.5 percent of total proposed tax was involved in these cases.

These latter two groups of cases balance off in numbers, but not in proposed tax, with the three cases which secured a favorable trial court decision representing 8 percent of total proposed tax, while the other three cases (trial court decision unfavorable to Government) represent 0.5 percent.

In one case, the trial court decision was partly in favor of the Government. The circuit court of appeals dismissed the case without decision on stipulation of the parties. The tax proposed in this case was $183,127.

Two cases received a trial court decision which was in favor of the Government, but, on appeal, they were remanded without decision, pursuant to a stipulation of no deficiency or on other grounds, without discussion of section 102 applicability. The proposed tax in these two cases was $104,162.

The Government has fared well in the litigation under section 102 with respect to proposed tax; less well in terms of the number of cases. In tax proposed, the Government received favorable decisions in the trial court and/or on appeal for 67 percent of total proposed tax; and favorable trial court decisions, with dismissal of case on appeal without decision on stipulation of parties, for 8 percent. On the whole, the Government, in the enforcement of section 102, should feel no compulsion to compromise cases in order to avoid litigation because the courts, though conservative, apparently have not been unsympathetic, and have supported the Bureau where it counts—in cases involving large deficiency assessments. On the other hand, the Bureau

has applied the tax, generally, when liability appears clear-cut and when the purpose to avoid personal surtax through surplus accumulations finds very strong evidentiary support. In view of the very conservative and cautious attitude of the Bureau in the imposition of deficiency assessment under section 102, an even better record in litigation might be expected. The fact that the Government has lost slightly more than half the cases emphasizes the conservatism of the courts and, possibly, their reluctance to support the imposition of a penalty tax. Trial courts have given to "reasonable business needs" a liberal and generous interpretation, and have been disposed to defer to the "more experienced" judgment of the corporate directors [28] in appraising the financial requirements of the business as to surplus accumulation and needed liquidity.[29]

Table 28 lists the 101 adjudicated cases in order of fiscal year of trial court decision with the name of the respondent corporation, the tax year or years of assessment, the name of the trial court and the court of final determination, the case citation (or citations), the nature of the final determination (favorable or unfavorable to Government), the tax proposed, and the type of corporation.

Although the initial litigation occurred in fiscal 1929–30, which involved two corporations and four tax years of assessment, the next two fiscal years were without any cases being brought before the courts (see table 29). In fiscal 1932–33, two corporations, having five assessable tax years, appealed to the courts for relief. From this time forward, cases were presented to the courts for adjudication each year. The smallest volume of litigation was never less than two cases in any year, with a maximum of 12 corporations seeking relief in fiscal 1942–43; also in 1943–44. The number of tax years of assessment were 18 and 23, respectively.

[28] The directors are customarily the owners of the majority of the voting shares, if not all the shares, in sec. 102 assessments, and, hence, are deeply concerned with the problem of the personal surtax. It is not to be expected that these same directors would be disinterested parties to the beneficial effects of surplus accumulation in minimizing surtax.

[29] William L. Cary, op. cit., pp. 1306–1307.

TABLE 28.—*Cases litigated under sec. 102 or under similar provisions in prior revenue acts*

Fiscal year trial court decision	Name of respondent corporation	Taxable year filing period	Name of court of final determination	Case citation	Decided favorably to Government	Decided adversely to Government	Tax proposed	Type of corporation: Personal holding company	Type of corporation: Investment corporation	Type of corporation: Operating corporation
1929-30	United Business Corp. of America.	1921	B. T. A Affirmed C. C. A. 2. Certiorari denied	19 B. T. A. 809 62 F. (2d) 754 290 U. S. 635	Yes		$19,710			
1929-30	French Mortgage & Bond Co.	1923 1924 1925	D. C., Mich	38 F. (2d) 841	Yes Yes Yes		(1) (1) (1)			
1932-33	R. C. Tway Coal Sales Co	1922 1923	D. C., Ky Affirmed C. C. A. 6.	3 F. Supp. 668 75 F. (2d) 336		Yes Yes	23,818			Yes. Yes.
1932-33	Williams Investment Co	1924 1925 1926	Court of Claims	77 Ct. Cl. 396 3 F. Supp. 225	Yes Yes Yes		18,539 100,532 164,315	(2)		
1933-34	Keck Investment Co	1923	B. T. A Affirmed C. C. A. 9. Certiorari denied	29 B. T. A. 143 77 F. (2d) 244 296 U. S. 633	Yes		19,806	(2)		
1933-34	Wm. C. deMille Productions, Inc.	1924 1925 1926 1927 1928	B. T. A Dismissed C. C. A. 9.	30 B. T. A. 826 80 F. (2d) 1010		B. T. A., yes do do	42,462 49,877 38,584 28,937 23,267			Yes. Yes. Yes. Yes.
1934-35	Cecil B. deMille Productions, Inc.	1924 1925 1926 1927 1928 1929	B. T. A Affirmed C. C. A. 9. Cert. denied	31 B. T. A. 1161 90 F. (2d) 12 302 U. S. 713		Yes Yes Yes Yes Yes	157,599 363,605 334,871 138,217 387,599 104,423			Yes. Yes. Yes. Yes. Yes. Yes.
1934-35	Fisher & Fisher, Inc	1926 1927	B. T. A Affirmed C. C. A. 2.	32 B. T. A. 211 84 F. (2d) 996		Yes Yes	58,872 58,101			
1935-36	Irvington Investments Co	1931	B. T. A	32 B. T. A. 1165		Yes	19,788			
1935-36	United Business Corp. of America.	1922 1923	B. T. A Remanded pursuant to stipulation of no deficiency C. C. A. 2.	33 B. T. A. 83	B. T. A., yes do		15,309 38,657			
1935-36	A. D. Saenger, Inc	1929	B. T. A Affirmed C.C.A. 5. Certiorari denied	33 B. T. A. 135 84 F. (2d) 23 299 U. S. 577	Yes		65,808	(2)		

Footnotes at end of table.

TABLE 28.—*Cases litigated under sec. 102 or under similar provisions in prior revenue acts*—Continued

Fiscal year trial court decision	Name of respondent corporation	Taxable year filing period	Name of court of final determination	Case citation	Decided favorably to Government	Decided adversely to Government	Tax proposed	Type of corporation		
								Personal holding company	Investment corporation	Operating corporation
1935–36	Edward G. Swartz, Inc.	1927	B. T. A.	33 B. T. A. 355	Yes		$61,104			
1935–36	R. & L., Inc.	1929	B. T. A.	33 B. T. A. 857	Yes		66,990	(1)		
			Affirmed C. C. A. 5.	84 F. (2d) 721						
			Certiorari denied.	299 U. S. 588						
1936–37	Sauk Investment Co.	1930	B. T. A.	34 B. T. A. 732		Yes	62,878			
1936–37	Rands, Inc.	1927			B. T. A., yes		315,306	(1)		
		1928	B. T. A.	34 B. T. A. 1094	do		475,025	(1)		
		1929	Dismissed C. C. A. 6.	101 F. (2d) 1018	do		239,051	(1)		
		1930			do		28,614	(1)		
1936–37	Almours Securities, Inc.	1931	B. T. A.	35 B. T. A. 61	Yes		1,282,169	(1)		
			Affirmed C. C. A. 5.	91 F. (2d) 427						
		1932	Certiorari denied.	302 U. S. 765	Yes		778,852	(1)		
1936–37	National Grocery Co.	Fiscal year ending Jan. 31, 1931.	B. T. A.	35 B. T. A. 163						
			Rev'd C. C. A. 3.	92 F. (2d) 931						
			S. Ct. reviewing C. C. A. 3.	304 U. S. 282	Yes		477,360			Yes.
1936–37	Rofam, Inc.	1932	B. T. A.	P-H Memo B. T. A., par. 37,080.		Yes	17,240			
1936–37	Emad, Inc. (reported Rofam, Inc. et al.).	1932	B. T. A.	P-H Memo B. T. A., par. 37,080 (supra).		Yes	17,240			
1937–38	Nipoch Corp.	1931	B. T. A.	36 B. T. A. 662	B. T. A., yes		250,272	(1)		
		1932	Dismissed C. C. A. 2.		do		155,579	(1)		
1937–38	C. H. Spitzner & Son, Inc.	1932	B. T. A.	37 B. T. A. 511		Yes	94,377			Yes.
1937–38	Reynard Corp.	Fiscal year ending Mar. 31, 1932.	B. T. A.	37 B. T. A. 552						
			Dismissed C. C. A. 2.		B. T. A., yes		21,375	(1)		
1937–38	R. L. Blaffer & Co.	Fiscal year ending Sept. 30, 1932.	B. T. A.	37 B. T. A. 851	Yes		15,734	(1)		
			Affirmed C. C. A. 5.	103 F. (2d) 487						
		Sept. 30, 1933	Certorari denied.	308 U. S. 559	Yes		11,866	(1)		
		Sept. 30, 1934			Yes		12,649	(1)		
1937–38	Charleston Lumber Co.	1924	D. C., W. Va.	20 F. Supp. 83						
			Dismissed C. C. A. 4.	93 F. (2d) 1018		D. C., yes	9,077			Yes.
1937–38	Industrial Bankers Securities Corp.	Fiscal year ending Sept. 30, 1932.	D. C., N. Y.			Yes	138,490			Yes.
			Affirmed C. C. A. 2.	104 F. (2d) 177		Yes	51,421			Yes.
		Sept. 30, 1933								
1938–39	W. S. Farish & Co.	Fiscal year ending Oct. 31, 1934.	B. T. A.	38 B. T. A. 150						
			Affirmed C. C. A. 5.	104 F. (2d) 833		Yes	39,715			
1938–39	Seaboard Security Co.	1932	B. T. A.	38 B. T. A. 560		Yes	10,875			Yes.

1938-39	Seaboard Small Loan Corp. (reported Seaboard Security Co. et al.).	1932	B. T. A.	38 B. T. A. 560 (supra).		Yes	36,797		Yes.
1938-39	Southern Security Co. (reported Seaboard Security Co. et al.).	1931	B. T. A.	38 B. T. A. 560 (supra).		Yes	13,039		Yes.
		1932				Yes	11,324		Yes.
1938-39	Mead Corp	1931	B. T. A. Reversed C. C. A. 3.	38 B. T. A. 687 116 F. (2d) 187		Yes	127,432	(3)	
1938-39	Mellbank Corp	1932	B. T. A.	38 B. T. A. 1108		Yes	49,222		Yes.
1938-39	A. and J., Inc	1931	B. T. A.	38 B. T. A. 1248	Yes		161,346		Yes.
1938-39	Dill Manufacturing Co	Fiscal year ending Nov. 30, 1932.	B. T. A.	39 B. T. A. 1023		Yes	105,087		Yes.
1938-39	J. E. Baker Co	1930	B. T. A.	P-H Memo B. T. A., par. 39, 257.		Yes	105,016		Yes.
1939-40	Corporate Investment Co	1929	B. T. A.	40 B. T. A. 1156		Yes	335,908		
1939-40	Delaware Terminal Corp	Period Sept. 13 to Dec. 31, 1932.	B. T. A.	40 B. T. A. 1180		Yes	185,591	(3)	
1939-40	Trico Securities Corp	1933	B. T. A.	41 B. T. A. 306		Yes	106,999		
1939-40	Chicago Stock Yards Co	1930 1932 1933	B. T. A. Reversed C.C.A. 1. S. Ct. reversing C.C.A. 1.	41 B. T. A. 590 129 F. (2d) 937 318 U. S. 693	Yes Yes Yes		1,817,686 1,301,638 1,147,111	(4) (5)	
1939-40	Suffolk Securities Corp	Fiscal year ending Nov. 30, 1930.	B. T. A. Affirmed C. C. A. 2. Certiorari denied	41 B. T. A. 1161 128 F. (2d) 743 317 U. S. 700	Yes		56,543	(3)	
1939-40	J. M. Perry & Co., Inc	1935 1936	B. T. A. Affirmed C. C. A. 9.	P-H Memo B. T. A., par. 40, 153, 120 F. (2d) 123	Yes Yes		18,642 5,971		Yes. Yes.
1939-40	C. R. Burr & Co., Inc	Fiscal year ending May 31, 1935.	B. T. A.	P-H Memo B. T. A., par. 40,250.		Yes	6,658		Yes.
		May 31, 1936				Yes	3,347		Yes.
1939-40	Wilson Bros. & Co	1932 1933 1934	B. T. A. Affirmed C. C. A. 9.	P-H Memo B. T. A., par. 40,271. 124 F. (2d) 606	Yes Yes Yes		10,865 19,207 11,017	(3) (3) (3)	
1939-40	Beim Co	1932 1933	D. C., Minn. Affirmed C. C. A. 8.	26 A. F. T. R. 1189 40-2 U. S. T. C., par. 9630. 113 F. (2d) 897	Yes Yes		17,640 31,167	(3) (3)	
1940-41	Olin Corp	1932 1933	B. T. A. Affirmed C. C. A. 7.	42 B. T. A. 1203 128 F. (2d) 185	Yes Yes		128,734 100,481	(3) (3)	
1940-41	Wilkerson Daily Corp., Ltd.	Fiscal year ending July 31, 1936.	B. T. A. Affirmed C. C. A. 9.	42 B. T. A. 1266 125 F. (2d) 998	Yes		17,199		Yes.

Footnotes at end of table.

TABLE 28.—*Cases litigated under sec. 102 or under similar provisions in prior revenue acts*—Continued

Fiscal year trial court decision	Name of respondent corporation	Taxable year filing period	Name of court of final determination	Case citation	Decided favorably to Government	Decided adversely to Government	Tax proposed	Type of corporation		
								Personal holding company	Investment corporation	Operating corporation
1940-41	Stanton Corp	1931	B. T. A.	44 B. T. A. 56	Yes		$453,640	(2)	(2)	(2)
		1932	Affirmed C. C. A. 2.	138 F. (2d) 512	Yes		81,968	(2)	(2)	(2)
1940-41	R. C. Reynolds, Inc	1935	B. T. A.	44 B. T. A. 356		Yes	35,258			Yes.
1940-41	United Block Co., Inc	Fiscal year ending Sept. 30, 1936.	B. T. A.	P-H Memo. B. T. A., par. 40,575.						
			Affirmed C. C. A. 2.	345 F. (2d) 704	Yes		29,841			Yes.
			Certiorari denied	315 U. S. 812						
1941-42	Saven Corp	1928	B. T. A.	45 B. T. A. 343	Yes		287,679	(2)	(2)	(2)
		1929			Yes		498,457	(2)	(2)	(2)
1941-42	Trico Products Corp	1934	B. T. A.	46 B. T. A. 346	Yes		413,439			Yes.
			Affirmed C. C. A. 2.	137 F. (2d) 424						
		1935	Certiorari denied	320 U. S. 799	Yes		1,220,933			Yes.
1941-42	Botsford, Constantine & Gardiner.	1938	B. T. A.	P-H Memo. B. T. A., par. 41,494.		Yes	3,784			
1941-42	Plant Shipping Co., Inc	1938	B. T. A.	P-H Memo. B. T. A., par. 42,213.		Yes	3,962			Yes.
1941-42	Plant Line Stevedoring Co., Inc.	1938	B. T. A.	P-H Memo. B. T. A., par. 42,221.	Yes		1,417			Yes.
1941-42	Hemphill Schools, Inc	Fiscal year ending Mar. 31, 1936.	B. T. A.	P-H Memo. B. T. A., par. 42,285.						
			Vacated and remanded C. C. A. 9, B. T. A.	137 F. (2d) 961	Yes		66,858			Yes.
1942-43	L. R. Teeple Co	1937	B. T. A.	47 B. T. A. 270		Yes	7,696			Yes.
		1938				Yes	15,558			Yes.
		1939				Yes	9,166			Yes.
1942-43	Florida Iron & Metal Co. of Jacksonville.	1938	B. T. A.	P-H Memo B. T. A. par. 42,408.		Yes	9,264			Yes.
1942-43	Howard Flint Ink Co	1938	B. T. A.	P-H Memo B. T. A. par. 42,410.		Yes	28,935			Yes.
		1939				Yes	30,721			Yes.
1942-43	Bosch Brewing Co	1938	B. T. A.	P-H Memo B. T. A. par. 42,429.		Yes	12,631			Yes.
1942-43	Becton, Dickinson & Co	Fiscal year ending June 30, 1939.	B. T. A. Affirmed C. C. A. 3.	P-H Memo B. T. A. par. 42,441. 134 F. (2d) 354.	Yes		66,540			Yes.
1942-43	Dietz & Co., Inc	1938	Tax Court	P-H Memo T. C. par. 42,597. 1 T. C. M. 93		Yes	9,711			Yes.

1942-43	Millane Nurseries & Tree Experts, Inc.	1938	Tax Court	P-H Memo T. C., par. 42,651, 1 T. C. M. 228.		Yes	4,195		Yes.
		1939				Yes	2,674		Yes.
1942-43	Metal Mouldings Corp	1939	Tax Court	P-H Memo T. C., par 43,087, 1 T. C. M. 616.		Yes	65,825		Yes.
1942-43	Medical Arts Hospital of Dallas.	1939	Tax Court. Affirmed CCA 5	P-H Memo T. C., par. 43,189. 1 T. C. M. 935. 141 F. (2d) 404	Yes		5,353		Yes.
1942-43	Calif. Motor Transport Co., Ltd	1939	Tax Court	P-H Memo T. C. par. 43, 192.		Yes	8,892		Yes.
		1940		1 T. C. M. 974		Yes	8,634		Yes.
1942-43	Calif. Motor Express Co., Ltd.	1939	Tax Court	P-H Memo T. C., par. 43, 192.		Yes	10,035		Yes.
		1940		1 T. C. M. 974		Yes	4,466		Yes.
1942-43	Steel's Mills (a corporation)	1938	D. C., N. C	32 A. F. T. R. 1734, 43-1 U. S. T. C. par. 9397.		Yes	11,958		Yes.
1943-44	Wean Engineering Co., Inc.	1936	Tax Court			Yes	68,519		Yes.
		1937		P-H Memo T. C. par. 43, 348. 2 T. C. M. 510		Yes	66,793		Yes.
		1938				Yes	54,173		Yes.
		1939				Yes	25,388		Yes.
		1940				Yes	46,406		Yes.
1943-44	McCutchin Drilling Co	Fiscal year ending Sept. 30, 1940.	Tax Court. Affirmed C. C. A. 5.	P-H Memo T. C., par. 43,370. 2 T. C. M. 554. 143 F. (2d) 480	Yes		9,933		Yes.
1943-44	Gibbs & Cox, Inc	1938	Tax Court. Affirmed C. C. A. 2.	P-H Memo T. C., par. 43, 400. 2 T. C. M. 688. 147 F. (2d) 60	Yes		41,512		Yes.
		1939			Yes		69,460		Yes.
		1940			Yes		60,370		Yes.
1943-44	T. Smith & Son, Inc	1938	Tax Court	P-H Memo T. C., par. 43, 412. 2 T. C. M. 740		Yes	16,829		Yes.
		1939				Yes	28,934		Yes.
1943-44	Smokeless Fuel Co	1938	Tax Court	P-H Memo T. C., par. 43,425. 2 T. C. M. 794		Yes	33,472		Yes.
1943-44	Hanovia Chemical & Manufacturing Co.	1938	do	P-H Memo T. C., par. 43,435. 2 T. C. M. 822		Yes	16,083		Yes.
1943-44	Baker & Co., Inc	1938	do	P-H Memo T. C., par. 43,436. 2 T. C. M. 827		Yes	67,108		Yes.
1943-44	W. H. Gunlocke Chair Co	Fiscal year ending June 30, 1939.	Tax Court. Affirmed C. C. A. 2.	P-H Memo T. C., par. 43,443. 2 T. C. M. 885. 145 F. (2d) 791	Yes		22,330		Yes.
1943-44	Litchfield Creamery Co	1938	Tax Court	P-H Memo T. C., par. 43,458. 2 T. C. M. 929		Yes	49,248		Yes.
		1939				Yes	49,003		Yes.

Footnotes at end of table.

TABLE 28.—*Cases litigated under sec. 102 or under similar provisions in prior revenue acts*—Continued

Fiscal year trial court decision	Name of respondent corporation	Taxable year filing period	Name of court of final determination	Case citation	Decided favorably to Government	Decided adversely to Government	Tax proposed	Type of corporation		
								Personal holding company	Investment corporation	Operating corporation
1943-44	Parker-Browne Co. (reported M. Greenspun, et al.).	1938	Tax Court, revised and remanded. C. C. A.-5 without discussion of this point.	P-H Memo T. C., par. 44, 122.	T. C., yes		$16,314			Yes.
		1939		7 T. C. M. 509	do		16,925			Yes.
		1940		156 F. (2d) 917	do		16,867			Yes.
1943-44	Lane Drug Co	Fiscal year ending Sept. 30, 1940.	Tax Court	P-H Memo T. C., par. 44,131. 3 T. C. M. 394		Yes	29,716			Yes.
1943-44	Coca-Cola Bottling Works	1936	D. C., Tenn	53 F. Supp. 992		Yes	11,003			Yes.
		1937				Yes	10,020			Yes.
1944-45	Whitney Chain & Manufacturing Co.	1939	Tax Court. Affirmed C. C. A. 2.	3 T. C. 1109. 149 F. (2d) 936	Yes		17,611			Yes.
1944-45	General Smelting Co	1939	Tax Court	4 T. C. 313		Yes	11,089			Yes.
		1940				Yes	16,255			Yes.
1944-45	Semagraph Co	Fiscal year ending Mar. 31, 1939.	Tax Court	P-H Memo T. C., par. 44,264, 3 T. C. M. 812.	Yes		3,683			
		Mar. 31, 1940	Affirmed C. C. A. 4	152 F. (2d) 62	Yes		8,918			
1944-45	Albert L. Allen Co., Inc	1937	Tax Court	P-H Memo T. C.	Yes		492			Yes.
		1938		Par. 44, 381	Yes		2,298			Yes.
		1939		3 T. C. M. 1246	Yes		1,794			Yes.
1944-45	John F. Boyle Co	1938	Tax Court	P-H Memo T. C. par. 44, 410.	Yes		20,417			Yes.
		1939		3 T. C. M. 1335	Yes		14,101			Yes.
1944-45	Syracuse Stamping Co	1940	Tax Court	P-H Memo T. C. par. 45, 118. 4 T. C. M. 371		Yes	4,690			Yes.
1944-45	Christmann Veneer & Lumber Co.	1941	Tax Court	P-H Memo T. C. par. 45, 174. 4 T. C. M. 529	Yes		7,928			Yes.
1944-45	Walkup Drayage & Warehouse Co.	1940	Tax Court	P-H Memo T. C. par. 45, 241. 4 T. C. M. 695		Yes	21,698			Yes.
1945-46	Universal Steel Co	1941	Tax Court	5 T. C. 627		Yes	41,380			Yes.
1945-46	Mabee Consolidated Corp	1939	D. C., Okla. Dismissed CCA 10	36 A. F. T. R. 1609. 46-1 U. S. T. C. par. 9146. 154 F. (2d) 1019		D. C., yes	(1)			

1946–47	Lion Clothing Co	1940	Tax Court	8 T. C. 1181		Yes	9,792			Yes.
		1941				Yes	16,819			Yes.
		1942				Yes	8,684			Yes.
1946–47	Southland Industries, Inc	Fiscal year ending July 31, 1940	Tax Court	P-H Memo T. C. par. 46,262; 5 T. C. M. 950	Yes		21,731			Yes.
1946–47	Kennedy Nameplate Co	Fiscal year ending June 30, 1941.	Tax Court	P-H Memo T. C., par. 47,150, 6 T. C. M. 622.		Yes	9.017			Yes.
		June 30, 1942	Affirmed C. C. A. 9.	170 F. (2d) 196		Yes	10,782			Yes.
1946–47	Trico Products Corp	1936	D. C., N. Y.	67 F. Supp. 311	Yes		532,468			Yes.
		1937	Affirmed C. C. A. 2.	169 F. (2d) 343						
			Certiorari denied	335 U. S. 899	Yes		602,119			Yes.
1946–47	World Publishing Co	1942	D. C., Okla.	72 F. Supp. 886	Yes		22,118			Yes.
		1943	Affirmed C. C. A. 10.	169 F. (2d) 186						
			Certiorari denied	335 U. S. 911	Yes		19,524			Yes.
1947–48	Gus Blass Co	Fiscal year ending Jan. 31, 1941.	Tax Court	9 T. C. 15		B. T. A., yes	99,203			Yes.
			Dismissed C. C. A. 8.	168 F. (2d) 833						
1947–48	William C. Atwater & Co	Fiscal year ending Dec. 31, 1942.	Tax Court	10 T. C. 218		Yes	42,261			Yes.
		Dec. 31, 1943				Yes	24,155			Yes.
1948–49	J. L. Goodman Furniture Co	1942	Tax Court	11 T. C. 530		Yes	9,119			Yes.
		1943				Yes	8,921			Yes.
1948–49	Eastern Railway & Lumber Co.	1943	Tax Court	12 T. C. 869	Yes		26,827			Yes.
1948–49	Colonial Amusement Corp	1942	Tax Court	P-H Memo T. C., pars. 48,149.	Yes		6,156			Yes.
		1943		7 T. C. M. 546	Yes		5,600			Yes.
1948–49 (C. C. A. 1949).	Marlborough Corp	Fiscal year ending Aug. 31, 1939.	D. C., Calif.		Yes		3,389			
			Remanded C. C. A. 9.	172 F. (2d) 787						
		Aug. 31, 1940	D. C., Calif.		Yes		5,112			
July 1, 1949–Jan. 1, 1950.	Koma, Inc	1943	Tax Court	P-H Memo T. C., pars. 49,284.	Yes		973			Yes.
		1944		8 T. C. M. —	Yes		2,228			Yes.
July 1, 1949–Jan. 1, 1950.	Tulsa Broadcasting Co. (reported Koma, Inc.).	1943	Tax Court	P-H Memo T. C. pars. 49,284.	Yes		9,334			Yes.
		1944		8 T. C. M. —(supra)	Yes		6,853			Yes.

[1] Not reported.
[2] Holding or investment company.
[3] Holding company.
[4] Holding or investment company (B. T. A.); not holding or investment company (C. C. A. 1).
[5] Unnecessary to consider this contention (Supreme Court).

NOTE.—Table prepared by the Bureau of Internal Revenue.

TABLE 29.—*Summary of litigation under sec. 102 and predecessor sections*

Fiscal year of trial court decision	Number of corporations	Number of assessable tax years	Number of appeals from trial court [1]	Tax years of assessment		Total tax proposed
				Number of decisions (final) favorable to Government	Number of decisions (final) adverse to Government	
1929-30	2	4	1	4		[2] $19,710
1930-31						
1931-32						
1932-33	2	5	1	3	2	307,204
1933-34	2	6	2	4	2	202,932
1934-35	2	8	2		8	1,603,287
1935-36	5	6	3	5	1	267,746
1936-37	6	10	3	7	3	3,693,735
1937-38	6	10	5	6	4	760,840
1938-39	9	10	2	1	9	659,853
1939-40	9	[3] 16	5	11	5	5,075,990
1940-41	5	7	4	6	1	847,121
1941-42	6	8	2	6	2	2,496,529
1942-43	12	18	2	2	16	312,254
1943-44	12	23	4	8	15	826,406
1944-45	8	13	2	9	4	130,974
1945-46	2	2	1		2	41,380
1946-47	5	10	3	5	5	1,253,054
1947-48	2	3	1		3	165,619
1948-49	4	7	1	5	2	65,124
1949-50 (to Jan. 1, 1950)	2	4		4		19,388
Total	101	170	44	86	84	18,749,146

[1] An appeal from the trial court, for purposes of this enumeration, will be listed as 1, even though appealed from the circuit court of appeals to the Supreme Court.
[2] Proposed tax not reported for the French Mortgage & Bond Co.
[3] Includes assessment against the Delaware Terminal Corp. for the period September 13, 1932, to December 31, 1932.

It will be observed that points of concentration in number of assessable tax years in litigation are fiscal 1937–40, with 46 assessable years, and fiscal 1943–45, with 54 assessable years. These two periods account for 100 of the 170 assessable tax years.

Appeals from trial-court decisions display a rising trend from fiscal 1930 to and including fiscal 1940, thereafter declining. The number of appeals from the trial courts total 44.

The number of final decisions favorable to the Government in terms of tax years of assessment was 86; unfavorable 84. In fiscal 1935, 1946, and 1948, all cases brought to trial resulted in decisions unfavorable to the Government; all decisions were favorable to the Government in fiscal 1930 and 1950 (first 6 months).

The largest amount of proposed tax in litigation in any one year was in fiscal 1940 with $5,075,990; fiscal 1937 was next with $3,693,735; and in fiscal years 1935, 1942, and 1947 the proposed tax was $1,603,287, $2,496,529, and $1,253,054, respectively. For each of the last three fiscal years, the amount of proposed tax has been comparatively small.

Assessed corporations have gone into the Federal district courts on 11 occasions; the Court of Claims in one instance; and the Board of Tax Appeals or the Tax Court 89 times.

Table 30 provides detail with respect to corporations assessed, with the assessments subject to adjudication. Total corporate assets, total earned surplus, total liquid assets, the ratio of current assets to current liabilities, the proportion of posttax net income retained, the total number of stockholders, the tax proposed, and the character of the court's decision are shown where the information was reported in the case.

TABLE 30.[1]—*Cases closed by Tax Court or by other courts under sec. 102 or similar provisions in prior revenue acts, 1913 to Jan. 1, 1950*

Fiscal year trial court decision	Name of corporation	Taxable year filing period	Total corporate assets	Total earned surplus	Total liquid assets (cash, securities, accounts receivable)	Ratio of current assets to current liabilities	Percent of net income after taxes retained for taxable year	Total number of stockholders	Tax proposed	Decided favorably to Government	Decided adversely to Government
1929-30	United Business Corp. of America.	1921	$4,213,689	$212,222	$1,500,000	3 to 1	100	1 except qualifying shares.	$19,710	Yes	
1929-30	French Mortgage & Bond Co.	1923	Statement of condition not reported.						[2]	do	
		1924	do						[2]	do	
		1925	do						[2]	do	
1932-33	R. C. Tway Coal Sales Co.	1922	do	$104,869		1.3 to 1	65	4	[3] 23,818		Yes.
		1923	do	$145,411		do	70	4			Do.
1932-33	Williams Investment Co.	1924	$699,979	$361,679	Statement of condition not reported.		100	1 except qualifying shares.	18,539	Yes	
		1925	$934,411	$571,111	do		100	do	100,532	do	
		1926	$1,247,749	$882,916	do		92	do	164,315	do	
1933-34	Keck Investment Co.	1923	$2,923,005	$657,397	$2,923,000	32 to 1	77	2 except for 1 share.	19,805	do	
1933-34	Wm. C. de Mille Productions, Inc.	1924	Statement of condition not reported.	$77,223			Paid some dividends.	1 except for 12 shares.	42,462		B. T. A., yes.
		1925	do	$153,265			87	do	49,877		Do.
		1926	do	$178,100			69	do	38,584	B. T. A., yes.	
		1927	do	$223,054			80	do	28,937	do	
		1928	do	$240,446			60	do	23,267	do	
1934-35	Cecil B. de Mille Productions, Inc.	1924	do	$309,366			97	4	157,599		Yes.
		1925	do	$708,730			99	3	363,605		Do.
		1926	do	$1,136,129			92	2	334,871		Do.
		1927	do	$1,239,403			75	6	138,217		Do.
		1928	do	$1,568,477			93	6	387,599		Do.
		1929	do	$1,606,515			28	6	104,423		Do.
1934-35	Fisher & Fisher, Inc.	1926	do	$92,344			100	1 except for 2 shares.	58,872		Do.
		1927	do	$168,848			100	do	58,101		Do.
1935-36	Irvington Investments Co.	1931	$566,106		$194,000	194,000 to 1.	100	1	19,788		Do.
1935-36	United Business Corp. of America.	1922	$4,977,180	$328,523	$2,193,000	4.9 to 1	100	1 except qualifying shares	15,399	B. T. A., yes.	
		1923	$5,603,928	$584,207	$2,796,000	5.9 to 1	100	do	38,657	do	

See footnotes at end of table.

TABLE 30.[1]—*Cases closed by Tax Court or by other courts under sec. 102 or similar provisions in prior revenue acts, 1913 to Jan. 1, 1950*—Con.

Fiscal year trial court decision	Name of corporation	Taxable year filing period	Total corporate assets	Total earned surplus	Total liquid assets (cash, securities, accounts receivable)	Ratio of current assets to current liabilities	Percent of net income after taxes retained for taxable year	Total number of stockholders	Tax proposed	Decided favorably to Government	Decided adversely to Government
1935-36	A. D. Saenger, Inc.	1929	$1,500,000 (securities).			13 to 1	100	1	$65,808	Yes	
1935-36	Edward G. Swartz, Inc.	1927	$862,324	$487,256	$727,000	1,000 to 1 (liabilities $68).	100	3	61,104	do	
1935-36	R. & L., Inc.	1929	$1,649,214	$271,387	$1,046,000	7 to 1	100	2 except qualifying shares.	66,990	do	
1936-37	Sauk Investment Co.	1930	Statement of condition not reported.	$144,115			100	4	62,878		Yes.
1936-37	Rands, Inc.	1927	In excess of $1,500,000.				100	1 owned substantially all.	315,306	B.T.A., yes.	
		1928	do				100	do	475,025	do	
		1929	Reduction in value.				100	do	239,051	do	
		1930	do				100	do	28,614	do	
1936-37	Almours Securities, Inc.	1931	$54,647,410	$609,148	$47,900,000	95 to 1	66	3 owned substantially all.	1,282,169	Yes	
		1932	$55,406,979	$1,305,944	$48,500,000	80 to 1	44	do	778,852	do	
1936-37	National Grocery Co.	Fiscal year ending Jan. 31, 1931.	$9,108,437	$7,938,965	$5,000,000	8 to 1	100	1 beneficially owned all.	477,360	do	
1936-37	Rofam, Inc.	1932	Statement of condition not reported.				100	1 except qualifying shares.	17,240		Do.
1936-37	Emad, Inc. (reported Rofam, Inc., et al.)	1932	do				100	do	17,240		Do.
1937-38	Nipech Corp.	1931	$10,939,883	$3,663,833	$10,939,883	6 to 1	78	1	250,272	B. T. A., yes.	
		1932	$11,423,830	$3,902,445	$11,423,830	5 to 1	82	1	155,579	do	
1937-38	C. H. Spitzner & Son, Inc.	1932	$4,220,270	$318	$3,000,000	15 to 1	100	2 plus few shares.	94,377		Do.
1937-38	Reynard Corp.	Fiscal year ending Mar. 31, 1932.	$270,609	$181,169	$177,000	5.3 to 1	100	1 plus qualifying shares.	21,375	B. T. A., yes.	

