

The Undistributed Profits Tax and Some Constitutional Safeguards

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CURRENT LEGISLATION

THE UNDISTRIBUTED PROFITS TAX AND SOME CONSTITUTIONAL SAFEGUARDS.—The Revenue Act of 1936¹ is a combination of two tax methods, one of which is entirely new in the history of corporation income tax legislation.² The Act continues the old method of taxing normal corporation incomes as determined by the established tax formula³ and in addition introduces a new method under which a surtax is imposed upon corporation profits of each taxable year where such profits are not distributed as dividends to stockholders. The admitted purpose of this new method is to force these profits into the hands of the individual stockholders where they can then be subjected to heavy personal income taxes.⁴ The principle upon which this method is based, that of taxing the real beneficiaries of profits rather than the nominal recipients, has long been applied in the taxation of fiduciaries,⁵ partnerships and syndicates. Partnership and syndicate profits are treated for purposes of taxation as though constructively received by the partners and syndicate members.⁶ The strength and vitality⁷ of the doctrine of corporate entity makes im-

¹ Effective generally in taxable years beginning after December 31, 1935.

² While the method of taxing undistributed profits had been proposed long before and had been under consideration as early as 1921, it was never adopted in any of the preceding acts.

³ The Act continues the tax on normal income but at graduated rates instead of at a flat rate as in prior acts.

⁴ It is claimed that such forced distributions when in the hands of the stockholders will in many cases be subject to surtax rates ranging as high as 75% on surtax net income. Compare this with the rate of 13¾% on such profits if they were retained in the corporate treasury.

⁵ The taxation of fiduciaries bears a striking resemblance to the tax on undistributed profits. This is especially true where the income of the trust may be either distributed or accumulated in the discretion of the fiduciary. Such income is taxable to the trust to the extent that it remains undistributed. It is taxable to the beneficiaries to the extent that it is paid or credited to them. See REVENUE ACT OF 1936, §§ 161, 162.

⁶ 1 PAUL AND MERTENS, LAW OF FEDERAL INCOME TAXATION (1934) 09.16. The authors submit this as an example of constructive receipt. This does not appear to be a true application of the doctrine of constructive receipt. That doctrine rests upon the ground that money is immediately due and available to the taxpayer and his failure to receive it in cash is due entirely to his own volition. Partnership or syndicate profits are specifically taxed to the members thereof by the statute, though the profits be neither available nor distributable and without regard to the doctrine of constructive receipt. (See 09.02 of same work.)

⁷ Beginning with the historic case *Trustees of Dartmouth College v. Woodward*, 4 Wheat. 518 (U. S. 1819), this doctrine has been recognized and respected by state and federal courts. Its applicability to tax legislation begins with *Lynch v. Hornby*, 247 U. S. 339, 38 Sup. Ct. 543 (1918). However, it does not prevent courts from disregarding the corporate form

possible such arbitrary tax imposition upon stockholders. This doctrine receives cautious and respectful consideration in the present and all prior Acts.⁸ As a result, Congress was faced with the problem of how to apply the principle to stockholders without violating the doctrine. Under prior Acts corporations were free to distribute or withhold profits from stockholders. Their discretion was tempered only by the requirement of reasonableness.⁹ The President was, however, now determined to close up this great legal loophole.¹⁰ He demanded that the profits so withheld be forced into the hands of their true beneficiaries so that the high surtax rates on individual incomes could operate upon them. The tax on undistributed profits is the President's contribution toward the solution of this problem. By taxing profits withheld from stockholders at graduated surtax rates ranging from 7 to 27 per cent the Act makes the withholding of corporation profits an extremely unprofitable practice.

