Boston College Law Review

Volume 3 | Issue 3 Article 11

4-1-1962

Federal Tax Legislation

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Recommended Citation

Robert F. Sylvia, *Federal Tax Legislation*, 3 B.C.L. Rev. 469 (1962), http://lawdigitalcommons.bc.edu/bclr/vol3/iss3/11

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validate formal action.[27] Similarly, where the directors are in the habit of acting informally they may bind the corporation.[28] The corporation may also be estopped to deny the validity of an action taken informally.[29] Cases have held that where the directors own all the stock of the corporation informal action by the board is valid,[30] and shareholders have authority to ratify informal action taken by the board.[31] It may thus be said that the statutes regulating informal action by the board represent a codification of, rather than a departure from, the existing case law.[32]

MICHAEL B. SPITZ

FEDERAL TAX LEGISLATION

INTRODUCTION

The second session of the 87th Congress which convened on January 10, 1962,[1] has at the time of this writing passed only one tax law, the celebrated "Du Pont Bill."[2] There is, however, an indication that at least some additional changes will be made in the Internal Revenue Code and, therefore, some of the significant proposals will also be discussed in this article.

LEGISLATION PASSED

The "Du Pont Tax Law"[3] is a product of a rather specialized situation; consequently, a brief glance at the events creating a need for the legislation will help clarify a later discussion of its provisions.

E. I. Du Pont de Nemours and Co., hereafter referred to as Du Pont, was the owner of twenty-three percent of the common stock of General Motors Corporation, most of which it had acquired about forty years ago.[4] The Justice Department determined that since Du Pont and General Motors were in allied fields, Du Pont's holdings in General Motors constituted a violation of the antitrust laws. As a result a complaint was filed in 1949 and there began a protracted litigation of the issue.[5]

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27 Sherman v. Fitch, 98 Mass. 59 (1867).

28 Scott v. Cord, 75 Nev. 179, 336 P.2d 773 (1959).

29 Jourdan v. Long Island R.R., 115 N.Y. 380, 22 N.E. 153 (1889).

30 Gerard v. Empire Square Realty Co., 195 App. Div. 244, 187 N.Y. Supp. 306 (1921).

31 Merchant's & Farmer's Bank v. Harris Lumber Co., 103 Ark. 283, 146 S.W. 508 (1912).

32 It may be observed that the North Carolina statute, supra note 22 is a striking example of case law which has been enacted into a statutory code. On the general subject of informal action by the board of directors, cf. 2 Fletcher, Corporations § 391 et. seq. (1954 rev. ed.); Ballantine, Corporations § 42 et. seq. (1946).

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1 108 Cong. Rec. 1 (daily ed. Jan. 10, 1962).

2 Public Law 87-403, 76 Stat. 4 (1962).

3 Supra note 2.

4 S. Rep. No. 1100, 87th Cong., 1st Sess. (1961).

5 Supra note 4.

The Supreme Court in 1957 determined that Du Pont's holdings in General Motors constituted a violation of Section 7 of the Clayton Act[6] since Dupont might be in a position to prevent General Motors from buying paints and fabrics from other suppliers. The Court felt that all parties acted honorably and fairly but that such a situation was not permitted by the Clayton Act.[7] The Court, therefore, remanded the case to the District Court for the Northern District of Illinois for proper equitable relief. The District Court refused, however, to order divestiture of the General Motors Stock because of the harsh tax consequences involved[8] and the Justice Department appealed. The Supreme Court determined that divestiture was the only appropriate relief and ordered this to take place within ten years. The Court then remanded the case to the District Court so that a plan of divestiture could be drawn up,[9] which plan has not yet been formulated.

As a result of this litigation, Du Pont became faced with the problem of either selling or distributing sixty-three million shares of General Motors stock. Obviously, the sale of such a large block would adversely affect the market; therefore, the only course open was to distribute the majority of the stock to its shareholders. The adverse tax consequences feared by the District Court[10] would then become a reality since such a distribution would be treated as a dividend to the individual shareholders of Du Pont to the extent of its fair market value and to corporate shareholders to the extent of Du Pont's basis for the stock.[11] Because of these tax consequences the bill under discussion was promulgated.