1937–38	R. L. Blaffer & Co.	Fiscal year ending Sept. 30, 1932.	$2,554,963	$58,003	Assets almost entirely liquid.	1.4 to 1	100	2 plus qualifying shares.	15,734	Yes	
		Sept. 30, 1933	$2,752,558	$71,843	do	do	100	do	11,866	do	
		Sept. 30, 1934	$3,230,107	$123,552	do	1.6 to 1	100	do	12,649	do	
1937–38	Charleston Lumber Co.	1924	$654,065	$526,732	$323,000	49 to 1	100	2	9,077		D.C., yes.
1937–38	Industrial Bankers Securities Corp.	Fiscal year ending Sept. 30, 1932.	Statement of condition not reported.				Paid dividends; retained some earnings.	1 common stockholder.	138,490		Yes.
		Sept. 30, 1933	do				do	do	51,421		Do.
1938–39	W. S. Farish & Co.	Fiscal year ending Oct. 31, 1934.	$2,029,096	$126,229 (deficit).	$1,916,000	1.3 to 1	100	4 plus qualifying shares.	39,715		Do.
1938–39	Seaboard Security Co.	1932	$232,538	$141,325	$116,000	2.3 to 1	86	1	10,875		Do.
1938–39	Seaboard Small Loan Corp. (reported Seaboard Security Co. et al).	1932	$1,238,797	$120,880	$724,000	14 to 1	70	1	36,797		Do.
1938–39	Southern Security Co. (reported Seaboard Security Co. et al).	1931	$218,432	$120,334	$144,000	1.8 to 1	88	1	13,039		Do.
		1932	$222,041	$123,942	$163,000	2 to 1	60	1	11,324		Do.
1938–39	Mead Corp.	1931	$5,600,775	$193,181	$5,600,775	2.9 to 1	Paid dividends; retained some earnings.	1 corporation; stock of which owned by 1 family.	127,432		Do.
1938–39	Mellbank Corp.	1932	$9,132,255	$364,673	$490,000	0.92 to 1	100	1	49,222		Do.
1938–39	A. & J., Inc.	1931	$3,673,209	$2,238,714	$3,200,000	6 to 1	100	2 plus qualifying shares.	161,346	Yes	
1938–39	Dill Manufacturing Co.	Fiscal year ending Nov. 30, 1932.	$1,273,308	$507,789	$542,000	13 to 1	77	3	105,087		Do.
1938–39	J. E. Baker Co.	1930	$4,133,052	$1,346,811	$915,000	99 to 1	100	1 owned 97 percent.	105,016		Do.
1939–40	Corporate Investment Co.	1929	$12,962,669	$2,770,041	$12,800,000	3.9 to 1	Paid dividends; retained some profits.	1	335,908		Do.
1939–40	Delaware Terminal Corp.	Period Sept. 13 to Dec. 31, 1932.	$365,899	$320,789	$345,000	14 to 1	86	6 principal stockholders.	185,591		Do.
1939–40	Trico Securities Corp.	1933	Statement of condition not reported.	$540,134			100	23	106,999		Do.
1939–40	Chicago Stock Yards Co.	1930	$37,429,052	$22,684,242	$13,000,000	130 to 1	88	1	1,817,686	Yes	
		1932	$40,760,137	$26,415,437	$12,400,000	124 to 1	81	1	1,301,638	do	
		1933	$42,629,789	$28,259,278	$14,000,000	140 to 1	82	1	1,147,111	do	

See footnotes at end of table.

TABLE 30.[1]—*Cases closed by Tax Court or by other courts under sec. 102 or similar provisions in prior revenue acts, 1913 to Jan. 1, 1950*—Con.

Fiscal year trial court decision	Name of corporation	Taxable year filing period	Total corporate assets	Total earned surplus	Total liquid assets (cash, securities, accounts receivable)	Ratio of current assets to current liabilities	Percent of net income after taxes retained for taxable year	Total number of stockholders	Tax proposed	Decided favorably to Government	Decided adversely to Government
1939-40	Suffolk Securities Corp.	Fiscal year ending Nov. 30, 1930.	$2,625,810	$72,947			100	1	$56,543	Yes.	
1939-40	J. M. Perry & Co., Inc.	1935	$612,933	$323,957	$398,000	398 to 1	100	2	18,642	do	
1939-40	C. R. Burr & Co., Inc.	Fiscal year ending May 31, 1935.	Statement of condition not reported.	$243,349	$281,000		100	3	6,658		Yes.
		May 31, 1936	do	$254,558	$303,000		100	3	3,347		Do.
1939-40	Wilson Bros. & Co.	1932	$2,100,000	$19,309	$535,000		100	2	10,865	Yes	
		1933	$2,000,000	$36,732	$786,000		100	2	19,207	do	
		1934	$1,900,000	$25,447	$883,000		100	2	11,017	do	
1939-40	Beim Co.	1932	$780,566	$174,668	$780,566	1.4 to 1	100	7	17,640	do	
		1933	$742,902	$237,003	$742,902	1.7 to 1	100	7	31,167	do	
1940-41	Olin Corp.	1932	$5,211,849	$2,491,551	$5,211,849	4 to 1	62	4	128,734	do	
		1933	$5,370,117	$2,699,281	$5,370,117	5 to 1	100	4	100,481	do	
1940-41	Wilkerson Daily Corp., Ltd.	Fiscal year ending July 31, 1936.	Statement of condition not reported.	$109,850			100	2	17,199	do	
1940-41	Stanton Corp.	1931	$4,972,320	$2,853,953	$4,332,000	3 to 1	79	3	453,640	do	
		1932	$5,934,146	$715,271 (after stock dividend).	$5,288,000	2 to 1	74	3	81,968	do	
1940-41	R. C. Reynolds, Inc.	1935	$1,374,003	$410,318	$872,000	8 to 1	100	2 held over 90 percent.	35,258		Do.
1940-41	United Block Co., Inc.	Fiscal year ending Sept. 30, 1936.	$1,487,908	$1,156,691	$921,000	7 to 1	90	7	29,841	Yes	
1941-42	Saven Corp.	1928	$2,561,801	None (balance sheet).	$2,560,000	40 to 1		1	287,679	do	
		1929	$2,913,646	$15,215 (balance sheet).	$2,862,000	7 to 1		1	498,457	do	
1941-42	Trico Products Corp.	1934	$10,000,000	$6,086,607		8 to 1	47	2,200 (6 owned 74 percent).	413,439	do	
		1935	$14,000,000	$8,762,708		5 to 1	72	do	1,220,933	do	
1941-42	Botsford, Constantine & Gardiner.	1938	Statement of condition not reported.						3,784		Do.

1941-42	Plant Shipping Co., Inc.	1938	$150,000	$73,924	$130,000	4 to 1	100	1	3,962	Do.
1941-42	Plant Line Stevedoring Co., Inc.	1938	$108,000	$76,000	$106,000	3.5 to 1	100	1	1,417	Yes
1941-42	Hemphill Schools, Inc.	Fiscal year ending Mar. 31, 1936.	$289,866	$15,929 (after stock dividends of $245,000).	$215,000	16 to 1	100	1	66,858	Do.
1942-43	L. R. Teeple Co	1937	$536,103	$369,462	$435,000	27 to 1	83	4 (1 family)	7,696	Do.
		1938	$592,812	$425,081	$455,000	do	84	do	15,558	Do.
		1939	$626,476	$456,070	$486,000	24 to 1	75	do	9,166	Do.
1942-43	Florida Iron & Metal Co. of Jacksonville.	1938	Statement of condition not reported.	$47,072			100	4 (2 officers and wives).	9,264	Do.
1942-43	Howard Flint Ink Co.	1938	do	$167,689 (after stock dividends of $250,000).	$447,000		77	5 (90 percent held by 1 family).	28,935	Do.
		1939	do	$32,603 (after stock dividends of $250,000).	$578,000		71	do	30,721	Do.
1942-43	Bosch Brewing Co	1938	$325,715	$239,243	$121,000	3.7 to 1	71	4	12,631	Do.
1942-43	Becton, Dickinson & Co.	Fiscal year ending June 30, 1939.	$3,208,225	$2,901,578	$1,942,000	15 to 1	61	3 owned 72 percent.	66,540	Yes
1942-43	Dietze & Co., Inc.	1938	4$79,004	$45,505	$77,000	5 to 1	79	7	9,711	Do.
1942-43	Millane Nurseries & Tree Experts, Inc.	1938	Statement of condition not reported.	$26,425			100	1 holds 496 out of 500 shares.	4,195	Do.
		1939		$37,122		do	do	do	2,674	Do.
1942-43	Metal Mouldings Corp.	1939	$900,000	$386,757	$529,000	2.2 to 1	28 ($100,000 declared December payable January.)	7	65,825	Do.
1942-43	Medical Arts Hospital of Dallas.	1939	$50,070	$27,850	$38,309	4 to 1	100	3	5,353	Yes
1942-43	California Motor Transport Co., Ltd.	1939	$306,158	$91,138	$124,000	1.8 to 1	do	Almost wholly owned.	8,892	Do.
		1940	$363,910	$125,967	$177,000	2.2 to 1	do	do	8,634	Do.
1942-43	California Motor Express Co., Ltd.	1939	$289,448	$48,330	$283,000	1.5 to 1	do	do	10,035	Do.
		1940	$306,720	$60,083	$299,000	1.6 to 1	do	do	4,466	Do.
1942-43	Steele's Mills (a corporation).	1938	Statement of condition not reported.		$841,946 (current assets).		74		11,958	Do.
1943-44	Wean Engineering Co., Inc.	1936	$1,562,703	$213,172	$1,477,000	2.5 to 1	87	3	68,519	Do.
		1937	$1,856,557	$409,539	$1,707,000	2.6 to 1	72	3	66,793	Do.
		1938	$1,899,174	$609,141	$1,833,000	3.4 to 1	62	3	54,173	Do.
		1939	$1,899,961	$708,616	$1,823,000	4.2 to 1	48	3	25,388	Do.
		1940	$2,215,131	$837,755	$2,132,000	3.4 to 1	55	3	46,406	Do.

See footnotes at end of table.

TABLE 30.[1]—*Cases closed by Tax Court or by other courts under sec. 102 or similar provisions in prior revenue acts, 1913 to Jan. 1, 1950*—Con.

Fiscal year trial court decision	Name of corporation	Taxable year filing period	Total corporate assets	Total earned surplus	Total liquid assets (cash, securities, accounts receivable)	Ratio of current assets to current liabilities	Percent of net income after taxes retained for taxable year	Total number of stockholders	Tax proposed	Decided favorably to Government	Decided adversely to Government
1943-44	McCutchin Drilling Co.	Fiscal year ending Sept. 30, 1940.	$479,153	$306,239	$275,000	5 to 1	100	1 except qualifying shares.	$9,933	Yes	
1943-44	Gibbs & Cox, Inc.	1938	$604,417	$458,123	$602,000	4.7 to 1	100	2	41,512	do	
		1939	$891,634	$690,761	$889,000	4.9 to 1	100	2	69,460	do	
		1940	$1,026,275	$880,985	$1,025,000	8.2 to 1	100	2	60,370	do	
1943-44	T. Smith & Son, Inc.	1938	$630,750	$241,483	$349,000	1.8 to 1	100	1 except 2 shares.	16,829		Yes.
		1939	$761,630	$349,258	$370,000	1.9 to 1	92	do	28,934		Do.
1943-44	Smokeless Fuel Co.	1938	$1,592,426	$932,859	$1,310,000	5 to 1	100	5	33,472		Do.
1943-44	Hanovia Chemical & Manufacturing Co.	1938	$4,268,620	$2,576,405	$445,000	2.6 to 1	75	4	16,083		Do.
1943-44	Baker & Co., Inc.	1938	$7.864,799	$4,089,764	$2,184,000	2.8 to 1	64	Over 5	67,108		Do.
1943-44	W. H. Gunlocke Chair Co.	Fiscal year ending June 30, 1939.	$756,114	$303,339	$332,000	9 to to 1	92 (dividend paid on preferred stock; no dividend paid on common stock).	4 (common stock).	22,330	Yes	
1943-44	Litchfield Creamery Co.	1938	$836,000	$300,000	$530,000	3.4 to 1	82	2 (families consisting of 22 owned ⅔; balance owned by 44).	49,248		Do.
		1939	$1,017,000	$468,019	$664,000	3.5 to 1	81		49,003		Do.
1943-44	Parker-Browne Co. (reported M. Greenspun et al.).	1938	$333,000	$60,181	$228,000	1.5 to 1	100	1	16,314	T. C., yes	
		1939	$359,000	$74,741	$210,000	1.2 to 1	100	1	16,925	do	
		1940	$327,000	$79,320	$231,000	1.8 to 1	100	1	16,867	do	
1943-44	Lane Drug Co.	Fiscal year ending Sept. 30, 1940.	Statement of condition not reported.	$145,399			99	2 plus qualifying shares.	29,716		Do.
1943-44	Coca-Cola Bottling Works.	1936	Statement of condition notreported.				23	1 owned 33 percent.	11,003		Do.
		1937	do				25	do	10,020		Do.
1944-45	Whitney Chain & Manufacturing Co.	1939	$2,907,667	$1,668,102	$972,000	15 to 1	52	5 plus qualifying shares.	17,611	Yes	

1944-45	General Smelting Co.	1939	Statement of condition not reported.	$134,857			100	3	11,089		Do.
		1940	do	$186,403			100	3	16,255		Do.
1944-45	Semagraph Co.	Fiscal year ending Mar. 31, 1939.	$1,655,819	$1,404,196	$1,162,000	9 to 1	100	1	3,683	Yes	
		Mar. 31, 1940	$1,690,378	$1,434,104	$1,212,000	9.4 to 1	100	1	8,918	do	
1944-45	Albert L. Allen Co., Inc.	1937	$66,547	$50,206	$56,000	9 to 1	100	1 plus 2 qualifying shares.	492	do	
		1938	$78,581	$68,000	$68,000	8 to 1	100	do	2,298	do	
		1939	$83,189	$66,722	$72,000	12 to 1	100	do	1,794	do	
1944-45	John F. Boyle Co.	1938	$1,387,223	$781,219	$633,000	15 to 1	100	1 plus qualifying shares.	20,417	Yes	
		1939	$1,454,304	$832,798	$733,000	13 to 1	100	do	14,101	Yes	
1944-45	Syracuse Stamping Co.	1940	$248,224	$233,240	$53,000	18 to 1	100	1	4,690		Yes.
1944-45	Christmann Veneer & Lumber Co.	1941	$470,000	$160,081	$96,934	2.7 to 1	66	3	7,928	Yes	
1944-45	Walkup Drayage & Warehouse Co.	1940	$699,387	$333,468	$367,000	1.8 to 1	82	3	21,698		Do.
1945-46	Universal Steel Co.	1941	$555,000	$188,608	$427,000	2 to 1	94	4	41,380		Do.
1945-46	Mabee Consolidated Corp.	1939	Statement of condition not reported.						(1)		D. C., yes.
1946-47	Lion Clothing Co.	1940	$1,278,374	$199,419	$332,000	2.7 to 1	77	3	9,792		Yes.
		1941	$1,347,392	$251,716	$398,000	2.7 to 1	77	3	16,819		Do.
		1942	$1,532,393	$305,025	$581,000	2.1 to 1	68	3	8,684		Do.
1946-47	Southland Industries, Inc.	Fiscal year ending July 31, 1940.	$913,470	$226,938	$757,000	8 to 1	53	1	21,731	Yes	
1946-47	Kennedy Nameplate Co.	Fiscal year ending June 30, 1941.	$162,683	$72,423	$61,000	1.6 to 1	100	3	9,017		Do.
		June 30, 1942	$225,861	$114,185	$115,000	2.1 to 1	100	3	10,782		Do.
1946-47	Trico Products Corp.	1936	Statement of condition not reported.	$10,913,000	$9,036,743		48	6 owned over 50 percent.	532,468	Yes	
		1937	do	$12,745,000	$10,192,815		49	do	602,119	do	
1946-47	World Publishing Co.	1942	$1,570,166	$643,062	$631,252	9 to 1	100	1 plus 3 shares.	22,118	do	
		1943	$1,595,883	$739,626	$859,099	4.5 to 1	100	do	19,524	do	
1947-48	Gus Blass Co.	Fiscal year ending Jan. 31, 1941.	$2,860,466	$1,359,449	$2,223,000	4.1 to 1	100 (paid dividends Apr. 20, 1941).	41 (29 related owned 94 percent).	99,203		B. T. A. yes.
1947-48	William C. Atwater & Co.	Fiscal year ending Dec. 31, 1942.	$2,170,555	$5,219	$1,436,000	1.9 to 1	100	11	42,261		Yes.
		Dec. 31, 1943	$2,062,643	$181,089	$945,000	1.4 to 1	100	8	24,155		Do.

See footnotes at end of table.

TABLE 30.[1]—*Cases closed by Tax Court or by other courts under sec. 102 or similar provisions in prior revenue acts, 1913 to Jan. 1, 1950*—Con.

Fiscal year trial court decision	Name of corporation	Taxable year filing period	Total corporate assets	Total earned surplus	Total liquid assets (cash, securities, accounts receivable)	Ratio of current assets to current liabilities	Percent of net income after taxes retained for taxable year	Total number stockholders	Tax proposed	Decided favorably to Government	Decided adversely to Government
1948-49	J. L. Goodman Furniture Co.	1942	$1,090,846	$854,357	$839,000	11 to 1	52	5	$9,119		Yes.
		1943	$1,160,421	$922,389	$954,000	12 to 1	53	5	8,921		Do.
1948-49	Eastern Railway & Lumber Co.	1943	$1,165,378	$172,185	$334,000	4 to 1	100	1 held 99½ percent.	26,827	Yes	
1048-49	Colonial Amusement Corp.	1942	$86,587	$80,943	$78,000	121 to 1	100	3	6,156	do	
		1943	$106,573	$101,493	$100,000	1,250 to 1	100	3	5,600	do	
1948-49 (CCA 1949).	Marlborough Corp.	Fiscal year ending Aug. 31, 1939	Statement of condition not reported.						3,389	do	
		Aug. 31, 1940	do						5,112	do	
July 1, 1949-Jan. 1, 1950.	Koma, Inc.	1943	$491,000	$163,382	$196,000	3 to 1	91	8	973	do	
		1944	$622,000	$210,404	$319,000	2.1 to 1	100	8	2,228	do	
July 1, 1949-Jan. 1, 1950.	Tulsa Broadcasting Co. (reported Koma, Inc.).	1943	$336,000	$221,038	$280,000	4 to 1	100	6	9,334	do	
		1944	$434,000	$263,144	$374,000	3 to 1	100	6	6,853	do	

[1] Computations were required in order to ascertain the information called for under the columns headed "Total liquid assets," the "Ratio of current assets to current liabilities," and the "Percent of net income after taxes retained for taxable year."

The term "liquid assets," as used in the column headed "Total liquid assets," includes cash, notes of less than 1-year maturity, and accounts receivable less reserves for accounts receivable, Government obligations, and securities, but not stock in subsidiary or controlled corporations.

In arriving at ratios set forth under the column headed "Ratio of current assets to current liabilities," the term "current assets" includes liquid assets as defined above, plus inventory and cash surrender value of life insurance on officers and employees, and the term "current liabilities" includes accounts payable, bonds, notes, and mortgages under 1-year maturity, and accrued expenses.

In computing "liquid assets," "current assets," and "current liabilities," the various balance sheet items included in arriving at the end result generally were rounded off and in most instances amounts of under $1,000 were dropped.

Except in cases where the ratio of current assets to current liabilities was small, no attempt was made to carry the ratio to decimals.

The computations represent as close an approximation as deemed practicable.

[2] Not reported.

[3] For 1922 and 1923.

NOTE.—Table prepared by the Bureau of Internal Revenue.

It will be noted that, in general, the assessed corporations had relatively large amounts of earned surplus and very high liquidities. Ratios of current assets to current liabilities, although showing extreme variation, were, even in the less favorable situations, quite adequate. Only one corporation had current liabilities in excess of current assets, i. e., the Mellbank Corp. (assessed for 1932), with a ratio of 0.92 to 1. High proportions of posttax net income retained is a common characteristic, with only nine of the corporations (for which data were available) retaining less than 50 percent of posttax net income for a given tax year or years. Ownership of the corporations customarily was vested in a very few individuals, with only four corporations having in excess of eight stockholders (for which the data were available). These were the Trico Securities Corp., assessed for 1933, with 23 shareholders; the Trico Products Corp., assessed for 1934 and 1935, with 2,200 shareholders (although 6 owned 74 percent of the voting stock); the Litchfield Creamery Co., assessed for 1938 and 1939, with 66 shareholders (however, two families consisting of 22 people owned two-thirds of the stock); and the Gus Blass Co., assessed for the fiscal year ending January 31, 1941, with 41 shareholders (29 of the 41 shareholders were related, however, and collectively owned 94 percent of the voting stock).

Ratios of current assets to current liabilities vary from a low of 0.92 to 1 (Mellbank Corp.) to a high of 194,000 to 1 (Irvington Investments Co.). The Colonial Amusement Corp. had ratios of 121 to 1 for 1942, and 1,250 to 1 for 1943; the Edward G. Swartz, Inc., 1,000 to 1 for 1927; J. M. Perry & Co., Inc., 398 to 1 for 1935; the Chicago Stockyards Co., 130 to 1 for 1930, 124 to 1 for 1932, and 140 to 1 for 1933; the J. E. Baker Co., 99 to 1 for 1930; the Almours Securities, Inc., 95 to 1 for 1931, and 80 to 1 for 1932; and the Charleston Lumber Co., 49 to 1 for 1924.

Corporations having ratios of current assets to current liabilities of less than 2 to 1 (13 in all), other than the Mellbank Corp., are R. C. Tway Coal Sales Co., 1.3 to 1; R. L. Blaffer & Co., 1.4 to 1, and 1.6 to 1; W. S. Farish & Co., 1.3 to 1; Southern Security Co., 1.8 to 1 (for 1931); Beim Co., 1.4 to 1, and 1.7 to 1; California Motor Transport Co., Ltd., 1.8 to 1 (for 1939); California Motor Express Co., Ltd., 1.5 to 1, and 1.6 to 1; T. Smith & Son, Inc., 1.8 to 1, and 1.9 to 1; Parker-Browne Co., 1.2 to 1, and 1.8 to 1; Walkup Drayage & Warehouse Co., 1.8 to 1; Kennedy Nameplate Co., 1.6 to 1; and William C. Atwater & Co., 1.4 to 1, and 1.9 to 1.

The high ratios of current assets to current liabilities reflect the very substantial liquidities of the corporations concerned. Of the corporations listed above with ratios 49 to 1 and above, the courts returned decisions against five of the corporations (favorable to Government) and in favor of three of the corporations. The courts rendered decisions favorable to 10 corporations and adverse to 3, when the current asset ratio was less than 2 to 1.

Conclusion

The large proportion of adverse decisions (84 tax years of 170) to the Government in the litigated cases, when viewed in the light of the financial, ownership, and surplus accumulation aspects of the assessed

corporations, is strongly testamentary of the conservatism of the courts. The high liquidity ratios, the continuation of earned surplus build-up by heavy retention of posttax net income, and the high concentration of ownership and control point in almost every instance to a *real* vulnerability under section 102 (and predecessor sections). It would indeed be difficult to accuse the courts of harsh and inconsiderate enforcement in the face of this record. The courts have been sympathetic listeners when the taxpayer corporations have come forward with evidence in support of their needs for, and uses of, surplus accumulations, and of their explanations that there is no purpose of personal surtax avoidance therein. However, the courts are not unrealistic and, even though "leaning backward" in enforcement, are aware that there are recognizable limits in business needs for surplus accumulation.

CHAPTER VII

PROPOSALS FOR MODIFICATION

In view of the penal character of section 102 and the fear and uncertainty which it engenders in the minds of many corporate managements, there has been a surprisingly small demand for its removal from the Internal Revenue Code. From many of the section's severest critics there has been tacit, if not open, admission that the section is required as a barrier to flagrant and widespread avoidance of personal surtax, and that, in this respect, it fulfills a necessary function. This has been reflected in the Congress, which, while providing for a few minor technical modifications in recent years and, on occasion, giving consideration to proposals which involved major changes, has shown no disposition to repeal the section. Admittedly, the section is a product of a Federal tax system which establishes an inequality in the treatment of distributed corporate income, i. e., double taxation of dividends in contrast with other income. It is in a sense a "necessary evil" to offset or counterbalance the "initial evil" of unequal or differential taxation of income flows. Until such time as full integration of corporate- and personal-income taxes is achieved, section 102, or a comparable tax device, appears not only desirable but of high necessity. Its elimination would encourage and permit tax avoidance of such scale as might seriously impair the revenues of the personal-income tax, as well as serving to promote an inequality in burden distribution which would be highly offensive to the public's sense of justice.

PROPOSALS FOR SECTION MODIFICATION

The principal proposals for the modification of section 102, which have come from a variety of sources, are as follows:

1. Shift in the burden of proof from the corporation to the Commissioner of the Bureau of Internal Revenue to show that there has been improper accumulation of surplus (with intent or purpose to avoid surtax).[1]

Amendment of section 102 to provide that the burden of proof should reside with the Commissioner would serve largely to emasculate the section. Prior to 1938, before the burden of proof was clearly placed on the taxpayer corporation by statute, the section could not be effectively enforced because of the difficulty of proving taxpayer

[1] Special Tax Study Committee, appointed by the Committee on Ways and Means pursuant to H. Res. 293 and H. Res. 297, Majority Report, November 4, 1947, in Revenue Revisions, 1947–48. Hearings before the Committee on Ways and Means, House of Representatives, 80th Cong., 1st sess., pt. 5, p. 3625; National Association of Manufacturers, Industry Believes (New York: National Association of Manufacturers, 1949), p. 32; Taxation Committee, New York Board of Trade, Revenue Revisions, 1947–48, op. cit., pt. 1, p. 73; committee on Federal finance, Chamber of Commerce of the United States, Revenue Revisions, 1947–48, op. cit., pt. 3, pp. 1607–1608; George Terborgh, representing the Machinery and Allied Products Institute, Revenue Revisions, 1947–48, op. cit., pt. 5, pp. 3306–3307; and many other associations and individuals.

intent to avoid surtaxes. Amendment of the section in this respect may be construed as "repeal in substance although not in form." The minority report of the Special Tax Study Committee to the Committee on Ways and Means of the House of Representatives comments as follows on this proposal:

> Admittedly the administration of section 102 involves difficulties, but the majority would wish us gladly to accept a cure which is worse than the disease. Section 102 is a protective statute, intended to safeguard the revenues. While it may be difficult at times to ascertain the permissible limits of corporate accumulations, it by no means follows that the Commissioner should have the burden of establishing those limits. If directors are the best judges of a corporation's needs, they are, by the same token, the very persons who should bear the burden of proof. Throughout the administration of the tax laws, with very few exceptions, the taxpayer has the burden of proving the facts. This burden is peculiarly appropriate under section 102, for, as the majority point out, the directors are especially informed as to circumstances which justify the accumulations.[2]

2. The penalty tax under section 102 should apply only to that portion of the undistributed section 102 net income which is unreasonably accumulated.[3]

The proposed amendment appears to serve no useful purpose. Historically, the Bureau has not applied the section except in the more extreme cases of unreasonable accumulation of surplus. Consequently, no problem arises, apparently, as to drawing a line between proper and improper surplus accumulation in any one year. Corporations subject to deficiency assessments customarily have surplus accruals extending over a considerable period of prior years, the result of which is to render the surplus accumulation of the year, or years, of assessment clearly excessive in its entire amount (in the view of the Bureau).

The minority report of the Special Tax Study Committee to the Ways and Means Committee of the House of Representatives contains the following statement regarding this proposal:

> In seeking to confine the penalty tax to the unreasonably accumulated income, the majority again disclose their usual tenderness to avoiders. The rates of 27½ and 38½ percent are pitifully low penalties to prevent the avoidance of far higher surtaxes. It is well known that in many instances directors are quite willing to risk the penalty because it is comfortably less than the avoided personal surtaxes. If the 102 tax is made applicable only to the unreasonable accumulations, the penalty tax should be simultaneously raised so as to function adequately.[4]

3. Dividends paid within 75 days after the close of the corporation's taxable year may, at the taxpayer's election, be deducted in computing section 102 net income for such year.[5]

This proposed amendment does not appear to be unreasonable. Corporate-taxpayers affected by section 102 are currently under pressure for immediate declaration and payment of dividends within the taxable year if dividends as paid are to be a deductible item from the tax base in the event of application of section 102. In other words, divi-

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[2] Revenue Revisions, 1947–48, op. cit., p. 3652.

[3] Special Tax Study Committee, Majority Report, op. cit., p. 3625; National Association of Manufacturers, Industry Believes, op. cit., p. 32; committee on Federal finance, Chamber of Commerce of the United States, op. cit.; committee on taxation, Association of the Bar of the City of New York, Revenue Revisions, 1947–48, op. cit., pt. 5, p. 3177; George Terborgh, representing the Machinery and Allied Products Institute, op. cit.; and many other associations and individuals.

[4] Revenue Revisions, 1947–48, op. cit., p. 3652.

[5] Special Tax Study Committee, Majority Report, op. cit.; National Association of Manufacturers, Industry Believes, op. cit.; committee on Federal taxation, New York State Society of Certified Public Accountants, Revenue Revisions, 1947–48, op. cit., pt. 5, p. 3594; and other associations.

dends paid after the close of the taxable year—even though only a few days thereafter—may not be deducted in resolving the "undistributed section 102 net income." Under this proposal, corporate directors would have 2½ months following the taxable year to appraise corporate earnings and corporate needs with respect to possible dividend distributions without jeopardizing the deductibility of dividends paid in establishing the section 102 tax base.

However, it does not seem that much would be accomplished to taxpayer advantage by this proposed amendment. Under existing law, although surplus accumulation is not reduced for the particular taxable year by dividends paid thereafter, surplus accumulation for the following year is reduced by the amount so paid—thus a counterbalancing advantage. Moreover, a dividend grace period of 2½ months post taxable year would accomplish little with respect to a more acute appraisal by the corporate officers of possible section 102 liability, thus permitting adjustment of dividends in accordance therewith, because of the time lag in Bureau examination of corporate-tax returns.

4. Long-term capital gains should be excluded from section 102 net income.[6]

In the Revenue Act of 1951 (sec. 315), the Congress amended section 102, providing for the exclusion of net long-term capital gains from the undistributed income constituting the section 102 tax base. This amendment applies to taxable years subsequent to December 31, 1950.

5. Corporate reserves derived from posttax net income, designated as a financial provision to offset higher replacement costs, should be excluded from section 102 net income.[7]

This proposal presumably would exclude from section 102 net income any earmarked surplus reserve intended to reflect or to offset higher replacement costs of corporate assets without specific limitation as to (*a*) total asset costs against which surplus may be accrued, and (*b*) the manner or method of determining the higher replacement costs for the particular assets. This appears to provide for an open-end accrual, or assignment of earned surplus, with corporate officers given wide latitude as to the timing and the amounts of such accruals.

As previously indicated,[8] surplus reserves designed and earmarked to cover higher replacement costs, particularly under accelerated depreciation, apparently will be excluded in determining whether or not there has been unreasonable accumulation of surplus. Further, there is reason to believe that surplus reserves, if reasonable in amount and designated for asset replacement purposes, may be accrued, even though the total financial provision for asset replacement exceeds the original cost of the assets.[9] Surplus accruals under accelerated depreciation (based on original cost of assets) and replacement reserves derived from surplus and geared to replacement costs of assets (rather than original cost) may be excluded in subjecting corporate surplus accumulations to test for reasonableness by the Bureau. However, if the resulting surplus accumulation is found to be unreasonable, and a deficiency assessment is levied, the "undistributed section 102 net in-

[6] National Association of Manufacturers, Industry Believes, op. cit.; subcommittee on Federal taxation, Pennsylvania State Chamber of Commerce, Revenue Revisions of 1950, op. cit., pp. 618–619.
[7] Ibid.
[8] Chapter II.
[9] *Syracuse Stamping Co.* v. *Commissioner*, op. cit.

come," which constitutes the base of the tax, will include for the taxable year assignments of retained earnings to cover such accelerated depreciation or higher replacement cost of assets. This is required by reason of the statutory definition of "section 102 net income" (code sec. 102 (d) (1)) and "undistributed section 102 net income" (code sec. 102 (d) (2)).

If section 102 were to be amended in the manner proposed, the base of the tax would be reduced, thus decreasing the severity of the tax penalty. Further, a contradictory policy with respect to depreciation would be established in that, under section 102, depreciation based on replacement cost would be allowable in the calculation of the tax, while under the corporate net-income tax, the allowable deduction for depreciation would be confined to original or acquisition cost.

Should this proposal succeed, a strong case can be made for a compensatory upward adjustment in the rates of tax under section 102 to offset the reduction in the base of the tax. In addition, in the interest of consistency—which has a virtue—a uniform policy with respect to deductibility of allowances for depreciation should be followed for the several taxes, unless there is some compelling reason to do otherwise.

6. Upon threat of section 102 deficiency assessment, corporate shareholders should be permitted the election of consent dividends under code section 28 as an alternative to the imposition of the tax.[10]

Consent dividends operate to reduce corporate earned-surplus accumulations and to increase paid-in surplus being regarded as a capital contribution of the shareholders. Consent dividends, of course, are subject to individual tax in the same manner as cash dividends. The advantage of consent dividends to the corporation is that corporate resources remain undepleted.

Under the existing statute, consent dividends are allowed as a credit in the computation of "undistributed section 102 net income." However, consent dividends may not be recognized nor applied retroactively for purposes of reducing corporate earned surplus, which is the gist of the above proposal. Corporations must file consent dividends with their income-tax returns, and shareholders must pay tax thereon in the taxable year in which this hypothetical distribution occurs. To permit the election of consent dividends at a later date as an alternative to a deficiency assessment is to allow corporate officers and shareholders to second-guess on dividend policy. Efforts of avoidance of personal surtax would be without penalty in that, if the effort of avoidance proved unsuccessful (i. e., recommended deficiency assessment), consent dividends could be filed in an appropriate amount retroactively, and shareholders would pay only the surtax which otherwise would have been paid had there been a distribution.[11] This proposal might just as well include the retroactive payment of cash dividends. It will be recalled that the purpose of section 102 is to deter efforts of personal-surtax avoidance by the imposition of a positive penalty when it occurs.

7. A 1-year statute of limitations applicable to deficiency assessments under section 102, with the Commissioner prohibited from requesting waivers of the statute from taxpayer corporations.[12]

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[10] C. S. Stein, Revenue Revisions, 1947–48, op. cit., pt. 5, pp. 3241–43.
[11] Other than for interest.
[12] Proposed by a respondent to the questionnaire of the Joint Committee on the Economic Report.

The Bureau has never been able administratively to establish a completely current position—i. e., within a year of filing—in the examination of corporate income-tax returns. There is no present prospect that it can be achieved. A 1-year statute of limitations applicable only to section 102 would impose pressure on the Bureau for a quick review of returns, with immediate assertion of deficiency assessments when excessive liquidity appears to be present. Presumably, examination of returns for possible section 102 liability would have high priority because the section could neither be ignored nor permitted to go by default. Hasty decisions on liability under the section might well lead to ill-considered deficiency assessments the consequences of which would be undesirable both to the corporation and the Bureau. Deficiency assessments could well be more, rather than less, numerous. It is well, perhaps, to recognize that the substantial time lag which exists between the filing of a corporate income-tax return and the final determination by the Commissioner as to whether or not a deficiency assessment should be asserted under section 102 may, often as not, be to the advantage of the corporate taxpayer. Certainly, with a 3-year statute of limitations and the extensive use of waivers, the Bureau has the opportunity to give careful and thorough consideration to those corporate returns to which suspicion of liability arises.

On the other hand, the time lag in the assertion of deficiency assessments does permit the Bureau to exercise extensive hindsight. To the corporation it means a comparatively long period of fear and uncertainty. In addition, with the lapse of time, the interest penalty can be a sizable byproduct of a deficiency assessment.

It does not appear that any good purpose can be served by subjecting the Bureau to the excessive pressure of a 1-year statute of limitations without waivers to the Commissioner. It might well result in more of a disadvantage than an advantage to corporate taxpayers. Nevertheless, there should be as early a determination of corporate liability under section 102 as possible, consistent with reasonable thoroughness in the examination of returns.

