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FEDERAL INCOME TAX—UNDISTRIBUTED PROFITS TAX—STATE LAW CONTROLLING IN DETERMINING WHETHER CORPORATION HAD A "DEFICIT."—The Ogilvie Hardware Corporation was organized under the laws of Louisiana in 1907 with a paid-in capital of \$100,000 represented by 1,000 shares of common stock having a par value of \$100 each. In 1924, the corporation, having a surplus of \$149,306 capitalized part of the surplus by issuing a stock dividend of \$100,000. Subsequently the corporation suffered reverses and its books for the fiscal years of 1937 and 1938 reflected deficits of \$71,347 and \$60,923, respectively. The corporation, in determining its deficit, considered the 1924 stock dividend liability.

This suit was instituted by the corporate taxpayer to recover the undistributed profits taxes exacted by the government for the years 1937 and 1938. The district court gave judgment for the defendant corporation. The circuit court affirmed and the Supreme Court of the United States granted certiorari. *Held*, taxpayer entitled to recover undistributed profits taxes where as here state law forbade such distribution. *United States v. Ogilvie Hardware Co.*, 1 C. C. H. 1947, Fed. Tax Rep. par. 9209 (T. C. 1947).

The Commissioner of Internal Revenue had determined that the respondent was subject to the undistributed profits tax according to the Revenue Act of 1936, Section 14,¹ imposing a heavy surtax on the undistributed net income of a corporation. The purpose of the section was to force corporations to pay dividends so that the dividends might be taxed as income to the shareholders.² Prior to the 1936 Act stock dividends were not taxable in the hands of stockholders³ and corporations could avoid taxes upon their income by declaring stock dividends.⁴

The claim of the taxpayer is hinged upon the Revenue Act of 1942⁵ which amended the Revenue Act of 1936 and was designed to grant refunds or credits to corporations which were required to pay undistributed profits taxes for tax years in which they had an accumulated deficit and where, for that reason, state or federal law prohibited distribution of dividends. Louisiana has such a statute.⁶

The government resisted the taxpayer's claim in the district court by contesting its right to include the amount of the stock dividend in determining the deficit. The district court held for the taxpayer pointing out that there was no question as to the taxpayer's good faith in declaring the dividend in 1924 and distinguishes this case, where the deficit arose from operating losses, from one in which

¹ Revenue Act of 1936 §§ 13, 14, 49 STAT. 1648, 1655-57 (1936).

² *United States v. Ogilvie Hardware Co.*, 155 F. (2d) 577 (C. C. A. 8th 1946).

³ *Eisner v. Macomber*, 252 U. S. 189, 64 L. ed. 521 (1920).

⁴ *United States v. Ogilvie Hardware Co.*, 62 F. Supp. 338 (W. D. La. 1945).

⁵ INT. REV. CODE § 501(c).

⁶ LA. GEN. STAT. (Dart. 1939) § 1106.

the deficit is caused by acts of the corporation in declaring stock dividends.⁷

The petitioner contended that "deficit" and "accumulated earnings and profits" as used in the Revenue Act of 1942 had a connotation peculiar to tax law and should be construed accordingly with the result that the stock dividend of 1924 declared by the corporation was not a deficit in the federal tax sense but remained a part of earnings and profits, hence the refund should be disallowed.

The Court rejected the argument declaring that such a construction would greatly limit the scope of the relief intended, and in support of the position taken, reviewed the legislative history of the 1942 amendment where it was demonstrated that corporations organized under state laws which forbade the declaration of dividends while the capital was impaired and, at the same time, subjected to heavy taxes on undistributed profits, were "caught in a trap."⁸

The Court further considered that the right to a refund under the 1942 amendment necessarily depended on whether a state or federal law prohibits the payment of dividends and, therefore, regard must not be limited to tax terminology but inquiry must be made as to what is meant by "deficit" and "accumulated earnings and profits" according to the state or federal law. And furthermore, to accept the Government's contention would be to require courts administering the 1942 Act to first determine whether a deficit exists under federal law; if such a deficit, in the federal sense, exists, the courts must look to state law to determine whether under it a deficit exists which prohibits the payment of dividends. The Court stated, "We do not think that Congress intended the Courts so to administer the 1942 amendment."⁹

The dissenting opinion of Justice Frankfurter, in which Justice Reed joined, was placed on the ground that the tax language employed should be read in its tax sense; and that, so read, "a deficit in accumulated earnings and profits" did not include a deficit resulting from the capitalization of profits by a stock dividend.

W. L. H.

⁷ *Century Electric Co. v. Com'r of Internal Revenue*, 144 F. (2d) 983 (C. C. A. 8th 1944).

⁸ *Hearing Before Senate Committee on Finance on Revenue Act of 1942 77th Congress, 2d Sess. 2343 (1942)*.

⁹ *United States v. Ogilvie Hardware Co.*, 1 C. C. H. 1947, FED. TAX REP. par. 9209 (T. C. 1947).