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The Taxation of Corporate Surplus Accumulations, by James K. Hall (1952)

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state them, (c) methods of communication—personal and substituted service, mailing, publication, posting, and (d) time limitations.

The last five chapters on absolute notice may, for the purposes of this review, be lumped under the heading of "notification by operation of law," although one should hasten to add that this is not Professor Merrill's terminology. Such notification may be either of facts, or of law. In the former category are public records which, by virtue of recording acts or other legislation, give constructive notice to the world of the facts which they contain. Also in this classification are judicial and quasi judicial records, and *lis pendens*. In the latter category are statutes, ordinances, and administrative rules, regulations, and determinations, of which the public is presumed to take notice. Also in this category are the common law rules which members of the public are presumed to know. The above enumeration is, of course, not intended to be a comprehensive list of the matters covered; it is suggestive only of the broad bench marks which the treatise surveys in great detail.

Vicarious notice, both cognitive and absolute, is the subject matter of the concluding portion of the book. It contains a comprehensive treatment of those portions of the law of agency, corporations, and fiduciaries which charge one person or legal entity vicariously with knowledge acquired by, or presumed to be in possession of another.

The exhaustive nature of Merrill on Notice, and the thoroughness with which it has been prepared, may be illustrated by a few statistics. The index covers 112 pages and contains 559 principal headings. More than 29,000 judicial decisions are listed in the Table of Cases, with references to the section numbers of the book where they are discussed or serve to document the text. Moreover, each chapter is headed by an analytical table of contents. Here is a reference work on a subject which has heretofore received practically no systematic attention. It is designed primarily to aid the busy practicing lawyer, but should also be of great service to law students and law teachers.

MILTON D. GREEN*

THE TAXATION OF CORPORATE SURPLUS ACCUMULATIONS, by James K. Hall, prepared for the Joint Committee on the Economic Report, United States Government Printing Office, Washington, 1952, pp. 260, \$0.55.

If *A*, an individual in the present top surtax bracket, receives \$100,000 in dividends from a corporation in which he is a dominant stockholder, he will have only \$8,000 left for reinvestment after payment of personal tax. If, however, the corporation retains these earnings, *A* will have the entire \$100,000 available for investment through the corporation which he controls. By accumulation of earnings in the corporation and reinvestment through that agency, *A* can expect to reap far greater future returns on the initial \$100,000 of income than if the earnings are distributed to him as dividends. These earnings can either be distributed to *A* in a later year when tax rates may be lower or his surtax position more favorable, or they can be pyramided until *A* decides to liquidate the corporation or sell his stock, at which time he can take advantage of capital gains treatment for the accumulated earnings.

Because of the obvious invitation to tax avoidance implicit in this sort of situation, Congress has attempted since as early as 1913, to compel distribution and/or investment of corporate earnings through the imposition of an additional tax with respect to unreasonable accumulations of corporate income. After a good deal of legislative tinkering, this penalty tax has evolved into Section 102 of the Internal Revenue Code.

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It is this provision of the tax laws which engages the attention of Dr. James K. Hall, Professor of Economics at the University of Washington, in this study prepared for the Joint Committee on the Economic Report. The result is a comprehensive and informative survey covering the basic purposes underlying Section 102, its history, its economic effects upon corporations within its orbit and upon the economy generally, the administration of the Section by the Bureau of Internal Revenue, its treatment by the courts, and the criticisms which have been leveled against it, together with proposals for its modification. Although designed as an appraisal of the effectiveness of Section 102 as a legislative mechanism for the achievement of a particular Congressional policy, Dr. Hall's study can be of real value to the practicing lawyer as well.

In Chapter I, Dr. Hall discusses the basic purposes of Section 102 and the necessity for some such safeguard against tax avoidance through the use of the corporate device. This necessity arises from the non-integration of the corporate and individual income taxes and from the legal doctrines recognizing the corporation as a distinct entity capable of being interposed between the source of income and its receipt by the individuals beneficially entitled thereto. The statute is designed to achieve two results: First, equality of tax treatment as between partnerships and individuals on one hand and corporations on the other; and, second, protection of the revenues derived from the individual income tax, which has become the federal government's chief instrument of taxation. Dr. Hall emphasizes the fact that since the repeal of the undistributed profits tax in 1939, Section 102 is the *only* device capable of preventing surtax savings through accumulation of corporate surplus.