8. Statutory immunity from section 102 for the year or years in which annual earnings had a minimum percentage distribution to shareholders, i. e., 50 or 60 per cent.[18]

This proposal runs counter to the theory of section 102 in that (*a*) the section is not intended to compel any given distribution of dividends as such—rather to induce employment of corporate income, i. e., investment of retained earnings and/or distribution to shareholders at the option of the owners of the corporation; and (*b*) the appropriate distribution of earnings to shareholders, with respect to existing corporate liquidity, is subject to wide variation, depending on the particular facts and circumstances in each case. The effect of this proposal for some corporations might well be to cause dividend distributions at the expense of investment. Further, it would protect excessive corporate liquidities and surtax avoidance within the percentage limits of earnings retention as prescribed.

On the other hand, it would establish a yardstick which, by its use, would permit affected corporations to escape the fear and uncertainty attendant upon the possible application of the section. However,

[18] Ibid.

corporations most concerned about their possible liability under the section would seem to be those, in general, which, by their own policies, create fear and uncertainty by knowingly "skating on the thin ice" of surtax avoidance.

This proposal, on balance, appears to have little in its favor. It would legally permit a specified level of surtax avoidance and tend to diminish the section induced flow of self-financed investment.

9. Section 102 should be limited in its application to corporations in which management owns 50 percent or more of the voting stock, or any one person owns in excess of 15 or 20 percent of the voting stock.[14]

Underlying this proposal is the presumption that control of a corporation requires the concentration of a very large proportion of the voting stock in the ownership of a comparatively few individuals. Only very closely owned and closely controlled corporations would be subject to the section—not corporations the voting stock of which is fairly widely distributed but, nevertheless, are effectively controlled by a few individuals with a minority of the voting stock. It is now well recognized that the wider the distribution of the voting shares the less will be required to effectuate control.

Amendment of the statute in this respect doubtless would exclude from the coverage of the section many corporations in which policy control resides in the hands of a few individuals, based on a minority of ownership of voting stock, who find personal advantage in excessive accumulation of liquid surplus with its subsequent withdrawal in the form of a capital gain. In addition, there would be an inducement to corporate owners, whose corporation is presently covered by the section, to divest themselves of enough voting shares to secure exemption, yet retaining effective control.

10. Section 102 should apply only to mere holding or investment companies.[15]

This proposal seeks the exemption of all operating companies from the section. Operating companies, as distinguished from purely holding or investment companies, may be used for purposes of personal surtax avoidance as effectively as any other kind of corporation by accumulation of surplus and its noninvestment in the business. There can be no presumption that operating companies, simply by reason of direct engagement in business operations, are not, and may not be, used in the avoidance of individual surtaxes. Evidence is quite to the contrary.

Should a proposal such as this succeed, section 102 would be substantially emasculated. Further, existing holding and investment companies might convert sufficiently to an operating company status to obtain the benefits of the exemption. So long as the section is to serve the purpose of restraining personal surtax avoidance in some measure, operating companies must necessarily be included in statute coverage. This proposal appears devoid of merit, except insofar as partial section repeal may be a desired end.

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[14] Ibid.

[15] John L. Connolly, "Enforcement of Section 102 of the United States Internal Revenue Code," Income Tax Administration (New York: Tax Institute, 1948), p. 170.

Integration of Income Taxes, Individual and Corporate

Section 102 may be regarded as an offspring or byproduct of a Federal income-tax structure which imposes an income tax on corporations and another on individuals in such a manner as to create a discrimination in burden (double tax) against income flows siphoned through corporations in the form of dividend income; on the other hand, corporate income reaching the individual in the form of a long-term capital gain provides favorable tax treatment to those in individual surtax brackets where the corporate tax, plus the long-term capital gains tax, is less than the marginal rate of personal surtax which would apply to such income if of noncorporate origin.

Until such time as these unneutral features of our income-tax structure are largely or entirely removed, section 102, or a similar provision, appears to be required. If income to individuals of corporate and noncorporate origin were subject to an equivalence of tax, the section would not be needed. Complaints about the section and its coercive pressure might better be directed to the basic cause of the "102 problem," namely, a discriminatory income-tax structure. The only purpose of the section is to offset, or neutralize, in some measure, the inducements to tax avoidance to which the inequitable tax treatment of income gives rise.

The problem of integration of the corporate and personal income taxes has aroused much interest and discussion. This has been especially true during the past decade, occasioned to a large extent by the major increases in income-tax rates.

Integration of the corporate and individual taxes, if full and complete, simply means that income to corporate shareholders, whether or not distributed by the corporation, would be taxed equally with noncorporate income. Various methods have been proposed to achieve full or partial integration of the corporate and individual income taxes.[16] Simple repeal of the corporate income tax, of course, would not secure equality in the tax treatment of income as income retained in the corporation would be free of income tax. Thus, the corporation would be a more effective instrument in personal tax avoidance than at present.

The only method which would achieve complete integration is the partnership method which, in its application, would mean that all corporate shareholders would include in their individual income tax returns their proportionate share[17] of the corporate income or loss regardless of whether the income had been distributed. With corporate stockholders treated the same way as owners of unincorporated businesses, i. e., proprietorships and partnerships, the corporate net income tax could be eliminated, the double taxation of dividend income would disappear, and equality in the taxation of different kinds of income (corporate and noncorporate) would obtain, with section 102 no longer needed. However, the administrative difficulties of universal application of the partnership method to corporations are so great as probably to render it impractical. For the very great majority of small closely held and closely controlled corporations which historically have

[16] For a discussion of methods of integration see Richard Goode, The Corporation Income Tax (New York: John Wiley & Sons, Inc., 1951), ch. 10; also, Richard Goode, The Postwar Corporation Tax Structure (Washington, D. C.: Treasury Department, 1946).

[17] Proportioned to equity ownership.

been the focal point of attention of section 102, the partnership method probably could be applied without encountering insuperable difficulties. These corporations, in general, have simple capital structures, and ownership is confined to relatively few shareholders with comparatively infrequent transfer of shares. Congress might well consider giving to corporate ownerships the opportunity of electing partnership taxation of shareholders. Once elected, however, there could be no return to the former (corporate income tax) method of taxation. For those electing the partnership method of taxation there would be, of course, no section 102 problem, with surtax avoidance [18] no longer existing. Should Congress act in this respect, the Bureau doubtless would be much interested in those corporations (which have a vulnerability under section 102) not electing the partnership method.

If the partnership method were given optional application, it is to be presumed that the corporations electing this method would be those which would secure a tax advantage thereby. The optional partnership method, of course, would be limited in its effect in tax equalization as between corporate and noncorporate business income.

Mandatory application of the partnership method, because of administrative difficulties, would require very careful definition of the corporations to be included. In general terms, probably only the private, as distinguished from the public, corporations should be covered by the mandatory method. Further limitation might be necessary in order that private corporations with complex capital structures and/or fairly numerous stockholders be excluded. It is likely that any attempt to establish a mandatory classification would be challenged as discriminatory and unfair. Nevertheless, it is worthy of careful consideration, particularly when so many of the small private corporations are only incorporated partnerships. The area of application of the partnership method would be larger, and greater tax uniformity would result, if the approach were mandatory rather than optional.

Methods of partial integration of the corporate and individual income taxes are found in (1) the credit for dividends paid, (2) the withholding tax credit, and (3) the credit for dividends received.[19]

Partial integration, as expressed in the credit for dividends paid, would continue the present system of income taxation, with provision for a tax credit to corporations for dividends paid. The effect would be to remove part or all of the corporate tax on distributed corporate income, with undistributed income, however, continuing to be subject to the full corporate tax. This method would either lessen or eliminate the double taxation of dividend income and convert the corporate income tax into essentially an undistributed profits tax.

The withholding tax credit [20] as a method of partial integration would provide that the income tax paid by corporations, in part or in whole, would be regarded as a withholding tax on dividend distributions, with shareholders reporting in taxable income the dividends received, plus withholding tax, and entering as a credit the amount of the tax withheld on the distributed income. All corporate net income, whether or not distributed, would be subject to the withholding tax, but shareholders would be limited in their credit to the tax

[18] Escaping personal surtax by corporate retention of earnings.
[19] See Richard Goode, op. cit.
[20] British method.

withheld on the distributed income. This withholding, or prepayment, against the tax liabilities of shareholders would reduce or remove the double tax against dividend income, yet provide for current taxation of undistributed corporate profits.

The credit for dividends received method would provide either exemption from part of the individual tax rates, i. e., first bracket rate, for dividends received or a tax credit of equivalent amount as an offset to the corporate tax. In the event the corporate tax were reduced to the first bracket rate of the individual tax, with the credit for dividends received equal thereto, double taxation of dividend income would be eliminated (for taxable income not exceeding the first bracket of tax). This method of partial integration was in use prior to 1936.

In addition to the above methods of partial integration, there is the capital gains approach to the problem of the double taxation of dividend income. Under this approach the corporate tax would be eliminated, with full individual rates applied to realized capital gains and with full deductibility of realized capital losses from any income.[21] Realization of a gain or loss would occur with transfers of property by sale, gift, or bequest. Some plan of averaging of taxable income over a specified number of years might well be included in any application of the capital gains method.

The methods of partial integration would not establish full tax equality as between corporate and noncorporate income, and as between distributed and undistributed corporate income. This, likewise, would be true of the capital gains approach.

In the credit for dividends paid method, the reduction or elimination of the corporate tax on distributed profits would not remove the incentive for unreasonable accumulation of surplus. Shareholders subject to individual surtax rates (on distributed corporate income) in excess of the tax credit for dividends paid plus the long-term capital gains rate would find a tax advantage in the nondistribution of corporate income. This would be true also of the withholding tax credit method and the credit for dividends received method. Thus, under these methods of partial integration section 102, or something similar, would still be required, even though the incentive to accumulate surplus has been somewhat reduced. With the removal of the corporate income tax and full taxation of capital gains, section 102 would have no place in the Internal Revenue Code as corporations, with Treasury approval, would be free to accumulate surplus to whatever extent desired.

In conclusion, it may be said that, while both the partnership method and the capital gains approach insure removal of the corporate income tax and section 102, the partnership method is to be preferred primarily for reasons of equity. Further, the partnership method appears to offer a feasible approach, if mandatory, for the elimination of the section 102 problem for the great majority of private corporations.

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[21] See Henry C. Simons, Personal Income Taxation (Chicago: The University of Chicago Press, 1938), chs. VII and IX; also, Richard Goode, The Postwar Corporation Tax Structure, op. cit., pp. 16–18.

CHAPTER VIII

SUMMARY AND CONCLUSIONS

Corporate retention of earnings has been a broad highway to individual avoidance of personal surtax. Although any retention of earnings permits individual surtax to be avoided, the concern of the Congress and the Treasury, as manifested in section 102, has been with retained earnings which take the form of corporate hoarding. Income held within the corporation which is put to some essential corporate use in the reasonably immediate future does not fall within the prohibition of the section. Section 102 is an injunction—a mandate of the Congress—against corporate hoarding. The index to corporate hoarding is found in corporate liquidity. Liquid assets are essential to business enterprise. Consequently, corporate liquidity which, under the particular circumstances, is reasonable in amount is not liquidity representative of a corporate endeavor to hoard. It is the corporate possession of an excessive volume of liquid assets, accumulated from retained earnings, which suggests the existence of the prohibited purpose.

The Congress, by a series of upward rate adjustments in personal surtax since the inception of the modern income tax, has provided ever greater inducement to personal tax avoidance by corporate retention of profits. To many taxpayers the means of avoidance has been available. Corporations have been brought into existence, and, subject to the bidding of the controlling shareholders, may be used to intercept and to retain taxpayer income. Taxpayers, not interposing an artificial personality—the corporation—between themselves and the source of their income, foreclose this means of surtax avoidance. Proprietorships and partnerships are subject to the full rates of personal surtax on all net income, even though little or none is distributed. The inducement, as well as the opportunity, for personal surtax avoidance is grounded in the nonintegrated Federal income tax structure. Double taxation of dividend income, high personal surtax rates, and a comparatively low maximum rate on long-term capital gains are tax factors which collectively contribute to efforts of avoidance of surtax.

The present section 102 of the Internal Revenue Code has its statutory parent in section II (A) (2) of the Tariff Act of 1913 [1] which ushered in our present personal income tax. The many changes made in the original section over the years, on the whole, have been designed to increase its administrative effectiveness and to sharpen its penalty character. The most important single amendment, which has been highly influential in increasing its contemporary effectiveness, is the statutory shift in the burden of proof to the taxpayer corporation in the Revenue Act of 1938. The formal rates of tax under the section

[1] See appendix 1 for the legislative and statutory history of section 102.

have remained unchanged since the Revenue Act of 1941. The most recent amendment to the section occurred in the Revenue Act of 1951, which provided for the exclusion of net long-term capital gains from the base of the tax.

Personal holding companies, previously covered by the predecessor sections of section 102, were excluded and placed under a separate taxing provision (now code sec. 500) in the Revenue Act of 1934. This act contained the first designation of the section as "section 102." Foreign personal holding companies were likewise excluded and made subject to a special taxing provision in the Revenue Act of 1937 (now code sec. 337). Except for personal holding companies and foreign personal holding companies, section 102 is of general application and represents the only present barrier to personal tax avoidance through corporate hoarding or unreasonable accumulation of surplus.

Section 102 explicitly approves surplus accumulations which serve necessary business purposes. The business purposes must be those of the corporation, however, as distinguished from those of the owner or owners. Because of the strong inducement (i. e., personal surtax rates) to avoid personal tax, some shareholders, as would be expected, endeavor to find ways to circumvent the prohibition of the section. Plausible words of rationalization are advanced in support of "high corporate liquidities," and the phrase "necessary business purposes" is given an interpretation sufficiently broad to encompass the personal interests of shareholders, as well as the business interests of the corporation. What may appear to be excessive corporate liquidities is justified on challenge as representing simply a prudent financial provision for the hazards and risks of the future, even though they may be of a nebulous character. When corporate accumulations are used to finance loans to influential shareholders, to purchase the shares of minority shareholders, to build oversize reserves, to establish unneeded reserves, to underwrite operating company speculative investments in unrelated securities, and the like, suspicion necessarily attaches that motivation to avoid personal surtax may be present.

Corporate liability under the section requires the conjuncture of two factors, namely, an intent or purpose to avoid personal surtax through surplus accumulations, and accomplishment of the purpose by the retention of earnings. Two presumptions are found in the section: First, "The fact that any corporation is a mere holding or investment company shall be prima facie evidence of a purpose to avoid surtax upon shareholders," and, second, "the fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid surtax upon shareholders unless the corporation by the clear preponderance of the evidence shall prove to the contrary." These presumptions are vital to enforcement of the section. Without these features, section 102 would have virtually no effectiveness.

Although the tax base ("undistributed sec. 102 net income" as derived from "sec. 102 net income") to which the surtax rates of section 102 apply allows only for "depreciation on cost," supplemental corporate surplus reserves designed and designated for accelerated depreciation and/or replacement cost depreciation will be excluded by the Bureau, apparently, if reasonable in amount, in determining the propriety of the existing surplus accumulation. This procedure seems

fully justified, even though it presents an anomaly in depreciation policy.

Historically, section 102 has been applied to the comparatively small closely held and closely controlled corporations rather than to the large public corporations. Admittedly, the existence of the interdicted purpose would be more likely to occur in the case of private corporations in which there is a close or complete identity of shareholders and corporate officers (i. e., corporate directors). On the other hand, there is much evidence which indicates that many of our large public corporations are subject to control, either directly or indirectly, by small groups of shareholders who, it may be presumed, are not unconscious of personal surtax savings resulting from surplus accumulation. Large numbers of shareholders and a minority stock interest by influential shareholders should not be permitted to disguise the existence of a control group and the possible shaping of corporate policy to serve personal advantage. In view of the purpose and intent of the section, it appears that the Bureau might properly direct attention to public, as well as to private, corporations.

The penalty character of the section 102 surtax, combined with the uncertainty and fear engendered by it, and its discretionary application by the Bureau have been among the factors responsible for the large amount of contemporary criticism which it has received. The section has been charged with forcing excessive dividend distributions, the acceleration of corporate real investment, excessive inventory accumulation, limiting the self-financed growth of corporations, inducing corporate mergers and industrial concentration, causing preferences for debt rather than equity financing, bringing about disincorporation, curtailment of business operations, and the like.

In an endeavor to obtain factual information regarding the economic effects of the section, questionnaires were employed by the Tax Institute, The Brookings Institution, and the Joint Committee on the Economic Report of the Congress. The questionnaire of the Tax Institute was sent to tax practitioners (accountants and attorneys), with the questionnaires of The Brookings Institution and the Joint Committee on the Economic Report directed to corporate officers. On the basis of respondent replies to these questionnaires, the following conclusions are indicated:

1. A significant proportion of the private profit-making corporations are seriously concerned with section 102, with their dividend, real investment, and liquidity policies being affected by it.

2. Corporations in virtually all types of business enterprise are affected by the section.

3. The forcing effect of the section applies to real investment and to dividends as alternatives to excessive corporate liquidity.

4. On balance, it appears that, for affected corporations, there is an important net inducement effect on real investment by the section.

5. The section, apparently, is a positive factor in business concentration for affected corporations.

6. Corporations affected by the section are induced to reduce existing indebtedness; also when additional outside capital is required to prefer debt rather than equity financing.

7. The section has a net expansionary effect on the inventories of affected corporations, apparently.

8. The section has a definite forcing effect on corporate dividends as to timing and amount.

9. Liquidities of corporations are negatively affected to the positive advantage of dividends and real investment.

10. The "immediacy" doctrine in section application tends, on balance, to accelerate rather than retard corporate planning of real investment and its implementation.

11. It is clear that the section has diverse, or opposing, effects with respect to affected corporations.

12. The section is of no small importance in limiting the use and development of closely held and closely controlled profitable corporations as personal "savings banks" as a means of avoiding personal surtax.

13. The section appears to be strongly cyclical in its effect with respect to the financial conduct of affected corporations under the "immediacy" doctrine.

14. Although of serious concern to vulnerable corporations, the net effect of the section in raising the level of aggregate demand (investment and consumption components) appears to be of a minor order. Its net inflationary and deflationary effects on the cycle, i. e., amplitude of cycle movement, do not seem to be of especial significance.

Although the section appears to be of minor importance in effecting a reduction of total corporate hoards, i. e., idle savings, such effect as it may have is of advantage to the economy in that a somewhat closer current balance between savings and investment results. Consequently, a favorable influence is exerted on the current level of employment and national income.

The maintenance of corporate solvency is a prime consideration of all corporate owners and officers. Section 102 has been challenged by many of its critics as compelling reductions in corporate liquidity below that required for minimum financial safety. There is no persuasive evidence, however, that the section has been a principal, or even an important contributing, factor in corporate insolvencies. The fact that the section has application only to profitable corporations, not to nonprofit or small profit corporations, combined with its conservative administration by the Bureau, lends support for the view that there has been no serious impairment of corporate solvencies.

The effectiveness of section 102 in forcing dividends as an alternative to liquid surplus accumulation (no investment of retained earnings contemplated) varies with the effective rates of personal surtax applicable to the income, if distributed. The Congress, by increasing the rates of personal surtax over the years, without a corresponding increase in section 102 surtax rates and/or the maximum rate on long-term capital gains, has seriously diminished the influence of the section in serving its intended purpose. Under present rates of tax, an individual even in the relatively low brackets of surtax will find an advantage in corporate retention of earnings, even though this results in a section 102 deficiency assessment, with subsequent withdrawal of the income in the form of a long-term capital gain. If section 102 is to be preserved as a barrier to personal surtax avoidance, and is to be reasonably effective therein, a strong case can be made for a substantial upward adjustment in its rates of tax.

With the minority stockholders' suit in the Trico Products Corp. case the Bureau of Internal Revenue became the beneficiary of unexpected assistance in bringing to the attention of corporate directors the importance of the section. In this action the minority stockholders sought reimbursement to the corporation, from the pockets of the directors, of the funds lost in consequence of deficiency assessments. Plaintiffs sued on the general grounds that the directors had been derelict in permitting surplus accumulations to reach excessive proportions, and that these accumulations were not to serve the advantage of the corporation but, instead, to secure surtax savings to the directors. The case was settled by agreement between the parties whereby the directors personally paid $2,390,000 to the Trico Products Corp. and declared a special cash dividend of $5.50 per share. Corporate directors who cause an excessive accumulation of surplus are now beset on two sides—on one side by the Bureau, on the other side by minority stockholders.

In an examination of Bureau deficiency assessments [2] under section 102 for the fiscal years 1940 to and including the first 6 months of 1950, which are estimated to be 67.5 percent of the total for the period, deficiency assessments under the section were found to vary more over time than those under income and profits tax generally. This is to be expected because of the nature of the penalty tax. Bureau enforcement activity with reference to the section was at a reduced level following fiscal 1943 to fiscal 1949.

Revenue yield per deficiency assessment was much higher for section 102 than for income and profits tax as a whole, averaging $15,522 for the former, as compared with $5,564 for the latter, for the period under review. In the closing of proposed assessments (imposition of tax), the Income Tax Unit averaged 78 percent of those initially recommended, the technical staff 54 percent of the cases receiving its attention, and the courts 86 percent. These proportions relate to corporate tax years of assessment.

High concentration of ownership characterized corporations subject to section deficiency assessments, with 93 percent of the corporations (corporate tax years of assessment) having less than 10 stockholders per corporation. Corporate control was likewise highly concentrated, with corporations representing 96 percent of the assessable tax years having either one or two shareholders owning more than 50 percent of the voting stock. It is clear from these data that the Bureau has directed its principal enforcement attention to the extreme cases of concentrated corporate ownership and control. Because efforts to effect personal surtax savings are in no sense limited to corporations representing close ownership and control, a far broader enforcement policy may be fully defended.

Corporations subject to deficiency assessments had the very high average ratio of liquid assets to total assets of 0.66. The ratios of earned surplus to total assets and current assets to current liabilities were likewise very high. A large proportion of current earnings were retained. The critical factor in establishing section liability is cor-

[2] Included in the analysis were 514 corporations, 919 assessable corporate tax years, and proposed deficiency assessments (Income Tax Unit) covering 1,033 tax years.

porate liquidity, apparently. Ratios of earned surplus to total assets and current assets to current liabilities were not, of themselves, significant criteria of vulnerability. A large earned surplus may represent real assets, and a high ratio of current assets to current liabilities may be simply indicative of a very small amount of current liabilities. Further, heavy corporate retention of earnings, while perhaps creating suspicion, may not express itself in an excessive liquidity.

Manufacturing corporations had the largest number of tax years of assessment with wholesale and retail trade corporations second, and corporations engaged in finance, insurance, and real estate third. Corporations in the mining and quarrying industry had the largest tax per corporation and per tax year, with an assessment of $76,949 per corporation and $41,972 per tax year.

The assessed corporations were concentrated, by asset size, in the $100,000 to $5,000,000 range. Very few corporations having assets of less than $100,000, or assets of $5,000,000 and above, were subject to assessment. The field examination procedure of the Bureau may explain, in part, the small number of assessed corporations with assets under $100,000; also, the Bureau may find high liquidities more defensible for these small corporations. For corporations with assets of $5,000,000 and above, the explanation for the small number of assessments may lie in the wider distribution of shares and less concentration of corporate control.

The majority of corporations assessed were retaining large amounts of earnings. On the basis of assessable corporate tax years, 57 percent retained all net earnings for the tax years of assessment. Only a few corporations were subject to deficiency assessments when less than 25 percent of the profits were retained.

The administration of section 102 by the Bureau has been most conservative, with section application (assessments) limited to the very closely held and closely controlled corporations. It should be said that Bureau enforcement policy doubtless has been affected by the "supercautious" attitude of the courts. Confined to this restricted corporate area, the section may not adequately serve its intended purpose. The Bureau might properly review its administrative policy with respect to the section.

Litigation under section 102 and its predecessor sections consists of 101 cases for the period 1913 to January 1, 1950. The first case made its appearance before the trial court in fiscal 1930, and involved the United Business Corp. of America. The statute and the deficiency assessment were upheld. It was not until 1938, however, that the United States Supreme Court dealt with the constitutionality of the statute in *Helvering* v. *National Grocery Co.* The Court found the statute constitutional and the deficiency assessment proper.

The Government has been relatively successful in the litigation under the statute with respect to proposed tax, i. e., 67 percent of total proposed tax; it has been less successful in terms of the number of cases, i. e., 42 percent of total number of cases of favorable decision to Government. In view of the very cautious and conservative attitude of the Bureau in section enforcement, a better record in litigation might well be expected. The decisions indicate that the courts are even more conservative than the Bureau, and are disposed to

interpret quite generously the "reasonable needs of the business" as expressed in surplus accumulations and liquidity requirements. On the other hand, the courts are not unrealistic in their conservatism; they are aware of the motivation for, and technique of, surtax avoidance through the instrumentality of the corporation, and that plausible explanations can usually be found for the efforts of avoidance.

A variety of proposals have been made for the modification of section 102. With few exceptions, these proposals, if implemented by the Congress, would result in seriously weakening the section substantively or undermining its enforcement. In this connection, it is of basic importance that the statutory burden of proof should remain on the taxpayer rather than be placed on the Commissioner (1938 amendment) if the section is to have some measure of effectiveness. It would be better to repeal the statute in its entirety than to reduce its effectiveness to a point where only the form is preserved, not its substance. By the successive increases in personal surtax rates over the years, without a corresponding increase in the rates of the penalty surtax, section effectiveness has been seriously reduced. In addition, the cautious policy of the Bureau in enforcement, and the limited area (assessed cases) to which it is directed have reduced its effectiveness in preventing tax avoidance. As a prop to an income-tax structure which establishes serious unneutralities, it is at best a very frail and inadequate instrument. Yet, it is the only available means of dealing with personal tax avoidance as found in corporate hoarding.

The answer to the "102 problem" and the avoidance of surtax lies in a full integration of the corporate and individual income taxes, if a satisfactory method can be devised. Partial integration by preserving some measure of unneutrality will not void the problem. The best approach appears to be the mandatory partnership method which can be made applicable probably to the great majority of the private corporations. This, of course, would not solve the problem of surtax avoidance of private corporations excluded from the partnership tax treatment, nor of public corporations. On the other hand, these corporations appear largely to be excluded from the impact of the section, thus, the situation would hardly be worsened. If the mandatory partnership method were given maximum corporate coverage, much practical justification would exist for dispensing with section 102.

As a final word, it should be said that no one likes penal taxation. Further, section 102 is a generalized and an imprecise adjuration to those who own and control corporations not to engage in the prohibited act. Because the line in earnings retention and surplus accumulation is not precisely drawn, uncertainty and insecurity result. To those who own and control corporations, this is irritating and generative of fear. Because the section in its application is of administrative initiation, corporate officers see their fate in the hands of Bureau officials for whose knowledge of business affairs and the problems of management they do not generally have high regard. This they dislike. It is understandable that this is so. Yet, on the other hand, if the line demarking unreasonable surplus accumulations were precisely drawn, discrimination and unfairness would doubtless be alleged, and with more or less justification, because that which would be reasonable for

one would be unreasonable for another. Bureau officials have demonstrated caution and conservatism in section administration. The record of administrative enforcement should at least allay unreasonable and prejudiced fears.

It should be added that others, besides those who own and control corporations, have an important stake in section 102. The great majority of our citizens whose incomes are primarily in the form of wages and salaries and business income from proprietorships and partnerships have a vital interest in seeing that the burdens imposed under income taxation are distributed as fairly as possible. In accomplishing this result under the unneutral income tax system provided by the Congress, section 102 has a place.

APPENDIXES

APPENDIX 1

LEGISLATIVE AND STATUTORY HISTORY

The statutory parent of the present section 102 is found in the Tariff Act of 1913 as an integral part of the first income tax on persons following adoption of the sixteenth amendment. Since its initial appearance as a part of the income tax, this additional tax (later called surtax), which was intended to close a recognized avenue of personal surtax avoidance, has been amended many times. Such alteration, however, represents consistent efforts toward strengthening the tax, particularly in respect to its administrative workableness. This is not to say that section 102 uncertainties have been removed, and that it is now equally understandable to taxpayer and Bureau in its application to particular cases. Its applicability to a taxpayer corporation requires the exercise of judgment with a wide area of administrative discretion on the part of the Bureau. So long as taxpayer avoidance of personal surtax is regarded as a function of the "unreasonableness" of the corporate surplus accumulation, the involvement of a large degree of Bureau judgment in the administration of the tax cannot be avoided.

The major changes in the original tax as found in section II (A) (2), of the Tariff Act of 1913 [1] may be listed as follows:

1. The striking of the word "fraudulently" in the Revenue Act of 1918.[2] Prior to 1918, the statute provided that profits "permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a *fraudulent* purpose to escape such tax * * * ." [Italics ours.]

The removal of the word "fraudulently" was for the purpose of making the section more enforceable because it had been found most difficult to procure the necessary evidence to establish the existence of fraud when the shareholders of the corporation permitted the unreasonable accumulation of corporate profits.

2. The transfer of the impact of the tax from the shareholders to the corporation in the Revenue Act of 1921, and the imposition of a tax of 25 percent (in addition to other corporate taxes) on the net income of the corporation when such corporation is formed or used to avoid personal surtax by permitting profits to accumulate.[3]

3. The increase in the rate of tax from 25 to 50 percent, and the redefinition of corporate net income in the Revenue Act of 1924.[4]

4. The adoption, in the Revenue Act of 1934,[5] of reduced but grad-

[1] 38 U. S. Stat. L. 166–167.
[2] 40 U. S. Stat. L. 1072.
[3] 42 U. S. Stat. L. 247–248. As an alternative to the 25 percent corporate tax stockholders, upon agreement, could be taxed under personal tax on their aliquot shares of the undistributed corporate income.
[4] 43 U. S. Stat. L. 277.
[5] 48 U. S. Stat. L. 702–703.

uated surtax rates, 25 percent on the first $100,000 of adjusted net income, and 35 percent on adjusted net income in excess of $100,000, certain revisions in the base of the tax, and the removal of personal holding companies from section 102 (the renumbered sec. 104), with such companies taxed under a separate section (sec. 351) at somewhat higher rates (30 to 40 percent).

5. The reduction in rates of tax in the Revenue Act of 1936 [6] for corporations subject to the undistributed profits surtax. Corporations subject to the tax on undistributed profits were taxable under section 102 at a rate of 15 percent of the first $100,000 of retained net income, and 25 percent on retained net income in excess of this amount.

6. The shift in the burden of proof to the taxpayer corporation in the Revenue Act of 1938 [7] under circumstances of where earnings of a corporation are permitted to accumulate beyond the reasonable needs of the business. Unreasonable accumulation was determinative of the purpose to avoid personal surtax, with the corporation having the burden of proof to show "by the clear preponderance of the evidence" that the unreasonable accumulation was not for the proscribed purpose.

7. The upward adjustment of formal rates in the Revenue Act of 1941 [8] to 27½ percent on the first $100,000, and 38½ percent on the excess undistributed section 102 net income.

Tariff Act of 1913

The relevant portion of the Tariff Act of 1913 provided that, supplemental to the regular income tax, an additional levy (income tax) shall be imposed upon individuals, and that—

> For the purpose of this additional tax the taxable income of any individual shall embrace the share to which he would be entitled of the gains and profits, if divided or distributed, whether divided or distributed or not, of all corporations, joint-stock companies, or associations however created or organized, formed or fraudulently availed of for the purpose of preventing the imposition of such tax through the medium of permitting such gains and profits to accumulate instead of being divided or distributed; and the fact that any such corporation, joint-stock company, or association, is a mere holding company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business shall be prima facie evidence of a fraudulent purpose to escape such tax; but the fact that the gains and profits are in any case permitted to accumulate and become surplus shall not be construed as evidence of a purpose to escape the said tax in such case unless the Secretary of the Treasury shall certify that in his opinion such accumulation is unreasonable for the purposes of the business. When requested by the Commissioner of Internal Revenue, or any district collector of internal revenue, such corporation, joint-stock company, or association shall forward to him a correct statement of such profits and the names of the individuals who would be entitled to the same if distributed.[9]

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[6] 49 U. S. Stat L. 1676.
[7] 52 U. S. Stat. L. 483.
[8] 55 U. S. Stat. L. 693. For the year 1940, a 10-percent defense tax was applied to existing rates of taxes, including the tax rates of sec. 102. The repeal of the defense tax by the Revenue Act of 1941 was compensated for (in the case of sec. 102) by an equivalent percentage increase in formal rates.
[9] Sec. II (A) (2), 38 U. S. Stat. L. 166–167.
"Under the Revenue Acts of 1913 to 1918, a corporation that permitted an unreasonable accumulation of profits was not subject to the ordinary corporation income tax, but the individual stockholders were taxed upon their proportionate shares of its net income, whether distributed or not. *Under the Revenue Acts of 1913 to 1917 such shares were subject only to the individual surtax rates, while under the 1918 act they were subject to both the normal tax and surtax rates.*" (Italics ours.) Secretary of the Treasury, Annual Report for the Fiscal Year 1940, footnote 16 (Washington, D. C.: Government Printing Office, 1941), p. 468.

From the congressional discussion of this section of the act, it is clear that there was full awareness of the problem of personal surtax avoidance through the use of the corporate entity, and that, as a problem, it was sufficiently important to require statutory recognition. In illustration:

Mr. WILLIAMS. * * * The Senator will see that unless we provide for this evil in some way men might escape not the normal tax but escape the additional tax by merely forming themselves, or using a brother, wife, or somebody, or an office boy. Then, while perfectly willing to pay the normal tax as a corporation, they would escape the additional tax by not having their amount distributed by an arrangement so that they could draw upon the corporation, of course, for whatever they needed. Now, it is for the purpose of preventing that sort of thing. Of course, they could have any arrangement with the corporation they chose, because they would be the corporation.

Now, then, it was thought that perhaps some corporation now in existence might lend themselves to things of that sort owing to the fact that men might be liable for the additional tax and would completely control it by owning a majority of the stock. So this was put in for that purpose.[10]

Another statement as to the purpose of the section:

Mr. WILLIAMS. It applies only to such profits and the heaping up of such surplus as shall justify the Secretary of the Treasury in concluding that it is done for the purpose of evading the tax. Its main purpose is to prevent the formation of holding companies.

