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Distributions in Kind and the Dividends Paid Deduction—Conflict in the Circuits

Dwight Drake*

The dividends paid deduction provided for in section 561 of the Internal Revenue Code1 is of vital importance to any corporation that is subject to the accumulated earnings tax or the personal holding company tax.2 Either of these taxes, if applicable, is imposed in addition to the federal income taxes otherwise payable by the corporation. Since the accumulated earnings tax is substantial3 and the personal holding company tax is downright confiscatory,4 a corporation must do whatever is necessary legally to avoid paying these additional taxes. A corporation subject to either of the taxes5 generally can avoid them only by taking ad-

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1. Unless otherwise indicated, all references to “Code” or “section(s)” are to the Internal Revenue Code of 1954.

2. I.R.C. §§ 531-537 govern the accumulated earnings tax. The personal holding company tax is governed by I.R.C. §§ 541-547. Other sections directly affected by the dividends paid deduction include I.R.C. § 556(a) (foreign personal holding companies), I.R.C. § 852(a)(1) (regulated investment companies), and I.R.C. § 857(a)(1) (real estate investment trusts). This article discusses the dividends paid deduction only in the context of the accumulated earnings tax and the personal holding company tax, both of which have a much broader application than the taxes on foreign personal holding companies, regulated investment companies, or real estate investment trusts.

3. The accumulated earnings tax is levied at a rate of 27.5% of the first $100,000 of “accumulated taxable income” and 38.5% of any “accumulated taxable income” in excess of $100,000. I.R.C. § 531.

4. If a corporation is determined to be a personal holding company, a 70% tax is imposed on its “undistributed personal holding company income.” I.R.C. § 541.

5. With the exception of personal holding companies, foreign personal holding companies, and Subchapter F tax-exempt corporations, the accumulated earnings tax is imposed on “every corporation . . . formed or availed of for the purpose of avoiding income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed.” I.R.C. § 532. This forbidden purpose is determined to exist if the corporation accumulates income beyond the “reasonable needs of the business.” I.R.C. § 533(a). For a discussion of the term “reasonable needs of the business,” see Treas. Reg. § 1.537-1, T.D. 7165, 1972-1 C.B. 167; Treas. Reg. §§ 1.537-2 to -3 (1959); B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶¶ 8.02-07 (3d ed. 1971); and 1975 B.Y.U. L. REV. 812. The accumulated earnings credit provided for in I.R.C. §535(c) has the effect of requiring that accumulated earnings exceed $150,000 before any tax is imposed. See note 6 infra.

Every corporation found to be a personal holding company is subject to the personal holding company tax. A personal holding company generally is any corporation (1) that
vantage of the dividends paid deduction, which directly reduces the income subject to the taxes.6

Section 561 provides that the dividends paid deduction is the sum of the dividends paid during the year, the consent dividends for the year, and, in the case of personal holding companies, certain dividend carryovers.7 This provision is supplemented by Treasury Regulation 1.562-1, which provides that if a dividend is paid in property other than cash, the dividends paid deduction shall equal the adjusted basis of the property in the hands of the corporation.8

This regulation has significant consequences for the corporation that must distribute sufficient cash or property to avoid the accumulated earnings tax or the personal holding company tax and yet desires to minimize the resulting tax to its shareholders. For example, under the regulation, a personal holding company that must distribute $100,000 to avoid the seventy-percent tax has "personal holding company income" (primarily dividends, interest, rents, and other passive investment income, plus personal service income in the case of "incorporated talents") equal to at least 50% of its "adjusted ordinary gross income," (2) of which over 50% of the value of outstanding stock is owned, directly or indirectly, by five or fewer shareholders. I.R.C. §§ 542-543.

6. In computing "accumulated taxable income" for purposes of the accumulated earnings tax, taxable income for the given year is adjusted to more accurately reflect the corporation's net economic gain for the year. See I.R.C. § 535(b). In addition to this adjustment, an accumulated earnings credit of $150,000 (or more if the reasonable needs of the business exceed $150,000) and the dividends paid deduction are subtracted to arrive at "accumulated taxable income" on which the accumulated earnings tax is imposed. I.R.C. § 535(a).

In the case of a personal holding company, taxable income is modified by adjustments similar to those made for the accumulated earnings tax. See I.R.C. § 545(b). From this amount, the dividends paid deduction is subtracted to arrive at "undistributed personal holding company income" on which the personal holding company tax is imposed. I.R.C. § 545(a).

7. The consent dividends procedure, outlined in I.R.C. § 565, allows a shareholder to agree with the corporation that a certain portion of the earnings and profits will be deemed to have been distributed as a dividend even though no distribution to the shareholder is actually made. The dividend is calculated as though a distribution in money had been made and then returned to the corporation in the form of a contribution of capital. For a further discussion of the consent dividend procedure, see text accompanying notes 78-79 infra.

A dividend carryover is allowed by I.R.C. § 564 in establishing the dividends paid deduction of a personal holding company. This procedure generally permits the corporate taxpayer to include as part of the dividends paid the excess of the dividends distributed during the two prior taxable years over the corporation's taxable income as determined in accordance with I.R.C. § 545 adjustments.

8. Treas. Reg. § 1.562-1(a), T.D. 6949, 1968-1 C.B. 107: "If a dividend is paid in property (other than money) the amount of the dividends paid deduction with respect to such property shall be the adjusted basis of the property in the hands of the distributing corporation at the time of the distribution."
would be required to distribute property with a tax basis of $100,000. If the fair market value of the property were less than $100,000, the corporation could deduct $100,000 while the shareholders would report less than $100,000 as dividend income under section 301—a highly desirable result. Conversely, if the property had appreciated in value, the shareholders' dividend income could exceed the deduction—a disastrous result. Thus, the effect of the regulation is to encourage distributions of depreciated property and to discourage distributions of appreciated property.

Although the validity of this regulation has been questioned by certain commentators for some time, the regulation was not officially challenged until 1971. In that year, the United States District Court for the Western District of Tennessee in H. Wetter Manufacturing Co. v. United States upheld the regulation but was reversed by the Sixth Circuit Court of Appeals. In reversing the lower court, the Sixth Circuit determined that sections 301, 316, and 562 of the Code are unambiguous in specifying that the deduction equals the fair market value of the property distributed. In response to Wetter, the National Office of the Internal Revenue Service added the issue of the validity of the regulation to its Prime Issue List, thereby announcing that the Service would not settle the issue in a contested proceeding. The issue was next considered in Gulf Inland Corp. v. United States, wherein the United States District Court for the Western District of Louisiana invalidated the regulation by summarily concluding that the Sixth Circuit's opinion in Wetter was "well reasoned and

9. Under I.R.C. § 301(b)(1)(A) and (c), the taxable dividend reportable by a noncorporate distributee equals the fair market value of the property distributed to the extent of the corporation's accumulated earnings and profits or current year's earnings and profits, as specified in I.R.C. § 316. Thus, if the adjusted tax basis of the property exceeds its fair market value, the dividends paid deduction under the regulation would exceed the dividends taxable to the shareholder. The same desirable result would be achieved in the case of a corporate distributee, since I.R.C. § 301(b)(1)(B) specifies that a corporate distributee is taxed on the lesser of (1) the fair market value of the property distributed or (2) its adjusted tax basis plus certain gains recognized by the distributing corporation.

10. This assumes that the shareholders are not corporations and that the corporation has sufficient earnings and profits under I.R.C. § 316 to tax the shareholders to the full extent of the property distributed. For an explanation of the result when the earnings and profits are less than the fair market value of the property distributed, see notes 88-89 and accompanying text infra.