Generally, the act attempts to minimize the tax consequences of the distribution to the Du Pont shareholders, who are individuals, by treating any gain as a capital gain thus subjecting them to a maximum tax of twenty-five percent.[12] As to corporate shareholders, the act treats the distribution as a dividend so that by use of the intercorporate dividend deduction a maximum tax of 7.8 percent will result.[13] Mechanically, these results are achieved by adding a new section to the Code[14] and by amending several other sections.[15]

The new section, section 1111, defines certain stock as divested stock in

6 This action is governed by the Clayton Act before its amendment in 1950. 64 Stat. 1125, 15 U.S.C. § 18 (1914).

7 United States v. E. I. Du Pont de Nemours & Co., 353 U.S. 586 (1957).

8 177 F. Supp. 1 (N.D. Ill. 1959).

9 366 U.S. 316 (1961).

10 Supra note 7.

11 Int. Rev. Code of 1954, § 301. Since Du Pont had sufficient post-1913 earnings and profits to cover all of this distribution, it would be a dividend under § 316 and therefore taxable as ordinary income under § 301(c)(1).

12 Int. Rev. Code of 1954, §§ 1201 and 1202.

13 Int. Rev. Code of 1954, § 243. The 7.8 figure results when the 85% deduction of § 243 is subtracted from the total dividend leaving 15%. This 15% multiplied by the 52% corporate tax results in a figure of 7.8%.

14 Int. Rev. Code of 1954, § 1111.

15 Int. Rev. Code of 1954, §§ 301, 312, 535, 543, 545, 556 and 561.

section 1111(e) to include stock which is the subject of an antitrust order[16] entered after January 1, 1961, which in essence directs distribution of itemized stock within three years (or at least makes distribution an alternative) and such divestiture furthers the policy of the anti-trust laws. The definition further requires that the court find that the use of this section is required to reach an equitable anti-trust order and that the period of time set for such divestiture is the shortest possible period within which divestiture can practically be accomplished. The section clearly points out that no stock can be divested stock if the violation of the anti-trust laws was intentional. The general rule of section 1111(a) treats any stock which is divested as a return of capital when in the hands of a qualified shareholder, which term means any shareholder except corporations entitled to the dividends received deductions of sections 243, 244 or 245. The receiving shareholder will then pay a capital gains tax and take its fair market value as a basis for the divested stock. It should be noted that section 1111(c)(1) provides in essence that any distribution in lieu of a cash dividend will not be covered by this section.

The corporate shareholders who are unable to qualify under section 1111 because they are entitled to the dividends received deduction are handled under an amendment to section 301.[17] Section 301(f)(1) defines anti-trust stock as stock received by a corporation which was a party to a suit, the result of which was an anti-trust order[18] requiring distribution after September 6, 1961. Such distribution must have been made either pursuant to or in anticipation of an anti-trust order. If the stock qualifies as anti-trust stock, the amount realized will be the fair market value.[19] The basis in the hands of the receiving corporation will be the fair market value decreased by as much of the dividends received deductions of sections 243, 244 and 245 as is attributable to the excess of the fair market value over the adjusted basis of the distributing corporation increased by any gain recognized to the distributing corporation. It follows that under sections 301 and 316 this distribution will be a dividend to the extent of the earnings and profits of the distributing corporation and will, therefore, qualify for the dividends received deductions allowed to corporations. It should be noted that this section requires that in order to receive this treatment, the corporate shareholder must have been a party to the anti-trust action, which in the Du Pont case would limit this section's application to the stock held by Christiana Corporation, a Du Pont family holding company.

16 Int. Rev. Code of 1954, § 1111(d) defines an anti-trust order as an order directed against a corporation under the Sherman Act, or the Clayton Act, by a final judgment of a court rendered after Jan. 1, 1961, in a suit in which the United States is a party and which was commenced on or before Jan. 1, 1959.