Here is a man, for example, with an income as large as Mr. Carnegie's income, let us say. There would be nothing to prevent him from organizing a holding company and passing his income from year to year up to undivided profits.[11]

As to the determination of the surplus accumulation:

Mr. BRANDEGEE. It gives the Secretary of the Treasury absolute power to say exactly what surplus shall be in his opinion proper for the conduct of any business, and if the views of the managers of the business do not coincide with his views they are guilty of a fraud.[12]

In reference to the responsibility of the Secretary of the Treasury:

Mr. WILLIAMS. He [the Secretary of the Treasury] must first proceed to consider the question whether that corporation as such has been fraudulently availed of for the purpose of permitting parties to escape this additional tax, and considering that question and deciding upon it himself he would consider whether this surplus were too large for the reasonable purposes of that business. If he concluded that the accumulations were too large for the reasonable purposes of that business, and that the fraudulent intent existed, he would then certify that, in his opinion, such accumulation was unreasonable for the purposes of the business. Whereupon it would become prima facie evidence to the fact that it was being fraudulently availed of to escape the tax, and the internal-revenue commissioner would proceed to assess the property.[13]

REVENUE ACT OF 1916

The Revenue Act of 1916 in all essential respects was similar to the 1913 act. Section 3 of the Revenue Act of 1916 had the following content:

For the purpose of the additional tax, the taxable income of any individual shall include the share to which he would be entitled of the gains and profits, if divided or distributed, whether divided or distributed or not, of all corporations, joint-stock companies or associations, or insurance companies, however created or organized, formed or fraudulently availed of for the purpose of preventing the imposition of such tax through the medium of permitting such gains and profits

[10] Congressional Record, vol. 50, p. 5318. See J. S. Seidman, Seidman's Legislative History of Federal Income Tax Laws, 1938–1861 (New York: Prentice-Hall, Inc., 1938), pp. 984–987, for the congressional discussion of sec. II (A) (2).
[11] Ibid., p. 4380.
[12] Ibid.
[13] Ibid., p. 5319.

to accumulate instead of being divided or distributed; and the fact that any such corporation, joint-stock company or association, or insurance company, is a mere holding company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a fraudulent purpose to escape such tax; but the fact that the gains and profits are in any case permitted to accumulate and become surplus shall not be construed as evidence of a purpose to escape the said tax in such case unless the Secretary of the Treasury shall certify that in his opinion such accumulation is unreasonable for the purposes of the business. When requested by the Commissioner of Internal Revenue, or any district collector of internal revenue, such corporation, joint-stock company or association, or insurance company shall forward to him a correct statement of such gains and profits and the names and addresses of the individuals or shareholders who would be entitled to the same if divided or distributed.[14]

Revenue Act of 1917

No change was made in the above section in the 1917 Revenue Act which continued operative. However, Congress, under pressure to provide more revenue for war financing, and conscious of surtax avoidance through corporate surplus accumulations, enacted an *additional* tax to strike at retained corporate profits not reasonably required in the business. Section 1206 (2) (b) of the Revenue Act of 1917 provided:

In addition to the income tax imposed by subdivision (a) of this section there shall be levied, assessed, collected, and paid annually an additional tax of ten per centum upon the amount, remaining undistributed six months after the end of each calendar or fiscal year, of the total net income of every corporation, joint-stock company or association, or insurance company, received during the year * * *.

The tax imposed by this subdivision shall not apply to that portion of such undistributed net income which is actually invested and employed in the business or is retained for employment in the reasonable requirements of the business or is invested in obligations of the United States * * * *Provided*, That if the Secretary of the Treasury ascertains and finds that any portion of such amount so retained at any time for employment in the business is not so employed or is not reasonably required in the business a tax of fifteen per centum shall be levied, assessed, collected, and paid thereon.[15]

The Report of the Senate Finance Committee on this legislation stated:

The purpose of this amendment is to subject to additional taxation such proportion, of the incomes of corporations as are not actually invested and employed in the business or retained for employment in the reasonable requirements of the business. If the Secretary of the Treasury shall ascertain and find that any portion of such amount so retained for employment in the business is not so employed, or is not reasonably required in the business, that portion of such amount so retained is made subject to a tax of 15 per cent. If any part of the undistributed surplus is retained for any purpose other than employment in the business it is subjected to a tax of 10 per cent.

Neither the existing law nor the House bill imposes a surtax upon the undistributed earnings of corporations. Under both the House bill and existing law the normal tax of the corporation and the normal tax of the individual is the same. In these conditions the earnings of the corporation escape surtax until distributed among its shareholders. This situation seemed to your committee to bring about an inequality between the corporation and the individual which should be remedied as far as practicable. In view of the fact that it has heretofore been the custom of corporations, for well recognized and sound economic reasons to retain in the business a greater or less proportion of their annual earnings, and in view of the further fact that the present situation calls for unusual outlays for purposes of expansion, development, etc., to meet the

[14] 39 U. S. Stat. L. 758.
[15] 40 U. S. Stat. L. 334.

demands and requirements of the situation, and the increased difficulty in borrowing money on satisfactory terms and conditions caused by the large demand of the Government upon the investing public to float its securities issued to raise revenue for the war, your committee believes that the situation would be best met by imposing the surtaxes above mentioned upon such portions of the retained surplus as is not retained for employment in the business * * *.[16]

In congressional discussion:

Mr. SIMMONS. It is also provided that if any concern, under the pretext that a certain amount was necessary, retained more than the Secretary of the Treasury ultimately found necessary to meet the reasonable requirements, it should pay a tax of 15 per cent instead of 10 per cent upon the amount so improperly retained.[17]

In the Senate discussion of the report of the conference committee:

Mr. SIMMONS. * * * neither the existing law nor the House bill require corporations to distribute their earnings or impose any surtax or penalty upon such part of their earnings as remain undistributed. As a result the corporations of the country have accumulated large undivided surpluses which have escaped the income surtax as long as they remained undistributed. It is evident that in these circumstances the greater the individual surtax the greater the inducement to corporations to refrain from distributing their surpluses.

Your committee thought it expedient to devise some method of coercing distribution of these earnings when not retained for the necessary requirements of the business. With this end in view the Senate adopted an amendment proposed by the Finance Committee imposing a tax of 10 per cent upon the undistributed surplus of a corporation but exempted from this tax such retained surplus as the Secretary of the Treasury should ascertain and find was reasonably required in the business and actually employed in it.[18]

This section of the Revenue Act of 1917 was not a general levy on all undistributed profits. Instead, it was designed to serve essentially the same purpose as section II (A) (2) of the Tariff Act of 1913 and section 3 of the Revenue Act of 1916, but in a different way. Improper surplus accumulations were taxed to the corporation rather than the shareholders—but, it should be noted, the tax covered *only* that portion of the retained corporate income not reasonably required nor employed in the business [19] (idle funds) and, consequently, to that extent represented unjustified avoidance of personal surtax. Corporate surplus accumulations, if invested or serving a necessary business use, were excluded from tax under the section as has been the case under section 102 and its predecessor sections since 1913.

With this section operative, in conjunction with section 3 of the Revenue Act of 1916, there was a "double-barreled" threat to unreasonable accumulations of surplus. The differential rates of tax, as indicated by Mr. Simmons in the discussion of the report of the conference committee, were apparently in recognition that some excess corporate surplus accumulations were not primarily the result of intent to avoid personal surtax but, rather, mistaken judgment as to financial requirements, and were taxable at 10 percent; other unnecessary accumulations developed under "pretext" of corporate need infer intent to avoid surtax and, hence, were taxable at 15 percent.

Present section 102 is not regarded as the lineal descendant of this section of the 1917 Revenue Act. However, it is a sister section in

[16] 65th Cong., 1st sess., S. Rept. 103, pp. 21–22.
[17] Congressional Record, vol. 55, pp. 5966–67.
[18] Ibid., p. 7615.
[19] Or invested in the obligations of the United States as specified in the section.

purpose and similar in its point of impact; i. e., on the corporation.[20] Section 1206 (2) (b) of the Revenue Act of 1917 was repealed by section 1400 of the Revenue Act of 1918.

REVENUE ACT OF 1918

Only one change of consequence was made in the Revenue Act of 1918, in contrast with the 1916 act, the removal of the word "fraudulently," although the Commissioner of Internal Revenue was named as the administering official instead of the Secretary of the Treasury. Enacted as section 220, it provided:

> That if any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its stockholders or members through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, such corporation shall not be subject to the tax imposed by section 230 [ordinary corporate income tax], but the stockholders or members thereof shall be subject to taxation under this title in the same manner as provided in subdivision (e) of section 218 in the case of stockholders of a personal service corporation, except that the tax imposed by Title III shall be deducted from the net income of the corporation before the computation of the proportionate share of each stockholder or member. The fact that any corporation is a mere holding company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax; but the fact that the gains and profits are in any case permitted to accumulate and become surplus shall not be construed as evidence of a purpose to escape the tax in such case unless the Commissioner certifies that in his opinion such accumulation is unreasonable for the purposes of the business. When requested by the Commissioner, or any collector, every corporation shall forward to him a correct statement of such gains and profits and the names and addresses of the individuals or shareholders who would be entitled to the same if divided or distributed, and of the amounts that would be payable to each.[21]

The reason for the elimination of the word "fraudulently" is clearly expressed in the Senate discussion:

> Senator SIMMONS. Another very important amendment recommended by the committee may vitally affect the question of the undistributed earnings of corporations. Undoubtedly there are corporations in this country which, without any regard to the requirements of the business, make a habit of retaining a large and unnecessary part of the earnings in the business, or pretending to retain it for business purposes, for the purpose of escaping the surtax. There is no doubt but that there are a number of so-called close corporations, corporations with only a small number of stockholders, that have been organized primarily for the purpose of availing themselves of the privilege of retention to escape surtaxes upon their earnings.
>
> The present law has a provision that would seem adequate to meet that situation, but it fails in adequacy by reason of the use of just one word. It authorizes the Secretary of the Treasury to determine whether these earnings are improperly retained; and if he shall find that they are fraudulently retained or fraudulently availed of for the purpose of escaping taxes they can be taxed as if distributed to the stockholders. *The law has been ineffectual because of difficulty in securing evidence to establish fraud.* We have, therefore, stricken from the provision of the present law the word "fraudulent"; and it is the belief of the department that as a result the administrative branch of the Government will be able to effectually cope with these fraudulent practices and schemes for evading the tax.[22] (Italics ours.)

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[20] See J. S. Seidman, op. cit., pp. 947–949, for congressional discussion of sec. 1206 (2) (b) of the Revenue Act of 1917.

[21] 40 U. S. Stat. L. 1072.

[22] Congressional Record, vol. 57, p. 253. See J. S. Seidman, op. cit., pp. 925–926, for reports of Senate Finance Committee and conference committee on sec. 220.

REVENUE ACT OF 1921

The decision of the Supreme Court in *Eisner* v. *Macomber*[23] created doubt as to the constitutionality of taxing corporate shareholders under the partnership method as was provided in section 220 of the Revenue Act of 1918 and similar antecedent provisions.[24] Congress, therefore, amended section 220 to impose the tax directly on the corporation, and established a flat-rate tax of 25 percent (an additional income tax). Stockholders by agreement, however, could decide to be taxed under the partnership method upon the retained net income of the corporation; such tax would be in lieu of all corporate income taxes.[25]

The revised section 220 in the Revenue Act of 1921 was as follows:

That if any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its stockholders or members through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be levied, collected, and paid for each taxable year upon the net income of such corporation a tax equal to 25 per centum of the amount thereof, which shall be in addition to the tax imposed by section 230 of this title and shall be computed, collected, and paid upon the same basis and in the same manner and subject to the same provisions of law, including penalties, as that tax: *Provided*, That if all the stockholders or members of such corporation agree thereto, the Commissioner may, in lieu of all income, war-profits and excess-profits taxes imposed upon the corporation for the taxable year, tax the stockholders or members of such corporation upon their distributive shares in the net income of the corporation for the taxable year in the same manner as provided in subdivision (a) of section 218 in the case of members of a partnership. The fact that any corporation is a mere holding company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax; but the fact that the gains and profits are in any case permitted to accumulate and become surplus shall not be construed as evidence of a purpose to escape the tax in such case unless the Commissioner certifies that in his opinion such accumulation is unreasonable for the purposes of the business. When requested by the Commissioner, or any collector, every corporation shall forward to him a correct statement of such gains and profits and the names and addresses of the individuals or shareholders who would be entitled to the same if divided or distributed, and of the amounts that would be payable to each.[26]

As reported by the Ways and Means Committee:

Section 220 of the existing law provides that if any corporation is formed or availed of for the purpose of evading the surtax upon its stockholders through the medium of permitting its gains and profits to accumulate instead of being divided, the stockholders shall be taxed in the same manner as partners. By reason of the recent decision of the Supreme Court in the stock dividend case (*Eisner* v. *Macomber*, 252 U. S., 189), considerable doubt exists as to the constitutionality of the existing law. Section 226 of the bill therefore proposes to amend section 220 of the existing law so as to impose upon corporations of the character above described a flat additional income tax of 25 per cent of the net income; but, if the stockholders agree, they may be taxed upon their distributive shares in the net income of the corporation in the same manner as members of a partnership, such taxes to be in lieu of all income taxes upon the corporation.[27]

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[23] 252 U. S. 189.
[24] Except sec. 1206 (2) (b) of the Revenue Act of 1917.
[25] Beginning of the "consent dividend."
[26] 42 U. S. Stat. L. 247–248.
[27] 67th Cong., 1st sess., H. Rept. 350, pp. 12–13. See J. S. Seidman, op. cit., pp. 852–853, for congressional discussion.

REVENUE ACT OF 1924

An important change in section 220 in the Revenue Act of 1924 was to increase the rate of tax from 25 percent to 50 percent as a means of compelling distribution of profits to holding companies from their subsidiaries. Congress was of the belief that the 25-percent rate was not an adequate deterrent to personal surtax avoidance. Avoidance through the instrumentality of holding and investment companies was of particular concern. The Secretary of the Treasury, on inquiry from Senator McKellar, admitted that section 220 was ineffective because he doubted whether an investment company could accumulate surplus beyond its business needs, as its "sole business was to invest," [28] and that a corporation investing exclusively in "Government securities exempt as to normal tax, or in the stock of other domestic corporations, under the law it had no taxable income"; [29] consequently, the 25-percent penalty tax had no base of taxable income against which it could apply. Net income to the corporation, therefore, was redefined to include corporate dividends and interest on Government securities which, in the hands of an individual, would be subject to tax.

The amended act read as follows:

SEC. 220. (a) If any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be levied, collected, and paid for each taxable year upon the net income for such corporation a tax equal to 50 per centum of the amount thereof, which shall be in addition to the tax imposed by section 230 * * *.

(b) The fact that any corporation is a mere holding or investment company, or that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax.

(c) When requested by the Commissioner, or any collector, every corporation shall forward to him a correct statement of such gains and profits and the names and addresses of the individuals or shareholders who would be entitled to the same if divided or distributed, and of the amounts that would be payable to each.

(d) As used in this section the term "net income" means the net income as defined in section 232, increased by the sum of the amount of the deduction allowed under paragraph (6) of subdivision (a) of section 234, and the amount of the interest on obligations of the United States issued after September 1, 1917, which would be subject to tax in whole or in part in the hands of an individual owner.[30]

The Senate Finance Committee reported that—

Section 220: This section of the Revenue Act of 1921 imposes upon a corporation formed or availed of for the purpose of preventing the imposition of the surtax upon its stockholders by failing to distribute its gains and profits a tax of 25 per cent of its net income. * * * The rate of tax upon the net income of such corporations has been increased from 25 per cent in the House bill to 50 per cent, in order to place a more effective check upon this method of evasion of surtaxes.[31]

A minority report of the Senate Finance Committee stated that—

* * * the Secretary of the Treasury and the majority members of the Finance Committee have made no attempt to change the provisions of the present law which afford the greatest avenues of escape from the high surtaxes. Under existing law the tax upon corporations is a flat or normal tax of 12½ per cent.

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[28] Congressional Record, vol. 65, p. 7355.
[29] Ibid.
[30] 43 U. S. Stat. L. 277.
[31] 68th Cong., 1st sess., S. Rept. 398, p. 26.

This has been increased by the majority of the committee to 14 per cent. Under this arrangement there is nothing to prevent an individual with an income taxed upon the average above 14 per cent thereof from organizing a corporation and transferring to it all his income-producing assets. The corporation would only pay a flat normal tax and the owner of the corporation would need to draw therefrom in dividends an amount only sufficient to pay his actual living expenses. It follows, therefore, that in the bill as presented there is a direct inducement for everyone having a net income which would be taxed to him as an individual in an amount in excess of 14 per cent to organize a corporation and evade the payment of more than that percentage of taxes. *It is true a penalty against the organization of a corporation for the sole purpose of evading taxation is included in the present law and increased in the proposed bill. In actual result, however, such penalty provision has been and will be for all practical purposes a nullity. The penalty of the present law has only been applied in one or two cases. The Secretary testified before the committee that corporations were not being availed of so as to result in a decrease in taxation. Before another committee of the Senate a prominent attorney from the city of New York testified that such was generally being done. We believe that so long as the inducements exist in the law they will be availed of by interested taxpayers.*[32] (Italics ours.)

Concerning the statutory presumption applying to investment and holding companies, the report of the Ways and Means Committee contained the following:

* * * the presumption is created that any investment company is availed of for the purpose of avoiding the imposition of surtaxes on stockholders.[33]

Further:

Section 220 of the existing law also provides that the fact that any corporation is a mere holding company shall be prima facie evidence of purpose to escape a surtax. The Treasury Department has had difficulty in applying this section to the case of pure investment companies which reinvest their entire net income. The bill, therefore, makes the fact that any corporation is a mere holding or investment company prima facie evidence of the purpose to escape the surtax.[34]

In congressional discussion:

Mr. JONES. I believe this section will be no more effective than the similar section which exists in the present law, because it all goes back to the one question as to whether or not the corporation is organized for the purpose of evading surtaxes. He is a mighty dumb individual who cannot overcome the alleged prima facie case which this provision attempts to make out.[35]

Further:

Why cannot a man organize a corporation for the express purpose of investing and reinvesting his funds? Why should not any individual having property of various kinds organize a corporation for the purpose of easy distribution in the event of his death? They are lawful purposes.[36]

As to the need for redefinition of "net income," the Ways and Means Committee said:

The penalty imposed by section 220 upon corporations availed of to avoid the imposition of surtaxes on the stockholders is now based upon all the income of the corporation which would be taxed in the hands of an individual * * *.[37]

Further:

This section is ineffective in the case of the holding company which fails to distribute its gains and profits, since its net income consists entirely of dividends from the corporation, the stock of which it owns, which under the law do not form a part of the net income of the holding company. Subdivision (d) of the

[32] Ibid., pp. 8–9.
[33] Ibid., H. Rept. 179, p. 7.
[34] Ibid., p. 22.
[35] Congressional Record, vol. 65, p. 7360.
[36] Ibid.
[37] 68th Cong., 1st sess., H. Rept. 179, p. 7.

bill corrects this error and also provides that in computing the net income of such corporation for the purpose of this section the amount of interest on Liberty bonds must be included if the interest on such bonds would be subject to tax in the hands of an individual owner. Under the present law such interest is not included in computing the net income of the corporation, since Liberty bonds (except the 3½ per cent issue) are not taxed to a corporation, although subject to surtax in the hands of an individual owner.[38]

Revenue Act of 1926

Amendment to section 220 by the Revenue Act of 1926 was in the addition of subdivision (e) which, while not changing the impact of the tax on the corporation, provided for optional stockholder reporting and payment of personal tax on their proportionate shares of the undistributed corporate earnings.

Subdivision (e):

(e) The tax imposed by subdivision (a) of this section shall not apply in respect of any taxable year if all the shareholders of the corporation include (at the time of filing their returns) in their gross income their entire distributive share, whether distributed or not, of the net income of the corporation for such year. Any amount so included in the gross income of a shareholder shall be treated as a dividend received. Any subsequent distribution made by the corporation out of the earnings or profits for such taxable year shall, if distributed to any shareholder who has so included in his gross income his distributive share, be exempt from tax in the amount of the share so included.[39]

The report of the Senate Finance Committee with reference to the proposed amendment:

Section 220 (e): The existing law, in the case of corporations formed or availed of for the purpose of preventing the imposition of a surtax by failure to distribute the earnings, imposes upon the net income of such corporations a tax of 50 per cent in addition to the regular corporation income tax. The committee recommends the addition of a provision that this tax shall not apply in any year if all the stockholders include in their gross income, and pay surtax upon, their entire distributive share, whether distributed or not, of the earnings of the corporation for such year. If the surtax is thus paid the failure to distribute the earnings has not resulted in any avoidance of tax and the reason for the imposition of the 50 per cent tax on the corporation no longer exists. The amendment also provides that upon any subsequent distribution by the corporation out of its earnings and profits for the year in which the shareholders have thus paid the surtax, the amounts distributed to the same shareholder who paid a tax on his distributive share shall be exempt from tax.[40]

The conference committee report contained the following:

The House recedes with an amendment specifically providing that the 50 per cent tax imposed shall not apply if the shareholders include their distributive share, whether distributed or not, in their gross income at the time of filing their returns.[41]

Revenue Act of 1928

Apart from proposals by the Ways and Means Committee of the House for an automatic application of the surtax and a reduction in the rate of tax from 50 to 25 percent, which proposals did not succeed, section 220 in its substantive language remained unchanged. It was, however, renumbered as section 104. Congressional discussion indicated continuing concern over the ineffectiveness of the section.

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[38] Ibid., p. 22. See J. S. Seidman, op. cit., pp. 742–747, for further congressional discussion of amendments to sec. 220.
[39] 44 U. S. Stat. L. 34–35.
[40] 69th Cong., 1st sess., S. Rept. 52, p. 22.
[41] 69th Cong., 1st sess., H. Rept. 356, p. 35.

Section 104 as enacted in the Revenue Act of 1928:

(a) If any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be levied, collected, and paid for each taxable year upon the net income of such corporation a tax equal to 50 per centum of the amount thereof, which shall be in addition to the tax imposed by section 13 and shall be computed, collected, and paid upon the same basis and in the same manner and subject to the same provisions of law, including penalties, as that tax.

(b) The fact that any corporation is a mere holding or investment company, or that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax.

(c) As used in this section the term "net income" means the net income as defined in section 21, increased by the sum of the amount of the dividend deduction allowed under section 23 (p) and the amount of the interest on obligations of the United States issued after September 1, 1917, which would be subject to tax in whole or in part in the hands of an individual owner.

(d) The tax imposed by this section shall not apply if all the shareholders of the corporation include (at the time of filing their returns) in their gross income their entire distributive shares, whether distributed or not, of the net income of the corporation for such year. Any amount so included in the gross income of a shareholder shall be treated as a dividend received. Any subsequent distribution made by the corporation out of the earnings or profits for such taxable year shall, if distributed to any shareholder who has so included in his gross income his distributive share, be exempt from tax in the amount of the share so included.[42]

The proposal of the Ways and Means Committee of the House:

Provision is made in section 104 that if such a company permits it[s] undistributed profits, as defined in the section, to exceed 30 per centum of the sum of its net income plus dividends and tax-free interest received an additional tax shall be imposed on such net income so increased, equal to 25 per centum of the undistributed profits.

Section 104 (c) is substantially the same as section 220 of the 1926 act in its application to corporations which are not within the definition of a "personal holding company," and provides that if any corporation, other than a personal holding company, is formed or availed of to permit its profits to remain accumulated, in order to evade surtaxes, a tax of 25 per centum of the net income, increased by dividends and tax-free interest received, shall be imposed. The tax under section 220 of the Revenue Act of 1926 was 50 per centum. It is believed that this reduction will eliminate unnecessarily harsh features of the former provision and will contribute to its practical effectiveness.[43]

Some comments in the House:

Mr. GREEN. * * * the difficulty with the proposition recommended by the advisory committee * * * to put a differentiated tax on profits distributed from the rate on profits which are not distributed, hits the honest man who has a necessity for keeping a surplus in his corporation just as hard as the dishonest man who is trying to avoid taxes. If there is anything men do not like to be penalized for it is when they have not done anything wrong. Take the banks in my State. They are having a hard time to try to build up a surplus. The plan proposed * * * would simply penalize those banks trying to build up a surplus. They lost their surplus in the hard times. Take the small corporations just starting. They have to build up a surplus in order to try to compete with the larger institutions. This provision proposed by the advisory committee, which was not approved by the joint committee, * * * would penalize those gentlemen who are honestly endeavoring to build up a surplus which they needed in their business, and without which they could not make a success of their business, and they are hit as hard or harder than those trying to avoid the tax.[44]

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[42] 45 U. S. Stat. L. 814–815.
[43] 70th Cong., 1st sess., H. Rept. 2, pp. 17–18.
[44] Congressional Record, vol. 69, p. 520.

Mr. LAGUARDIA. The recommendation provided for a blanket tax on all profits not declared whether kept legitimately for building up a surplus or not.[45]

Some comments in the Senate:

Mr. SMOOT. * * * The Finance Committee decided to strike out section 104, and then make section 105 correspond to section 220 as it is in the law to-day.[46]

Mr. SIMMONS. That means, as I understand the Senator, that we revert to the present law?[47]

Mr. SMOOT. Word for word we incorporate section 220 of the present law.[48]

Mr. KING. * * * how much shall be allowed as a surplus before the penalty shall be applied? I do not know. Should we attempt to circumscribe those engaged in business and limit the amount of reserves and accumulations before the penalty of 50 per cent is applied, or should the entire matter be committed to the discretion of those administering the law?

I am not satisfied with this section, and yet I am not in position to offer an amendment to supersede it. The Finance Committee considered the House amendment, which was intended to clarify the situation; and I think that after due consideration the committee reached the conclusion that instead of clarification it would add to the uncertainty and dubiety if attempts were made to prescribe the limitation upon the amount allowed as reserves and the circumstances under which such reserves should be set up.[49]

Mr. SIMMONS. In all of our discussions about this question, however, we have all realized the fact that sound economy in the conduct of a business by a corporation made it necessary that they should set aside a certain part of their annual earnings for purposes of enlargement, for purposes of improvement of their methods and their equipment, and that the requirements of one class of corporations in this respect were different from those of another class of corporations; that it was almost impossible to lay down any fixed rule to regulate the distribution of these accumulated surpluses which would not be to the disadvantage of some and to the advantage of other corporations. In that state of inability to adjust what the several corporations of the country might legitimately and reasonably require in order to be upon a safe footing in the conduct of their business, and to enlarge and develop their business and improve their methods, we felt that we were hopeless unless the Secretary of the Treasury would enforce this provision of the law.[50]

REVENUE ACT OF 1932

Section 104 was not subject to any substantive change by the Revenue Act of 1932.[51] However, there was congressional discussion which indicated some misunderstanding as to the coverage of the section, its effectiveness in preventing surtax avoidance, and a reluctant acquiescence that the section as drawn represented about the best that could be done. The ineffectiveness of the section was attributed to inadequate Treasury administration.

Congressional discussion relating to the coverage of the section:

Mr. LAGUARDIA. * * * Section 104 covers only such corporations as holding companies, where no dividends are distributed for the purpose of evading income taxes. Has the committee considered a tax on undivided profits in corporations where profits are not divided but permitted to build up in order to avoid taxes? I point out that while the provisions of section 104 referred to in this paragraph cover fully what the gentleman has in mind, these particular holding companies, does it cover an existing evil of avoiding taxes by placing profits in surplus? I know that many corporations instead of dividing their profits in dividends after building up a reasonable surplus, keep piling up a surplus to avoid taxes, and then use this money for call money or even gamble in the stock market.[52]

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[45] Ibid.
[46] Congressional Record, vol. 69, p. 7976.
[47] Ibid.
[48] Ibid.
[49] Ibid., p. 7977.
[50] Ibid. See J. S. Seidman, op. cit., pp. 527–530, for additional congressional discussion.
[51] 47 U. S. Stat. L. 195.
[52] Congressional Record, vol. 75. pp. 6477–6478.

Mr. CRISP. Mr. Chairman, as I understand the section, it applies to all corporations that hold moneys and surplus for purposes of evading taxation.[53]

Mr. LAGUARDIA. Would it apply to a commercial corporation that is not dividing its profits for the purpose of tax evasion and is building up a surplus?[54]

Mr. CRISP. It is intended to apply to all corporations, holding companies, and others that are holding surpluses for the purpose of evading taxation.[55]

Mr. LAGUARDIA. Suppose it is not a holding corporation; suppose it is an operating corporation.[56]

Mr. CRISP. If it is any corporation, whether an operating corporation or a holding corporation, that holds its surplus to evade taxes, it is my understanding that that comes within the provisions of the law, and the chief of the legislative drafting bureau advises me that that is what it does.[57]

Effectiveness of section questioned:

Mr. BLANTON. Many corporations have gotten into the habit of refusing to distribute their annual profits, but have been setting aside each year a large proportion of such annual profits as surplus just to evade the payment of income taxes. If these annual profits were distributed to the stockholders in dividends an income tax would be paid. They escape and evade paying the income tax by not distributing same but by setting same by as surplus.

And then, when years have passed, they will liquidate and distribute this surplus with other capital stock, and the Government will receive nothing whatever from this surplus accumulated over a series of years from annual profits. They also practice another scheme to set aside a large amount as a surplus each year, and then after a while they issue additional stock certificates for it. And all tax to the Government is evaded.[58]

As to Treasury administration:

Mr. LAGUARDIA. * * * The only difficulty with section 104 is that it has been on the books but has not been administered.[59]

As to substantive changes in section 104 to increase effectiveness:

Mr. CRISP. The gentleman from New York [Mr. LaGuardia] has asked me to please say what I understood section 104 to mean. This is a matter that the experts of the Treasury Department and the legislative drafting bureau of the House have been considering for 15 years, trying to devise some method whereby these accumulated unnecessary surpluses could be taxed when they were withheld from distribution for the purpose of evading taxes. Section 104 provides that any corporation, no matter how organized or for what purpose originally organized, if it were organized as a holding company to evade taxes or if it were organized for other purposes and used for the purpose of evading taxes, the income held in those holding companies from distribution was subject to a 50 per cent tax.

Of course, like all laws, some human being had to administer it, and I grant that it is hard sometimes to get proof to make out a case. It is up to the Treasury Department to decide. But this section provides that any corporation which attempts to hold those earnings to evade taxes is subject to a 50 per cent tax.[60]

Mr. LAGUARDIA. Of course, we are in complete agreement as to the end sought. It simply occurred to me that, in the light of the experience of the past, the section should be so drafted as to provide the necessary machinery, with sufficient teeth in it, to accomplish the purpose which the House has in mind.[61]

Mr. WOODRUFF. Is it the opinion of the gentleman that that section as now drawn, and is it the opinion of the experts in the Treasury Department, that section 104 as drawn in this bill can be successfully enforced?[62]

Mr. CRISP. They think it is the best they can do.[63]

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[53] Ibid.
[54] Ibid.
[55] Ibid.
[56] Ibid.
[57] Ibid., p. 6477.
[58] Ibid., p. 6483.
[59] Ibid., p. 6486.
[60] Ibid.
[61] Ibid.
[62] Ibid.
[63] Ibid.

REVENUE ACT OF 1934

Important changes in the section resulting from the Revenue Act of 1934 were the introduction of reduced but graduated rates of tax and the exclusion of personal holding companies from the section, with such companies taxable under a separate provision. The problem of tax avoidance presented by personal holding companies had become acute.[64] Congress believed that the most effective way to reach these "incorporated pocketbooks" was by an automatic levy without the necessity of proving a purpose to avoid the personal surtax.[65] Section 104, and its predecessor sections, had not proven effective in meeting the flagrant tax-avoidance problem of the personal holding company, largely because of the necessity of proving "purpose to avoid" on the part of the taxpayer corporation.[66]

Other changes in the section were to make it a surtax, rather than an additional income tax, in order "to remove any doubt of the right of Congress to include in the income subject to the tax the interest from partially tax-exempt securities," as the "acts authorizing the issue of such securities exempt the interest therefrom from all income taxation, except surtaxes and excess- and war-profits taxes";[67] also to renumber the section, making it section 102.

As enacted in the Revenue Act of 1934, section 102 was as follows:

(a) IMPOSITION OF TAX.—There shall be levied, collected, and paid for each taxable year upon the adjusted net income of every corporation (other than a personal holding company as defined in section 351) if such corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting gains and profits to accumulate instead of being divided or distributed, a surtax equal to the sum of the following:

(1) 25 per centum of the amount of the adjusted net income not in excess of $100,000, plus

(2) 35 per centum of the amount of the adjusted net income in excess of $100,000.

(b) PRIMA FACIE EVIDENCE.—The fact that any corporation is a mere holding or investment company, or that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to avoid surtax.

(c) DEFINITION OF "ADJUSTED NET INCOME".—As used in this section, the term "adjusted net income" means the net income computed without the allowance of the dividend deduction otherwise allowable, but diminished by the amount of dividends paid during the taxable year.

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[64] The Ways and Means Committee on the revenue bill of 1934 declared that—

"Perhaps the most prevalent form of tax avoidance practiced by individuals with large incomes is the scheme of the 'incorporated pocketbook.' That is, an individual forms a corporation and exchanges for its stock his personal holdings in stock, bonds, or other income-producing property. By this means the income from the property pays corporation tax, but no surtax is paid by the individual if the income is not distributed.

"For instance, suppose a man has $1,000,000 annual income from taxable bonds. His tax under existing law will be $571,100. However, if he forms a holding company to take title to the bonds and to receive the income therefrom, the only tax paid will be a corporate tax of $137,500 as long as there is no distribution of dividends. Thus a tax saving of $443,600 has been effected," (73d Cong., 2d sess., H. Rept. 704, p. 11).

[65] The Ways and Means Committee stated:

"The effect of this system recommended by your committee is to provide for a tax which will be automatically levied upon the holding company without any necessity for proving a purpose of avoiding surtaxes. It is believed that the majority of these corporations are in fact formed for the sole purpose of avoiding the imposition of the surtax upon the stockholders." (Ibid., p. 12).

[66] "It is true that section 104 of the existing income-tax law puts a 50-percent penalty on this accumulation of profits to avoid surtaxes, but, nevertheless, there seems no doubt that this form of avoidance is still practiced to a large extent. By making partial distribution of profits and by showing some need for the accumulation of the remaining profits, the taxpayer makes it difficult to prove a purpose to avoid taxes." (Ibid., p. 11).

[67] Senate Finance Committee, 73d Cong., 2d sess., S. Rept. 558, p. 31.

(d) PAYMENT OF SURTAX ON PRO RATA SHARES.—The tax imposed by this section shall not apply if all the shareholders of the corporation include (at the time of filing their returns) in their gross income their entire pro rata shares, whether distributed or not, of the "adjusted net income" of the corporation for such year. Any amount so included in the gross income of a shareholder shall be treated as a dividend received. Any subsequent distribution made by the corporation out of earnings or profits for such taxable year shall, if distributed to any shareholder who has so included in his gross income his pro rata share, be exempt from tax in the amount of the share so included.

(e) TAX ON PERSONAL HOLDING COMPANIES.—For surtax on personal holding companies, see section 351.[68]

The House Ways and Means Committee, in reporting on proposed changes in the section, said:

In regard to the tax on other corporations [other than personal holding companies] which improperly accumulate surpluses for the avoidance of surtaxes, two important changes are made. First, it is recommended that the rate of tax on these other corporations be reduced to 25 percent. The 50-percent rate now imposed is too high to be readily enforceable. Generally, it represents a tax of more than would have been imposed if the surplus had been distributed. Moreover, such surplus, even after the payment of tax, is still subject to the surtax in the hands of the individual when ultimately distributed. Second, the present law imposes the tax upon the entire net income; that is, the tax is the same whether 50 percent of the net income was distributed or whether none of it was distributed. It is, therefore, recommended that the tax be applied to the net income after the amount of such net income has been diminished by the amount of dividends paid during the taxable year.[69]

The Senate Finance Committee, in its report, stated:

This section [section 102] takes the place of section 104 of existing law and is designed to take care of those corporations which do not fall within the category of personal holding companies, but which, nevertheless, have accumulated surplus to prevent the imposition of surtaxes on their stockholders. The House bill changes the existing law in two respects, namely, the rate of the added tax is changed from 50 to 25 percent, and dividends paid during the taxable year are permitted to be deducted from the net income to which the 25 percent rate applies. Your committee makes the following changes in the House bill:

(1) Instead of providing for an increased tax of 25 percent, a graduated surtax is imposed at the following rates:

(*a*) 25 percent of the amount of the adjusted net income not in excess of $100,000 plus (*b*) 35 per centum of the amount of the adjusted net income in excess of $100,000.