13. 458 F.2d 1033 (6th Cir. 1972).


clear.” The issue was considered a third time in the recent case of *Fulman v. United States.*16 In *Fulman*, the United States District Court for the District of Massachusetts and the First Circuit Court of Appeals disagreed with the Sixth Circuit and upheld the regulation. To date, no other reported cases have decided the issue.

This article analyzes the issue of whether the dividends paid deduction should equal the adjusted tax basis of property distributed in kind, as required by regulation 1.562-1, or the amount of dividend income taxable to the shareholder as a result of the distribution. The conclusion of this article is that the deduction should equal the dividend income taxable to the shareholder. Whereas Treasury regulations generally are entitled to deference when judicially reviewed,17 a court could justifiably conclude that regulation 1.562-1 is invalid because it does not focus on the objective of the personal holding company tax and the accumulated earnings tax and is not supported by the statutory scheme of the Code. Therefore, the regulation should be changed or invalidated and, if necessary, the Code should be amended to remove any remaining ambiguity.

**I. THE CONFLICT IN THE CIRCUITS**

**A. Wetter**

The first court to consider the validity of the regulation was the District Court for the Western District of Tennessee in *H. Wetter Manufacturing Co. v. United States.* The court held that

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17. In the language of the *Fulman* court:
   
   In considering appellants’ attack on this regulation, we begin by observing that Treasury regulations are entitled to deference. “As ‘contemporaneous constructions [of the Internal Revenue Code] by those charged with administration of [it], the Regulations ‘must be sustained unless unreasonable and plainly inconsistent with the revenue statutes,’ and should not be overruled except for weighty reasons.” 545 F.2d at 269. Although this view appears to be well settled in the law, certain noteworthy qualifications have been perceived by other tribunals. As the Third Circuit has noted, “Treasury Regulations must be interpreted in the context of the statute they are designed to explicate; ‘there is no power to amend [a statute] by regulation.’” Bank of New York v. United States, 526 F.2d 1012, 1018 (3d Cir. 1975) (quoting Koshland v. Helvering, 298 U.S. 441, 447 (1936)). And as a Texas district court confirmed, a regulation may be declared invalid whenever it “adds restrictions that are not contained in the statute it interprets. . . . It is clear that taxes cannot be exacted by regulation; only the statute can do that.” Baker v. United States, 398 F. Supp. 1143, 1151 (W.D. Tex. 1975) (citations omitted). Thus, while a Treasury regulation warrants deference, it should not be held sacred, particularly in those cases where it adds restrictions not contained in the statutes.
the regulation was valid, basing its decision on a determination that Congress "intended to incorporate" section 27(d) of the Internal Revenue Code of 1939 into the Internal Revenue Code of 1954. Section 27(d) of the 1939 Code had expressly resolved the issue presented in Wetter by providing that the dividends paid deduction equaled the adjusted tax basis or the fair market value of the property distributed, whichever was lower.

The Tennessee district court's determination that Congress intended to incorporate section 27(d) into the 1954 Code was not based upon any language appearing in the 1954 Code. Indeed, nothing in the 1954 Code suggests the result previously obtained under section 27(d) of the 1939 Code. Rather, the district court in Wetter based its determination exclusively upon the Senate Finance Report on the Internal Revenue Code of 1954. That report states that the "requirements of sections 27 (d), (e), (f), and (i)" of the 1939 Code are "contained" in the definition of "dividend" in section 312 of the 1954 Code. On the basis of this statement, the district court upheld the regulation by reasoning that its validity "should be resolved by Congressional intent rather than by oversight."22

In reversing the district court in Wetter, the Sixth Circuit refused to consider the legislative history that formed the basis for the lower court's decision and held the regulation invalid. According to the Sixth Circuit, the 1954 Code unambiguously provides that the deduction equals the fair market value of the property distributed and, therefore, the plain meaning rule of statutory construction requires that the statute be given effect.

18. 330 F. Supp. at 446. The Tennessee district court also concluded that Congress intended to incorporate sections 27(e), (f), and (i) of the 1939 Code into the 1954 Code. Id. For a discussion of each of these sections, see notes 61-66 and accompanying text infra.

   (d) DIVIDENDS IN KIND—If a dividend is paid in property other than money (including stock of the corporation if held by the corporation as an investment) the amount with respect thereto which shall be used in computing the basic surtax credit shall be the adjusted basis of the property in the hands of the corporation at the time of the payment, or the fair market value of the property at the time of the payment, whichever is the lower.

20. The only possibly relevant section of the Code that uses a formula similar to that set forth in section 27(d) of the 1939 Code is I.R.C. § 301(b)(1)(B), which describes the amount that a corporate distributee receives when a corporation makes a distribution in kind. For a discussion of this section, see note 40 and accompanying text infra.


22. 330 F. Supp. at 446.
according to its literal language and makes it "unnecessary and improper" to resort to legislative history or other extrinsic aids.23

The Sixth Circuit's determination that the 1954 Code is unambiguous is based upon its analysis of the interrelationship of various sections of the Code, including sections 561, 562, 316, and 301(d)(1). The court's entire analysis of these sections was as follows:

Section 562 provides that "... the term 'dividend' shall, except as otherwise provided in this section, include only dividends described in section 316. ..." Section 316 provides that if the distributing corporation is a personal holding company during the year in which the distribution is made, "... the term 'dividend' also means any distribution of property ... made by the corporation to its shareholders, to the extent of its undistributed personal holding company income ... for such year."

In addition, Section 301(d)(1) provides in the event that the recipient of the dividend is not a corporation, the basis of the property so distributed shall be "the fair market value" of the property.24

The court's brief discussion of why these sections are not ambiguous is itself unclear, and it proved unpersuasive to the Massachusetts district court and the First Circuit in Fulman v. United States.25

B. Fulman

In Fulman, the Massachusetts district court, while agreeing that a court may not enforce a regulation that is plainly inconsistent with the statute it purports to interpret, rejected the Sixth Circuit's contention that the plain meaning rule should be applied to resolve the issue presented.26 In finding that the 1954 Code is ambiguous, the district court in Fulman pointed to the fact that section 301(d), the principal section relied upon by the Sixth Circuit in Wetter, "speaks only of the valuation of a corpo-

23. 458 F.2d at 1035.
   Like other extrinsic aids to construction, the use of legislative history is to solve but not to create an ambiguity. ... The ambiguity in this case is between the Code and the Regulations, and in such a case it is well settled that the provisions of the Code are controlling. Where the provisions of an act are unambiguous, and its direction specific, the Secretary of the Treasury has no power to amend the statute by regulations.
   (citation omitted)(emphasis in original).
24. 458 F.2d at 1034.
rate dividend received by a shareholder-distributee” and “does not by its terms purport to govern the effect of the distribution on the corporate-distributor of property distributed as a dividend.”27 The court proceeded to uphold the regulation, concluding that it was consistent with the congressional purpose that was “explicitly revealed” in the legislative history of the 1954 Code.28 The legislative history, which in the court’s view “explicitly revealed” Congress’ intentions, was the same legislative history that formed the basis of the lower court’s opinion in Wetter.