17 The old subsection (f) is now 301(g) and a new 301(f) is added by this act.

18 Supra note 15.

19 Under existing law it would be the lesser of the fair market value or the adjusted basis in the hands of the distributing corporation immediately prior to distribution increased by the amount of any gain recognized to the distributing corporation. Int. Rev. Code of 1954, § 301(b)(1).

The remaining sections of the act concern technical amendments relating to the adjustment of earnings and profits[20] and the accumulated taxable income[21] of the distributing corporation, when the distribution is treated as a dividend. Further amendments cover the treatment of personal holding companies[22] and also adjust the dividends paid deduction when such distribution is treated as a dividend.[23]

The bill as enacted raises a few problems. For one thing, at least on the surface, the bill is not a private bill passed exclusively for the relief of the Du Pont situation, and yet in the Senate Report it is noted that at the request of the Administration the bill is limited to distributions in the Du Pont anti-trust case.[24] It would appear that the formulation of a plan of divestiture for Du Pont by the District Court was probably delayed until the passage of the act so that the court, if it desired, could draft the plan in a manner which would allow the Du Pont shareholders to take advantage of the new sections. With the increase in anti-trust litigation, however, the problem is sure to arise as to the precise nature of the bill, and whether although designated a Public Law, it is in fact private as the minority opinion in the Senate Report points out.[25]

The minority opinion further raises what it considers to be three basic objections to the bill. They believe it is premature, provides unwarranted tax relief for a group which does not need it, and is inconsistent in that it calls for capital gains treatment and, at the same time, dividend treatment for the same distribution.[26] It is submitted that the first two objections can be treated as one. If it is felt that these shareholders do deserve favorable tax consideration, the fact that the bill was passed prior to the court's formulation of a plan for Du Pont is clearly the better approach rather than being premature, as the minority contends, since the new law gives the court a guide under which these shareholders can be given the tax treatment desired if the court feels so moved. However, if, as the minority contends, this tax relief is unwarranted, the passage of any act would be premature. The third objection raised by the minority would appear to be without merit. While it is true that this distribution is treated as a return of capital to individual shareholders and a dividend to corporate shareholders, this type of approach is not novel in the Internal Revenue Code. For example, under section 333(e) a non-corporate shareholder who elects to fall under this section and qualifies under it may have to treat as a dividend a portion of his liquida-

[20] The new subsection will be Int. Rev. Code of 1954, § 312(k).

[21] The new subsections will be Int. Rev. Code of 1954, §§ 535(b)(9) and (b)(10).

[22] The sections amended will be Int. Rev. Code of 1954, §§ 543, 545, and 556.

[23] The new subsections will be Int. Rev. Code of 1954, §§ 561(b)(1) and (b)(2).

[24] S. Rep. No. 1100, 87th Cong. 1st Sess. (1961). See also the presidential release given out when President Kennedy signed the bill into law which strongly indicates that the new law is limited to stock involved in the Du Pont litigation, 7 CCH 1962 Stand. Fed. Tax Rep. § 6283.

[25] Supra note 4 (minority views).

[26] Ibid.

tion distribution while a qualified electing corporate shareholder would treat his distribution as a return of capital.[27]

In any event the bill has been signed into law by the President,[28] and thus the main consideration for the future is its scope, not its merit. It would appear that practitioners and investors concerned with Du Pont stock can chart their course with some certainty. As to any stock not involved in the Du Pont litigation, the effect of the act remains somewhat in doubt.

PROPOSED LEGISLATION

The President, in his State of the Union message of January 11, 1962,[29] made several proposals which can be categorized into three groups. First, he requested the enactment of an investment credit; second, he expressed a desire to close several tax "loopholes"; and, third, he requested standby power to reduce taxes as an anti-recession measure.

The proposed investment credit is discussed elsewhere in this volume,[30] and therefore needs no discussion here. It is well to note, however, that the President has scaled down his request from fifteen percent credit in "new plant and equipment" made last year[31] to the current eight per cent credit in "new machinery and equipment."[32] The reason for this change stems from the fact that the discussion draft of the proposed tax bill due to be delivered to this Session rejected the President's dual rate system and adopted a flat eight percent rate.[33]

Of the "loopholes" the President requested Congress to close, the most significant are: (1) a twenty percent withholding system on dividends and interest; (2) the removal of the dividend exclusion and credit; (3) the tightening up of deductions for entertainment and travel expenses; and (4) the termination of the exemption for income of citizens earned abroad.[34] Of this group, Congress seems likely to consider in some form or other all but the repeal of the dividend exclusion and credit which is not included in the discussion draft.[35]

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[27] See Int. Rev. Code of 1954, §§ 336(f) and 331(a)(1).