* * * * * * *

(2) The term "adjusted net income" is used instead of the term "net income" provided for in the House bill. This change is made for the reason that the income upon which the tax is imposed by this section is different from "net income" as defined in other sections of the income-tax title. Defining net income to mean one thing under one section of the income-tax title and another thing under other sections of that title leads to confusion. * * *

(3) Since the tax under this section is now made a surtax, its computation, collection, and payment are already provided for in other sections of the income-tax title. In other words, the tax under title I of a corporation subject to the provisions of this section consists of the ordinary corporate normal tax plus the surtax imposed by this section. The House provision providing for the computation, collection, and payment of such tax is, therefore, omitted as surplusage.[70]

In the report of the conference committee:

The "net income" as specifically defined in the House bill has the same legal effect as the "adjusted net income" defined in the Senate amendment. Both the tax proposed by the House bill and the surtax proposed by the Senate amendment are in addition to the corporate tax imposed in section 13. The Senate

[68] 48 U. S. Stat. L. 702–703.
[69] Ways and Means Committee, 73d Cong., 2d sess., H. Rept. 704, p. 12.
[70] Senate Finance Committee, 73d Cong., 2d sess., S. Rept. 558, pp. 30–31.

amendment adds to this provision a paragraph permitting the corporation to avoid liability in respect to the surtax if all of its shareholders include in their gross income their entire pro rata shares, whether distributed or not, of the "adjusted net income" of the corporation for the year. The Senate amendment also omits as surplusage the provision of the House bill as to computation, collection, and payment of tax. The House recedes with an amendment making a clarifying change.[71]

House discussion:

Mr. SAMUEL B. HILL. An individual with an income in the higher brackets will organize a corporation, a holding company, and will have the income from his investments paid into this corporation and pay a corporation tax of 13¾ percent and thereby escape high surtaxes.

The case that was brought out by the Banking Committee of the Senate with reference to a certain prominent banker in New York who had resorted to the organization of corporation-holding companies in order to keep down or avoid surtax rates grew out of this very condition in the revenue law. You will recall that the president of one of the prominent banks of New York had a group of holding corporations, through the agency of which he collected the interest and gains on his investments and would transfer them from one corporation to another, stepping up the tax base, and then in turn transferring them to a Canadian corporation and from the Canadian corporation back into the United States. Through this series of corporate agencies he escaped a capital gains tax, and escaped the surtax which he, as an individual, would have paid if holding the investments in his own name.

Now, in this bill and in the act of 1932 we feel that we have blocked that kind of a scheme.[72]

Further:

Mr. SAMUEL B. HILL. * * * In addition to that we have another provision for a 25-percent tax on earnings of corporations that do not come within the category of personal holding companies.

So that when in such corporations a unreasonable accumulation of earnings or surpluses has occurred, we will place a tax of 25 percent on such excess earnings. We hope thereby to force a distribution of these earnings into the hands of individual stockholders so that they may be subject to surtaxes now provided in the revenue act. If such unreasonable surpluses are not distributed to individual stockholders and become subject to surtaxes, they will pay the 25-percent additional corporation tax. Such tax of 25 percent as well as the 35-percent tax on holding companies will be imposed in addition to the present tax of 13¾ percent on the net income of such corporations.[73]

Senate discussion:

Mr. REED. * * * This amendment provides that if the individual shareholder shall account for his proportion of the earnings and pay surtaxes on it, he may do so. The Senator understands that this amendment would subject the earnings to surtaxes and not exempt them. It would allow an individual in one of these small holding companies to report his full share of the earnings.[74]

Mr. COUZENS. Mr. President I want to point out that this is one of the most extraordinary amendments that I have ever seen offered. It is offered with the intent of permitting evasion by holding companies of the safeguarding provisions which the committee wrote into the bill. In other words, it permits a stockholder of a corporation to report falsely an income which he has not received. He may report an income from a corporation that is not paying out of its earnings as though he had it, when, in fact, he has not received it; and by so doing, if he is subject to a surtax on his income, he pays that surtax and by that method the earnings accumulated by the corporation avoid the penalty provided in the bill.[75]

Mr. REED. Mr. President, it is found by some people who have interests in investment companies that if such a corporation pays out all its earnings, the combination of the American tax with the foreign tax which they might have to pay because of their residence abroad brings the total tax to more than their

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[71] 73d Cong., 2d sess., H. Rept. 1385, p. 21.
[72] Congressional Record, vol. 78, p. 2662.
[73] Ibid., pp. 2662–2663.
[74] Ibid., p. 6240.
[75] Ibid., p. 6307.

income. Consequently, the purpose of this amendment is to allow such an individual to pay the full American surtaxes on the earnings of such corporations as if they were distributed; but as they are not declared as dividends, they are not liable for the supertaxes that are levied by foreign countries. It means an increase of revenue to the United States. The whole purpose of the holding-company provision is to stop the avoidance of surtaxes. In this case the taxpayer does not avoid the surtaxes, but he deliberately courts them by paying these surtaxes on his entire pro rata share of the corporation's earnings, although those earnings are not distributed as dividends. The American Treasury gains by it.[76]

Further:

Mr. REED. The holding-company section has been put in to prevent tax avoidance by means of what is called the incorporated pocketbook. * * *

The provision I am now offering will take care of the exact opposite of those cases. It will allow the stockholders, if for some reason they want to accumulate their surplus in the corporation, to do so, provided they pay the full amount of surtax which they would have to pay if all the earnings were distributed in dividends.[77]

REVENUE ACT OF 1936

With the exception of rate reduction for corporations subject to the surtax on undistributed profits, section 102 was subject to minor changes only in the Revenue Act of 1936. The Ways and Means Committee of the House in its report stated that section 102 was "more or less ineffective" because of the difficulty of proving purpose to avoid the personal surtax in the corporate accumulation of surplus.[78] However, no change was made in the act in regard to the necessity of proving "purpose" to avoid the personal tax.

In the message of the President to the Congress, dated June 19, 1935, it was recommended to the study and consideration of Congress that "we should likewise discourage unwieldy and unnecessary corporate surpluses."[79] Again, in the Presidential message to the Congress dated March 3, 1936, it was said:

The accumulation of surplus in corporations controlled by taxpayers with large incomes is encouraged by the present freedom of undistributed corporate income from surtaxes. Since stockholders are the beneficial owners of both distributed and undistributed corporate income, the aim, as a matter of fundamental equity, should be to seek equality of tax burden on all corporate income whether distributed or withheld from the beneficial owners. As the law now stands our corporate taxes dip too deeply into the shares of corporate earnings going to stockholders who need the disbursement of dividends, while the shares of stockholders who can afford to leave earnings undistributed escape current surtaxes altogether.

This method of evading existing surtaxes constitutes a problem as old as the income-tax law itself. Repeated attempts by the Congress to prevent this form of evasion has not been successful. The evil has been a growing one. It has now reached disturbing proportions from the standpoint of the inequality it represents and of its serious effect on the Federal revenue. Thus the Treasury estimates that, during the calendar year 1936, over four and one-half billion dollars of corporate income will be withheld from stockholders. If this undistributed income were distributed, it would be added to the income of stockholders and there taxed as is other personal income. But, as matters now stand, it will be withheld from stockholders by those in control of these corporations. In one year alone the Government will be deprived of revenues amounting to over $1,300,000,000.[80]

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[76] Ibid., pp. 6307–6308.
[77] Ibid., p. 6326. See J. S. Seidman, op. cit., pp. 327–330.
[78] 74th Cong., 2d sess., H. Rept. 2475, p. 5.
[79] As reported in U. S. Treasury Department, Internal Revenue Bulletin, Cumulative Bull. 1939–1, pt. 2 (Washington, D. C.: Government Printing Office, 1939), p. 644.
[80] Ibid., p. 668.

In the report of the House Ways and Means Committee with reference to the Presidential message:

> The President requests the Congress to raise $620,000,000 of additional revenue annually by some form of permanent taxation. He suggests some form of undistributed profits tax. Your committee recognizes the fact that the greatest defect in our present system of taxation lies in the fact that surtaxes on individuals are avoided by impounding income in corporate surpluses. * * *
>
> The major purposes of the change in the method of taxing corporate incomes are (1) to prevent avoidance of surtax by individuals through the accumulation of income by corporations * * *.[81]

Further:

> Corporations should not be permitted to withhold from the beneficial shareholders unneeded corporate income at the expense of the revenues of the United States and to the detriment of the shareholder.[82]

The Senate Finance Committee in its report stated:

> Your committee recognizes that our present system of taxation offers the opportunity, in certain cases, for individuals to avoid surtaxes by the retention of earnings in the corporations which they may control. However, your committee believes that the undistributed-profits tax plan proposed by the House bill has certain fundamental defects, some of which are as follows:
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> * * * * * * *
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> Second. The plan will penalize many corporations not availed of for surtax avoidance in order that a comparatively few corporations availed of for that purpose may be reached.
>
> Third. The plan will prevent the growth of new corporations in that they will be unable to build up reasonable reserves for working capital and future development.
>
> Fourth. The plan may retard business expansion and seriously affect the unemployment problem.
>
> Fifth. The plan penalizes the small corporation and the corporation with insufficient reserves and is of decided advantage to the large corporation and the corporation with excessive surplus.
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> * * * * * * *
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> Your committee takes the view that the evil sought to be remedied, to wit, the retention of profits by corporations to protect investors having large incomes against paying on larger incomes, may be soundly corrected without doing the injustices above described; and that this can be done by retaining the general corporate income tax with a * * * tax on retained income, supplemented by a strengthening of section 102 of the present law which deals with corporations improperly accumulating profits.[83]

Congressional realization of the ineffectiveness of section 102 and its predecessor sections to cope with the problem of corporate surplus accumulations to avoid personal tax was highly influential in the enactment of the undistributed profits surtax of 1936 as an alternative tax approach.[84] However, section 102 was retained as a supplemental and supporting measure.

Section 102 of the Revenue Act of 1936 was as follows (49 U. S. Stat. L. 1676):

(a) IMPOSITION OF TAX.—There shall be levied, collected, and paid for each taxable year (in addition to other taxes imposed by this title) upon the net income of every corporation (other than a personal holding company as defined in section 351) if such a corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of

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[81] 74th Cong., 2d sess., H. Rept. 2475, p. 3.
[82] Ibid., p. 4.
[83] 74th Cong., 2d sess., S. Rept. 2156, pp. 4–5.
[84] The ineffectiveness of sec. 102 was not, of course, the only consideration leading to the congressional passage of the undistributed-profits surtax; it was, however, a highly important factor, as the above-quoted excerpts from committee reports indicate.

permitting earnings or profits to accumulate instead of being divided or distributed—

(1) In the case of corporations not subject to the surtax on undistributed profits imposed by section 14, a surtax equal to the sum of the following:

25 per centum of the amount of the retained net income not in excess of $100,000, plus

35 per centum of the amount of the retained net income in excess of $100,000.

(2) In the case of corporations subject to the surtax on undistributed profits imposed by section 14, a surtax equal to the sum of the following:

15 per centum of the amount of the retained net income not in excess of $100,000, plus

25 per centum of the amount of the retained net income in excess of $100,000.

(b) PRIMA FACIE EVIDENCE.—The fact that any corporation is a mere holding or investment company, or that the earnings or profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to avoid surtax upon shareholders.

(c) DEFINITIONS.—As used in this title—

(1) SPECIAL ADJUSTED NET INCOME.—The term "special adjusted net income" means the net income minus the sum of—

(A) Taxes.—Federal income, war-profits, and excess-profits taxes paid or accrued during the taxable year, to the extent not allowed as a deduction by section 23, but not including the tax imposed by this section or a corresponding section of a prior income-tax law.

(B) Disallowed charitable, etc., contributions.—Contributions or gifts, not otherwise allowed as a deduction, to or for the use of donees described in section 23 (o), for the purposes therein specified.

(C) Disallowed losses.—Losses from sales or exchanges of capital assets which are disallowed as a deduction by section 117 (d).

(D) Bank affiliates.—In the case of a holding company affiliate (as defined in section 2 of the Banking Act of 1933), the amount allowed as a credit under section 26 (d).

(E) National mortgage associations.—In the case of a national mortgage association created under Title III of the National Housing Act, the amount allowed as a credit under section 26 (e).

(2) RETAINED NET INCOME.—The term "retained net income" means the special adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends. For the purposes of this subsection, such credits shall be computed by substituting in section 26 (c) and in section 27 for the words "adjusted net income" wherever appearing in such sections the words "special adjusted net income."

(d) PAYMENT OF SURTAX ON PRO RATA SHARES.—The tax imposed by this section shall not apply if (1) all the shareholders of the corporation include (at the time of filing their returns) in their gross income their entire pro rata shares, whether distributed or not, of the retained net income of the corporation for such year, and (2) 90 per centum or more of such retained net income is so included in the gross income of shareholders other than corporations. Any amount so included in the gross income of a shareholder shall be treated as a dividend received. Any subsequent distribution made by the corporation out of earnings or profits for such taxable year shall, if distributed to any shareholder who has so included in his gross income his pro rata share, be exempt from tax in the amount of the share so included.

(e) TAX ON PERSONAL HOLDING COMPANIES.—For surtax on personal holding companies, see section 351.

The Ways and Means Committee of the House stated that—

It is true that, if the Government can prove a corporation is formed or availed of for the purpose of preventing the imposition of surtaxes upon its shareholders, a special surtax can be collected from the corporation under section 102 of the existing law. The difficulty of proving such purpose, however, has rendered section 102 more or less ineffective.[85]

[85] 74th Cong., 2d sess., H. Rept. 2475, p. 5.

Further: .

Section 102 of existing law dealing with the surtax on corporations improperly accumulating surplus, has been revised so as to apply only to banks, insurance companies, foreign corporations, China Trade Act corporations, certain domestic corporations doing business in the possessions of the United States, and personal holding companies. Most corporations are taken care of under the new plan and it is only necessary to bring the above list under section 102 in order to prevent tax avoidance. Section 351 of existing law dealing with personal holding companies has been eliminated from the bill.[86]

The Senate Finance Committee report contained the following:

The reported bill recommends important changes over existing law and the House bill in section 102, which imposes tax on domestic and foreign corporations accumulating profits in order to avoid the imposition of surtaxes on their stockholders or the stockholders of other corporations. One general effect of the changes is to strengthen the section by reasonable deductions in determining the retained net income subject to the tax so that the tax will not be thought to be arbitrary by courts and their disposition will be to give effect to its provisions. Another aspect of these changes is that they will facilitate administration of the tax by clarifying its intention and by arming the Treasury with additional means of enforcement. The two most important changes in this respect are the one which requires a statement of reasons for accumulation in the case of certain corporations and the one extending the period of limitations on assessing and collecting the tax under the section. The significant changes from the House bill are as follows:

(1) The reported bill strikes out the provisions of the House bill which limited the section to personal holding companies, banks, insurance companies, foreign corporations, China Trade Act corporations, and corporations receiving a large portion of their income from sources within a possession. As reported, the section applies to every corporation (domestic and foreign) which improperly accumulates surplus, except personal holding companies. They are treated separately in section 351.

(2) The bill as reported makes it clear that the surtax imposed by the section is in addition to surtax imposed by section 14.

(3) The reported bill adds the requirement that every corporation subject to income taxation (except personal holding companies) whose retained net income is more than 40 percent of the special adjusted net income, or more than $15,000, whichever is greater, must include a statement in its return fully explaining the reasons for accumulating the earnings or profits. The Treasury, if it has in its possession such a statement, is in a better position to check from year to year the nature of the accumulations and the intention of the stockholders and the corporation.

(4) The 3-year statute of limitations on assessment and suit for the collection of income taxes is increased to 4 years for the assessment and collection of the amount of the tax under this section. * * * This provision is particularly important, not only in its obvious effect of permitting a longer time for ascertaining liability for this tax, but also because of its force when taken in connection with the requirement of a statement of reasons for accumulation. The longer period permits a more thorough check on the bona-fide nature of the reasons assigned for accumulation.

(5) The bill as reported substitutes for the word "gains" the word "earnings" wherever "gains" is used in the section in connection with the word "profits." The phrase describes the fund out of which taxable dividends are paid. The substitution makes no change in existing law but more accurately describes such fund and uses the same expression as is employed in section 115 and elsewhere in the act.

(6) To avoid confusion between the description of the measure of the tax for the purposes of this section and the tax in section 14 and section 351, the bill as reported * * * uses the term "special adjusted net income." This term is defined as net income less the sum of (*a*) that part of the Federal income, war-profits, and excess-profits taxes (except taxes imposed under this section and similar sections of prior revenue acts) paid or accrued during the taxable year which is not allowed as a deduction from gross income under section 23; (*b*) charitable contributions disallowed under section 23 (o) because in excess of the

[86] Ibid., p. 10.

limitations provided in that subsection; and (c) capital losses disallowed under section 117 (d). In the case of a holding company affiliate (within the meaning of sec. 2 of the Banking Act of 1933), "special adjusted net income" means net income less the amount allowed because of compliance with that act as a credit under section 26 (d) in addition to the deductions enumerated in (a), (b), and (c) above.

(7) The term "retained net income" is defined as "special adjusted net income" reduced by the sum of the credit for dividends paid, allowed under section 27, and the credit allowed under section 26 (c), relating to contracts not to pay dividends.

(8) The House bill provided that the surtax under the section shall not apply if all the shareholders take up their pro rata shares of the retained net income on their returns. The bill as reported adds the further limitation that the tax will apply unless 90 percent of the retained net income is included in the returns of shareholders other than corporations—i. e., taxpayers subject to normal and surtax on individuals.[87]

Further:

Holding company affiliates of banks, which under the provisions of law contained in the Banking Act of 1933, are required to invest a part of their funds in readily marketable assets other than bank stocks, are given relief from the surtax on undistributed profits and the tax imposed under section 102 on improper accumulation of surplus with respect to amounts devoted by them to the acquisition of such assets. (Sec. 14 (a) (1) (C) and section 102 (c) (1) (B).)[88]

House discussion on the report of the conference committee:

Mr. DOUGHTON. Section 102 dealing with the surtax on corporations improperly accumulating surplus is restored to the bill in a similar form as found in existing law with certain changes which make it more consistent with the new scheme of taxation.[89]

REVENUE ACT OF 1937

The content of the Revenue Act of 1937 was a product of the joint concern of the President, the Treasury, and the Congress over the widespread and successful efforts of tax avoidance and evasion then occurring, and contained preventative legislation to this end. In response to the message of the President (dated June 1, 1937),[90] Congress, by joint resolution, promptly provided for the creation of a Joint Committee on Tax Evasion and Avoidance.[91]

Concerning personal holding companies the Committee declared that:

The problem of the personal holding company has been one requiring the continued attention of the Congress beginning with the Revenue Act of 1913. All of the earlier revenue acts as well as the existing law contain provisions imposing additional taxes upon corporations organized or availed of for the purpose of preventing the imposition of the surtax upon the shareholders thereof. These provisions have proved difficult of enforcement due to the fact that it is necessary to prove a purpose to avoid the imposition of the surtax upon the shareholders.[92]

Further:

The testimony taken by the committee has shown that foreign personal holding companies are being utilized by citizens and residents of the United States

[87] 74th Cong., 2d sess., S. Rept. 2156, pp. 16–18. The Senate Finance Committee believed that sec. 102 with the above changes "will produce directly or indirectly $40,000,000 of additional revenue annually."
[88] Ibid., p. 14.
[89] Congressional Record, vol. 80, p. 10270.
[90] See Presidential message, Joint Committee on Tax Evasion and Avoidance, Tax Evasion and Avoidance, letter and report, 75th Cong., 1st sess., H. Doc. 337 (Washington, D. C.: Government Printing Office, 1937), pp. 1–6.
[91] The committee submitted a report to the Congress on August 5, 1937.
[92] Joint Committee on Tax Evasion and Avoidance, op. cit., p. 7.

as a device for tax-avoidance purposes. Income which otherwise would be subjected to the Federal income taxes is being diverted to, and accumulated by, such companies in order that the American shareholders may escape being taxed thereon. Because of the jurisdictional difficulties and the difficulties of collection of taxes involved in reaching these foreign entities, they present a distinct problem. While the provisions of sections 351 and 102 of the present law, which impose surtaxes on the undistributed profits of corporations, by their terms apply to foreign as well as to domestic corporations, it appears necessary for the protection of the revenue that a separate method of taxation be provided for with respect to certain types of foreign personal holding companies.

* * * * * * *

The committee's recommendation in general is that the undistributed part of a foreign personal holding company's net income should be included in the gross income of the American citizen or resident just as if such undistributed income had actually been distributed. Provision has been made so that such income would not be again subject to tax when actually distributed.[93]

Congress followed the recommendation of the committee and created a separate tax classification of foreign personal holding companies, with a special method of taxation applicable thereto. Foreign personal holding companies were excluded from coverage under section 102. Section 102 was amended by the Revenue Act of 1937 as follows:

(a) Section 102 (a) of the Revenue Act of 1936 is amended by striking out "(other than a personal holding company as defined in section 351)" and inserting in lieu thereof "(except as provided in subsection (f))".

(b) Such section 102 is further amended by adding at the end thereof a new subsection to read as follows:

"(f) CORPORATIONS EXCEPTED.—This section shall not apply to any corporation—

"(1) With respect to a taxable year beginning after December 31, 1936, if the corporation is with respect to such year a personal holding company as defined in section 352.

"(2) With respect to a taxable year beginning before January 1, 1937, if the corporation is with respect to such year a personal holding company as defined in section 351 (b) (1) before the amendment of Title IA by section 1 of the Revenue Act of 1937.

"(3) With respect to a taxable year ending after the date of the enactment of the Revenue Act of 1937, if the corporation is with respect to such year a foreign personal holding company as defined in section 331."[94]

The Ways and Means Committee of the House, in its report on the above amendment to section 102, said:

This section adds to section 102 of the present law, which imposes a surtax on corporations improperly accumulating surplus, a new subsection which excludes certain domestic and foreign corporations from the operation of that section. The present law and the amendments proposed have as a basic principle that a corporation is not improperly accumulating surplus if the amount accumulated is subject to substantially the same taxes as if it were distributed. Under the present law corporations subject to title 1A of the present law are excluded from section 102. Section 601 carries out a corresponding policy with respect to a corporation subject to new title 1A and a foreign corporation whose United States shareholders are obliged to include its undistributed income in their return. The effect of the amendment is to exclude from section 102 domestic and foreign personal holding companies for taxable years for which they are subject to title 1A before or after its amendment by the bill or to the provisions of supplement P added by the bill.[95]

[93] Ibid., pp. 16–17.
[94] 50 U. S. Stat. L. 830–831.
[95] 75th Cong., 1st sess., H. Rept. 1546, pp. 31–32

REVENUE ACT OF 1938

A major factor which contributed largely to the ineffectiveness of section 102 was the necessity of proving intent or purpose to avoid the personal tax through corporate surplus accumulations. This the Treasury had found most difficult to do. The insertion of subsection (c) in the 1938 Revenue Act was an endeavor to strengthen the enforceability of section 102 by making unreasonable corporate accumulation evidence determinative of the purpose to avoid the personal tax, and placing on the taxpayer the burden of proving by the clear preponderance of the evidence that the purpose of avoidance was not present.

Other changes made in section 102 by the Revenue Act of 1938 were the elimination of the lower rates of tax for corporations subject to the undistributed profits surtax, and the provision permitting exemption from the penalty tax if shareholders included in their gross income their pro rata shares of the retained net income of the corporation. The striking of this latter provision was because the 1938 act permitted the deduction of "consent dividends" as defined in section 28 in the computation of income subject to penalty tax.

In the House bill, under title 1B, an attempt was made to deal with the problem of closely held operating companies used for personal tax avoidance which were not covered by the surtax on personal holding companies nor reached effectively under section 102. This was known as the "third-basket" provision.[96] The House did not approve this proposal, and the Senate Finance Committee believed this class of corporations could more properly be handled under a strengthened section 102.[97]

Section 102 of the Revenue Act of 1938 was as follows (52 U. S. Stat. L. 483):

(a) IMPOSITION OF TAX.—There shall be levied, collected, and paid for each taxable year (in addition to other taxes imposed by this title) upon the net income of every corporation (other than a personal holding company as defined in Title 1A or a foreign personal holding company as defined in supplement P) if such corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting earnings or profits to accumulate instead of being divided or distributed, a surtax equal to the sum of the following:

25 per centum of the amount of the undistributed section 102 net income not in excess of $100,000, plus

35 per centum of the amount of the undistributed section 102 net income in excess of $100,000.

(b) PRIMA FACIE EVIDENCE.—The fact that any corporation is a mere holding or investment company shall be prima facie evidence of a purpose to avoid surtax upon shareholders.

(c) EVIDENCE DETERMINATIVE OF PURPOSE.—The fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid surtax upon shareholders unless the corporation by the clear preponderance of the evidence shall prove to the contrary.

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[96] The Ways and Means Committee of the House provided for a new surtax applicable only to closely held companies which were not included in the personal holding company class. Reprinted in Treasury Department, Internal Revenue Bulletin, op. cit., 766–70.

[97] See Senate Finance Committee, 75th Cong., 3d sess., S. Rept. 1567, pp. 4–5.

(d) DEFINITIONS.—As used in this title—

(1) SECTION 102 NET INCOME.—The term "section 102 net income" means the net income minus the sum of—

(A) *Taxes.*—Federal income, war-profits, and excess-profits taxes paid or accrued during the taxable year, to the extent not allowed as a deduction by section 23, but not including the tax imposed by this section or a corresponding section of a prior income-tax law.

(B) *Disallowed charitable, etc., contributions.*—Contributions or gifts payment of which is made within the taxable year, not otherwise allowed as a deduction, to or for the use of donees described in section 23 (o), for the purposes therein specified.

(C) *Disallowed losses.*—Losses from sales or exchanges of capital assets which are disallowed as a deduction by section 117 (d).

(2) UNDISTRIBUTED SECTION 102 NET INCOME.—The term "undistributed section 102 net income" means the section 102 net income minus the basic surtax credit provided in section 27 (b), but the computation of such credit under section 27 (b) (1) shall be made without its reduction by the amount of the credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations.

(e) TAX ON PERSONAL HOLDING COMPANIES.—For surtax on personal holding companies, see Title 1A.

The report of the Ways and Means Subcommittee of the House contained the following discussion of the problem of proving purpose or intent in applying section 102, which had made the section difficult to enforce:

The provisions of section 102 of the Revenue Act of 1936 and corresponding provisions of prior revenue acts have proved very troublesome to enforce. The barrier to effective enforcement has been found to lie chiefly in the difficulty of proving the intent to avoid surtaxes. Little aid has been rendered such proof by the prima facie presumption of intent arising from the fact that the corporation is a mere holding company or has accumulated surplus beyond the reasonable needs of the business. A workable evidentiary test of unreasonable accumulations has not yet been found.

This may be illustrated by the case of *National Grocery Company* v. *Helvering*, decided by the Third Circuit Court of Appeals October 21, 1937. In that case a mercantile corporation had a surplus of more than $8,000,000 and current earnings of $780,000 on January 31, 1931, at the end of its taxable year. The only dividends which it had ever paid were a dividend of $25,000 in 1917 and a dividend of like amount in 1918. Its liabilities were less than $1,000,000, and its accounts payable were never more than $400,000. Inventories, on the other hand, never exceeded $3,200,000. When the sole stockholder required funds for his personal needs he habitually procured them from the corporation without interest. He had borrowed a total of $610,000 from the corporation including $140,000 during the taxable year. The president and sole stockholder of the corporation testified to the effect that the corporation and its officers and stockholder were innocent of any purpose or intent to avoid surtax upon the stockholder. On the foregoing facts the court held that there was no evidence to support the findings of the Board of Tax Appeals which had held that the taxpayer was liable to tax under section 102.

In the case of *Cecil B. DeMille Productions, Inc.* (C. C. A. 9th, 90 Fed. (2d) (12)), the facts and circumstances were very similar. In addition to showing the existence of a large accumulated surplus, the facts indicated that the petitioner was what has frequently been described as an incorporated pocketbook. The corporation was also used to receive the earnings of its principal stockholder. The taxpayer, however, prevailed in its contention that the accumulation was for the purpose of enabling it to engage in the production of motion pictures at some indefinite time in the future.

The difficulties involved in the enforcement of section 102 have long been realized by the Congress. In the Revenue Act of 1934 the problem of individual surtax avoidance through accumulations of corporate surpluses was partially solved by the enactment of section 351 (Title 1A), which imposed a special surtax on personal holding companies in lieu of the surtax provided in section 102. The surtax on personal holding companies has since been retained in principle, its provisions having been strengthened and its rates increased by the Revenue Act of 1937.

Under Title 1A, the difficulties of section 102 are avoided because liability is made automatic upon corporations which come within specified objective standards relating to percentage of investment and similar income received, and to limited stock ownership. No proof of intent to avoid surtax is necessary. The subcommittee believes that Title 1A has worked well and efficiently in those cases to which it is applicable.

The tax in Title 1A was imposed with respect to corporations having limited stock ownership and deriving their income primarily from investment sources because it had been found that such corporations were being used to accumulate surpluses and thus avoid individual surtaxes.

The corporations subject to title 1A, however, constitute a very limited class. It is the view of the subcommittee that there are other corporations which are used in a similar manner to avoid the imposition of individual surtaxes. It is believed that operating companies with closely held stock ownership and net incomes of substantial size which retain a considerable portion of their incomes are commonly used to avoid individual surtaxes. The control of corporate policy by a few individuals which exists in such cases makes it easy for corporate income to be accumulated rather than distributed. The fact that large sums are involved to which high surtaxes would be applicable in the hands of the stockholders makes such accumulation desirable.[98]

The Ways and Means Committee in its report stated:

It also provides in paragraph (h) thereof that if any corporation is a mere holding or investment company, or that the earnings or profits are permitted to accumulate beyond reasonable needs of the business shall be prima facie evidence of a purpose to avoid surtax upon shareholders.

Under this section it is necessary to prove "purpose" in connection with retaining beyond reasonable needs to avoid the payment of surtaxes.

This section is directly aimed at the corporation that is guilty of the violation of its provisions: it is not aimed at the innocent corporation. Section 102 is a direct approach to the solution of the problem that confronts the committee in obtaining the objective that the majority of the committee contends that title 1-B will accomplish.

It is the opinion of the undersigned that the method of dealing with this problem should be approached by the strengthening of said section 102. We propose an amendment to paragraph (b) of said section 102, which would remove the necessity of proving "purpose to avoid surtax upon shareholders." Such an amendment would accomplish the objective which title 1-B proposes to obtain.[99]

Also:

Under the bill the tax is imposed upon "undistributed section 102 net income," instead of upon the "retained net income" specified in the Revenue Act of 1936. "Undistributed section 102 net income" is computed by deducting from "section 102 net income" the basic surtax credit provided in section 27 (b) rather than the entire dividends-paid credit set forth in section 27 (a). This results in denying the benefits of the dividend carry-over to corporations subject to the section 102 surtax. Distribution of unnecessary surpluses in a year should not permit the corporation to make unreasonable accumulations in a subsequent year. Such corporations, however, are given the benefit of the net operating loss carry-over provided in section 26 (c), since that credit enters into the computation of the basic surtax credit.[100]

The report of the Senate Finance Committee:

It has long been recognized that much tax avoidance occurs through the unreasonable accumulation of corporate earnings and profits. As far as personal holding companies, or "incorporated pocketbooks," are concerned, this has been taken care of since 1934 by a special surtax on personal holding companies which retain such earnings. However, this evil still exists to a considerable extent in the case of operating companies. In the House bill, as originally reported, an attempt to cure this evil was made in title 1B, aimed at closely held operating companies. The House failed to approve of this drastic remedy.

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[98] Proposed Revision of the Revenue Laws, 1938, 75th Cong., 3d sess., in Revision of Revenue Laws 1938, Hearings before the Committee on Ways and Means * * * (Washington, D. C.: Governnrent Printing Office, 1938), pp 28–30.

[99] 75th Cong., 3d sess., H. Rept. 1860, p. 72.

[100] Ibid., p. 31.

Your committee is dealing with this problem where it should be dealt with—namely, in section 102, relating to corporations improperly accumulating surplus. The proposal is to strengthen this section by requiring the taxpayer by a clear preponderance of the evidence to prove the absence of any purpose to avoid surtaxes upon shareholders after it has been determined that the earnings and profits have been unreasonably accumulated. This will clearly shift the burden of proof to the taxpayer in such cases. The committee believes that substantial revenue will result from this change although no exact estimate of such revenue has been made by the Treasury Department. A reasonable enforcement of this revised section will reduce tax avoidance to a minimum and increase the revenues from sources where there is ability to pay.[101]

Further:

This subsection of the bill provides that the fact that the earnings or profits are accumulated beyond the reasonable needs of the business shall be determinative of the purpose to avoid surtax upon shareholders unless the corporation by the clear preponderance of the evidence shall prove to the contrary. Under existing law, an unreasonable accumulation is merely prima facie evidence of purpose to avoid surtax upon shareholders. Consequently, it has been argued that the only effect of an unreasonable accumulation is to shift to the taxpayer the burden of going forward with the evidence relating to purpose. Under the amendment, however, it is clear that an unreasonable accumulation puts upon the taxpayer the burden of proving by the clear preponderance of all the evidence submitted that it did not have the purpose of avoidance.[102]

The conference committee report:

This amendment provides with respect to section 102 that the fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid surtax upon shareholders unless the corporation by the clear preponderance of the evidence proves to the contrary. The House recedes.[103]

House discussion:

Mr. BUCK. What does the gentleman think of the decision of the third circuit court in the National Grocery case?

Mr. HARLAN. I think it is crazy.

Mr. BUCK. If it is crazy, and I agree with the gentleman, is it not the duty of Congress to adopt some kind of a yardstick by which we can measure this thing?

Mr. HARLAN. We could do that, Mr. Chairman, by inserting in paragraph B, after the phrase "reasonable needs of business," these words, "for current operating expenses, plus contractual obligations."

* * * * * * *

It is because of the fact that the phrase "reasonable needs of business" was too indefinitely defined that the Government lost both the DeMille case and the National Grocery case. In both cases these defendants set up projected plans for expansion which were wholly independent of contract and highly speculative. If this phrase had been properly defined the Government would have won both these cases.[104]

Senate discussion:

Mr. HARRISON. Many persons believe that there ought to be a strengthening of the law with reference to corporations which have built up and accumulated their profits in large surpluses. We strengthened section 102. Section 102 imposes a high penalty tax upon such corporations, whether they are holding or operating companies or what not, if they build up unreasonable reserves for the purpose of relieving the shareholder from the necessity of paying his surtax. We have changed the rule in such cases. We have strengthened the law, and we have said that when an unreasonable accumulation is shown, that fact is determinative, and the burden of proof is placed upon the taxpayer to show by a clear preponderance of the evidence that he was not trying to avoid the surtax. We think that provision in itself will force many corporations which have accumu-

[101] 75th Cong., 3d sess., S. Rept. 1567, pp. 4–5.
[102] Ibid., p. 16.
[103] 75th Cong., 3d sess., H. Rept. 2330, p. 37.
[104] Congressional Record, vol. 83, p. 2940.

lated vast reserves to stop their former practices, and to begin to distribute the profits.[105]

Further:

Mr. HARRISON. As the Senator will recall, we went the limit in amending section 102 so as to force distribution where there was a large accumulation of profits, and even went to the extent of putting the burden on the taxpayer to prove, by a clear preponderance of the evidence, that there was no unreasonable accumulation.

Mr. BARKLEY. Is it the Senator's view that to that extent the principle involved in the undistributed-profits tax is retained in the bill?