On appeal, the First Circuit upheld the regulation,29 agreeing with the lower court that the statute was ambiguous.30 The court noted further that legislative history indicated that Congress did not intend to abrogate section 27(d) of the 1939 Code, which, according to the First Circuit, was substantially incorporated in the regulation.31 Unlike the other three courts, the First Circuit in Fulman extended its analysis by questioning whether the regulation was consistent with the purposes of the personal holding company tax. The court concluded that “ultimately” the “most persuasive” consideration favoring the regulation was that the purposes of the personal holding company tax would be undermined and irrational results would follow if the dividends paid deduction were to equal the fair market value of the property distributed.32

27. Id. at 1041.
28. 407 F. Supp. at 1043:
   Even if the personal holding company tax, 26 U.S.C. § 541 et. seq., is a penalty, and therefore to be construed narrowly against defendant, where the Congressional purpose is explicitly revealed in the legislative history, the Treasury Regulation is consistent with that purpose, and there is no statutory language that supports the construction urged by the taxpayer, the court will accord full weight to the regulation. (citation and footnote omitted).
29. 545 F.2d at 269.
30. Id. at 271.
31. Id. at 270. In fact, the regulation differs from § 27(d) of the 1939 Code in that the regulation provides that the deduction equals the adjusted basis of the property distributed whereas § 27(d) stated that the deduction equaled the lesser of the fair market value and the adjusted tax basis of the property distributed.
32. The First Circuit described the purpose of the personal holding company tax as follows:

The personal holding company tax, as we have noted, was enacted to combat the tax avoidance that could result from the accumulation of income from passive investment activity in a closely held corporation. It operates to force both the distribution of such earnings and the realization of dividend income at the shareholder level by imposing a penalty tax on the undistributed income which had been realized by such corporations during given tax years. 545 F.2d at 272 (emphasis in original).
The First Circuit gave two illustrations of how it believed the purposes of the personal holding company tax would be frustrated if the deduction were based on the fair market value of the property distributed. First, the court explained that if the deduction were to equal the fair market value of the property distributed and a corporation were to distribute appreciated property, the corporation could secure a sufficient deduction to avoid the personal holding company tax without actually having to distribute the earnings that it realized during the year. Such a result, according to the court, would be “contrary to the clear intent” of the personal holding company provisions.33 Second, the court explained that if the dividends paid deduction were to equal the fair market value of the property distributed, a personal holding company whose investments had appreciated in value could avoid the personal holding company tax by distributing assets representing a lower level of corporate investment than could a personal holding company that had identical earnings and amounts invested but whose assets had not appreciated at the same rate. Such a result, according to the First Circuit, would be “impossible to square with the structure and operation” of the personal holding company tax.34

In order to determine whether any of the four courts properly examined the issue presented, it is necessary to examine in detail the applicable Code sections, legislative history, and policy considerations.

II. THE CODE SECTIONS—ARE THEY AMBIGUOUS?

The 1954 Code does not contain a provision which, by its express terms, states the amount of the dividends paid deduction when a corporation distributes property in kind to its shareholders. Nevertheless, an examination of the interrelationship of various sections of the 1954 Code may provide the answer. This is not to suggest, however, that the 1954 Code is sufficiently unambiguous to justify invoking the plain meaning rule of statutory construction.

The plain meaning rule essentially provides that legislative history and other extrinsic aids should not be used to construe a statute when the literal language of the statute is clear and unam-

33. 545 F.2d at 272. For an examination and critique of the court's analysis of this point, see text accompanying notes 82-83 infra.
34. 545 F.2d at 272. For an examination and critique of the court's analysis of this point, see text accompanying notes 84-86 infra.
The following examination of the applicable Code sections demonstrates that the 1954 Code is sufficiently ambiguous that the rule cannot reasonably be applied to resolve the controversies surrounding the dividends paid deduction.

Section 545(a) of the Code provides that a personal holding company is entitled to the dividends paid deduction defined in section 561 in computing its personal holding company tax. Similarly, section 535(a) provides that the accumulated earnings tax shall be computed only after adjusted taxable income is reduced by the dividends paid deduction defined in section 561. Section 561, in turn, provides that the corporation is entitled to a deduction for "dividends paid during the year" and states that the rules set forth in section 562 will determine the amount of the deduction for dividends paid. Following the trail, one learns from the pertinent part of section 562 that "the term 'dividend' shall . . . include only dividends described in section 316." Section 316 provides that a dividend is "any distribution of property made by a corporation to its shareholders" to the extent of its post-1913 earnings and profits, its earnings and profits for the current tax year and, in the case of personal holding companies, "its undistributed personal holding company income . . . for such year."
The statutory trail up to this point is easily followed. It is of little help, however, in solving the problem presented, since none of the sections in the trail even remotely suggest the amount of the deduction when property is distributed in kind. But does the trail stop with section 316? That question has split the circuits, and a careful analysis of the Code suggests that there are at least three possible answers.

A. The Section 301 Alternative

First, an argument can be made that the statutory trail goes one step further, and that the additional step establishes that regulation 1.562-1 is invalid. The basic premise of this argument is that when a distribution is made, the rules of sections 301 and 316 must be read together in determining the amount of the dividend under section 316. Section 301 is significant because subsection (b) of that section expressly provides that the amount of a distribution of property by a corporation to its shareholder is, in the case of a noncorporate distributee, the fair market value of the property.40

panies shall be dividends “to the extent of [the corporation’s] undistributed personal holding company income” for the year notwithstanding an absence of earnings and profits, was added to the 1939 Code in 1942. Revenue Act of 1942, ch. 619, § 186, 56 Stat. 798. Its specific purpose was to aid those personal holding companies that had undistributed personal holding company income in a particular year but had no earnings and profits. As stated in the House Report to the Revenue Act of 1942, without such a provision, such a company “is subject to the personal holding company tax and cannot avoid such tax by making distributions to its shareholders.” H.R. REP. NO. 2333, 77th Cong., 2nd Sess. 136 (1942), reprinted in 1942-2 C.B. 372, 473; see B. Bittker & J. Eustice, supra note 5, ¶ 8.25 n.102.

In its opinion in Fulman, the First Circuit described § 316(b) as follows:

Section 316(b) suggests that, as to distributions in property by personal holding companies, the term “undistributed personal holding company income” may be substituted for “earnings and profits” wherever the latter appears in the Code. If § 316(b) were conceived as having this implication, § 312 would announce the rule contained in the regulation.

545 F.2d at 271 n.6.

The legislative history of § 316(b), as described above, demonstrates that it was never intended to have such broad implications. Its limited purpose is to enable corporations that have no earnings and profits to create a tax at the shareholder level and thereby avoid the personal holding company tax.

40. In the case of a corporate distributee, section 301(b)(1)(B) provides that the amount of the distribution is the lesser of (1) the fair market value of the property, and (2) the adjusted tax basis of the property plus certain gains recognized by the distributing corporation. In applying the formula to determine the amount distributed to a corporate distributee, the adjusted tax basis of the property is increased by the amount of gain recognized by the distributing corporation under subsections (b), (c), or (d) of § 311 (concerning distributions of inventories and encumbered property and certain redemptions); under § 341(f) (concerning gains recognized by consenting collapsible
This argument is supported by the express reference to section 301 contained in section 316. In order for section 316 to apply, there must be a “distribution of property.” In that connection, section 316 states that any distribution to which section 301 applies shall be a distribution under 316.41 Similarly, section 301(c), which defines the amount of distributed property that is taxable as a dividend, incorporates by reference the definition of dividend in section 316. This cross-referencing is reflective of an important relationship between these two sections. The definition of a dividend under section 316 provides the standard for distinguishing a dividend from a return of capital when a nonliquidating distribution of property is made with respect to stock. Section 301, in turn, explains the differences in tax effect of a dividend and a return of capital. Thus, the meaning of the term “dividend” cannot be fully understood unless the two sections are read jointly.