Certain criteria in the application of Section 102 are outlined in Chapter II, making this one of the most useful parts of the book from the standpoint of the tax practitioner. Whether an attorney is called upon to advise a client with respect to the possible impact of Section 102, or is actually involved in litigation thereunder, he may find valuable suggestions in the listings of indications of proper and improper accumulation of surplus which are to be found here. Two of the most fruitful of Dr. Hall's observations are set out in this chapter. It is here that he first makes the point, which is reiterated throughout the study, that the critical factor in determining the applicability of Section 102 is likely to be corporate liquidity, rather than the size of the corporation's surplus, its ratio of current assets to current liabilities, or its volume of working capital. The command of the statute with respect to corporate earnings is actually in the alternative—either pay dividends or find proper "employment" for the funds within the business. Earnings may be retained if they are actually invested in physical assets or inventories, or are otherwise actively utilized. However, if large sums in cash, investments or other liquid assets are accumulated, the corporation may expect trouble unless it can supply a persuasive justification for such an accumulation. The other very practical suggestion which Dr. Hall makes is with respect to the possibility of justifying accumulation of liquid funds in terms of reserves for replacement of depreciated assets at figures higher than cost.

In Chapters III and IV consideration is given to the economic effects of Section 102, both upon the corporations concerned and upon the economy generally. Some twenty-two specific criticisms of the statute are listed, from the claim that it discriminates against small business to the suggestion that it tends toward concentration of industry. Detailed attention is given not only to the results of a questionnaire circulated by the Joint Committee on the Economic Report, but also to questionnaires prepared by the Tax Institute and the Brookings Institution. A good many statistical analyses are presented, and although lawyers may tend to shy away from such arrays

of figures, there are a number of revealing averages and ratios disclosed which might be of material assistance in determining whether a corporate client is in danger under the statute.

Dr. Hall concludes that most of the criticisms of Section 102 are not too serious. He notes that the Section does tend to force dividends in excess of those which corporate directors may deem sound, but doubts whether it has had any tendency to induce corporate insolvency. He concedes that the statute operates to reinforce both the inflationary and deflationary phases of the business cycle, but doubts whether the effect is sufficient quantitatively to be of any real significance. In this chapter, Dr. Hall adverts to one important sidelight on Section 102. This arises from the fact that it has been held that directors who involve a corporation in liability under the Section may in turn be personally liable to minority stockholders as a consequence. In one case, suits to assert such liability were compromised for \$2,390,000. The Bureau of Internal Revenue has thus received unexpected assistance in its efforts at enforcing the statute.

The Bureau's administration of Section 102 is dealt with at length in Chapter V. It is pointed out that in the early years the statutory forerunners of the present section were largely ineffectual and were not enforced except in particularly glaring cases. It was not until the Revenue Act of 1938 shifted the burden of proof to the corporation to establish the reasonableness of its accumulation that enforcement really became practicable. Dr. Hall emphasizes that Section 102 is a penalty tax and that its effectiveness should be measured not by the revenues brought in but by the extent of its influence upon corporate fiscal policy.

A detailed analysis of the enforcement of the section in fiscal 1940 to 1950 is included in Chapter V. Here again, the lawyer willing to wade through the statistics will find enlightening conclusions as to the size of corporation most often affected, the significance of close ownership and control, and the fiscal ratios and dividend policies of the corporations against which deficiencies have been asserted.

Judicial enforcement of Section 102 is covered in Chapter VI. After noting that the first of the 101 cases litigated under the Section prior to January 1, 1950, arose in Seattle and involved the Smith Tower, Dr. Hall discusses some recent cases going both ways on the question of reasonableness of surplus accumulations. He also includes a very useful summary of all the litigated cases, complete with citations, nature of decision (favorable or unfavorable to the government), petitioner's assets, surplus, number of stockholders, percentage of earnings retained, and other similar data.