Mr. HARRISON. It is retained in section 102 in as strong language as the experts could write and the committee could fashion.[106]

REVENUE ACT OF 1939

Section 102, following the Revenue Act of 1938, has, on the whole, been subject to relatively minor changes only to the present time. The Internal Revenue Code—the codification of the relevant sections of antecedent revenue acts—was enacted by the Congress in 1939.[107]

The Revenue Act of 1939 amended section 102 by providing that section 102 net income (for taxable years subsequent to December 31, 1939) was to be computed without the net operating loss deduction provided in section 23 (s). The amendment was as follows:

(f) DENIAL OF DEDUCTION TO SECTION 102 CORPORATIONS.—Section 102 (d) (1) of the Internal Revenue Code (relating to the definition of section 102 net income) is amended by striking out "The term 'section 102 net income' means the net income minus the sum of" and inserting in lieu thereof "The term 'section 102 net income' means the net income, computed without the net operating loss deduction provided in section 23 (s), minus the sum of."[108]

REVENUE ACT OF 1940

Section 201 of the Revenue Act of 1940 provided for the insertion into the Internal Revenue Code of section 15 which imposed an additional tax (defense tax) of 10 percent to the existing rates of income tax, including the tax under section 102. The defense tax applied subsequent to December 31, 1939. The defense tax amendment to the code:

SEC. 15. DEFENSE TAX FOR FIVE YEARS.

In the case of any taxpayer, the amount of tax under this chapter for any taxable year beginning after December 31, 1939, and before January 1, 1945, shall be 10 per centum greater than the amount of tax computed without regard to this section. In no case shall the effect of this section be to increase the tax computed without regard to this section by more than 10 per centum of the amount by which the net income exceeds such tax. For the purposes of this section, the tax computed without regard to this section shall be such tax before the application of the credit provided in section 31 ("foreign tax credit"), and the credit provided in section 32 (taxes withheld at the source).[109]

REVENUE ACT OF 1941

Section 104 (a) of the Revenue Act of 1941 repealed section 15 (defense tax) of the Internal Revenue Code, and in section 103 (d) provision was made for translating the defense tax into permanently

[105] Congressional Record, vol. 83, pp. 4928–4929.
[106] Ibid., p. 4967. See J. S. Seidman, op. cit., pp. 46–47, for congressional discussion.
[107] 53 U. S. Stat. L. 1–504, first part.
[108] 53 U. S. Stat. L. 868.
[109] 54 U. S. Stat. L. 520.

higher rates of tax for section 102. Section 103 (d) of the Revenue Act of 1941 was as follows:

SURTAX ON CORPORATIONS IMPROPERLY ACCUMULATING SURPLUS.—The rate schedule of section 102 of the Internal Revenue Code is amended to read as follows:

"27½ per centum of the amount of the undistributed section 102 net income not in excess of $100,000, plus

"38½ per centum of the undistributed section 102 net income in excess of $100,000." [110]

Section 202 (b) of the Revenue Act of 1941 further amended section 102 by providing:

AMENDMENT OF SECTION 102 (d).—Section 102 (d) (1) (A) of the Internal Revenue Code (relating to the deduction of taxes in computing section 102 net income) is amended to read as follows:

"(A) TAXES.—Federal income, war-profits, and excess-profits taxes (other than the tax imposed by Subchapter E of Chapter 2 for a taxable year beginning after December 31, 1940) paid or accrued during the taxable year, to the extent not allowed as a deduction by section 23, but not including the tax imposed by this section or a corresponding section of a prior income-tax law." [111]

This amendment was applicable to taxable years following December 31, 1940.[112]

The Ways and Means Committee of the House, in regard to the formal increase in rates for section 102, said:

This section makes permanent the defense tax imposed by section 15 of the Internal Revenue Code as added by section 201 of the Revenue Act of 1940.[113]

As to the latter amendment (with reference to the excess profits tax) the Ways and Means Committee stated:

In the case of corporations subject to tax under section 102 of the Code, the credit provided in section 26 (e) is also allowed by an amendment to section 102 (d) (1).[114]

REVENUE ACT OF 1942

The Revenue Act of 1942 amended the Internal Revenue Code to provide that section 102 corporations should be denied the advantage of the capital loss carry-over (section 138); that income subject to the excess profits tax was an additional credit in the computation of section 102 net income (sec. 105 (e) (2)); and that income need not be placed on an annual basis for corporations subject to section 102 (sec. 135 (b) (1)).

The amendment providing for denial of capital loss carry-over:

That part of section 102 (d) (1) (relating to definition of section 102 net income) which precedes subparagraph (A) is amended to read as follows:

"(1) SECTION 102 NET INCOME.—The term 'section 102 net income' means the net income, computed without the benefit of the capital loss carry-over provided in section 117 (e) from a taxable year which begins after December 31, 1940, and computed without the net operating loss deduction provided in section 23 (s), minus the sum of * * *." [115]

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[110] 55 U. S. Stat. L. 693.
[111] Ibid., p. 700.
[112] Sec. 205, Revenue Act of 1941, 55 U. S. Stat. L. 703.
[113] 77th Cong., 1st sess., H. Rept. 1040, p. 36.
[114] 77th Cong., 2d sess., H. Rept. 2333, p. 65.
[115] 56 U. S. Stat. L. 836.

The amendment establishing an additional credit against section 102 net income of income subject to the excess-profits tax:

COMPUTATION OF SECTION 102 NET INCOME.—Section 102 (d) (1) (relating to the definition of section 102 net income) is amended by inserting at the end thereof the following new subparagraph:

"(D) INCOME SUBJECT TO EXCESS-PROFITS TAX.—The credit for income subject to the tax imposed by Subchapter E of Chapter 2 provided in section 26 (e)." [116]

The amendment providing for nonannualization of income for purposes of section 102 surtax:

SURTAX ON CORPORATIONS IMPROPERLY ACCUMULATING SURPLUS.—Section 102 is amended by inserting at the end thereof the following new subsection:

"(f) INCOME NOT PLACED ON ANNUAL BASIS.—Section 47 (c) shall not apply in the computation of the tax imposed by this section." [117]

REVENUE ACT OF 1945

The Revenue Act of 1945 provided in section 122 (g) (5) a technical amendment (effective for taxable years subsequent to December 31, 1945) to section 102 (d) (1) of the Internal Revenue Code as follows:

Section 102 (d) (1) (defining terms for the purposes of the tax imposed by section 102) is amended by striking out subparagraph (D) thereof.[118]

The purpose of this amendment was to strike out the credit for income subject to the excess-profits tax under section 102. The repeal of the excess-profits tax by the Revenue Act of 1945 necessitated this technical amendment to the code.

REVENUE ACT OF 1951

Section 315 of the RevenueAct of 1951 amended section 102 of the Internal Revenue Code by providing—

(a) LONG-TERM CAPITAL GAINS.—Section 102 (d) (1) (relating to definition of section 102 net income) is hereby amended by adding at the end thereof the following new subparagraph:

"(D) LONG-TERM CAPITAL GAINS.—The excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year, minus the taxes imposed by this chapter attributable to such excess. The taxes attributable to such excess shall be an amount equal to the difference between (i) the taxes imposed by this chapter (except the tax imposed by this section) for such year and (ii) such taxes computed for such year without including such excess in net income."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall be applicable only with respect to taxable years beginning after December 31, 1950.

This amendment was proposed by the Senate Finance Committee and was agreed to by the House and Senate conferees.[119] In explanation of the amendment, the Senate Finance Committee said:

Section 102 of the code imposes an additional tax on corporations improperly accumulating surplus to avoid payment of surtax by stockholders. This additional tax is imposed on the undistributed "section 102 net income," which is, in general, net income minus the normal tax, surtax, and excess profits tax of

[116] Ibid., p. 807.
[117] Ibid., p. 835.
[118] 59 U. S. Stat. L. 570.
[119] Staff of the Joint Committee on Internal Revenue Taxation, Summary of the Provisions of the Revenue Act of 1951 (H. R. 4473) as agreed to by the conferees (Washington, D. C.: Government Printing Office, 1951), pp. 27–28.

the corporation. Under present law, the section 102 tax applies to the long-term capital gains of the corporation as well as to its ordinary income. Your committee is of the opinion, however, that the problem of avoidance of surtax by stockholders does not arise in the case of net long-term capital gains, since these gains would have been taxed at a maximum rate of 25 percent if they had been realized by the stockholder directly. Furthermore, with present high replacement costs, corporate capital gains must be reinvested in order to keep the corporation's business activities at their current level. Therefore, section 315 of your committee's bill amends section 102 in order to exclude net long term capital gains from the undistributed income subject to the section 102 tax. However, this amendment further provides that the capital gain tax is not to be allowed as a deduction in computing income subject to the section 102 tax.

This provision is effective with respect to taxable years beginning after December 31, 1950.

The revenue loss from this amendment is expected to be negligible.[120]

A Recent Congressional Effort To Amend Section 102

Congressman McMahon, January 14, 1947, introduced a bill which provided for the exemption from tax of the first $100,000 of undistributed section 102 net income. The bill was designed to afford tax relief for the smaller corporations. The bill died in committee.

A BILL To amend Section 102 of the Internal Revenue Code

"Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That Section 102 (a) of the Internal Revenue Code (relating to surtax on corporations improperly accumulating surplus) is amended by striking out that part thereof which reads:

"27½ per centum of the amount of undistributed Section 102 net income not in excess of $100,000 plus

"38½ per centum of the undistributed Section 102 net income in excess of $100,000.

and by inserting in lieu thereof the following:

"27½ per centum of the amount of the undistributed Section 102 net income in excess of $100,000 and not in excess of $200,000 plus

"38½ per centum of the undistributed Section 102 net income in excess of $200,000.

"Section 2. The amendment made by this Act shall be applicable to taxable years beginning after December 31, 1946." [121]

Reports of the Special Tax Study Committee

A Special Tax Study Committee (Magill committee) was appointed [122] by the Committee on Ways and Means to assist in the general revision of the Internal Revenue Code. This committee held its initial meeting in June 1947 and, subsequently, concerned itself largely with the more important structural improvements in the tax system. On November 4, 1947, the committee submitted majority and minority reports. As a citizens' advisory committee to the Committee on Ways and Means, the committee's recommendations are of significance.

The majority report of the committee discussed section 102 at some length, saying:

There have been some recent evidences of renewed activity by the Bureau in scrutinizing corporation returns and questioning the purposes back of the decision of the directors to retain corporate earnings instead of distributing them in dividends. For the past year, corporations have been required to file an ex-

[120] 82d Cong., 1st sess., S. Rept. 781, p. 61.
[121] 80th Cong., 1st sess., H. R. 961.
[122] Pursuant to H. Res. 293 and H. Res. 297.

planation on their income-tax returns if they failed to distribute 70 percent of their earnings.

Many situations arise, especially in the cases of smaller enterprises, which require the retention of earnings for perfectly legitimate corporate purposes. Plant expansion and improvement, the development of additional products, and provision for the retirement of outstanding debt are obvious cases for which directors will wish to provide. The financing of additional inventory and of accounts receivable, the development costs of new products, and the maintenance of needed reserves for various purposes are other common needs.

So long as the general threat of the section 102 penalty hangs over directors' heads, they are likely to seek to avoid trouble by distributing more earnings than they honestly believe to be desirable. Yet it is clear that the best interests of the enterprise will not be served by such a policy. With individual surtaxes at their present heights, the natural sources of new venture capital—namely, individual stockholders—are largely dried up. If the corporation is to grow and advance, it must be permitted to reinvest substantial amounts of its own earnings in its own business. Small American businesses have grown great in just this fashion.

The corporate directors are the best judges of the company's needs. A revenue agent in the field cannot be the best judge, for he does not have the intimate familiarity with the corporation's business that its own directors have. Consequently, this is a case where the Commissioner (and the revenue agent under him) should have the burden of showing that the decision of the directors is unreasonable and incorrect. A stockholder who seeks to compel the declaration of dividends must assume the burden of showing that the corporate earnings have been improperly retained. The Commissioner should occupy a similar position.

To revise the revenue law in this way will not cause widespread evasion by personal holding corporations or other closely held companies. Personal holding corporations are rigidly taxed under other provisions of the law. The income of any business corporation is subject to the general tax; and under our recommendation, the Commissioner can exact the penalty tax, if he can show that earnings have been improperly withheld to avoid or defeat the individual surtaxes. The penalty ought not to be imposed unless such facts can be shown.

We, therefore, recommend that:

(1) The Commissioner should have the burden of proving that profits have been unreasonably accumulated.

(2) The tax should apply only to that part of the undistributed section 102 net income which is unreasonably accumulated.

(3) Dividends paid within 75 days after the close of its taxable year may at the taxpayer's election, be deducted in computing section 102 net income for such year.[123]

The minority report by Matthew Woll on section 102 differed sharply from the majority report, as is indicated by the following language:

Stockholders would easily escape surtax if corporations were completely free to accumulate their earnings or profits without making periodic distributions. Therefore, section 102 and predecessor provisions have since 1921 placed a penalty tax on corporations used to avoid the surtax on its shareholders by permitting their earnings or profits to accumulate. Under section 102 it is presumed, unless the corporation proves otherwise by the clear preponderance of the evidence, that an accumulation beyond the reasonable needs of the business was motivated by a purpose to avoid the surtax. The rate of tax is 27½ percent of the first $100,000 of undistributed section 102 net income, and 38½ percent of any excess.

The majority state that section 102, as written and administered, harasses the legitimate retention of profits for purely business purposes, such as debt retirement and contemplated expansion. They argue that the directors of a

[123] Special Tax Study Committee to the Committee on Ways and Means, U. S. House of Representatives, November 4, 1947, Revenue Revisions, 1947–48. Hearings before the Committee on Ways and Means, House of Representatives, 80th Cong., 1st sess., pt. 5, pp. 3624–3625.

corporation are the best judges of its needs, since they alone are intimately familiar with its affairs. Therefore, they recommend two basic changes:

1. The Commissioner should have the burden of proving an unreasonable accumulation of profits.
2. The tax should apply only to that portion of the undistributed section 102 net income which was unreasonably accumulated.

Admittedly the administration of section 102 involves difficulties, but the majority would wish us gladly to accept a cure which is worse than the disease. Section 102 is a protective statute, intended to safeguard the revenues. While it may be difficult at times to ascertain the permissible limits of corporate accumulations, it by no means follows that the Commissioner should have the burden of establishing those limits. If directors are the best judges of a corporation's needs, they are, by the same token, the very persons who should bear the burden of proof. Throughout the administration of the tax laws, with very few exceptions, the taxpayer has the burden of proving the facts. This burden is peculiarly appropriate under section 102, for, as the majority point out, the directors are especially informed as to circumstances which justify the accumulations.

In seeking to confine the penalty tax to the unreasonably accumulated income, the majority again disclose their usual tenderness to avoiders. The rates of 27½ and 38½ percent are pitifully low penalties to prevent the avoidance of far higher surtaxes. It is well known that in many instances directors are quite willing to risk the penalty because it is comfortably less than the avoided personal surtaxes. If the 102 tax is made applicable only to the unreasonable accumulations, the penalty tax should be simultaneouly raised so as to function adequately.[124]

Revenue Revision Bill of 1948

The bill [125] entitled the "Revenue Revision Act of 1948" provided for substantial alteration of section 102. The proposed amendment—section 125 of the bill—passed the House but failed of enactment. Section 125 was as follows:

Sec. 125. Surtax on Corporations Improperly Accumulating Surplus

(a) Reasonable Needs of the Business.—Section 102 (c) (relating to evidence determinative of purpose) is hereby amended to read as follows:

"(c) Accumulation of Surplus.—

"(1) Evidence determinative of purpose.—The fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid surtax upon shareholders unless the corporation by the clear preponderance of the evidence shall prove to the contrary.

"(2) Reasonable needs of the business.—In any case in which the Commissioner proposes to determine a deficiency with respect to the tax imposed by subsection (a) he may, prior to the mailing of a notice of deficiency as provided in section 272 (a), give the taxpayer notice, by registered mail, of an opportunity to file with the Commissioner a statement of the grounds (together with facts sufficient to apprise the Commissioner of the basis thereof) on which the taxpayer relies as establishing that the earnings or profits of the corporation have not been accumulated beyond the reasonable needs of the business. If a statement of such grounds, with such supporting facts, is filed with the Commissioner within such time (not less than thirty days after such notice is mailed) as the Commissioner may prescribe, the burden of proof with respect to the issue as to whether earnings or profits have been permitted to be accumulated beyond the reasonable needs of the taxpayer's business shall be upon the Commissioner if the taxpayer (after the mailing of a notice of deficiency as provided in section 272 (a) files a petition with The Tax Court of the United States, and if the taxpayer in the proceedings before such Court does not rely upon any grounds with respect to such issue other than those presented to the Commissioner in such statement. If the Commissioner mails such notice of deficiency for any taxable year without giving the taxpayer an opportunity to file such a statement, the

[124] Special Tax Study Committee to the Committee on Ways and Means, U. S. House of Representatives, op. cit., p. 3652.
[125] 80th Cong., 2d sess., H. R. 6712.

Commissioner shall have the burden of proof in any proceeding before The Tax Court of the United States with respect to such issue for such year."

(b) LONG-TERM CAPITAL GAINS.—Section 102 (d) (1) (relating to definition of section 102 net income) is hereby amended by adding at the end thereof the following new subparagraph:

"(D) LONG-TERM CAPITAL GAINS.—The excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year, minus the taxes imposed by this chapter attributable to such excess. The taxes attributable to such excess shall be an amount equal to the difference between (i) the taxes imposed by this chapter (except the tax imposed by this section) for such year and (ii) such taxes computed for such year without including such excess in net income."

(c) DIVIDENDS PAID AFTER CLOSE OF YEAR.—Section 102 (d) (2) (relating to definition of undistributed section 102 net income) is hereby amended by adding at the end thereof the following new sentences: "At the election of the taxpayer, the computation of such credit under section 27 (b) for any taxable year shall be made by considering the dividends paid within seventy-five days after the close of such taxable year, to the extent such dividends exceed the dividends paid within the first seventy-five days of such year, as paid within such taxable year; but if such election is made for the taxable year, then such dividends to the extent of such excess shall not, for the purposes of computing the tax imposed by this section for the succeeding taxable year, be considered as paid during such succeeding taxable year. Such election shall be made in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, but may not be made at any time after the filing of any claim for refund, or after the date of the filing of a petition with The Tax Court of the United States, with respect to the tax imposed by this section."

The Ways and Means Committee of the House in its report discussed its reasons for the proposed amendment (sec. 125, H. R. 6712) of section 102:

At the present time, section 102 provides for the imposition of a surtax on corporate earnings accumulated to prevent the imposition of the surtax on individual stockholders. This tax is intended to compensate for the revenue lost because such earnings escape the impact of the graduated individual income tax. Improperly accumulated earnings, if not in excess of $100,000, are taxed at 27.5 percent, and any excess over $100,000 is taxed at 38.5 percent. This tax is in addition to the regular corporate income tax.

Your committee has received many taxpayers' complaints that the administrative officials are too strict in their interpretation of section 102. Reports have been received that the fear of subjecting earnings to this tax has in many cases resulted in distributions of funds needed by the corporation for expansion, protection against possible business decline, or other valid purposes.

On the other hand, administrative officials have presented statistical evidence showing that the penalty tax has been imposed in relatively few cases. These statistical data do not, however, allay the quite evident fear of the business community or prevent the distribution of earnings which are needed in the business.

Your committee's bill (sec. 125) contains three amendments to section 102, designed to reduce the pressure on taxpayers to distribute earnings needed for real business purposes, and to remove some of the harsher aspects of the tax treatment under this provision. These provisions, however, do not prevent the functioning of this tax as a safeguard against the improper accumulation of surplus.

The first amendment places on the Commissioner of Internal Revenue in certain cases the burden of proving that an accumulation of earnings and profits is beyond the reasonable needs of the business. However, to shift the burden of proof in this fashion, the taxpayer, having received notice from the Commissioner, must file a statement indicating the reasons why the needs of the business require such retention. If the taxpayer does not file such a statement, or presents additional grounds, he must bear the entire burden of proof as under existing law. If the Commissioner fails to give the taxpayer proper notice, then the Commissioner must bear the burden of proof even though the taxpayer has filed no statement. This provision is designed to assure the taxpayer that the penalty tax will be imposed only where there is proof of an improper accumulation of surplus.

The second amendment provides that the excess of net long-term capital gains over net short-term capital losses of any corporation shall not be included in the tax base on which the penalty tax under section 102 is imposed. However, this does not prevent such gain from being taken into consideration in determining whether other income was accumulated beyond the reasonable needs of the business.

Your committee believes that the application of the penalty tax under section 102 to long-term capital gains is undesirable. Such income, when realized by a corporation, is taxed at a 25-percent rate. This represents the maximum rate at which it would be taxed if realized directly by an indivdual. Thus the income does not escape its proper tax burden by reason of being realized and accumulated by a corporation rather than by an individual. Moreover, under existing law net long-term capital gains are not subject to the special undistributed net income tax imposed on personal holding companies. It is not believed that ordinary corporations should be subjected to a greater burden.

The third amendment provides that dividends paid within 75 days after the close of a corporation's taxable year may, at the election of the taxpayer, be deducted in computing the corporation's income for the purposes of the penalty tax under section 102. This provision is intended to take care of cases where dividend distributions are customarily made after the close of a taxable year. At present, where an unusually large income is realized in one year but not distributed until the forepart of the next year, a corporation might be subjected to the tax under section 102 even though there was every intention of distributing its current earnings promptly. Your committee believes that a distribution of earnings shortly after the close of a taxable year is unobjectionable, and should not be subject to a penalty tax.[128]

SECTION 102 OF THE INTERNAL REVENUE CODE

The last amendments to be made to section 102, following the Revenue Act of 1945, were (1) the technical amendment of the act of October 25, 1949, section 3 (b) (81st Cong., 1st sess.) to subsection (d) (1) (B), namely, "For the purposes of the preceding sentence, payment of any contribution or gift shall be considered as made within the taxable year if and only if it is considered for the purposes of section 23 (q) as made within such year"; and (2) the exclusion of net long-term capital gains from the base of the tax as provided by section 315 of the Revenue Act of 1951, as previously indicated.

Thus, section 102, as presently found in the code (including the above amendments), is as follows:

SEC. 102. SURTAX ON CORPORATIONS IMPROPERLY ACCUMULATING SURPLUS.

(a) IMPOSITION OF TAX. There shall be levied, collected, and paid for each taxable year (in addition to other taxes imposed by this chapter) upon the net income of every corporation (other than a personal holding company as defined in section 501 or a foreign personal holding company as defined in Supplement P) if such corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting earnings or profits to accumulate instead of being divided or distributed, a surtax equal to the sum of the following:

27½ per centum of the amount of the undistributed section 102 net income not in excess of $100,000, plus

38½ per centum of the undistributed section 102 net income in excess of $100,000.

(b) PRIMA FACIE EVIDENCE.—The fact that any corporation is a mere holding or investment company shall be prima facie evidence of a purpose to avoid surtax upon shareholders.

(c) EVIDENCE DETERMINATIVE OF PURPOSE.—The fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid surtax upon

[128] 80th Cong., 2d sess., H. Rept. 2087, pp. 8–9.

shareholders unless the corporation by the clear preponderance of the evidence shall prove to the contrary.

(d) DEFINITIONS.—As used in this chapter—

(1) SECTION 102 NET INCOME.—The term "section 102 net income" means the net income, computed without the benefit of the capital loss carry-over provided in section 117 (e) [from a taxable year which begins after December 31, 1940], and computed without the net operating loss deduction provided in section 23 (s), minus the sum of—

(A) TAXES.—Federal income, war-profits, and excess profits taxes (other than the tax imposed by subchapter E of Chapter 2 of the Internal Revenue Code of 1939 for a taxable year beginning after December 31, 1940) paid or accrued during the taxable year, to the extent not allowed as a deduction by section 23, but not including the tax imposed by this section or a corresponding section of a prior income tax law.

(B) DISALLOWED CHARITABLE, ETC. CONTRIBUTIONS.—Contributions or gifts payment of which is made within the taxable year, not otherwise allowed as a deduction, to or for the use of donees described in section 23 (o), for the purposes therein specified. For the purposes of the preceding sentence, payment of any contribution or gift shall be considered as made within the taxable year if and only if it is considered for the purposes of section 23 (q) as made within such year.

(C) DISALLOWED LOSSES.—Losses from sales or exchanges of capital assets which are disallowed as a deduction by section 117 (d).

(D) LONG-TERM CAPITAL GAINS.—The excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year, minus the taxes imposed by this chapter attributable to such excess. The taxes attributable to such excess shall be an amount equal to the difference between (i) the taxes imposed by this chapter (except the tax imposed by this section) for such year and (ii) such taxes computed for such year without including such excess in net income.[127]

(2) UNDISTRIBUTED SECTION 102 NET INCOME.—The term "undistributed section 102 net income" means the section 102 net income minus the basic surtax credit provided in section 27 (b), but the computation of such credit under section 27 (b) (1) shall be made without its reduction by the amount of the credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations.

(e) TAX ON PERSONAL HOLDING COMPANIES.—

For surtax on personal holding companies, see section 500.

(f) INCOME NOT PLACED ON ANNUAL BASIS.—Section 47 (c) shall not apply in the computation of the tax imposed by this section.

SECTION 102 AND OFFICIAL TREASURY REGULATIONS

In association with the provisions of the Internal Revenue Code are the official regulations of the Treasury which are interpretive and explanatory of the various sections. Regulations 111 contains the following section which applies to section 102 of the code:

SEC. 29.102–1. TAXATION OF CORPORATIONS FORMED OR UTILIZED FOR AVOIDANCE OF SURTAX.—Section 102 imposes (in addition to other taxes imposed by chapter 1) a graduated income tax or surtax upon any domestic or foreign corporation formed or availed of to avoid the imposition of the individual surtax upon its shareholders or the shareholders of any other corporation through the medium of permitting earnings or profits to accumulate instead of dividing or distributing them. However, personal holding companies, as defined in section 501, and foreign personal holding companies, as defined in Supplement P (see section 331), are excepted from taxation under section 102. The surtax imposed by section 102 applies whether the avoidance was accomplished through the formation or use of only one corporation or a chain of corporations. For example, if the capital stock of the M Corporation is held by the N Corporation so that the dividend distributions of the M Corporation would not be returned as income subject to the individual surtax until distributed in turn by the N Corporation to its

[127] The effective date of subpar. (D) is with respect to taxable years beginning after December 31, 1950 (sec. 315 of the Revenue Act of 1951).

individual shareholders, nevertheless the surtax imposed by section 102 applies to the M Corporation, if that corporation is formed or availed of for the purpose of preventing the imposition of the individual surtax upon the individual shareholders of the N Corporation.

A foreign corporation, whether resident or nonresident, formed or availed of for the purpose specified in section 102 is subject to the tax imposed thereby if it derives income from sources within the United States as defined in section 119 and the regulations thereunder, if any of its shareholders are (1) citizens or residents of the United States and therefore subject to the surtax with respect to distributions of the corporation or (2) nonresident alien individuals who, by the application of section 211 (b) or section 211 (c), would be subject to the surtax with respect to distributions of the corporation which if made would constitute income from sources within the United States (see section 119) or (3) foreign corporations if any beneficial interest therein is owned directly or indirectly by any shareholders specified in (1) or (2). On the other hand, the tax imposed by section 102 will not apply even though a foreign corporation, whether resident or nonresident, derives income from sources within the United States, if all of its shareholders are nonresident alien individuals who, by the application of section 211 (a), would not be subject to surtax with respect to distributions of the corporation if made.

For the computation of the surtax see section 29.102–4.

SEC. 29.102–2. PURPOSE TO AVOID SURTAX; EVIDENCE; BURDEN OF PROOF; DEFINITION OF HOLDING OR INVESTMENT COMPANY.—The Commissioner's determination that a corporation was formed or availed of for the purpose of avoiding the individual surtax is subject to disproof by competent evidence. The existence or nonexistence of the purpose may be indicated by circumstances other than the evidence specified in the Internal Revenue Code, and whether or not such purpose was present depends upon the particular circumstances of each case. In other words, a corporation is subject to taxation under section 102 if it is formed or availed of for the *purpose* of preventing the imposition of surtax upon shareholders through the medium of permitting earnings or profits to accumulate, even though the corporation is not a mere holding or investment company and does not have an unreasonable accumulation of earnings or profits; and on the other hand, the fact that a corporation is such a company or has such an accumulation is not absolutely conclusive against it if, by clear and convincing evidence, the taxpayer satisfies the Commissioner that the corporation was neither formed nor availed of for the purpose of avoiding the individual surtax. All the other circumstances which might be construed as evidence of the purpose to avoid surtax cannot be outlined, but among other things the following will be considered: (1) Dealings between the corporation and its shareholders, such as withdrawals by the shareholders as personal loans or the expenditure of funds by the corporation for the personal benefit of the shareholders, and (2) the investment by the corporation of undistributed earnings in assets having no reasonable connection with the business. The mere fact that the corporation distributed a large portion of its earnings for the year in question does not necessarily prove that earnings were not permitted to accumulate beyond reasonable needs or that the corporation was not formed or availed of to avoid surtax upon shareholders.

If the Commissioner determines that the corporation was formed or availed of for the purpose of avoiding the individual surtax through the medium of permitting earnings or profits to accumulate, and the taxpayer contests such determination of fact by litigation, the burden of proving the determination wrong by a preponderance of evidence, together with the corresponding burden of first going forward with evidence, is on the taxpayer under principles applicable to income tax cases generally, and this is so even though the corporation is not a mere holding or investment company and does not have an unreasonable accumulation of earnings or profits. However, if the corporation *is* a mere holding or investment company, then the Internal Revenue Code gives further weight to the presumption of correctness already arising from the Commissioner's determination by expressly providing an additional presumption of the existence of a purpose to avoid surtax upon shareholders, while if earnings or profits are permitted to accumulate beyond the reasonable needs of the business, then the Code adds still more weight to the Commissioner's determination by providing that irrespective of whether or not the corporation is a mere holding or investment company, the existence of such an accumulation is *determinative* of the purpose to avoid surtax upon shareholders unless the taxpayer

proves the contrary by such a clear preponderance of all the evidence that the absence of such a purpose is unmistakable.

A corporation having practically no activities except holding property, and collecting the income therefrom or investing therein, shall be considered a holding company within the meaning of section 102. If the activities further include, or consist substantially of, buying and selling stocks, securities, real estate, or other investment property (whether upon an outright or a marginal basis) so that the income is derived not only from the investment yield but also from profits upon market fluctuations, the corporation shall be considered an investment company within the meaning of section 102.

SEC. 29.102-3. UNREASONABLE ACCUMULATION OF PROFITS.—An accumulation of earnings or profits (including the undistributed earnings or profits of prior years) is unreasonable if it is not required for the purposes of the business, considering all the circumstances of the case. It is not intended, however, to prevent accumulations of surplus for the reasonable needs of the business if the purpose is not to prevent the imposition of the surtax. No attempt is here made to enumerate all the ways in which earnings or profits of a corporation may be accumulated for the reasonable needs of the business. Undistributed income is properly accumulated if retained for working capital needed by the business; or if invested in additions to plant reasonably required by the business; or if in accordance with contract obligations placed to the credit of a sinking fund for the purpose of retiring bonds issued by the corporation. The nature of the investment of earnings or profits is immaterial if they are not in fact needed in the business. Among other things, the nature of the business, the financial condition of the corporation at the close of the taxable year, and the use of the undistributed earnings or profits will be considered in determining the reasonableness of the accumulations.

The business of a corporation is not merely that which it has previously carried on, but includes in general any line of business which it may undertake. However, a radical change of business when a considerable surplus has been accumulated may afford evidence of a purpose to avoid the surtax. If one corporation owns the stock of another corporation in the same or a related line of business and in effect operates the other corporation, the business of the latter may be considered in substance although not in legal form the business of the first corporation. Earnings or profits of the first corporation put into the second through the purchase of stock or otherwise may, therefore, if a subsidiary relationship is established, constitute employment of the income in its own business. Investment by a corporation of its income in stock and securities of another corporation is not of itself to be regarded as employment of the income in its business. The business of one corporation may not be regarded as including the business of another unless the other corporation is a mere instrumentality of the first; to establish this it is ordinarily essential that the first corporation own all or substantially all of the stock of the second.

The Commissioner, or any collector upon direction from the Commissioner, may require any corporation to furnish a statement of its accumulated earnings and profits, the name and address of, and number of shares held by each of its shareholders, and the amounts that would be payable to each, if the income of the corporation were distributed. (See section 148 (c).)

SEC. 29.102-4. COMPUTATION OF UNDISTRIBUTED SECTION 102 NET INCOME.—In ascertaining the tax basis for corporations subject to the provisions of section 102, the "section 102 net income" is first computed. This is accomplished in the case of a domestic corporation by subtracting from the corporate net income (as defined in sections 21 and 204) computed without the benefit of the capital loss carry-over provided in section 117 (e) from a taxable year beginning after December 31, 1940, and computed without the net operating loss deduction provided in section 23 (s), (*a*) Federal income, war-profits, and excess-profits taxes (other than the tax imposed by subchapter E of chapter 2 for a taxable year beginning after December 31, 1940) paid or accrued during the taxable year, to the extent not allowed as a deduction by section 23 (c), but not including the graduated income tax or surtax imposed by section 102 or corresponding sections of prior Revenue Acts; (*b*) contributions or gifts payment of which is made within the taxable year, not otherwise allowed as a deduction, to or for the use of donees described in section 23 (o) and section 29.23 (o)-1 for the purposes therein specified; (*c*) losses from sales or exchanges of capital assets which are disallowed as a deduction by section 117 (d) for the taxable year. In the case of a foreign corporation, whether resident or nonresident, which files

or causes to be filed a return the "section 102 net income" means the net income from sources within the United States (gross income from sources within the United States, as defined in section 119 and the regulations thereunder, less statutory deductions) minus the amount of the deductions enumerated in (*a*), (*b*), and (*c*) above. In the case of a foreign corporation, whether resident or nonresident, which files no return the "section 102 net income" means the gross income from sources within the United States, as defined in section 119 and the regulations thereunder, without the benefit of the deductions enumerated in (*a*), (*b*), and (*c*) above, or any other deductions. (See section 233.) In the case of a taxable year of less than 12 months on account of a change in the accounting period of the corporation, the corporate net income is computed on the basis of the period included in the taxable year, and is not placed on an annual basis under the provisions of section 47 (c).

The "section 102 net income" includes interest upon obligations of the United States and obligations of a corporation organized under Act of Congress, if such corporation is an instrumentality of the United States, except as provided in section 22 (b) (4). The "section 102 net income" does not include interest on obligations of States or Territories of the United States or any political subdivision thereof or of the District of Columbia or of the possessions of the United States.

The "undistributed section 102 net income" is computed by subtracting from the "section 102 net income" described above, the amount of the basic surtax credit provided in section 27 (b). In computing the basic surtax credit for the purpose of section 102, the credit under section 27 (b) (1) is not to be reduced by the amount of the credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations.

APPENDIX 2

TAX INSTITUTE QUESTIONNAIRE ON SECTION 102

1. If your corporate tax clients increased dividend distributions after 1945, please give an estimate of the percentage of these clients where the fear of 102 was a—

(a) Sole controlling factor_____ %
(b) Major controlling factor_____ %
(c) A contributing factor_____ %
(d) An incidental factor_____ %
(e) An inconsequential factor_____ %
(f) Not considered_____ %

2. If your corporate clients increased dividends because of fear of 102, please indicate the financial effects or business decisions resulting from such increases.

	Check here	
	Frequently	Infrequently
(a) None		
(b) Conversion of assets		
(c) Increased borrowings:		
From stockholders		
From banks or other outside sources		
(d) Curtailment of operations		
(e) Additional stock issues		
(f) Others. List briefly and check		

3. Exclusive of dividend policies, were other actions of your corporate tax clients either stimulated or retarded in some way by 102? Please indicate which.