The regulations to section 316 further support this argument by adopting the principle that sections 301 and 316 should be read together in determining the amount of a dividend under section 316 when a distribution of property in kind is made. Regulation 1.316-1(a)(3) illustrates that when a corporation with earnings and profits of $10,000 distributes property having a fair market value of $16,000 and a tax basis of $3,000 to noncorporate shareholders, the amount of the dividend under section 316 is $10,000. This amount represents the lesser of the earnings and profits (under section 316) and the fair market value of the property distributed (under section 301).42 Thus, the corporation’s adjusted tax basis in the property is irrelevant in determining the amount of the dividend, even though section 312 provides that the corporation’s earnings and profits are reduced only by the corporation’s adjusted tax basis in the property.

41. This reference to § 301 insures that § 316, like § 301, will be applied to any distribution made “with respect to stock.” A distribution “with respect to stock” is any distribution made to a shareholder in his capacity as a shareholder. See Treas. Reg. § 1.301-1(c) (1955). Neither section is applicable to a distribution made to a shareholder in another capacity—such as creditor or employee—unless the distribution in substance constitutes a disguised dividend. See B. Bittker & J. Eustice, supra note 5, ¶ 7.05. note 5, ¶ 7.05.

42. This regulation resolves an issue that has been heatedly debated in the past and arguably is not resolved by the 1954 Code. For an excellent discussion of the issue, see B. Bittker & J. Eustice, supra note 5, ¶ 7.22.
Those who argue against relying upon section 301 to determine the amount of the dividends paid deduction point out that that section deals only with tax consequences to the shareholder, not the distributing corporation. It is critical to remember, however, that the term "dividend" has significance principally for the shareholder, not the corporation.\(^\text{43}\) Thus, the presence of the term "dividend" in the phrase "dividends paid deduction" leads one to assume the shareholder's point of view, \(i.e.,\) to value the dividends paid deduction by the same measure used by the shareholder in determining the amount of the taxable dividends he has received. This measure, of course, is provided by section 301.

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B. \text{ The Section 312 Alternative}
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As an alternative, it can be argued that section 312, not section 301, should be looked to for the answer. Section 312 provides that a corporation's earnings and profits are reduced by the adjusted tax basis of property distributed to its shareholders.\(^\text{44}\) In contending that regulation 1.562-1 is valid, the government has relied upon the argument that section 312's reference to the adjusted tax basis of property distributed supports the regulation.\(^\text{45}\)

Proponents of this argument point to the fact that while section 301 deals only with the effect of a property distribution on the shareholder, section 312 specifically deals with the effect of the distribution on the corporation. Accordingly, one could conclude, as did the First Circuit in \textit{Fulman}, that section 312 is more "relevant" than section 301, since the personal holding company tax and the accumulated earnings tax are imposed upon the distributing corporation, not the shareholders.\(^\text{46}\)

\(^{43}\) Dividends received by a shareholder are generally taxed as ordinary income, while a return of capital frequently escapes taxation altogether. On the other hand, nonliquidating distributions in kind made by a corporation with respect to its stock are governed by § 311 and § 312; the tax consequences are the same whether the distribution is a dividend or not.

\(^{44}\) This is the general rule. Section 312 contains specific provisions dealing with, among other things, inventories, encumbered property, depreciable property, certain distributions of stock and securities, and antitrust stock.

\(^{45}\) See \textit{Fulman v. United States}, 545 F.2d at 271 n.6; \textit{Fulman v. United States}, 407 F. Supp. at 1041 n.5.

\(^{46}\) 545 F.2d at 272:

Although § 301 is one of the few places in the Code where the phrase "amount distributed" appears, we can see no reason to treat it as establishing the rules for determining the amount of a personal holding company's dividends paid
This argument is suspect because the deduction is for "dividends paid." The term "dividends" signals the reader from section 316 to section 301, as explained above, and is crucial in determining the tax effect of a distribution on the shareholder. Whether a distribution constitutes a "dividend" does not effect the application of section 312; the tax effects on a corporation of any distributions governed by section 312 (together with section 311) are the same whether the distribution is a dividend or a return of capital. Section 312 speaks only in terms of the corporation's earnings and profits and appears to have nothing to do with the dividends paid deduction provided for in sections 561 and 562. Nothing in the Code explicitly or impliedly links section 312 to these provisions. For this reason, the district court in Fulman concluded that section 312 does not in any way establish a "yardstick of valuation for determining the amount of dividends paid deduction."

C. A Final Alternative

It can be argued that the statutory trail stops at section 316, and that neither section 301 nor section 312 is helpful or determinative in resolving the issue. This argument results in the conclusion that the Code is so ambiguous that the issue must have been overlooked when the 1954 Code was drafted.

Given the scope of these alternatives and the support that can be mustered for each, it is difficult to see how the plain meaning rule can be relied upon in resolving the issue. The Sixth Circuit in Wetter felt that the link between sections 301 and 316 was sufficiently clear and unambiguous to justify application of the rule, but the Sixth Circuit's analysis of the sections is so cursory as to be of little or no comfort to anyone relying upon the deduction. It, of course, deals only with the effect of a distribution on the recipients, and is thus less relevant than § 312.

47. Section 311 describes the gain or loss recognized by the corporation on the distribution; § 312 describes the effect of the distribution on the corporation's earnings and profits.
49. For the Sixth Circuit's entire analysis of the Code sections, see text accompanying note 24 supra.
court’s opinion. Even though the plain meaning rule should not be applied, it does not necessarily follow that the ultimate result of the Sixth Circuit’s decision in Wetter is wrong. Although the Code is not free of ambiguity, one can conclude from reading the Code that sections 301 and 316 should be read together in determining the amount of the dividends paid deduction under section 562. In addition, as explained below, the legislative history can be reconciled with this interpretation, and the purposes and policies of the personal holding company tax and the accumulated earnings tax are best served by this result.

III. The Legislative History

In commenting upon section 562 of the 1954 Code, the Senate Finance Committee Report on the Internal Revenue Code of 1954 states:

Subsection (a) provides that the term “dividend” for purposes of this part shall include, except as otherwise provided in this section, only those dividends described in section 316 (relating to definition of dividends for purposes of corporate distributions). The requirements of sections 27 (d), (e), (f), and (i) of existing law are contained in the definition of “dividend” in section 312, and accordingly are not restated in section 562.50

As previously noted, the significance of this statement is that section 27(d) of the 1939 Code expressly provided that the dividends paid deduction equaled the lesser of the fair market value or the adjusted tax basis of the property distributed.51

On the basis of this statement in the Senate Finance Committee report, the district court in Wetter and the district court and the First Circuit in Fulman concluded that Congress intended that former section 27(d) be incorporated in the 1954 Code and, therefore, that regulation 1.562-1 is valid because it “substantially reflects” the rule set forth by the old section 27(d). In fact, the regulation differs from former section 27(d) in that the regulation provides that the deduction equals the adjusted basis of the property distributed, whereas section 27(d) stated that the deduction equaled the lesser of the fair market value or the adjusted tax basis of the property distributed. Moreover, the government has relied upon the statement from the Senate report in

51. Note 19 supra.
arguing for the regulation, contending that the reference to section 312 in the statement indicates that the dividends paid deduction should be determined according to the rule for deductions from earnings and profits that is set forth in section 312 of the 1954 Code.\textsuperscript{52}

The reliance that has been placed upon the statement from the Senate Finance Committee report is disturbing for two reasons. First, the statement's reference to section 312 is inaccurate. Section 312 does not define the term "dividends," but merely states the effect that a distribution of property has on a corporation's earnings and profits. The rule provided in section 312 is applicable whether or not the distribution constitutes a dividend.\textsuperscript{53} Section 316, not section 312, defines the term "dividends." Second, if one concludes, as did the three courts mentioned previously, that the statement demonstrates that Congress intended to incorporate the rules of old sections 27(d), (e), (f), and (i) into the 1954 Code, then one must conclude that an error was made in drafting the 1954 Code and that the issue was overlooked.