Aside from the practical difficulty¹¹ of distributing as dividends each year every dollar that the corporation earns, many corporations, both large and small, are bound by all sorts of legal restrictions against payment of dividends. Contractual obligations, provisions of state statutes, charter provisions and by-laws often impose strict prohibitions and restrictions upon dividend distributions. These facts seem to require no explanation. Yet Congress has seen fit to all but ignore them. Bitter protest has resulted only in some unsatisfactory concessions. Thus, where the corporation cannot distribute its income without violating a provision of a written contract executed by the corporation prior to May 31, 1936, which provision expressly deals with the payment of dividends, it is entitled to a credit in computing the amount of profits remaining undistributed and subject to surtax.¹² Similarly if the written contract, though not containing terms of prohibition, expressly deals with the disposition of the earnings and profits of the taxable year and requires them to be paid or irrevocably set aside in discharge of a debt, a credit is allowed to the extent that such

where fraud or evasion were the purposes of its creation. See *U. S. v. Milwaukee Co.*, 142 Fed. 247 (E. D. Wis. 1905).

⁸ A separate and distinct tax on corporation profits is imposed upon the corporation, while the stockholder computes his income without regard to corporation profits.

⁹ Section 102, Revenue Act of 1935, imposed a surtax upon improperly accumulating corporate surplus. This section is continued in the Revenue Act of 1936 and is in addition to all other taxes.

¹⁰ The President's message to Congress, *N. Y. Times*, March 3rd, 1936, in which he estimates that a loss of over a billion dollars a year resulted from the wilful withholding of corporation profits by controlling stockholders. He termed this the greatest loophole in all prior acts.

¹¹ Some of the practical considerations which have been entirely ignored by Congress are:

a—Nothing is left for necessary reserves.

b—Corporation profits hardly ever are represented by cash, but most often in a going business are reflected in inventories and other assets not readily convertible into cash.

¹² REVENUE ACT OF 1936 § 26, (c) (1).

amount has been paid or set aside.¹³ These credits are further qualified to preclude a taking of a double credit in cases where both types of restrictions prevail.¹⁴

The discussion which follows undertakes only to raise a few of the Constitutional problems which the Act seems to create and to suggest in a limited way the probable direction in which their solution lies. No attempt is made to give full consideration to the problems treated.

"When a corporation is organized under a general enabling act, its charter consists of the provisions of the existing state constitution, the particular statute under which it is formed and all other general laws which are made applicable to corporations formed thereunder and of the articles of association or incorporation filed thereunder * * *."¹⁵ The right of incorporation conferred by a general law is after acceptance in the nature of a contract which cannot be avoided without the consent of the parties. Therefore a reservation in the state constitution,¹⁶ or in any of the statutes which become part of the charter,¹⁷ constitute assent in advance by the parties to alteration or repeal by the state legislature and the prohibition against impairment of the obligation of contracts by the *states* which is set forth in the Constitution of the United States does not apply.¹⁸ No similar prohibition restricts federal legislation. Congress when dealing with a subject lying within its control cannot be bound by contracts between private parties and contract obligations of states and municipalities and it may expressly prohibit and invalidate contract provisions which interfere with the carrying out of its policy, unless its action in such respect is so arbitrary and capricious as to invoke the protection of the 5th Amendment.¹⁹

In view of the facts stated in the preceding paragraph we might well confine ourselves to the conclusion that the Act cannot be successfully attacked on the ground that it violates the Constitutional prohibition against the impairment of contracts. However, we ought not to leave this question without inquiring into the nature of the impairment, if any, caused by the Act. Impairment results when a corporation having a deficit distributes its current year's profits in violation of a prohibition contained in the state's general or penal statutes. A careful reading of the Act fails to disclose any legal compulsion upon the taxpayer to distribute dividends in violation of its charter. The burden imposed by the Act is the payment of taxes not dividends. There is no attempt to prescribe a course of conduct for the taxpayer.

¹³ REVENUE ACT OF 1936 § 26, (c) (2).

¹⁴ REVENUE ACT OF 1936 § 26, (c) (3).

¹⁵ 14 C. J. § 108.

¹⁶ N. Y. CONST. ART. 8 § 1.

¹⁷ N. Y. GEN. CORP. LAW Art. 2, § 5.