	Stimulated		Retarded	
	Frequently	Infrequently	Frequently	Infrequently
(a) Expansion or rehabilitation of plant, or acquisition of new machinery				
(b) Development of a wholly new product, never produced before				
(c) Improvement, extension, or embellishment of a previous product				
(d) Acquisition of properties				
(e) Mergers or sales of businesses				
(f) Change from corporate to partnership or sole proprietorship form				
(g) Complete liquidation and discontinuance of business in any form				
(h) Choice of debt financing rather than equity financing				
(i) Resort to outside sources for financing by borrowing or issues of new stock				
(j) Pension and profit sharing plans				
(k) Reduction of debt				
(l) Increase of inventories				
(m) Other actions. State briefly				

4. Check in each group below the class of corporation where management decisions by your tax clients have been influenced in any way by 102.

(a) Kind of business:

Personal service corporation ------
Textiles ------
Glass ------
Publishing ------
Others:

(b) Number of stockholders:

Less than 5 ------
5 to 10 ------
10 to 25 ------
25 to 100 ------
Over 100 ------

(c) Net assets:

Less than $20,000 ------
$20,000 to $50,000 ------
$50,000 to $100,000 ------
$100,000 to $250,000 ------
$250,000 to $500,000 ------
Over $500,000 ------

5. Has section 102 by forcing dividends on the part of any of your corporate clients retarded their venturing of capital investments in—

Check Here and Indicate Number of Clients Affected

(a) A wholly new product—completely novel—never produced before ----------
(b) An improvement—extension—embellishment of a previous product ----------

6. Check your estimate of the average annual number of corporate clients your office has represented in tax matters over the last four years.

(a) Under 50 _____ 50–100 _____ 100–200 _____ over 200 _____
(b) If you have been engaged exclusively by one corporation for the last four years, check here _____

7. What is your estimate of the percentage of your corporate tax clients where the 102 problem was considered by you or your client?

(a) Casually_____ _____%
(b) Carefully_____ _____%
(c) Intensively_____ _____%

Accompanying the questionnaire was the following letter from the president of the Tax Institute:

DEAR_____

I'd like you to do me a personal favor.

The Tax Institute is conducting an extensive research job on the impact of taxes upon productive investment. You'll find it described on the enclosed leaflet.

We need actual, down-to-earth, authentic information on the effect on business of Section 102. I can think of no better source than the practitioner members of the Tax Institute, the participants of our New York University Institute on Federal Taxation, and an N. Y. U. practitioner discussion group. You have had actual experience with the Section. We can get a good picture of the ramifications of 102 if you will spend a few minutes with the enclosed questionnaire.

We have had voluminous writing on 102. What is now sought is some concrete, practical evidence from professionals who handle the problem in their daily activities.

May I invite you to answer this questionnaire. I personally assure you there will be no tie-in of your information with yourself. You don't have to identify yourself at all. We're enclosing a self-addressed stamped envelope. Please let us have your reply by October 31, if possible.

Many thanks. We'll be glad to send you the results of this research.

Very truly yours,

(signed) J. K. LASSER, *President.*

P. S. You might be interested in giving us suggestions, criticisms, reactions, or anything else on Section 102 and the economic effects it produces. We'd be glad to receive them on a separate sheet, anonymous or otherwise.

APPENDIX 3

STATEMENTS OF RESPONDENTS PROPOSING REVISION OF SECTION 102 IN ANSWER TO THE QUESTIONNAIRE OF JOINT COMMITTEE ON THE ECONOMIC REPORT

A corporate president:

It has been my personal opinion that the instances are so rare where avoidance of personal surtax might occur, and the loss of tax revenue would be so comparatively insignificant, that section 102 might well be eliminated, so that corporate directors could accumulate funds for growth and future contingencies without constant fear of tax penalties.

A corporate treasurer:

Best way to avoid personal surtax is to economize in governmental operations. We recommend repeal of section 102 because it is detrimental to expansion programs of small business.

A corporate president:

Section 102 as presently in effect can be used to an almost unlimited degree against a corporation, apparently even in the absence of voting control by any

small group, and places the burden of disproving intent on the corporate taxpayer. It is suggested that a total or partial exemption of dividends from individual income tax would substantially alleviate the conditions which section 102 is designed to reach and permit its elimination or substantial modification.

A corporate vice president:

Small business would not be so concerned with the potential threat in section 102 if the burden of proof of unwarranted accumulation of surplus rested with the tax examiner. As the law stands now, the taxpayer is at a disadvantage in trying to justify his use of good judgment in withholding profits for future capital needs when the examiner views his judgment in retrospect.

A corporate vice president:

Yes, I believe a corporation should be allowed to accumulate surpluses for a period of, say, 5 years. This accumulated surplus could be used for expansion, renovation, the payment of dividends, or used for operations in nonprofitable years. If this surplus was not used at the end of the 5-year period, a surtax patterned after section 102 could be imposed. This method, I believe, would supply capital for expansion for many corporations which now do resort to bank or security financing, also it would insure corporations in lean years.

A corporate treasurer:

Probably better method would be to eliminate double taxation of corporate earnings, so that the same dollar of earnings would not be taxed both to corporation and then taxed again when paid to the stockholders.

A corporate controller:

This section should be changed to place the burden of proof entirely upon the Revenue Department and it should apply only to companies whose directors and management own a majority of the stock.

A corporate treasurer:

If double tax on corporate earnings paid out in dividends were eliminated the problem would be minimized.

A corporate treasurer:

Application of section 102 should be restricted to closely held companies where avoidance of personal surtax can be controlled by the stockholders. When stock ownership is spread the avoidance of personal surtax is not a factor in dividend policies.

A corporate president:

Yes. As I see it, the uncertainty as to whether one would be held to be in violation of section 102 may cause action contrary to the sound operation of a business, especially in a small company. Now if individuals were free from any further tax on dividends from earnings on which the corporation had already paid a tax, there would be no advantage surtaxwise to the individual by an unreasonable retention of earnings. By this method, the uncertain section 102 could be eliminated, as well as, a correction of what appears to be an inequitable double taxation of earnings.

A corporate vice president:

By allowing the amount of dividend distributed to stockholders as a deduction in computing taxes on the income of the corporation.

A corporate treasurer:

By all means. Better the occasional avoidance by one in a high tax bracket than the stifling of legitimate business expansion.

A corporate treasurer:

Yes. Have a maximum tax on United States corporation dividends of 25 percent.

A corporate president:

Section 102 could cause a severe hardship by forcing premature expenditures, and making it impossible for a company to accumulate reserves for future expansion or against possible future depressions. In an effort to penalize the few dishonest operators, the great majority of honest ones may well be forced to act in a manner detrimental to the future soundness of their companies. The law should specify that the burden of proof with regard to section 102 should rest entirely with the Treasury Department.

A corporate president:

We believe attempts at avoidance of personal surtax would be much prevented by adopting a more equitable method of taxing corporate distributions. It is suggested that the tax paid by a corporation on earnings distributed as dividends be allowed to the stockholder against the tax on dividends received which he pays on his individual return.

A corporate secretary:

I believe the act should permit flexibility of company financial policy, so that capital expansions can be financed either from accumulated earnings or from outside borrowing depending upon expediency. Also provision should be made in the case of highly cyclical industries for the accumulation of reasonable reserves. This is the case with our type of business.

A corporate controller:

Funds not employed are important. So long as they are utilized and produce income, corporate tax is collected. If corporations accumulate unwarrantedly, what valid complaint can there be? From a long-range point of view how can time be a real cause for injury to the Treasury? By using [permitting] ordinary business consideration to be influenced by tax considerations, business judgment is warped and serious injury may result.

It is my belief that the threat of the application of section 102 is a serious handicap to the decisions of all privately owned companies. A conservative dividend policy is restricted in publicly owned companies. One result is that given a choice, why engage in new enterprise? The burden of higher corporate taxes plus capital gain taxes with the further risk of being forced to pay out unwarrantedly high dividends, makes an ordinary enterprise unattractive. Actually, the entire corporate taxing program needs a complete overhauling.

A corporate secretary:

We sincerely believe if 102 were repealed it would eventually produce much more revenue than with it. The small companies are the ones that are particularly vulnerable to 102. They are generally undercapitalized and are trying to build themselves up into a strong company. The taxpayer advises with his attorney or accountant regarding 102 and the attorney or accountant, knowing of some terrible example of some other company who has been penalized under 102, finds it advisable to recommend that the corporation pay out dividends when, in many cases, they should be retained to strengthen its financial position. Along comes poor times and bad luck and the corporation folds up. Out of 100 companies probably 20 overpay in dividends and eventually are in trouble on account of 102. Without 102 more small companies would have lived and continued; and eventually would have been a permanent source of revenue to the Government. Hence, our contention that the repeal of 102 will produce more revenue than as now. The one company out of 100 that the law was aimed at eventually has to disgorge to the Government through the death of its principals, new officers, new activities,and through additional taxes on increased earnings. The Government eventually gets it, but maybe not quite so soon.

A corporate assistant treasurer:

Surtax on corporations improperly accumulating surplus is highly penal. Despite this fact, the burden of proof as to every material issue is on the corporation. If liability to the tax is contested, the fact that the case was a close one is not taken into consideration in fixing the punishment. The amount of the penalty in the close case and in the flagrant case is exactly the same. There is no compromise and no middle road.

While the law is aimed at the tax avoider, it is a constant menace to concerns whose policy it is to put aside something for a rainy day and to concerns whose future plans, however sound, have not yet reached the blueprint stage where they can be read before the courts. One of the practical difficulties which corporations must face is the fact that most of the cases reach the courts a long time after the event determining liability to the tax has occurred.

Whether or not the law so intends, a corporation that estimates its future needs clearly is in a stronger position than one that guessed wrong. For example, cases decided in 1942 to 1945 point out that the corporations' officers had foreseen the war. That fact hardly would have given as much weight if no war had occurred. The lack of any set standard of measurement greatly complicates enforcement of the law.

Obviously, some corporations can retain all of their earnings without becoming liable, whereas others can't retain any. The result is that an assessment usually can be made only after a careful examination involving not only the business needs of the corporation but also the attitude of the persons responsible for its financial policies. The Department's instructions state that close attention will be given to corporations that have not distributed at least 70 percent of their earnings as taxable dividends. This figure, however, is purely arbitrary, and only a small fraction of the corporations distributing less than 70 percent will actually be assessed a penalty tax. On the other hand, there is no absolute assurance that a corporation distributing more than 70 percent will escape that tax.

Section 102 in its present form is most inequitable in that it works a hardship upon corporations with conservative management, which, after all, represents the majority of the businesses of our country, and it serves as a club to force taxpayers to pay double taxation upon earnings of a corporation.

The policies of conservative management are usually made from a long-term viewpoint, and in this connection the Circuit Court of Appeals, Second Circuit, has stated recently in one of its decisions that "Business, like everything else, can only be conducted on prophecies and prophecies are never infallible."

If a corporation is bona fide in all respects and has not been set up to evade taxes but merely to avoid taxes, then double taxation should not be imposed upon any taxpayer by forceful means as is provided in section 102. If a corporation is merely incorporated as a sham to evade taxes, then it should be ignored completely and the earnings therefrom taxed to the stockholders, but as long as the corporation has paid income taxes on its proper net income there should be no further taxation as far as distributions not made to its stockholders are concerned. If the Government desires distributions to be made to stockholders, the means of taxation should be changed whereby a corporation receives proper credit for its distribution to stockholders.

A corporate chairman of board of directors:

Elimination of double taxation on corporate earnings would help. Also a more realistic rate of depreciation on productive machinery would help.

A corporate treasurer:

Yes. We believe that if dividends were not doubly taxed but were allowed to be distributed by corporations free of tax there would not be the incidents of double taxation, and under this fairer method there would be less likelihood of avoidance by individuals who would be required to pay the one income tax that should be levied.

A corporate treasurer:

Yes. The principal objection, in my opinion, in section 102 is in its administration rather than in its substance. In cases where some doubt as to the validity of the corporation's reasons for retaining profits in the business may be open to question by the Internal Revenue Bureau, the Bureau's opinion is not available to the corporation officials in time for them to take whatever steps they may deem necessary or expedient to avoid this additional tax. Some method should be found, either by the corporation rendering a preliminary statement of their financial condition and the probable results of the year's operations or by some similar means, so that the Treasury Department's opinion may be rendered to them in sufficient time so that the corporation may take whatever steps may be expedient to avoid the imposition of this tax before the end of their fiscal year.

A corporate assistant treasurer:

Do not tax corporate dividends or allow credit for the corporation income tax.

A corporate assistant secretary:

Assess a lower (or no) tax on dividends paid; regular tax earnings retained. This device may make dividends desirable, thus causing a reappearance of equity money.

A corporate vice president:

1. Burden of proof of purpose to avoid individual surtaxes should be shifted to Commissioner. Present requirement on taxpayer to negative purpose by "clear preponderance of the evidence" is inconsistent with rest of code, unrealistic as applied to composite mind of boards of directors, and unfair to small taxpayers without adequate professional advice.

2. Tax penalty should apply only to amount determined to have been accumulated unreasonably, not full "undistributed section 102 net income." The determination of how much in dividends can be afforded is always difficult and may be influenced by temporary conditions, such as cash shortage. Taxpayers should be permitted latitude of judgment, not held to all-or-none decision.

A corporate controller:

The most objectionable feature about the section is its vagueness. It should indicate the difference between a company formed or acquired for the purpose of avoiding personal surtax and those conducting legitimate business. The latter should be free from the fear of application of the section. The small or medium-size companies, by their nature closely held, would then be in position to become financially strong and stable and compete over the years with the large corporations against whom the section does not apply.

A corporate president:

The company believes that the adverse influence of section 102 on business can be partially eliminated if (1) a special 1-year statute of limitations were enacted covering assessments under section 102, without any right in the Commissioner to obtain extensions; (2) the Commissioner was made to carry the burden of proving violation of the section; (3) statutory immunity from the section 102 penalty were given if a company distributed a certain percentage of its earnings (say, 50 to 60 percent) annually, except in the case of personal holding companies.

A corporate controller:

Yes. Provide for dividends of current earnings of 50 percent before penalty. Allow 45 days after determination of amount of earnings subject to surtax for dividends to be paid without penalty. Also exclude all operating companies from being subject to this section of the law.

A corporate president:

Yes. Double taxation of dividends should be eliminated. This would eliminate the necessity for section 102 and would permit corporations to follow a sound fiscal policy. As matters now stand, corporations must spend money that should be put aside as a reserve against future contingencies.

A corporate treasurer:

Under section 102 the sound economic welfare of a corporation may be arbitrarily penalized as a measure of eliminating the evasion of personal income tax. Considered from an over-all point of view, it would seem advisable to repeal this section, in that the evils outweigh the advantages. Perhaps as good a result could be obtained through the Personal Holding Company Act.

A corporate vice president:

Basically we believe dividends being taxed to the security holder should be allowable on the corporation tax return before computation of corporate income tax.

Proof by corporation that earnings must of necessity be used for improvement of plant should release the corporation from any risk that 3 years later claim

for additional tax under section 102 might occur, except in case of fraudulent returns.

A corporate controller:

Place burden of proof on Government that earnings retained will not be needed for reasonable requirements of business. Presumption that management's judgment of requirements is correct.

A corporate president:

Special consideration should be given small companies that are expanding.

A corporate secretary:

We believe a corporation should be eligible to retain more than 30 percent. The present rule works well as long as good years are encountered, but have two or three lean years and you may see a national disaster.

A corporate treasurer:

We believe that elimination or minimization of the double taxation of corporate earnings (i. e., first as net income to the corporation and second as dividend income to the stockholder) would effectively remove the incentive to avoid personal surtax by retention of earnings, and more especially would bring forth new investment capital.

A corporate treasurer:

Yes. Tax on undistributed profits.

A corporate accountant:

Make dividends taxable as capital gains held over 6 months, and this would give incentive to corporate earnings and distributions.

A corporate president:

We believe the penalty tax under section 102 should be applicable only to that part of corporate earnings that are unreasonably withheld. Determination of such an amount is a no more difficult question of fact than determining if any earnings are unsuitably withheld. Also, it would seem far more equitable that burden of proof in this respect should rest with the Internal Revenue Department rather than with the taxpayer.

A corporate treasurer:

Yes. Section 102 in its present form leaves too much to an individual's interpretation. A businessman wants to know as soon as possible after rendering his income-tax return if it settles his tax liability for the period. However, under section 102 a revenue agent may within 3 years make his own interpretation and assess both additional taxes and penalties.

A corporate president:

Section 102 has a hampering influence on the advisable and to-be-recommended policy of accumulating funds for plant restorations, improvements, or expansion, thus retarding the natural trend in industrial development. It should be repealed or satisfactorily amended.

A corporate president:

We believe that there should be a liberal interpretation of this section so that companies operating in good faith can carry out business policies approved by the directorate without fear.

A corporate president:

Yes. By giving the stockholder, as an individual taxpayer, relief from double taxation of corporate earnings distributed in the form of dividends.

My principal objection to section 102 is the fact that it is neither definite nor exact and leaves the determination of whether a corporation has violated section 102 completely in the hands of an administrative official whose decision cannot be based upon a knowledge of the affairs of the corporation involved, because he

does not have that knowledge; and the corporation officers, not being familiar with the thinking of the administrative officers who have to pass upon his particular case, have no way of knowing how they will be influenced and decided. In other words, it establishes a government by men and not by law.

The average businessman has trained himself to meet almost any situation with which he is confronted so long as he knows or can ascertain what he is up against. The one thing that he cannot cope with is uncertainty, and the wording of section 102 as it stands at present leaves him completely up in the air as to what some official may decide is the proper interpretation of section 102. It should be simplified and clarified so that any intelligent person can understand it and apply it to his business operations with confidence, which he cannot do at present.

A corporate controller:

The law should limit 102 assessments to corporations in which the stock is closely held, to those whose principal stockholder holds perhaps 20 percent or more of the outstanding stock.

A corporate president:

We disapprove of the whole theory behind this section. It is designed to catch out the 1 man in 10,000 who uses a corporation for avoidance of personal surtaxes. In doing so, it constitutes a major financial hazard for all small and medium-sized businesses. In effect it comes pretty close to putting prudent financial management of such enterprises outside of the law and creates the necessity of keeping RFC available to bail them out. If such a provision is necessary at all, it should be limited to personal holding companies.

A corporate treasurer:

Believe that same benefits of net loss carry-back and carry-over as now apply to income taxes should be made applicable to section 102 surtax and that subsequent dividends paid within 90 days after year's end should be used as a credit in computing surtax net income.

A corporate treasurer:

Yes. The retention of earnings that have been made was solely for the best interests of the corporation in the judgment of its directors, who have been in no way influenced in their judgment by the personal status of any individual stockholder or group of stockholders.

Subsection (c) of section 102 should either be struck out or so changed that the burden of showing that earnings were accumulated for the purpose of avoiding surtax is placed on the taxing authority. What the "reasonable needs of the business" are should be determined in good faith by the directors and not subject to the whim or opinion of any governmental tax authorities in no way responsible for the proper conduct of a corporation's business or its efficiency of operation. Also, the penalty should be imposed only on the proportion retained which is unreasonable.

A corporate treasurer:

We are not able to suggest any alternative method. However, we do feel that the law should be absolutely clear so that no corporation would be forced to distribute earnings for fear of the fact that broad interpretation of the statute might result in imposition of penalty when in fact retention of earnings would be a more prudent course. In the final analysis, it may be that the answer lies in correction of the inequitable taxing of corporate earnings both as profits and as dividends. Legislation to grant the shareholder a credit for a fair percentage of the tax paid by his corporation in computing tax liability on dividends received would remove the motive for not distributing corporate earnings and no doubt make section 102 and its difficult administration unnecessary.

A corporate treasurer:

This is too complicated a question to answer generally. We do not know how other businesses have been affected. The law and regulations are indefinite and it is difficult to know what the standards are in any particular instance. In our situation we have been conservative and kept on the safe side. The directors believe the corporation would be much better protected if less dividends were

declared. It seems probable that businessmen generally might be more willing to consider expansion and development if they would do so freely without risking the penalties of section 102.

A corporate assistant treasurer:

Yes. We believe section 102 should not apply to any corporation when the management as a whole owns less than 50 percent of the outstanding stock, or where no one person owns in excess of 15 or 20 percent of the stock.

A corporate treasurer:

Yes. The penalty surtax is too harsh in effect since it applies to the *entire* undistributed section 102 net income and the law has no mitigation provision such as a consent dividends credit which would ease the burden on corporations found vulnerable. Some standard should be established whereby a corporation can determine for itself in advance whether section 102 vulnerability exists and the amount of dividend payment necessary to avoid the penalty tax.

A corporate president:

Section 102 should not apply to small mercantile and manufacturing concerns. The law should be repealed or these above business enterprises should be excluded from its application. Anyone who was operating a small business during the depression of the 1930's realizes that you need a large cash surplus. * * * It is my opinion that if the stockholders are satisfied with the dividends paid by a small business, the Government should be. In fact it looks to me like section 102 goes after the marrow of a small corporation.

A corporate assistant treasurer:

We have not been concerned about section 102 because of financial difficulties and large deficit. It is our view that the section 102 problem should be disposed of by eliminating all or part of the inequitable double tax on dividends.

A corporate treasurer:

Cut down on Government expenditures.

A corporate attorney:

We believe section 102 unnecessary. The corporation will distribute all the money it can to its shareholders commensurate with a conservative policy. The section penalizes conservative financing and prevents a corporation from building up adequate reserves for future expansion particularly where expansion is unplanned but where a large surplus would probably result in subsequent improvements.

A corporate treasurer:

Yes. The law should permit firms to accumulate reserve funds for future expansion of their plants, unprofitable years, and set up pension plans for their employees.

A corporate president:

We believe that corporations with combined capital and surplus of under $1,000,000 should be exempt.

A corporate controller:

Place burden of proof on Government that earnings retained will not be needed for reasonable requirements of business. Presumption that management's judgment of requirements is correct.

A corporate auditor:

The company has deliberately decided policy of dividend distribution, etc., without regard to section 102. The only effect the section has had is to worry the officers and accountants of the company, and they have spent much time and effort in trying to outguess the Treasury Department. We do not like the section and feel that industry as a whole would be much better off without it. No progressive economic policy can be decided by a set of arbitrary rules laid down in Washington or anywhere else. Each company should be allowed to decide

policies of expansion, salary setting, dividends, and accumulation of surplus without penalty. The country as a whole and tax collections as a whole would be better off.

A corporate controller:

We believe credit should be given to dividend recipients for 38 percent corporate tax on earnings.

A corporate controller:

Yes, by eliminating double taxation on dividends.

A corporate president:

The officers of this corporation are definitely opposed to double taxation of corporate dividends under present laws. The officers and directors also believe that small business should have greater relief under section 102.

A corporate president:

Yes. It is unfair to tax the corporation and then tax the stockholder for dividends that represent only 62 percent of the income actually earned. This should be corrected either by—

(*a*) Allowing the corporation full credit against net income for all dividends paid to stockholders, thus shifting the tax direct to the stockholder where tax rates vary with income. This would encourage large dividend payments because of tax savings.

(*b*) Following the English system of allowing taxpayer credit for taxes already paid on any dividends received.

As section 102, Internal Revenue Code, now stands, the Commissioner of Internal Revenue is given entirely too much authority. If the Congress feels that section 102 is desirable and should be retained, the taxpayer should know definitely what is expected of him and not leave the decision to the Commissioner three or more years after his tax return has been filed.

A corporate treasurer:

Remove double taxation of dividends.

A corporate president:

Yes. Set up definite regulations for dividend distributions under section 102 and provide machinery for timely application for exemption by any corporation seeking relief for business reasons, such exemptions to be granted or refused with reasonable dispatch. This should eliminate one of the current uncertainties under which management operates a business and remove the 3-year waiting period.

A corporate president:

As a corporation executive I rather dislike a provision such as section 102 that is likely to influence a corporate management to deplete its resources through dividend distributions at times when it would be much sounder in the securityholders' interests for the corporation to retain such funds for proper corporate purposes, but I am not prepared at present to urge an alternative. I do think, however, that the Commissioner should lay down fairly precise regulations and not leave the statute to be construed any number of ways by as many different field agents.

A corporate president:

Yes. Free dividends from double taxation by allowing amount of dividends paid by corporations as a deduction from taxable income on stockholders' individual tax returns.

A corporate president:

Repeal of the section 102. This section works a great hardship on a corporation as it is unable to provide in good times the funds to carry it through a depression. This corporation, like a great many others, has several classes of stock which are held by the general public. The receipt by these stockholders of larger dividends in good times will not compensate them if the company faces bankruptcy in periods of depression.

Respondent Statements Approving Section 102 in Its Present Form in Answer to the Questionnaire of Joint Committee on the Economic Report

A corporate president:

We know of no better way at present to prevent avoidance of personal surtax than by using section 102, but we do believe that double taxation of dividends that have already been paid by corporations is unjust and unjustified. If the corporation has paid them, it would appear that the dual taxation should not be.

A corporate accountant:

No. Because our observation has been that the Treasury Department is trying to be realistic in the enforcement of section 102 in a period of postwar growth where company financing is, for a period of time, excessive due to inabilities and delays caused by a major war. Secondly, the high cost of replacement in kind at twice or more than the original cost has placed an operating burden upon this company that has been most excessive, particularly because it is a distributing company with approximately half the personnel and truck equipment on the highways, and representing an asset that has a comparatively short life requiring more rapid replacement.

A corporate secretary:

No. Present statutory rule is probably sound. Adverse effects on business stability and growth are dependent on application to specific situations, if unreasonably interpreted or applied so as to prevent accumulation of reasonable reserves in good years as a protection against operating losses in bad years.

A corporate vice president:

Section 102, properly administered, is satisfactory, but it is now open to serious abuse by inexperienced or prejudiced internal revenue examiners.

A corporate vice president:

Do not believe that a change is desirable.

A corporate president:

Viewing wide range in types and activities of corporations, we believe some section like 102 is probably essential to avoid undue capital agglomerations and concentrations. However, as stated above, we believe legitimate business suffers from uncertainties and apprehensions under indefiniteness of existing section, and that public benefit would result from more explicit expression of intent of Congress with standards set forth for guidance of those responsible for corporate and dividend policies.

Statements of Treasury and Bureau Administrative Policy Regarding Section 102 and Predecessor Sections

Statements Made to the Press re Treasury and Bureau Policy, December 13, 1934

Department policy.—Executives are also inquiring what the Treasury will regard as "reasonable needs of the business" in measuring corporate surplus. Congress did not lay down in advance a definite rule applicable to all cases, and the Bureau of Internal Revenue is unable to do so. No corporation, however, will be assessed this tax until it is advised of the Bureau's intention and after a hearing of its case, at which time the Bureau will take into consideration every fact and prospect that a prudent businessman would consider in determining what surplus was reasonably needed for that enterprise. Among other things, the Bureau will consider the hazards of that business, its normal rate of expansion, any contingencies against which reserves ought to be set up, any unemployment insurance or employee benefits that require reserves, whether the surplus is actively used in the business of the corporation or is invested in lines of business foreign to its own, together with any other facts which the particular corporation desires the Bureau to consider. With the assurance that, while the Bureau

intends to apply the Acts just as they were written, it has no purpose by interpretation to extend them beyond the intent of Congress, we believe that few executives will have difficulty in determining whether their surplus is a reasonable business surplus or whether it is withheld from stockholders for other reasons.

* * * * * * *

No operating corporation accumulating surpluses and using the same in the business in which it is engaged should be apprehensive. As an illustration, a manufacturing company in good faith setting up surpluses for the purpose of acquiring material, offsetting a fluctuation in wage scale, carrying the proper amounts to offset accounts receivable or accumulating a reasonable reserve to pay present indebtedness, would not be taxed under Section 102 of the law of 1934 for accumulating unreasonable surpluses.

It would be an entirely different matter, however, if it accumulated these surpluses for the purpose of purchasing stocks, bonds, and securities of other corporations. For example, a corporation in the soap manufacturing business using the earnings to acquire large blocks of bonds and securities and with large surpluses already accumulated, should not be allowed to escape a tax under this Section if the additional surplus was for the purpose of expansion of business into another field as, for instance, the grocery business. Nor should an automobile business be allowed to build up large surpluses for the purpose of acquiring railroad or mining properties simply because it ships its products over railroads and uses the output of mines in the manufacture of its product.

Large surpluses have been accumulated by holding companies for example and the following are typical examples where, in the opinion of the Bureau, taxes should be assessed under the provisions of Section 104:

A Company;

Capital stock	$200,000.00
Earnings for two years	5,400,000.00

No dividends declared.

In this case it is the purpose of the Bureau to assess the company 50% of the undistributed income under the provisions of Section 104.

B Company

(Another typical corporation holding company):

Capital stock	$3,000,000.00
Existing surplus	4,750,000.00
Income, one particular year in excess of	3,000,000.00

No dividends declared.

It is the purpose in this case to apply Section 104.—*Excerpts from Press Service*, dated Dec. 17, 1934, being statements made to the press on December 13, 1934.[1]

EXCERPTS FROM ADDRESS BY DEPUTY COMMISSIONER EDWARD I. MCLARNEY ON RECENT PROGRESS IN FEDERAL INCOME TAX ADMINISTRATION GIVEN NOVEMBER 20, 1946, BEFORE THE TAX EXECUTIVES INSTITUTE, LOS ANGELES, CALIF.

Since the excess profits tax law was repealed by the Revenue Act of 1945, some tax practitioners have expressed the fear that the Bureau of Internal Revenue may endeavor to expand the administration of section 102 of the Internal Revenue Code to serve as a substitute for the repealed tax. (Note the article, The Section 102 Penalty, by Richard F. Barrett, in Taxes, the Tax Magazine for July 1946, vol. 24, No. 7, p. 656; also comment on p. 704). The tax imposed by section 102 is collected from corporations, usually close corporations, which have improperly accumulated surplus earnings in an attempt to avoid the individual surtaxes that would be payable by stockholders if such earnings were distributed to them as dividends. Many corporations that prospered during the war period had their surplus earnings markedly reduced by the excess profits tax, and the directors felt warranted in retaining the balance of net profits in the belief that the need for postwar conversion and emergency reserves would rebut a charge of improper accumulation to avoid individual surtaxes. After postwar conversion has been completed, will the Bureau arbitrarily assume that there is no longer a substantial business reason for further accumulation of surplus?

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[1] C. C. H., vol. 2, 1940, par. 679.026.

I can assure you that the Bureau has no intention of arbitrarily departing from the long-established policy that it has followed in the administration of section 102. If the accumulation of earnings and profits is required for the purposes of the business, whether in peace or in war, and if there is no purpose to prevent the imposition of the surtax upon the stockholders, the Bureau will have no objection to the accumulation of profits for the reasonable needs of the business. Undistributed income is properly accumulated if it is retained for working capital needed in the business, or if it is invested in additions to plant reasonably required by the business. The nature of the business, the financial condition of the corporation at the close of the taxable year, and the use made of the undistributed earnings or profits should be considered in determining the reasonableness of the accumulations. That determination is the responsibility of the corporation directors and officers, and they have some discretion and judgment as to the reasonable business needs of the company. Their state of mind as indicated by the evidence is an important factor. Where the officers and directors of a corporation can show that all of the capital and surplus on hand would be required for the proper conduct of the business, the tax will not be incurred. The Bureau will take into consideration every fact and prospect that a prudent businessman would consider in determining what surplus is reasonably needed for that enterprise.

In order to afford such a corporation an opportunity to state its business needs, legal requirements, or other reasons for retaining its earnings in the business, the corporation income tax return, Form 1120, for 1946 will include a question as to whether the total dividends to stockholders during the taxable year 1946 were less than 70 percent of the earnings and profits for the year.

Don't be disturbed when you see this question—its only purpose is to make easy the presentation to the Bureau of appropriate evidence in cases where the answer is "Yes," and thus avoid, if possible, the expense and inconvenience to both the taxpayer and the Bureau of further development of the subject. So if you answer "Yes," you should give the reasons why your corporation retained the profits instead of distributing them to its stockholders.

STATEMENT OF W. A. GALLAHAN, BUREAU OF INTERNAL REVENUE, BEFORE THE NATIONAL INDUSTRIAL CONFERENCE BOARD IN NEW YORK CITY ON MAY 28, 1947

I want to say that I have enjoyed being here and listening to the discussion. I haven't anything else to say other than to try to assure the folks here of the Bureau's intentions and purposes with respect to the administration of section 102 as we now have it.

I think we all agree that under the present tax system, we have to have section 102 or something comparable to it. The problem was dumped in our laps by Congress, with no instructions as to how it should be administered; so we had to formulate such rules as we could, and have done the best we could ever since.

I think the so-called 70-percent rule has given us more headaches than anything else. We have tried, and are still trying, to relieve the public of the idea that the failure of a corporation to pay less than a given percentage of its earnings as dividends is a determining factor in deciding whether section 102 is applicable. It is used only as one of the means of selecting cases for examination. The mere fact that a corporation distributes less than 70 percent of its earnings as dividends has no bearing in determining whether section 102 applies. The case must be, and is, decided on all the facts which show whether the failure to distribute was for the purpose of avoiding surtax.

We will probably issue a new ruling in the near future in which we will make known to the public all the rules applied by the Bureau in the audit of these cases and, at the same time, assure the public that we are not making arbitrary determinations. The Bureau has not, and will not attempt to impose section 102 without considering all the facts, circumstances, conditions and prospects that any prudent businessman would consider in arriving at a determination as to what he needs to run his business.

The purpose of a ruling at this time is to combine all the policies and procedures with respect to these types of cases in one document available to the public and Bureau employees alike, in order that each may be fully conversant with all the rules to the end that a better understanding may be had by all concerned and a better administration of section 102 accomplished.

With that, I would like to thank you gentlemen again for inviting me up and I wish you every success in your efforts.

EXCERPTS FROM AN ADDRESS BY DEPUTY COMMISSIONER EDWARD I. MCLARNEY ENTITLED "SOME INCOME TAX REFLECTIONS," SEPTEMBER 15, 1947, BEFORE THE TAX EXECUTIVES INSTITUTE, ATLANTIC CITY, N. J.

I have been frequently asked whether the Bureau is changing its policy concerning the administration of section 102, which imposes a surtax upon corporations that have "improperly" accumulated surplus earnings in an attempt to avoid the individual surtaxes that would be payable to stockholders if such earnings were distributed to them as dividends. This topic is an apt illustration of the old adage that a little knowledge is a dangerous thing. There seems to be a widespread fear of section 102 on the part of individuals for whom it has no application whatever. The Income Tax Unit recently received a frantic telephone call by long distance, asking what a certain corporation should do about section 102. Asked to describe its situation, the attorney stated that the corporation had a deficit of more than a million dollars, and he was greatly worried about the effect that the section 102 surtax would have on the company's financial condition. He was almost in a state of hysteria. It was tactfully pointed out to him that a corporation with a deficit and no surplus is not in a position to pay dividends to its stockholders, and that the section 102 surtax is directed only at those corporations which have a surplus in excess of business needs and which deliberately refrain from paying this excessive surplus to the stockholders in the form of dividends, in order that they may avoid the individual surtax that would be due in the high surtax brackets of their personal income tax returns on such dividends.