In view of these inaccuracies, it can be argued that the Committee's statement does not clarify the ambiguity in the Code sections but merely creates additional confusion. However, a closer look at the statement and other legislative history of the 1954 Code suggests that rather than revealing a blunder on the part of those drafting the 1954 Code, the statement identifies the sections of the 1954 Code that should be considered in determining the amount of the dividends paid deduction.

A. The Senate Report's Inaccurate Reference to Section 312

The statement's purportedly inaccurate reference to the definition of "dividend" in section 312 is easily explained. The statement consists of two sentences, the first correctly stating that the term "dividend" is described in section 316, and the second incorrectly stating that the term "dividend" is defined in section 312. The Report of the House Ways and Means Committee on the 1954 Code, which was prepared prior to the Senate report, contains the same back-to-back sentences as the Senate report, except that the reference in both sentences is to section 312.\textsuperscript{54} At the time of

\textsuperscript{52} See 545 F.2d at 270 n.2; 407 F. Supp. at 1041-42 n.5.
\textsuperscript{53} See note 47 and accompanying text supra.
the drafting of the House report, what is now section 316 of the Code was section 312 of the House bill. The Senate subsequently renumbered the sections.\textsuperscript{55} Reading the two reports together leads to the inescapable conclusion that after the Senate renumbered the sections, the Senate pulled the statement verbatim out of the House report, correctly changed the reference in the first sentence to section 316 because of the renumbering, but failed to make a similar correction in the second sentence.\textsuperscript{56} Accordingly, the reference to section 312 in the second sentence of the Senate report should have been to section 316. This conclusion is certainly reasonable, since section 562 of the 1954 Code, the Code section that the statements are intended to explain, merely refers the reader to section 316 for the definition of “dividend.” Moreover, section 316, not section 312, defines the term “dividend.” Of course, this conclusion destroys the government’s argument that the reference to section 312 was intended to show that the earnings and profits rules of section 312 of the 1954 Code should be used in determining the amount of the dividends paid deduction.

\textbf{B. Rule of 1939 Code Incorporated in Section 316}

The district court and the First Circuit in Fulman concluded that even if the reference to section 312 is changed to section 316, the second sentence of the statement (which states that the “requirements” of old sections 27(d), (e), (f), and (i) are contained in section 312) still clearly indicates that Congress intended to perpetuate the rule contained in old section 27(d).\textsuperscript{57} This conclusion necessarily assumes that an error was made in drafting the Code, since the rule of section 27(d) is not “contained” in the 1954 Code; it also assumes that both the House and Senate reports are in error for suggesting that section 27(d) is incorporated in the 1954 Code. Moreover, this conclusion fails

\textsuperscript{55} As the Senate Report indicates, “[s]ection 316 sets forth the definition of a dividend for purposes of the subtitle. This definition corresponds generally . . . to section 312(a) of the House bill.” S. Rep. No. 1622, 83d Cong. 2d Sess. 251, reprinted in \textit{[1954]} U.S. Code Cong. & Ad. News 4621, 4889.

\textsuperscript{56} The Massachusetts district court and the First Circuit in Fulman both noted that this error was made in preparing the Senate Finance Committee report. 407 F. Supp. at 1041-42 n.5; 545 F.2d at 270 n.2.

\textsuperscript{57} 545 F.2d at 270: “Although the language of this report is ambiguous in several respects and may not support the government’s claim that it indicates that § 312 is to govern such matters, this report certainly indicates that Congress did not contemplate the abrogation of the rule of old § 27(d).” (footnote omitted).
to consider the possible significance of the word "requirements," which appears in the second sentence of the statement.

As an alternative to the conclusion of the Fulman courts, one can reasonably argue that the term "requirements" in the second sentence of the statement suggests that the drafters of the reports merely intended that this sentence communicate to the reader that the functions or "requirements" previously satisfied by sections 27(d), (e), (f), and (i) of the 1939 Code are now satisfied by section 316 of the 1954 Code. In other words, the second sentence of the statement was not intended to indicate that section 316 of the 1954 Code incorporates the exact rules of section 27 of the 1939 Code, but rather that the term "dividend" as defined in section 316 of the 1954 Code eliminates the need for the old rules. A number of arguments can be made in support of such an interpretation.

First, the proposed interpretation is completely consistent with and arguably buttressed by the first sentence of the statement. The first sentence informs the reader that the definition of dividends under section 316 determines what dividends are deductible under sections 561 and 562. According to the suggested interpretation, the second sentence merely amplifies the first by explaining that since the definition of dividend in section 316 serves the same function as old section 27, it eliminates the need for the rules previously set forth in old section 27. Under such an interpretation, the second sentence logically follows the first. Moreover, this interpretation is consistent with section 562 of the 1954 Code, which the statement in the reports is intended to explain, because section 562, like the first sentence of the statement, simply states that the dividends deductible are those dividends defined in section 316.

Second, the proposed interpretation of the second sentence does not require the conclusion that an oversight was made in drafting the 1954 Code or in drafting the legislative reports.

Of course, section 316 does not indicate the amount of a dividend when a corporation distributes property in kind to its shareholders. For this reason, it may be argued that the sentence is in error even under the suggested interpretation. As previously illustrated, however, the amount of the dividend can be readily determined if sections 301 and 316 are read together and, in this connection, the same Senate and House reports that contain the

58. See notes 40-43 and accompanying text supra.
statement in issue indicate by word and example that sections 301 and 316 should be read together in determining the amount of a dividend when property is distributed in kind. 59 Thus, it can be persuasively argued that the legislative reports in their total context suggest that the functions previously covered by section 27(d) are now covered by sections 316 and 301 of the 1954 Code. If sections 301 and 316 are read together, the deduction equals the fair market value of property distributed to a noncorporate shareholder. 60

The legislative history provides an additional basis for suggesting that sections 301 and 316 should be read together in determining the amount of the dividends paid deduction. The statement from the House and Senate reports indicates that, in addition to the requirements of section 27(d) of the 1939 Code, the requirements of section 27(e), (f), and (i) are contained in section 316 of the 1954 Code. An examination of these other subsections to section 27 of the 1939 Code reveals that sections 301 and 316 of the 1954 Code, if read together, embrace all the situations referred to in these subsections of old section 27.

Subsection (e) of old section 27 specified the amount of the dividend when a corporation distributed its own obligations, and subsection (f) specified the amount of the dividend when a corporation distributed a taxable stock dividend. 61 Under the 1954

60. See note 40 and accompanying text supra.
61. Int. Rev. Code of 1939, ch. 1, § 27(e), (f), 53 Stat. 1:
(e) dividends in obligations of the corporation.—If a dividend is paid in obligations of the corporation, the amount with respect thereto which shall be used in computing the basic surtax credit shall be the face value of the obligations or their fair market value at the time of the payment, whichever is the lower. . . .
(f) taxable stock dividends.—In case of a stock dividend or stock right which is a taxable dividend in the hands of shareholders under section 115(f), the amount with respect thereto which shall be used in computing the basic surtax credit shall be the fair market value of the stock or the stock right at the time of the payment.
Code, a corporation's own obligations and taxable stock dividends are treated as property under section 301, and the general rules of section 301 and 316, read together, are used in determining the amount of the dividend under such circumstances. Moreover, the result obtained under sections 301 and 316 of the 1954 Code is identical to the result obtained under old section 27(f).