[28] The bill was signed into law on Feb. 2, 1962, 7 CCH 1962 Stand. Fed. Tax Rep. § 6283.

[29] 108 Cong. Rec. 49 (daily ed. Jan. 11, 1962).

[30] See 3 B.C. Ind. & Com. L. Rev. 232-39 (1962).

[31] 107 Cong. Rec. 5992 (daily ed. Apr. 11, 1961).

[32] Supra note 29.

[33] Sections 38 and 46-48, House Committee on Ways and Means, 87th Cong., 1st Sess., "General Explanation of Committee Discussion Draft of Revenue Bill of 1961."

[34] Other loopholes that the President seeks legislation to close are:

(1) Remove tax benefits from foreign investment companies controlled by citizens.
(2) Remove capital gain treatment when a taxpayer sells property on which actual depreciation is less than the depreciation previously taken on tax returns.
(3) Taxation of cooperatives and patrons.
(4) Reduce deductions by insurance underwriters for their reserves.

These reforms were all requested last year, 107 Cong. Rec. 5992 (daily ed. Apr. 11, 1961), and the President indicated his intent to stand by them this year, 108 Cong. Rec. 49 (daily ed. Jan. 11, 1962).

[35] House Committee on Ways and Means, 87th Cong., 1st Sess., "General Explanation of Committee Discussion Draft of Revenue Bill of 1961."

There likewise is no indication of a bill to give the President the standby power he requests to reduce taxes although one may be forthcoming later in the Session.

CONCLUSION

While the tenor of the President's latest message indicates that he will not present to this Session the comprehensive tax program he forecast in April of 1961,[36] there has been one bill passed,[37] and other significant proposals indicate that major tax consequences will stem from the work of this Session.

ROBERT F. SYLVIA

STATE TAXATION

During 1961 state legislatures enacted numerous new tax laws. The most important developments occurred in the areas of sales and property taxation and the taxation of net income of multistate businesses. Many of these new laws have a direct and important effect on the business taxpayer, especially the taxpayer who conducts business in more than one state.

SALES AND USE TAXES

Perhaps the most significant items of state tax legislation which were passed during 1961 were new sales and use taxes in Texas and Wisconsin. The Texas act, which took effect on September 1, 1961, imposes two per cent sales tax complemented by a two per cent use tax. The tax applies to all retail sales of personal property within the state.[1] Wisconsin imposed a three per cent sales tax on a more restricted basis. The main items covered by the Wisconsin tax are alcoholic beverages, tobacco products, motor vehicles, aircraft, and household and commercial furniture. A three per cent tax is also imposed on gross receipts from the sale of admission to theatres and other amusements, the furnishing of rooms by hotels, and sales of telephone or telegraph service. This tax became effective on February 1, 1962.[2]

With the addition of Texas and Wisconsin thirty-five states now depend on some form of sales tax for a large part of their revenue.[3] This type of

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36 Supra note 30.

37 Supra note 2.

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1 Tex. Acts 1961, H.B. 20.

2 Wis. Laws 1961, H.B. 716.

3 Alabama, Arizona, Arkansas, California, Colorado, Connecticut, Florida, Georgia, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Michigan, Mississippi, Missouri, New Mexico, North Carolina, North Dakota, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Utah, Washington, West Virginia, Wisconsin, Wyoming. See generally, Haig & Shoup, The Sales Tax in the American States (1934); Jacoby, Retail Sales Taxation (1938); Cline, The Literature of Sales Taxation, 9 Vand. L. Rev. 360 (1956); Due, The Nature and Structure of Sales Taxation, 9 Vand. L. Rev. 123 (1956).