¹⁸ Trustees of Dartmouth College v. Woodward, 4 Wheat. 518, 533 (U. S. 1819).

¹⁹ Norman v. Baltimore & O. R. R. Co., 294 U. S. 40, 55 Sup. Ct. 103 (1935).

It is free to distribute or withhold profits. The purpose and policy of the Act is the same as that of all preceding revenue acts; it attempts only to raise revenues.

The provisions of the Federal Constitution which apply to the taxation of income are:

1. Article 1, Section 8, Clause 1.
2. Article 1, Section 2, Clause 3.
3. The 16th Amendment.
4. The 5th Amendment.

The first provision above enumerated states that, "Congress shall have the power to lay and collect taxes, duties, imposts and excises." The power of Congress to levy income taxes rests solely upon this provision. A great deal of confusion has resulted from the misconception that the 16th Amendment is the source of this power. That Amendment provides that, "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." This provision does not create the power to tax income. It recognizes the existence of that power and merely attempts to free it from the requirement of apportionment set forth in Art. 1, Sec. 2, Cl. 3.²⁰

Differences of opinion exist as to whether a tax on *gross income* before allowance for business expenses would constitute a tax on income within the original Constitution and the 16th Amendment. Art. 1, Sec. 8, Cl. 1, does not use that term nor does the Amendment define or distinguish between one kind of income and another. For our purpose it is sufficient to note that the Act does allow the deduction of business expenses in the determination of taxable income. The undistributed profits tax uses as its base the taxable income determined after deduction of business expenses.²¹ Therefore no question can be raised as to whether the tax is upon such income as is within the meaning of the Constitution.

Another question which suggests itself is whether the restrictions contained in the general laws²² and in the penal codes²³ of the several states against the payment of dividends from capital is a contract obligation within the meaning of the sections²⁴ of the Act which grant credits where contract obligations relating to dividends exist. The Treasury Department in its capacity as official interpreter of the Act has taken a definite stand on this question.²⁵ It does not recog-

²⁰ *Brushabel v. Union Pac. R. R. Co.*, 240 U. S. 1, 36 Sup. Ct. 236 (1916);
1 PAUL AND MERTENS, LAW OF FEDERAL INCOME TAXATION (1934) 04.06.

²¹ REVENUE ACT OF 1936 § 14, (a) (2), (b).

²² N. Y. STOCK CORP. LAW § 58.

²³ N. Y. PENAL LAW § 664.

²⁴ REVENUE ACT OF 1936 § 26, (c) (1) (2) (3).

²⁵ T. D. 4674 Art. 26-3 (a).

nize the charter of the corporation as a contract restricting the payment of dividends within the intent of the Act. In view of the opinion expressed in preceding paragraphs that no impairment of contract obligation is involved, this decision would seem to be quite proper. Since Congress cannot be bound by contract obligations and since in fact no contract obligation is impaired, it could have *expressly* ignored these restrictions. Despite the failure to express its intention in unequivocal terms there can be no doubt that such intention is manifested by a fair reading of the Act. That the refusal to recognize such obligations may result in inequality and discrimination under the 5th Amendment is, however, an entirely different question.

The 5th Amendment to the Constitution declares that no person shall be "deprived of life, liberty or property without due process of law." Does the Act discriminate between equal classes of taxpayers? Is the corporation with a deficit which is compelled to pay the surtax through its inability to defy charter restrictions against dividends from capital, discriminated against when the corporation with a surplus may avoid the tax? Are all corporations, subject to the undistributed profits tax, equal classes of taxpayers? A corporation may under the income tax formula have a profit which in fact does not exist due to losses and expenditures not allowed by law. If the profit as computed under the tax formula is not distributed it will be subject to the surtax though no profit exists which can be distributed.