Subsection (i) of old section 27 was the other subsection whose “requirements,” according to the statement in the legislative reports, are contained in the definition of dividends in section 316 of the 1954 Code. Subsection (i) stated:

(i) **NONTAXABLE DISTRIBUTIONS**—If any part of a distribution (including stock dividends and stock rights) is not a taxable dividend in the hands of such of the shareholders as are subject to taxation under this chapter for the period in which the distribution is made, such part shall not be included in computing the basic surtax credit.

The effect of this subsection was to prevent a corporation from receiving a dividends paid deduction (referred to as “credit” under the 1939 Code) on any part of a distribution that was not taxed to shareholders as a dividend. Since section 301 of the 1954 Code explains the tax effect of a dividend on a shareholder, a similar result can be obtained under the 1954 Code only if sections 316 and 301 are read together in determining the amount of the dividends paid deduction. Under regulation 1.562-1, the mandate of subsection (i) is violated if the corporation distributes to a noncorporate shareholder property that has depreciated in value, since the shareholder would report dividend income equal to the fair market value of the property under section 301, assuming there are sufficient earnings and profits. An identical rule for taxable stock dividends was provided in § 27(f) of the 1939 Code. Section 27(e) of the 1939 Code provided that, with respect to distributions of a corporation's own obligations, the amount distributed equaled the fair market value or face amount of the obligation, whichever was the lower. Note 61 supra.

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62. When dealing with a noncorporate distributee, it is universally conceded, although the Code itself is not explicit, that a distribution by a corporation of its own obligations is to be treated as a distribution of property under section 301(b)(1)(A). B. Brittker & J. Eustice, supra note 5, ¶ 7.40. Likewise, taxable stock dividends, subject to the provisions of section 305(b), are treated as distributions of property to which section 301 applies. For a detailed discussion of the history and intricacies of taxable stock dividends, see id. ¶ 7.60-62.

63. See id. ¶¶ 7.40, .61(3), .62(1).

64. Under § 301 and § 316, an individual shareholder reports dividend income equal to the fair market value of the corporate obligation or taxable stock distributed, assuming there are sufficient earnings and profits. An identical rule for taxable stock dividends was provided in § 27(f) of the 1939 Code. Section 27(e) of the 1939 Code provided that, with respect to distributions of a corporation's own obligations, the amount distributed equaled the fair market value or face amount of the obligation, whichever was the lower. Note 61 supra.

whereas under the regulation the corporation would obtain a dividends paid deduction equal to the tax basis of the property. 66

The net effect of this discussion is that the legislative history, like the Code, does not provide a definite, unambiguous answer to the question presented. Nevertheless, a few helpful conclusions can be drawn. It clearly appears that the reference to section 312 in the statement in the Senate report should have been to section 316. Also, the conclusion reached by all courts that have upheld the regulation that the legislative history “clearly manifests” Congress’ intention to retain the rule contained in old section 27(d) is incorrect. The legislative history does not “clearly” support such a conclusion. Indeed, a strong argument can be made that the legislative history, when viewed in its total context, suggests that together section 301 and 316 of the 1954 Code were intended to and do resolve those situations previously resolved by section 27(d), (e), (f) and (i) of the 1939 Code, and that the dividends paid deduction should therefore be determined by reference to sections 301 and 316.

IV. POLICY CONSIDERATIONS

This section analyzes which method of computing the dividends paid deduction for distributions of property in kind best serves the purpose and objective of the accumulated earnings tax and the personal holding company tax.

A. Objective of the Taxes

The accumulated earnings tax can be traced to the Revenue Act of 1913. 67 At that time, Congress recognized that shareholders of a corporation could avoid individual income taxes by allowing the corporation to accumulate earnings. To prevent such abuse, the Revenue Act of 1913 provided that if any corporation was “formed or availed of” for the purpose of avoiding the tax to its

66. Neither the Fulman courts nor the Wetter courts considered subsections (e), (f), or (i) of § 27 of the 1939 Code, all of which are referred to in the same sentence of the legislative reports that mentions subsection 27(d). As the discussion in the text demonstrates, the function each of the subsections served under the 1939 Code is satisfied under the 1954 Code only if sections 301 and 316 are read together in computing the amount of the deduction for dividends paid.

shareholders by accumulating earnings, the shareholders would be taxed as if the earnings were distributed. The effect of this provision was to create a tax at the shareholder level equal to the corporation’s annual earnings, whether or not these earnings were distributed. In 1921, Congress determined that the 1920 case of Eisner v. Macomber created “considerable doubt” as to the constitutionality of taxing shareholders on income they never received. As a result, the accumulated earnings tax was changed by the Revenue Act of 1921, and Congress elected to accomplish its purpose by imposing the tax at the corporate level unless the shareholders consented to include their share of the annual corporate earnings in their income. Although Congress changed the means of accomplishing its purpose in 1921, the objective of the tax has always been the same—to force improper accumulations of each year’s income out of the ‘incorporated pocketbook’ of business corporations and into the hands of stockholders where they will be taxable . . . .” This purpose is still recognized by

68. The “formed or availed of” test has accompanied the accumulated earnings tax since its beginning in the Revenue Act of 1913. Under this test, whether a corporation was formed for the purpose of avoiding taxes by accumulating earnings and profits is immaterial if the corporation was actually availed of for the purpose during the taxable year. In practice, the test is difficult to apply. For an in depth consideration, see B. Bittker & J. Eustice, supra note 5, ¶ 8.02 and 7 J. Mertens, supra note 67, at § 39.27.

69. 252 U.S. 189 (1920). In Eisner, the Supreme Court held that Congress could not tax income to a shareholder of a corporation until it was actually “realized.” Since a stock dividend, evidencing nothing more than the transfer of accumulated surplus to the capital account of a corporation, took nothing from the corporation’s property and added nothing to that of the shareholder, no income was “realized” by the individual.


Section 226: Section 220 of the existing law provides that if any corporation is formed or availed of for the purpose of evading taxes by accumulating earnings and profits is immaterial if the corporation was actually availed of for the purpose during the taxable year. In practice, the test is difficult to apply. For an in depth consideration, see B. Bittker & J. Eustice, supra note 5, ¶ 8.02 and 7 J. Mertens, supra note 67, at § 39.27.


72. A corporation can still avoid the accumulated earnings tax and personal holding company tax by having its shareholders consent to include in their taxable income their share of the annual corporate earnings. I.R.C. § 566; see note 7 supra; notes 78-79 and accompanying text infra.

The personal holding company tax was added in 1934 for the purpose of automatically imposing a substantial penalty tax upon those corporations that constitute "personal holding companies" and enable their shareholders to avoid paying taxes on earnings accumulated by the corporation. Although applicable to a far smaller class of corporations than the accumulated earnings tax, the personal holding company tax is much easier to apply, since there is no need to prove that the corporation was "formed or availed of" for the purpose of avoiding the income tax on its shareholders. The House report to the Revenue Act of 1934 leaves no doubt that the objective of the personal holding company tax is the same as that of the accumulated earnings tax—to prevent shareholders from avoiding the individual tax by the use of "incorporated pocketbooks." The report indicates that the function of the dividends paid deduction is to insure that the tax works "no real hardship upon any corporation except one which is being used to reduce surtaxes upon its shareholders."