You may remember that considerable excitement was created by the insertion in the corporation income tax return for 1946 of a statement that if the corporation's distributions to stockholders from earned surplus had been less than 70 percent of the current earnings, it should state the reasons for retaining such earnings. The average corporation, of course, retained these earnings for the needs of its business, but there were some corporations which came out of the war period with enormous accumulations of profits that were far in excess of the needs of the business. By inserting the statement in the 1946 return, the Bureau was actually aiding these corporations, enabling them to avoid expensive section 102 litigation and thus to avoid much trouble and inconvenience, by reminding them of the possible application to their excess earnings of the surtax imposed by section 102. Having served its purpose, it will not be necessary to repeat the statement in the return for 1947, but I can assure you that there has been no change in the long-established policy of the Bureau on this subject, either in inserting the statement in the 1946 return or in omitting it from the 1947 return. Under this policy, the Bureau has no objection to the accumulation of profits for the reasonable needs of a business, if that accumulation is required for the purposes of the business, and if there is no purpose to prevent the imposition of the surtax upon the stockholders.

[Press release, Friday, December 5, 1947]

TREASURY DEPARTMENT

Washington

George J. Schoeneman, Commissioner of Internal Revenue, in response to requests from many corporations which determine their dividend policies at this time of year, today made the following statement of administrative policy with regard to section 102 of the Internal Revenue Code:

"The ordinary practice of profit-making corporations is to retain each year, whatever surplus is reasonably needed for the business, distributing the remainder to stockholders in the form of dividends. Such policies do not conflict with any provision of the Internal Revenue Code and do not subject any corporation to the additional tax provided by section 102. The applicability of section 102 is not based upon the retention of any percentage of profits but rather upon the retention of profits in excess of the reasonable requirements of the particular business. In view of some apparent misinformation and unjustified apprehension as to the administration of section 102, it may be helpful to state again what has been the long-established policy of the Bureau of Internal Revenue.

"Section 102, or a substantially equivalent provision, has been in the income tax law ever since the modern income tax was adopted in 1913. It never has been and is not now the policy of the Bureau of Internal Revenue to apply this provision to any corporation unless it withholds from its stockholders surplus

earnings clearly in excess of the reasonable needs of the business and for the purpose of enabling stockholders to avoid personal income taxes. In determining whether surplus is retained for business purposes, it is our unvarying policy to give due consideration to the judgment of the corporation's own management as to what sums are needed for working capital, expansion of facilities, sinking funds for debt retirement, contingency funds to cover employee benefits, and similar bona fide business and legal needs. In all questionable cases, it is our policy to give the corporation's management an opportunity to explain the purpose of its surplus retention before applying section 102. We believe the administrative record of the past 35 years provides ample assurance that section 102 has not been, and is not being, applied so as to affect adversely the bona fide operation or conduct of any business.

"To some extent, misunderstanding appears to have arisen because the 1946 corporate tax return asked corporations to state whether they had distributed at least 70 percent of their earnings to stockholders. This question has been deleted for the 1947 return. The Bureau of Internal Revenue used this 70 percent figure only as a convenient method of selecting corporation income tax returns for examination, but under no circumstances does it use this, or any other percentage, as a measure for liability under section 102."

[Press release by Secretary of the Treasury John W. Snyder on April 13, 1949]

STATEMENT IN RESPECT TO ADMINISTRATION OF SECTION 102

Section 102 provides that the tax on corporations improperly accumulating a surplus shall attach if the corporation is formed or availed of for the purpose of preventing the imposition of the surtax on its shareholders. It also provides that the fact that the earnings or profits of the corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid surtax upon shareholders, unless the corporation by the clear preponderance of the evidence shall prove to the contrary. The regulations provide that it is not intended to prevent accumulation of surplus for the reasonable needs of the business.

The purpose to avoid the imposition of the surtax upon the shareholders of a corporation can be determined only upon a careful study of every fact, condition, circumstance and prospect that a prudent businessman would consider in determining the surplus reasonably needed for the business. It will not be imputed, even though none or a small percentage of the earnings have been distributed to the shareholders, where a reasonable showing has been made that all or a large part of the earnings are necessary for the requirements of the business.

Some of the more important facts, conditions, circumstances and prospects requiring careful study and analysis to determine whether section 102 is applicable are: The purpose for which the corporation was formed; the dividend distribution history of the corporation; its dealings with its stockholders; the advances or loans made to stockholders in lieu of dividends; the accumulation of surplus resulting from the retention of cash, securities, or other assets unrelated to and not essential to the normal operations of the business; the need to acquire or finance additional working assets, such as larger inventories, purchase of additional machinery or to meet present demands or provide for reasonably expected expansion; whether the distribution of earnings to stockholders would not have resulted in surtax because of individual losses or small individual incomes; the stock is widely held in small blocks; the financial condition of the business at the close of the year; and all other factors applicable in any particular case which would be considered by a normally prudent businessman in the conduct of a business. In other words the determination of whether distributions of earnings are adequate is one of fact depending upon all the conditions and circumstances of each particular case.

Neither size of the corporation nor the amount of the accumulation alone is controlling. The determination is made on the basis of all the facts including the size of the corporation and whether or not there has been an accumulation beyond the reasonable needs of the business to enable the shareholders to avoid the individual surtax.

It is the purpose of the Bureau to administer the tax laws in accordance with the intent of Congress. The Bureau will, therefore, continue its present policy of interpreting and applying section 102 in such manner as to impose no hardship upon any taxpayer, and at the same time, to insure that the law is applied and the intention of the statute accomplished in appropriate cases.

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BUREAU OF INTERNAL REVENUE
Washington, D. C.

(The following address by J. F. Addor, Practice and Procedure Division, Income Tax Unit, scheduled for delivery before a convention of certified public accountants in Savannah, Ga., on May 26, 1950.)

IMPROPER ACCUMULATION OF SURPLUS—SECTION 102

I appreciate very much this opportunity to discuss with you today, as a representative of the Bureau of Internal Revenue, the principles and administrative policy of the Bureau with respect to section 102 of the Internal Revenue Code.

A discussion of the subject, "improper accumulation of surplus," with representative accounting groups such as is gathered here today is particularly desirable at this time in view of some apparent misinformation and unjustified apprehension as to the administration of section 102 of the code. It is the wish of the Commissioner of Internal Revenue, George J. Schoeneman, that every opportunity should be availed of to correct this erroneous conclusion with an accurate presentation of the Bureau's views. Accordingly, I feel that his statement to the press on the policy of the Bureau with respect to the administration of section 102 should, in part, be repeated at this time. He said:

"Section 102, or a substantially equivalent provision has been in the income tax law ever since the modern income tax was adopted in 1913. It never has been and is not now the policy of the Bureau of Internal Revenue to apply this provision to any corporation unless it withholds from its stockholders surplus earnings clearly in excess of the reasonable needs of the business and for the purpose of enabling stockholders to avoid personal income taxes. In determining whether surplus is retained for business purposes, it is our unvarying policy to give due consideration to what sums are needed for working capital, expansion of facilities, sinking funds for debt retirement, contingency funds to cover employee benefits, and similar bona fide business and legal needs. In all questionable cases, it is our policy to give the corporation's management an opportunity to explain the purpose of its surplus retention before applying section 102. We believe the administrative record of the past 35 years provides ample assurance that section 102 has not been, and is not being, applied so as to affect adversely the bona fide operation or conduct of any business."

This statement by Commissioner Schoeneman in December 1947 likewise describes the administrative policy of the Bureau today with respect to section 102. It should serve as ample assurance to all taxpayers that a premonition of "fear" of an unreasonable or arbitrary enforcement of the provisions of section 102 is unwarranted.

Let us consider the current provisions of this section of the code, its development through the various revenue acts from 1913 to the present time, together with a detailed description of the procedure and policy prescribed by the Bureau for its enforcement.

Section 102 imposes in addition to other taxes imposed by chapter 1, a graduated surtax on the undistributed net income of a corporation "formed or availed of for the purpose of preventing the imposition of the surtax on its shareholders, or the shareholders of any other corporation, through the medium of permitting earnings or profits to accumulate instead of being divided or distributed." The surtax is 27½ percent of the first $100,000 of undistributed section 102 net income and 38½ percent of any amount in excess of $100,000.

The first version of the surtax on unreasonable accumulation of surplus by corporations is found in the Tariff Act of 1913, section II, A, subdivision 2, which provided that the shareholders include their aliquot shares of the corporate gains in their individual returns and the tax was paid by them.

The second revenue act, that is, the Revenue Act of 1916, section 3, contained no material change.

The Revenue Act of 1918 made several changes, principally the elimination of the necessity of proving fraud in order to include the income in the stockholders' returns.

In the 1921 act the imposition of the tax was shifted from the stockholders to the corporation, and the rate was set at 25 percent of its net income. The stockholders, however, could agree to have the tax shifted to them, which was the beginning of the so-called consent dividend, now covered by section 28 of the present law.

The 1924 act first enunciated the "presumption" concept, and the tax rate was upped to 50 percent of the net income.

When the revenue bill of 1926 was being discussed there was some feeling that the tax should be returned to the shareholders, but the tax remained on the corporation, with an election to the shareholders to include their aliquot shares of the corporate earnings, and a provision was added to the effect that when distributions were made out of such taxed earnings, they should be exempt. That is, such taxed earnings became the same as paid-in surplus or capital.

Two years later efforts were made to provide for a mandatory imposition of the surtax where undistributed profits exceeded 30 percent of the corporation's net income plus dividends and tax-free interest, the tax to be 25 percent, but this was rejected and the law remained approximately the same except that it became known as section 104 of the Revenue Act of 1928. The tax rate remained at 50 percent.

Section 104 was included in the 1932 act with practically no change.

The Revenue Act of 1934 introduced a number of new concepts, such as the graduated rate of tax and a new tax upon the undistributed profits of personal holding companies (the incorporated pocketbook) which took the place of section 104 with respect to holding or investment companies that fell in the personal holding company category. The Revenue Act of 1934 first labeled the tax "section 102" and provided for a determination of the income upon which the tax was imposed as the net income without the allowance of the dividend received deduction but diminished by the dividends distributed, and the rate was set at 25 percent of the first $100,000 and 35 percent of the amount in excess thereof.

In the Revenue Act of 1936 some difficulties were ironed out, such as the retained net income was defined, permitting deductions for taxes, disallowed charitable contributions, disallowed losses, credits for bank affiliates, and dividends paid, including the so-called consent dividends.

Prior to the Revenue Act of 1938, the administration of section 102 (and earlier equivalent sections) was not particularly effective because the burden of evidence and proof seemed to be placed by the courts upon the Commissioner of Internal Revenue if an individual denied intention of evading the taxation of his personal income through nondistribution of earnings by a corporation in which he had a substantial interest. To cure this difficulty Congress added a strengthening provision to section 102 of the Revenue Act of 1938 which provides that "The fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid surtax upon shareholders unless the corporation by the clear preponderance of the evidence shall prove to the contrary." In House of Representatives Report No. 1860, the committee expressed itself as follows: "This will clearly shift the burden of proof to the taxpayer in such cases" (p. 782, C. B. 1939–1, pt. 2).

Since then section 102 has remained substantially the same. The rates of tax now are 27½ percent and 38½ percent. The increase was due to absorption of the so-called 10 percent defense tax of 1940.

The Revenue Act of 1938 in effect brought relief to corporations from the controversial undistributed profits tax of 1936, but at the same time, it substantially strengthened the position of the Bureau in its administration of the surtax of section 102. The hearings before the Congressional Finance Committee on the 1938 act contain almost unanimous expressions of willingness to accept a strengthened section 102 if Congress would only repeal the undistributed profits tax of the 1936 act; consequently, it is felt that business in general supported the provisions of section 102 contained in the Revenue Act of 1938.

To more clearly define the prescribed procedure under the amended section 102, there was issued for the benefit of Bureau personnel and taxpayers Treasury Decision No. 4914 dated July 26, 1939. This Treasury decision instructed all officers and employees of the Bureau to give particular attention to corporate income tax returns in order "to determine the application of the provisions of section 102 * * * relating to unreasonable accumulation of earnings or profits to avoid surtax." Attention was directed to section 102 (c) with the "clear preponderance of the evidence" phrase.

Treasury decision 4914 also emphasized article 102–2 of Regulations 101 (published early in 1939) relating to income taxes under the 1938 Revenue Act. This article indicated the importance of the Commissioner's determination of fact in section 102 cases. Instructions were then given by the Treasury decision for the examination of tax returns for certain classes of corporations to which section 102 might well be applicable. However, let me emphasize at

this time that the criteria of Treasury Decision 4914 is not the basis for the assertion of the section 102 surtax, but solely for the selection of corporate returns for examination that fall within the following classes:

(1) Corporations which have not distributed at least 70 percent of their earnings as taxable dividends.

(2) Corporations which have invested earnings in securities or other properties unrelated to their normal business activities.

(3) Corporations which have advanced sums to officers or shareholders in the form of loans out of undistributed profits or surplus from which taxable dividends might have been declared.

(4) Corporations, a majority of whose stock is held by a family group or other small group of individuals, or by a trust or trusts for the benefit of such groups.

(5) Corporations the distributions of which, while exceeding 70 percent of their earnings, appear to be inadequate when considered in connection with the nature of the business or the financial position of the corporation or corporations with accumulations of cash or other quick assets which appear to be beyond the reasonable needs of the business.

For corporate returns in the first four classes mentioned the examining officer's report was to contain a specific recommendation for the application or nonapplication of section 102. Additional paragraphs of Treasury Decision 4914 provided for qualified employees to be designated to pass upon such recommendations, for the deposit of adequate data in Washington on all section 102 cases, and for special consideration in any review of such cases by the Bureau.

The general directions of Treasury Decision 4914 were supplemented by instructions to the Bureau personnel indicating those aspects of section 102 cases which required careful study. Attention, of course, was to be directed by examiners to the apparent purpose of the corporation's formation, its history of dividend distributions, dealing with its shareholders, and accumulation of surplus (in whatever form) unrelated to the normal business activities of the corporation.

Another paragraph gave "instances in which the utilization of the corporation for the purpose of avoiding surtaxes cannot be imputed (although none or a small percentage of the earnings have been distributed to the shareholders)." Among such instances were earnings necessary to finance larger inventories, and reserves to retire bonded indebtedness incurred in the normal conduct of business. Wide distribution of stock in small blocks would usually remove a corporation from the category of a section 2 case, as would distributions counterbalanced by individual losses.

By specific instructions to its personnel, the Bureau has carefully established its policies for the administration of section 102. Cases arising under this section necessarily require scrutiny because a cut-and-dried determination of "improperly" accumulated corporation surpluses cannot be made.

Various articles have appeared in tax services and financial publications outlining the possible postwar effect under section 102 of large accumulation of earnings during the war years and what to do about it. Also, there has been much inquiry relative to the Bureau policy with respect to section 102, that is, as to whether a drive is about to be launched; whether some new instructions have been or are about to be issued and the meaning of Treasury Decision 5398 dated August 12, 1944, which amended Tax Code 4914 dated July 26, 1939.

Beginning with Treasury Decision 5398 the provision therein, most inquired about, reads as follows: "The examining officer's report in every instance shall contain a specific recomendation for the application or nonapplication of section 102." That phrase was intended merely to effect an administrative change. It did away with a procedural requirement of filling in a form for every nonapplication recommendation and the sending of copies of application reports to Washington before completion of the consideration of the case. That is, this amendment was merely a work and paper-saving change, and was not intended to encourage agents to "bear down" under section 102 in an indiscriminate way. No new instructions have been issued and at present none are in process. The Bureau policies, as announced in Treasury Decision 4914 dated July 26, 1939, are still in full force and effect.

The Treasury decision received wide publicity in 1939 and still is receiving considerable publicity, particularly the 70-percent provision. Supplemented by the regulations under section 102 and in the light of the court decisions now available, taxpayers should have no great difficulty in determining dividend distribution policies that will enable them to avoid incurring liability under section 102.

The effect of the instructions in the Treasury decision is simply to require revenue agents examining corporate returns, especially in the five classes described therein, to give close attention to the question of whether the corporation has withheld earnings from distribution to permit the avoidance of surtax by individual shareholders. The first of the five classes is of corporations which have not distributed at least 70 percent of their earnings as taxable dividends.

It has been contended that the 70-percent distribution and closely held stock criteria discriminate against small corporations, which need to retain a larger portion of their earnings than do big corporations and which are usually owned by a small number of stockholders. These and other tests, however, are not applied in a mechanical way but are intended merely to direct the attention of Bureau personnel to cases that may need careful consideration.

The figure of 70 percent was adopted for the reason that that figure represents the approximate average over a long period of prior years of the annual ratios of dividends paid to adjusted net income for corporations with income. The 70-percent rule is regarded as restricting rather than expanding any inclination of the revenue agents to recommend the application of section 102.

Commissioner Schoeneman commented in his statement to the press regarding the 70 percent rule that "The Bureau of Internal Revenue used this 70-percent figure only as a convenient method of selecting corporation income-tax returns for examination, but under no circumstances does it use this or any other percentage as a measure for liability under section 102."

In order that there might be no abuse of the provision and no harassing of taxpayers, the Treasury decision directed that in each field division a "qualified employee" will "pass personally upon each case," and that there be maintained in the Bureau a record of the names and titles of such employees. These instructions were in the interest of an intelligent use of the section. They were designated for the protection of the taxpayer as well as the protection of the Government.

Assurance that the Bureau has not been unreasonable or arbitrary in its enforcement activities is evidenced by the fact that in a period of over 10 years, dating from July 1, 1939, to December 31, 1949, only a few cases involving section 102 reached the courts. Incidentally, the number of cases decided by litigation stand at 101 for all time. The box score is 54 for the taxpayer and 47 for the Government.

In a large percentage of the cases in which section 102 has been applied, there has been evidence of flagrant avoidance schemes, such as loans to officers or stockholders, large accumulations of cash, or investments in securities unrelated to the business, retirement of capital stock instead of distributing excess earnings as dividends.

During the war years the great uncertainties of the war and transition period gave at least the semblance of reasonableness to most accumulations of earnings by ordinary business firms. With the end of the war and the immediate transition, however, many of the grounds on which large accumulations of earnings had been justified during the war became no longer valid. The Bureau of Internal Revenue has not changed its long-established policies with respect to section 102, but an effort has been made to revert to normal peacetime standards.

With the end of the wartime dollar requirements and subsequent rehabilitation, most of the extraordinary wartime needs for retaining surpluses no longer exist, and the corporation should, accordingly, take the necessary action to adjust its wartime surplus policy unless it can show a business reason for such accumulation. This action will preclude a corporation that retained a large portion of their earnings during the war years from being subject to the provisions of section 102.

However, the surtax under section 102 is never assessed against any corporation until it is advised of the Bureau's intention and after a hearing of its case, at which time the Bureau will take into consideration every fact and prospect that a prudent businessman would consider in determining what surplus was reasonably needed for that enterprise. Among other things the Bureau will consider are the hazards of that business, its normal rate of expansion, any contingencies against which reserve ought to be set up, any unemployment insurance or employee benefits that require reserves, whether the surplus is actively used in the business of the corporation or is invested in lines of business foreign to its own, together with any other facts which the particular corporation desires the Bureau to consider.

In cases in which the section 102 issue is raised, the procedure through which such case passes is similar to that of other income-tax cases except for the designation by the field offices of a particularly qualified person to pass upon

each case. If the taxpayer finds the recommendation of the examining officer unacceptable, he may ask for a conference, and from the conference decision appeal may be taken to the technical staff before and after the Commissioner's final notice.

An appeal from the Bureau's determination lies to the courts on three levels. The first step takes the taxpayer to the Tax Court (formerly the Board of Tax Appeals) or one of the United States district courts. The next level consists of the circuit courts of appeals (including the court for the District of Columbia), and from one of them the last step is to the Supreme Court of the United States.

On questions of fact relative to an alleged improper accumulation of earnings or profits by a corporation, the tax or district court assumes the correctness of the Commissioner's determination, with the burden on the taxpayer to prove by a preponderance of all the evidence that the Commissioner is wrong. The weight of proof is even heavier on the taxpayer if it is "a mere holding or investment company" and "the clear preponderance" of evidence is and should be required of a taxpayer with profits accumulated "beyond the reasonable needs of the business."

The burden of proof was shifted by Congress in the Revenue Act of 1938 from the Commissioner to the taxpayer. The purpose of this change was to strengthen the position of the Bureau and to assure a more effective execution of section 102. That the corporate directors are the best judges of the company's needs and that no justification existed for the shift in the burden of proof is well answered in an article entitled "The '102' Cases" by J. K. Lasser and Robert S. Holzman in Tax Law Review, October-November 1947, New York School of Law, where it is stated on page 119:

" 'Unreasonable' is a relative term; and, if it were left to every board of directors to determine what surplus could be retained by its corporation, the objectives of section 102 could not be attained. Surpluses are sometimes accumulated unreasonably to circumvent the personal surtax rates; on other occasions, the accumulation is innocent or has been achieved because management believes there is (or will be) business justification for it. *Someone* has to be the arbiter of what is reasonable insofar as a particular set of circumstances is concerned; and while, in the final analysis, this may be the United States Supreme Court, in the first analysis it will be the revenue agent.

"Only the directors (if even they) know why a corporation really accumulated surplus, but the revenue agent is helped immeasurably by the fact that his finding is presumptively correct. The Commissioner's presumptive proof helps not only the revenue agent but also the courts * * *."

In conclusion, I can assure you that the Bureau will continue the long-established policy that it has followed in the administration of section 102. If the accumulation of profits is required for the purposes of the business and if there is no purpose to prevent the imposition of the surtax upon the stockholders, the Bureau will have no objection to the retention of earnings for the reasonable needs of the business.

[T. D. 4914]

TITLE 26—INTERNAL REVENUE

CHAPTER I. BUREAU OF INTERNAL REVENUE

SUBCHAPTER A—PART 22

Income Tax

Corporate income tax returns to be given particular attention to determine the application of the provisions of section 102 of the Internal Revenue Code, and the corresponding section of the Revenue Act of 1938, relating to unreasonable accumulation of earnings or profits to avoid surtax[1][2]

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

To Collectors of Internal Revenue and Other Officers and Employees of the Bureau of Internal Revenue Concerned:

Section 22.0 Introductory.—(*a*) Attention is directed to the provisions of section 102 of the Internal Revenue Code (53 Stat. Part 1) which imposes a

[1] Sections 22.0 and 22.1 issued under the authority contained in sections 62 and 102 of the Internal Revenue Code (53 Stat. Part 1) and of the Revenue Act of 1938 (52 Stat. 480, 483; 26 U. S. C. Sup. IV, 62, 102).

[2] The source of sections 22.0 and 22.1 is Treasury Decision 4914, approved July 26, 1939.

surtax on corporations improperly accumulating surplus, particularly section 102 (c), which provides as follows:

"(c) Evidence Determinative of Purpose.—The fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid surtax upon shareholders unless the corporation by the clear preponderance of the evidence shall prove to the contrary."

The above-quoted provisions first appeared in the Revenue Act of 1938 (52 Stat. 483).

(*b*) Attention is also directed to the following provisions of article 102–2 of Regulations 101 issued under the Revenue Act of 1938, and made applicable to the Internal Revenue Code by Treasury Decision 4885, approved February 11, 1939 (Part 465; Subpart B, Title 26, Code of Federal Regulations):

"If the Commissioner determines that the corporation was formed or availed of for the purpose of avoiding the individual surtax through the medium of permitting earnings or profits to accumulate, and the taxpayer contests such determination of fact by litigation, the burden of proving the determination wrong by a preponderance of evidence, together with the corresponding burden of first going forward with evidence, is on the taxpayer under principles applicable to income tax cases generally, and this is so even though the corporation is not a mere holding or investment company and does not have an unreasonable accumulation of earnings or profits. However, if the corporation is a mere holding or investment company, then the Act gives further weight to the presumption of correctness already arising from the Commissioner's determination by expressly providing an additional presumption of the existence of a purpose to avoid surtax upon shareholders, while if earnings or profits are permitted to accumulate beyond the reasonable needs of the business, then the Act adds still more weight to the Commissioner's determination by providing that irrespective of whether or not the corporation is a mere holding or investment company, the existence of such an accumulation is determinative of the purpose to avoid surtax upon shareholders unless the taxpayer proves the contrary by such a clear preponderance of all the evidence that the absence of such a purpose is unmistakable."

(*c*) It is to be remembered that personal holding companies are now taxed under section 351 of the Revenue Act of 1934 (48 Stat. 751, 26 U. S. C. 331) and the corresponding sections of the Revenue Acts of 1936 (49 Stat. 1732, 26 U. S. C. Sup. 2, 331) and 1938 (52 Stat. 557, 26 U. S. C. Sup. 4, 331) and the Internal Revenue Code. The provisions of law establishing high tax rates on earnings held in such corporations have eliminated the largest group of cases which previously fell within the provisions of section 102, and that section now has application only to corporations other than personal holding companies.[1 2]

Sec. 22.1 Instructions. (*a*) Returns filed by the following classes of corporations will be given close attention to determine whether section 102 is applicable:

(1) Corporations which have not distributed at least 70 percent of their earnings as taxable dividends.

(2) Corporations which have invested earnings in securities or other properties unrelated to their normal business activities.

(3) Corporations which have advanced sums to officers or shareholders in the form of loans out of undistributed profits or surplus from which taxable dividends might have been declared.

(4) Corporations, a majority of whose stock is held by a family group or other small group of individuals, or by a trust or trusts for the benefit of such groups.

(5) Corporations the distributions of which, while exceeding 70 percent of their earnings, appear to be inadequate when considered in connection with the nature of the business or the financial position of the corporation or corporations with accumulations of cash or other quick assets which appear to be beyond the reasonable needs of the business.

(*b*) Insofar as the classes of cases referred to in (1), (2), (3), and (4) are concerned, the examining officer's report in every instance shall contain a specific recommendation for the application or nonapplication of section 102.

(*c*) Each internal revenue agent in charge and each head of a field division of the Technical Staff will designate a qualified employee in his office, whose responsibility it will be to pass personally upon each case in which a recommendation has been made by an examining or reviewing officer with respect to the application or nonapplication of section 102. The internal revenue agent in

charge or head of the field division of the Technical Staff will advise the Commissioner of the names and titles of such employees.

(*d*) There will be maintained currently in Washington, D. C., detailed data regarding cases in which recommendations have been made with respect to the application or nonapplication of section 102, in order that the officers of the Department may be kept appropriately informed. To this end, there will be forwarded to this office by internal revenue agents in charge or heads of field divisions of the Technical Staff, as the case may be, immediately upon preparation thereof, a copy of each examining officer's report, revenue agent's report, field conference memorandum, or action memorandum in cases referred to in (1), (2), (3), and (4) of paragraph (*a*) of this section, in which a recommendation has been made with respect to the application or nonapplication of section 102, and a copy of each examining officer's report, revenue agent's report, field conference memorandum, or action memorandum in cases referred to in (5) or paragraph (*a*) of this section in which a recommendation has been made for the application of section 102.

(*e*) In the review of income-tax cases by the Bureau, the returns of corporations of the classes enumerated in paragraph (*a*) of this section will be given special consideration to determine whether field officers have complied fully with these instructions.

(*f*) Correspondence, reports, and memorandums from internal revenue agents in charge in regard to this Treasury decision should refer to the number thereof and the symbols IT : F. Correspondence, reports, and memorandums from heads of the field divisions of the Technical Staff in regard to this Treasury decision should refer to the number thereof and the symbols C : TS.[12]

HAROLD N. GRAVES,
Acting Commissioner of Internal Revenue.

Approved: July 26, 1939.

H. MORGENTHAU, Jr.,
Secretary of the Treasury.

(Filed with the Division of the Federal Register July 27, 1939, 12 : 47 p. m.)

[T. D. 5398]

TITLE 26—INTERNAL REVENUE

CHAPTER I

SUBCHAPTER A

Income Tax

Corporate income-tax returns to be given particular attention to determine the application of the provisions of section 102 of the Internal Revenue Code, and the corresponding section of the Revenue Act of 1938, relating to unreasonable accumulation of earnings or profits to avoid surtax

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington 25, D. C.

To Collectors of Internal Revenue and Others Concerned:

Effective immediately, section 22.1 of Treasury Decision 4914, dated July 26, 1939 [sec. 9.102–2, note, title 26, Code of Federal Regulations, 1939 Sup.], is amended as follows:

(A) By striking out subsection (*b*) and inserting in lieu thereof the following:

"(*b*) The examining officer's report in every instance shall contain a specific recommendation for the application or nonapplication of section 102."

(B) By striking out subsection (*d*).

(C) By relettering subsection (*e*) as subsection (*d*) and changing the word "paragraph" therein to read "subsection."

(D) By relettering subsection (*f*) as subsection (*e*) and striking out the phrase "reports, and memorandums" in both places in which it occurs therein.

(This Treasury decision is issued under the authority contained in secs. 62 and 3791 of the Internal Revenue Code, 53 Stat. 32, 467; 26 U. S. C., 1940 ed., 62, 3791.)

HAROLD N. GRAVES,
Acting Commissioner of Internal Revenue.

Approved August 12, 1944.

HERBERT E. GASTON,
Acting Secretary of the Treasury.

(Filed with the Division of the Federal Register August 14, 1944, 3 : 21 p. m.)

Form 1200–A (1951)

U. S. TREASURY DEPARTMENT

OFFICE OF INTERNAL REVENUE AGENT IN CHARGE

INTERNAL REVENUE SERVICE

The attached report, which has been carefully reviewed by this office, discloses certain adjustments or conclusions resulting from the examination of

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If you accept the findings, please execute the enclosed agreement form and return it to this office promptly. If you do not accept the findings, you may, WITHIN 30 DAYS from the date of this letter, file a protest in accordance with the enclosed instructions. This office will be pleased to answer any questions with respect to the report, and any protest filed will be given careful consideration and a conference will be granted if requested.

Submission of the agreement form will expedite assessment of the proposed deficiency and stop the running of interest thereon 30 days after receipt of the form, or on the date of assessment, or on the date of payment to the Collector, whichever is earlier. If desired, payment of the proposed deficiency may be made without awaiting assessment by making remittance therefor to the COLLECTOR OF INTERNAL REVENUE at_____
enclosing this letter or a copy thereof. The remittance should include interest on the additional tax (exclusive of penalties, if any) computed at 6 percent per annum from the due date of the return to the date of the payment.

This is not a statutory notice of deficiency. If, however, upon the expiration of the 30-day period you have not submitted the agreement form or a written protest or advised that the deficiency has been paid or will be paid upon notice and demand, a statutory notice will then be sent you as provided by law.

Prompt execution and return of the enclosed receipt form indicating your position with respect to the findings disclosed by the report will be greatly appreciated.

Very truly yours,

_____,
Internal Revenue Agent in Charge.

Enclosures:
Report of Examination
Agreement Form
Receipt Form
Instructions

Form 1230–A (1951)

U. S. TREASURY DEPARTMENT

OFFICE OF INTERNAL REVENUE AGENT IN CHARGE

INTERNAL REVENUE SERVICE

You are advised that the determination of your income tax liability for the taxable year(s)_____
discloses a deficiency of $_____ as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency or deficiencies mentioned.

Within 90 days from the date of the mailing of this letter you may file a petition with The Tax Court of the United States, at its principal address, WASHINGTON 4, D. C., for a redetermination of the deficiency. In counting the 90 days you may not exclude any day unless the 90th day is a Saturday, Sunday, or legal holiday in the District of Columbia, in which event that day is not counted as the 90th day. Otherwise Saturdays, Sundays, and legal holidays are to be counted in computing the 90-day period.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to this office for the attention of _____ _____. The signing and filing of this form will expedite the closing of your return(s) by permitting an early assessment of the deficiency or deficiencies, and will prevent the accumulation of interest, since the interest period terminates 30 days after receipt of the form, or on the date of assessment, or on the date of payment, whichever is earlier.

Very truly yours,

_____
Commissioner,

By _____
Internal Revenue Agent in Charge.

Enclosures:
Statement
Form 1276
Agreement Form

Form 870 (1951).
U. S. TREASURY DEPARTMENT, INTERNAL REVENUE SERVICE. (Date Received)

WAIVER OF RESTRICTIONS ON ASSESSMENT AND COLLECTION OF DEFICIENCY IN TAX AND ACCEPTANCE OF OVERASSESSMENT

Pursuant to section 272 (d) of the Internal Revenue Code or corresponding provisions of prior internal revenue laws, the restrictions provided in section 272 (a) of the Internal Revenue Code or corresponding provisions of prior internal revenue laws are hereby waived and consent is given to the assessment and collection of the following deficiencies together with interest on the tax as provided by law; and the following overassessments are accepted as correct:

DEFICIENCIES

Type of tax	Year ended	Tax	Penalty	Total

OVERASSESSMENTS

Type of tax	Year ended	Tax	Penalty	Total

_____
(Taxpayer)

_____
(Taxpayer)

_____
(Address)

[SEAL] By _____ _____
(Date)

NOTE.—The execution and filing of this form at the address shown in the accompanying letter will expedite the adjustment of your tax liability as indicated above. It is not, however, a final closing agreement under section 3760 of the Internal Revenue Code, and does not, therefore, preclude the assertion of a deficiency or a further deficiency in the manner provided by law should it subsequently be determined that additional tax is due, nor does it extend the statutory period of limitation for refund, assessment, or collection of the tax.

If this form is executed with respect to a year for which a JOINT RETURN OF A HUSBAND AND WIFE was filed, it must be signed by both spouses, except that one spouse may sign as the agent for the other.

Where the taxpayer is a corporation, the form shall be signed with the corporate name, followed by the signature and title of such officer or officers of the corporation as are empowered to sign for the corporation, in addition to which the seal of the corporation must be affixed.

Form 872. U. S. TREASURY DEPARTMENT, INTERNAL REVENUE SERVICE (Revised Feb. 1951)
ORIGINAL

CONSENT FIXING PERIOD OF LIMITATION UPON ASSESSMENT OF INCOME AND PROFITS TAX

_____, 19__.

In pursuance of the provisions of existing Internal Revenue Laws _____, a taxpayer (or taxpayers) of _____, and the Commissioner of Internal Revenue hereby consent and agree as follows:

That the amount of any income, excess-profits, or war-profits taxes due under any return (or returns) made by or on behalf of the above-named taxpayer (or taxpayers) for the taxable year ended _____, under existing acts, or under prior revenue acts, may be assessed at any time on or before *June 30, 1953*, except that, if a notice of a deficiency in tax is sent to said taxpayer (or taxpayers) by registered mail on or before said date, then the time for making any assessment as aforesaid shall be extended beyond the said date by the number of days during which the Commissioner is prohibited from making an assessment and for sixty days thereafter.

_____
Taxpayer.[1]

_____
Taxpayer.[1]

[SEAL [2]] By _____

_____
Commissioner of Internal Revenue.

By _____ _____
(Date)

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[1] This consent may be executed by the taxpayer's attorney or agent, provided such action is specifically authorized by a power of attorney, which, if not previously filed, must accompany the consent.

If executed with respect to a year for which a JOINT RETURN OF A HUSBAND AND WIFE was filed, this consent must be signed by both spouses unless one spouse, acting under a power of attorney, signs as agent for the other.

If a consent form is executed by a person acting in a fiduciary capacity, such as executor, administrator, or trustee, such person must submit Form 56, "Notice to the Commissioner of Internal Revenue of Fiduciary Relationship," together with certified copy of letters of administration, letters testamentary, trust instruments, or court certificate.

[2] If this consent is executed on behalf of a corporation, it shall be signed with the corporate name, followed by the signature and title of such officer or officers of the corporation as are empowered under the laws of the State in which the corporation is located to sign for the corporation, in addition to which the seal of the corporation must be affixed. Where the corporation has no seal, the consent must be accompanied by a certified copy of the resolution passed by the board of directors, giving the officer authority to sign the consent.

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