Ten specific proposals for modification of Section 102 are discussed in Chapter VII. Although he sees merit in some of these, Dr. Hall regards most of them (e.g. the shifting of the burden of proof to the Commissioner) as likely seriously to impair the effectiveness of the statute. He offers, instead, some very interesting suggestions for the complete or partial integration of individual and corporate income taxes, some of which would in large measure obviate the necessity for Section 102. Dr. Hall urges the advantages of the partnership method of integration under which all stockholders of closely held corporations (administrative difficulties precluding universal application) would include in their individual income tax returns their proportionate share of the corporate income, whether distributed to them or not.

In Chapter VIII Dr. Hall concludes with an excellent short summary of the experience under Section 102. His ultimate conclusion is that the only real answer is integration. Short of that he recommends increasing the rates under Section 102 in order to make it a more effective barrier to tax avoidance. He regards this as necessary because the individual surtax rates have so far outrun the penalty rates under this Section that even an individual in relatively low surtax brackets may find it

advantageous to have corporate earnings retained, even though this results in liability under Section 102, with subsequent withdrawal of the income in the form of a long term capital gain.

This study is concluded with a number of appendices, the most useful for a lawyer being a complete legislative history of the statutory policy now lodged in Section 102. There is also a comprehensive bibliography which would be useful to an attorney faced with a Section 102 problem.

Dr. Hall has performed a valuable service in collecting so effectively a wealth of material bearing upon this controversial tax provision. Although his study is primarily intended to assist Congress in framing future tax policy, it contains much of interest and value to the tax attorney.

KENNETH A. COX*

POLITICAL AND CIVIL RIGHTS IN THE UNITED STATES, by Thomas I. Emerson and David Haber. Buffalo: Dennis and Co., Inc., 1952, pp. 1209. \$7.50.

Although not so described on its title page, this is essentially a casebook and is an amplification of materials prepared by the editors for a course offered by them at Yale Law School. In addition to cases, the great majority of which are decisions of the United States Supreme Court, there are numerous excerpts from legal and non-legal literature designed to provide a factual background for the problems considered in the cases, and to supplement the doctrinal analyses and arguments of the opinions. Then there are digests of a host of recent cases, and finally, extensive bibliographies of the literature, legal and nonlegal, on each of the areas covered in the book. These last two features are designed, most successfully, to meet the needs of the practicing lawyer, or any other person who wishes to pursue a particular subject further.

The aim of the book, according to its editors, "is to throw light upon those institutions, rules and procedures of our society which keep the system functioning on a democratic level, which permit our people to solve their problems through the exercise of democratic choice, which, in short, form the ground rules for the practice of democracy." (p.v.) That is a pretty ambitious undertaking, and we are immediately told that only some of the "ground rules" are to be considered. In general, it appears that the book covers only those areas where controversies currently flourish and legislative and judicial battles rage. Even so, limitations of space compelled the omission of several important and "live" problems; notably the treatment of aliens, "emergency" restrictions, and military law. (p. xv) The topic "Restrictions on Aliens" is covered briefly in slightly more than three pages of editorial exposition (pp. 522-6), excellent as far as it goes. This subject deserves treatment as a major topic on a parity, for example, with racial discrimination in housing, for the cruelty with which some aliens are now being treated at the command of Congress and with the approval of the Supreme Court (see, e.g., *Harisiades v. Shaughnessy*, 342 U.S. 580 (1952); *Carlson v. Landon*, 342 U.S. 524 (1952); *U.S. v. Spector*, 343 U.S. 169 (1952)) is a most revealing—and disturbing—sign of the times.

As the title indicates, the topics which are covered in the book may be divided into two categories which overlap to a certain extent. In addition to the right of franchise, under which head are treated the various means whereby Negroes have been prevented or discouraged from voting, and the inequalities resulting from outdated apportionment of legislative districts and discriminations against minority parties, the category of "political rights" includes, in the classification of Professors

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