The objective of both taxes focuses on the income taxable at the shareholder level. That the tax is directed at shareholder's income is perhaps best demonstrated by the fact that Congress has specifically provided a means whereby the accumulated earnings tax and the personal holding company tax can be avoided if the shareholders consent to report as dividend income the annual corporate earnings. If such a consent is obtained, the corporation

74. Ivan Allen Co. v. United States, 422 U.S. 617, 624-25 (1975):
Without some method to force the distribution of unneeded corporate earnings, a controlling shareholder would be able to postpone the full impact of the income taxes on his share of the corporate earnings in excess of its needs . . . .
In order to foreclose this possibility of using the corporation as a means of avoiding the income tax on dividends to the shareholders, every Revenue Act since the adoption of the Sixteenth Amendment in 1913 has imposed a tax upon unnecessary accumulations of corporate earnings effected for the purpose of insulating shareholders.

76. H.R. REP. NO. 704, 73d Cong., 2d Sess. 11 (1934):
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 . . . . 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.
77. Id. at 12.
78. The dividends paid deduction of I.R.C. § 561 includes the sum of the consent
gets a deduction for dividends paid under section 565 without having to sell, exchange, or distribute any assets. The justification for the provision is that there is no need for a corporation to alter its affairs or actually distribute assets, since the common objective of the taxes will be satisfied as long as the government is not deprived of "the revenue which would flow from the receipt of dividends by the shareholders."

In order to determine whether the dividends paid deduction should equal the adjusted tax basis of property distributed in kind, as required by the regulation, or the amount of dividend income taxable to the shareholders, a distinction must be drawn between the common objective of the accumulated earnings and personal holding company taxes and the means used to accomplish that objective. As indicated above, the objective of the taxes is to prevent use of the corporation as a means of avoiding the income tax on dividends to shareholders. This objective focuses upon the dividend income reportable by the shareholders. In the case of both the accumulated earnings tax and the personal holding company tax, the means used by the Code to accomplish this objective is to provide that a substantial additional tax will be imposed upon the adjusted taxable income of the corporation unless the corporation secures a deduction for dividends paid equal to its adjusted taxable income. As previously noted, this method of taxation was drafted following Eisner v. Macomber because Congress foresaw possible constitutional problems in taxing a shareholder directly on income he may never receive. Because the Code accomplishes the common objective—tax at the

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dividends for the taxable years. Thus, if the shareholder consents to report income as though a dividend had been received, the corporation can avoid the penalty taxes without actually distributing property or money.

79. The consent dividend procedure in I.R.C. § 565 can be traced to the Revenue Act of 1938, ch. 289, § 28, 52 Stat. 447. The purpose for the provision was aptly described in the House Report to the Revenue Act of 1938 as follows:

One of the principal objections which has been urged to any form of corporation tax measured by undistributed profits has always been that many corporations, for a variety of reasons, find it difficult, if not impossible, in certain situations to declare dividends in cash or scrip or to distribute taxable stock dividends. Section 28 of the bill is intended to provide a method whereby such a corporation, with the cooperation of its shareholders, may obtain the tax benefits incident to actual distribution without violation of any contractual commitment or any rule of law which might prevent it, in whole or in part, from distributing its earnings and without depriving the Government of the revenue which would flow from the receipt of dividends by the shareholders.


80. See note 6 and accompanying text supra.

81. See notes 69-72 and accompanying text supra.
shareholder level—by the means of threatening a substantial additional corporate tax on realized earnings for the given year, it is possible to confuse the means with the objective, by concluding that the objective of the taxes is to impose an additional tax at the corporate level on undistributed realized earnings. The effect of such a mistake is to lose sight of the income reportable by the shareholders, thereby frustrating the real objective. As explained below, the First Circuit in *Fulman* made this very mistake and, as a result, incorrectly analyzed the issue presented.

B. The First Circuit's Error

The First Circuit in the *Fulman* case was the only court that examined the objective of the personal holding company tax in resolving the issue. That court gave two illustrations of how there would be "irrational results" if the dividends paid deduction were to equal the amount of the dividend income taxable to the shareholders under sections 301 and 316. Both illustrations demonstrate that the court misperceived the objective of the personal holding company tax.

The court first explained that the purpose of the personal holding company tax could be undermined if the deduction were to equal the dividend taxable to the shareholders because, with such a rule, a corporation that distributes appreciated property could avoid the tax and, at the same time, could "continue to accumulate the income it had realized on its investments during the relevant tax year—without being under any compulsion to distribute such earnings." This would be that the corporation, and hence the shareholders, could succeed in shielding passive investment income from the operations of the personal holding company tax.

The court's argument focuses on the corporation and incorrectly assumes that the objective of the tax is to impose an additional tax at the corporate level on undistributed realized income for the year. As explained above, the real objective of the tax is to create a tax at the shareholder level equal to the corporation's earnings for the year. This objective, by definition, is satisfied only if the corporation's deduction for dividends paid is equal to the dividends taxable to its shareholders. Accordingly, the objective is satisfied, not frustrated, when individual shareholders,
pursuant to sections 301 and 316, report dividends equal to the fair market value of the property distributed in kind and the corporation gets a deduction in the same amount for dividends paid. The fact that the fair market value of the property is greater or less than its adjusted tax basis is not relevant in determining whether the basic objective has been satisfied.

The court's second illustration of how there would be "irrational results" if the deduction equaled the dividends taxable to the shareholders under sections 301 and 316 can best be explained by an example. Suppose personal holding companies A and B each have $50,000 of undistributed personal holding company income before the dividends paid deduction and each have invested $10,000 in marketable securities. Suppose further that the securities in which Company A invested have appreciated in value to $50,000, whereas the securities in which Company B invested have appreciated in value to only $20,000. If both companies distribute their securities as dividends, the shareholders of Company A would have to report a dividend of $50,000, the fair market value of the stock, and the shareholders of Company B would have to report a dividend of $20,000.

If the dividends paid deduction equals the amount of dividends reportable by the shareholders, Company A would have a large enough deduction for dividends paid to avoid the personal holding company tax, but Company B would have to distribute additional property or secure the necessary consent for its shareholders to report an additional $30,000 of dividend income. According to the First Circuit in Fulman, such a result would be irrational because the companies would have "completely different tax liabilities after distributing assets representing the same level of corporate investment."

The court gives no explanation of how the purpose and objective of the tax square with its argument that companies with equal earnings should be treated equally if they distribute assets representing the same level of corporate investment.

84. This example and subsequent examples assume that the distribution is made to an individual rather than to a corporate distributee.
85. 545 F.2d at 273.
86. Id:

The disparate treatment would not arise from any differences in their tax situation during the tax year in question, but from the fact that the assets which they had distributed had appreciated at different rates during the period prior to that tax year.

Since we think the regulation in question is entirely consistent with the
ment completely ignores the amount of dividends taxable to the shareholders of the respective companies. The objective of the tax is to create a tax at the shareholder level equal to the corporation's annual earnings. This objective will be served if the only way each company can avoid the tax is by having its shareholders report dividend income of $50,000 under sections 301 and 316. Therefore, there is nothing irrational in allowing Company A to avoid the tax without any additional distributions and specifying that Company B can avoid the tax only if its shareholders either consent to report an additional $30,000 as dividend income or receive additional property requiring them to report an additional $30,000 of dividend income. The purpose of the tax is not to force Company A to distribute its property but only to assure that the shareholders of A and B each report income equal to $50,000, the amount of undistributed personal holding company income.