Highly arbitrary discrimination between equal classes of taxpayers is undoubtedly a violation of the "due process" clause. On the other hand, "A statute is not unconstitutional under the 'due process' clause unless it is so arbitrary and capricious that it constrains to the conclusion that it is not the exercise of taxation, but a confiscation of property. In other words a statute is not unconstitutional unless it is so wanting in a basis for classification as to produce a gross and patent inequality."²⁶ Accordingly, it has been held to be not unconstitutional to discriminate between corporations and individuals,²⁷ domestic corporations and foreign corporations,²⁸ and partners and individuals,²⁹ for tax purposes.

CONCLUSION.

The power to tax is also the power to destroy. Constitutional safeguards limit this power but it nevertheless remains a broad and far reaching one. The continuation and very existence of the fed-

²⁶ 1 PAUL AND MERTENS, LAW OF FEDERAL INCOME TAXATION (1934) 04.08.

²⁷ *Flint v. Stone-Tracey Co.*, 220 U. S. 107, 35 Sup. Ct. 342 (1911); 24 HARV. L. REV. (1910-11).

²⁸ *Barclay & Co. v. Edwards*, 267 U. S. 442, 45 Sup. Ct. 348 (1924); *Nat'l Paper & Type Co. v. Bowers*, 270 U. S. 630, 46 Sup. Ct. 335 (1925).

²⁹ *Wm. Grey*, 13 B. T. A. 51, 53, *aff'd*, 35 F. (2d) 139 (C. C. A. 4th, 1929).

eral government depend upon this power. Therefore, the Supreme Court has not hesitated to disregard fine-drawn distinctions reaching into infinity. Unless the sections relating to undistributed profits flagrantly violate all tests under the 5th Amendment the entire Act must be declared constitutional.

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THE LEGAL EFFECT OF THE SEAL ON AN INSTRUMENT.—The New York Legislature in recent enactments hastened the final destruction of the common-law effects of a seal on a written instrument. One of the statutory changes is the new Section 342 of the Civil Practice Act, which reads as follows:

"1. A seal upon a written instrument hereafter executed shall not be received as conclusive or presumptive evidence of consideration. A written instrument, hereafter executed, which changes or modifies or which discharges in whole or in part a sealed instrument shall not be deemed invalid or ineffectual because of the absence of a seal thereon. A sealed instrument may not be changed, modified or discharged by an executory agreement unless such agreement is in writing and signed by the party against whom it is sought to enforce the change, modification or discharge. A sealed instrument so changed or modified shall continue to be construed as an instrument under seal.

"2. The rights and liabilities of an undisclosed principal under any sealed instrument hereafter executed shall be the same as if the instrument had not been sealed."¹

Through the years, regulations concerning the seal became embedded in our statutory law. Instances of this may be seen in the necessity of a seal on public documents, on certificates issued by public officers, and on statutory bonds.² The seals that are thus required by statute remain unaffected by the recent legislation.

¹ N. Y. LAWS 1936. c. 685.

² N. Y. CIV. PRAC. ACT § 330. A writ of *habeas corpus* must be issued under the seal of the court awarding it. N. Y. CIV. PRAC. ACT § 1236. A certified copy of a record kept by a court or officer having a seal must be admitted into evidence if certified under the hand and seal of such court or officer. N. Y. CIV. PRAC. ACT § 382. Courts of record are required to have seals. N. Y. JUDICIARY LAW § 28. The seal kept by the county clerk of each county shall continue to be the seal of the Supreme Court in that county, N. Y. JUDICIARY LAW § 158, except New York County where the seal of the county clerk shall continue to be the seal of the county court. N. Y. JUDICIARY LAW § 194. An order under the Agriculture and Markets Law must have the official seal attached thereon. N. Y. AGRICULTURE AND MARKETS LAW §§ 15, 36. N. Y. EDUCATION LAW § 25. N. Y. LABOR LAW § 15. N. Y. INS. LAW § 4. N. Y. EXECUTIVE LAW § 74. N. Y. TAX LAW § 172. N. Y. Surr. Ct. Act §§ 3, 31. N. Y. C. MUNI. Ct. CODE § 143, (2). N. Y. BANKING LAW § 11.