C. The Section 301 Alternative Best Serves the Objective of the Taxes

If the dividends paid deduction is measured by any standard other than the rules set forth in sections 301 and 316, then whenever a corporation distributes property in kind as a dividend there will inevitably be a difference between the amount of dividend income taxable to the shareholders and the deduction given to the corporation for having distributed the dividend. This difference generally will create results inconsistent with the basic objective of the taxes.

Regulation 1.562-1, which provides that the dividends paid deduction equals the adjusted tax basis of the property distributed, aptly illustrates the point. Suppose personal holding Company C, having $50,000 of undistributed personal holding company income, had invested in two marketable securities. Suppose the first marketable security cost $50,000 and had declined in value to $10,000 and that the second security had cost $10,000 and had appreciated in value to $50,000. If Company C distributes the first security, its shareholders would have to report dividend income of only $10,000 under sections 301 and 316. Yet, under regulation 1.562-1, Company C would be entitled to a deduction for dividends paid of $50,000, its adjusted tax basis in the property and, therefore, could avoid the personal holding com-

objectives and terms of the revenue act, we hold that the district court was correct in sustaining the validity of this regulation . . . .
pany tax without having to make any further distributions. The net effect under the regulation is that the company could avoid the personal holding company tax by requiring that its shareholders only report $10,000 of the $50,000 actually earned by the company during the year. The result is to encourage companies to frustrate the basic objective of the taxes by picking and choosing for distribution those securities in their portfolios that have declined the most in value.

A similar unreasonable result is obtained if regulation 1.562-1 is applied and Company C distributes the securities that have appreciated in value. The shareholders would report a dividend under sections 301 and 316 equal to $50,000, the fair market value of the property distributed, but the corporation would only receive a deduction for dividends paid equal to $10,000 under the regulation. The objective of the tax is satisfied by this distribution because the shareholders would report dividend income equal to the company's personal holding company income for the year. Nevertheless, under the regulation, Company C would have to distribute an additional $40,000 to its shareholders in order to avoid the tax. If the corporation has sufficient earnings and profits, the effect of such an additional distribution will be that the dividends taxable to the shareholders would exceed the company's personal holding company earnings for the year by $40,000.87 If the company had not accumulated earnings and profits, the likely result for a personal holding company,88 the net effect would be even more absurd since the additional distribution would be treated as a nontaxable return of capital to the shareholders under sections 301 and 316.89 Nothing suggests that any

87. This would follow from the fact that the shareholders have already reported income to the extent of personal holding company earnings on the original distribution of property with a fair market value of $50,000. The incongruity of this result with the objective of the personal holding company tax is compounded where the company is forced to distribute additional appreciated property, the shareholder being forced to report as dividend income perhaps twice or three times more than the amount of personal holding company earnings of the corporation. For example, if the company distributes additional stocks with a basis of $40,000 and a fair market value of $100,000, the company will avoid the penalty tax by having distributed property with a cumulative basis equal to the earnings for the year. The shareholder, however, must report as income an amount equal to three times the corporation's earnings, since the fair market value of the dividends received is $150,000.

88. Personal holding companies generally do not accumulate significant earnings and profits because they must distribute all of their personal holding company income annually in order to avoid the 70% penalty tax.

89. A noncorporate distributee is taxed only to the extent that a distribution is made from the corporation's earnings and profits. I.R.C. §§ 301(b)(1)(A), 301(c), 316. If there are no earnings and profits, the distribution is treated as a return of capital and works to
purpose or objective of the accumulated earnings tax or the personal holding company tax would be served by requiring a company to distribute nontaxable returns of capital or dividends in excess of the current year’s earnings.

The First Circuit in *Fulman* thought it would be an “anomaly” to value the dividends paid deduction under section 301, since the amount of the deduction for a dividend in kind would then vary, depending upon whether or not the shareholder was a corporation. The First Circuit has clearly misperceived the objective of the accumulated earnings and personal holding company taxes. The fact that Congress had a sound reason for treating corporate and noncorporate shareholders differently when property is distributed in kind does not in any way alter the fact that the purpose of the taxes—to create dividend income at the shareholder level—can only be satisfied if the dividends paid deduction equals the amount of dividend income taxable by the shareholders, whatever that amount might be under the Code. Indeed, the fact that Congress has set forth in section 301 different rules for different types of shareholders when property is distributed in kind demonstrates that no single rule should be used for determining the dividends paid deduction and confirms the importance of referring to sections 301 and 316 in determining the amount of the deduction.

V. CONCLUSION

The common objective of the accumulated earnings tax and the personal holding company tax will be served best if the deduction for dividends paid equals the dividend income taxable to the

reduce the shareholder’s basis in the corporation’s stock which he holds. I.R.C. § 301(c)(2). If the return of capital exceeds the shareholder’s basis in his stock, the excess is treated as gain recognized on the sale or exchange of property and is subject to capital gains treatment. I.R.C. §§ 301(c)(3)(A), 1221, 1222.

90. 545 F.2d at 272. The court gave no reason why it should be considered an anomaly that the amount of the dividends paid deduction would depend upon the characterization of the recipient of the dividend.

91. See note 40 and accompanying text supra.

92. The drafters of the 1954 Code specifically designed section 301 to insure that when property is distributed in kind, the dividend income taxable to a corporate shareholder and the corporate shareholder’s tax basis in the property distributed would not exceed the tax basis of the property in the hands of the distributing corporation. This provision was necessary because § 243 of the 1954 Code gives corporate shareholders an 85% deduction for dividends received from a domestic corporation. Thus, without such a provision, a corporate shareholder could get a stepped up basis in the property distributed by paying tax on only 15% of the amount of the unrealized appreciation. See H.R. Rep. No. 1337, 83d Cong., 2d Sess. A71, reprinted in [1954] U.S. Code Cong. & Ad. News 4017, 4208.
shareholders when property is distributed in kind. Although am-
biguous, the relevant Code sections and the legislative history in
its full context appear to be consistent with and arguably suppor-
tive of such a conclusion. Whereas the Sixth Circuit in Wetter
ultimately reached the correct conclusion, it erred in reasoning
that the Code was sufficiently unambiguous to warrant applica-
tion of the plain meaning rule of statutory construction. The First
Circuit in Fulman reached the wrong conclusion by reading too
narrowly one sentence in the legislative history and misperceiving
the real objective of the personal holding company tax.

As the Fulman court recognized, Treasury regulations are
entitled to deference when reviewed by a court and should be
upheld unless they are “unreasonable and plainly inconsistent”
with the revenue statutes. Since regulation 1.562-1 does not
focus on the common objective of the accumulated earnings tax
and the personal holding company tax, but actually provides a
means whereby corporations and shareholders can frustrate the
objective, a court could certainly conclude that the regulation
is unreasonable and inconsistent with the statutory scheme. If the
courts are unwilling to invalidate the regulation, however, then
the regulation should be changed or, if necessary, section 562 of
the Code should be amended to remove any ambiguity by ex-
pressly providing that when property is distributed in kind, the
deduction for dividends paid will equal the amount of dividend
income taxable to the shareholders under sections 301 and 316 of
the Code.

93. See note 17 and accompanying text supra.
94. See notes 86-89 and accompanying text supra.