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Taxation

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TAXATION

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Old issues of constitutional law never die; they won't even fade away. The Supreme Court of South Carolina handed down two important decisions in the field of taxation during the period covered by this Survey. Each case presented problems with constitutional law overtones familiar to the federal tax practitioner. In each case, counsel relied heavily on decisions of the Supreme Court of the United States which most students of federal tax jurisprudence perhaps agree would be overruled if they could be squarely presented before that Court today. The line of decisions[1] invoked by counsel in *Roper v. South Carolina Tax Commission,* 231 S. C. 587, 99 S. E. 2d 377 (1957), *cert. denied,* 78 S. Ct. 342 (1958), was held by the Supreme Court of South Carolina to be inapplicable under the tax statute involved in that case; the decisions[2] relied upon in *Crawford v. South Carolina Tax Commission,* 232 S. C. 113, 101 S. E. 2d 267 (1957), were held by the Court to be controlling, without extended discussion.

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1. Towne v. Eisner, 245 U. S. 418 (1918) (stock dividend held not income under federal act of October 3, 1913, although the act specified that net income should include "dividends"); Eisner v. Macomber, 252 U. S. 189 (1920) (provision of Revenue Act of 1916 that a "stock dividend shall be considered income, to the amount of its cash value," held, in case involving common dividend on outstanding common, not within the 16th Amendment, and unconstitutional under Article 1, § 2, cl. 3, and Article 1, § 9, cl. 4, of the Constitution); Koshland v. Helvering, 298 U. S. 441 (1936) and Helvering v. Gowran, 302 U. S. 238 (1937) (holdings which weakened the doctrine of Eisner v. Macomber, by stating that Congress could tax as income distributions of stock which essentially changed the proportional interest of the shareholder in the corporation); Helvering v. Griffiths, 318 U. S. 371 (1943) (dividend of common on common held not taxable, by statutory construction, despite language in Internal Revenue Code of 1939 that "a distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution"); Strassburger v. Commissioner, 318 U. S. 604 (1943) (dividend of preferred on common, rule of Griffiths case held controlling). The cases are discussed in the excellent opinion of Circuit Judge Griffith, below, Transcript of Record p. 15.

2. Schlesinger v. State of Wisconsin, 270 U. S. 230 (1926), and Heiner v. Donnan, 285 U. S. 312 (1932).

Taxability of Stock Dividend — Preferred on Common — Where Single Shareholder

The *Roper* case involved the taxability under the Income Tax Act of 1926[3] of a preferred stock dividend issued in 1951 to the holder of all outstanding common stock of the corporation.[4] Prior to this dividend, the corporation had no outstanding preferred. Taxpayer argued that the State Income Tax Act was modeled on the federal act, and hence that federal law should conclusively supply the answer. Directly in point is the federal decision in *Strassburger v. Commissioner,* 318 U. S. 604 (1943),[5] holding that a preferred stock dividend to the holder of all then outstanding stock of the corporation, all of which was common stock, was not taxable under the Revenue Act of 1936.[6] Mr. Justice Moss for the Supreme Court rejected the major premise of this argument, pointing out that although the 1922 State Income Tax Act[7] in terms adopted the federal income tax law, and the rules and regulations promulgated thereunder, the 1926 South Carolina Income Tax Act repealed the 1922 Act. The Court held that the effect of this repeal was to give the state a "separate and distinct income tax law."[8]

3. CODE OF LAWS OF SOUTH CAROLINA, 1952 § 65-201 *et seq.*

4. Roper Motor Company had an authorized capital stock of $6,000, divided into 60 shares of common, all held by the taxpayer, J. A. Roper. In 1951 the charter of the corporation was amended to provide for the issuance of $124,000 par value preferred, and 1240 shares of $100 par preferred were issued to taxpayer as a stock dividend. The Tax Commission contended that the shares constituted income in the entire face amount of the preferred, and assessed the taxpayer $6200 plus interest. Taxpayer paid under protest and brought this action to recover. Respondent Tax Commission demurred to the complaint, Circuit Judge Griffith sustaining the demurrer.

5. The opinion of Mr. Justice Moss, 99 S. E. 2d 379, erroneously refers to this case as the *Sprouse* case, decided in the same opinion as Strassburger. The *Sprouse* case involved a dividend of non-voting common to holders of voting and non-voting common.

6. CH. 690, 49 STAT. 1648, 1688; INT. REV. CODE OF 1939 § 115 (f) (1). The pertinent language of the Act is quoted in note 1, *supra,* in discussion of the *Griffiths* case.

7. Act No. 502, March 13, 1922, 32 STAT. 896.

8. The decision not to open the Pandora's box of federal law on this subject is sound on pragmatic as well as historical grounds. The involutions of federal law are reviewed in Circuit Judge Griffith's opinion below, Transcript of Record, p. 15, and are more helpful to indicate to the Court the problems that are involved in stock distributions than to provide the answers thereon. The Internal Revenue Code of 1954 adopts a new approach to the problem, §§ 305, 306, which in brief provide that no tax arises upon the distribution of a stock dividend, but a tax arises, under some circumstances at ordinary income tax rates, when the shares are sold.

Since the definition of "gross income" in the 1926 Act included "income . . . from . . . dividends,"[9] the Court deemed the remaining question to be the meaning of the term "dividends" in the 1926 Act. Mr. Justice Moss said:[10]

> We must construe the word "dividend" in the plain, ordinary and popular sense of gain or profit. There is nothing in the Income Tax Act of 1926 which shows that the General Assembly used the word in a technical or peculiar sense. . . .

The Court held that as commonly understood, a preferred stock dividend on common was a "dividend" and thus constituted income under the Act. The "peculiar and distinguishing characteristics" of preferred stock were judicially noticed, and some reliance was placed by the Court on the administrative construction given the Act by the Tax Commission.[11]

The Court refrained from dicta on the interesting question whether a dividend of common stock on common would be taxable. That question arose in the leading federal case of *Eisner v. Macomber*, 252 U. S. 189 (1920), in which the Supreme Court of the United States held that an income tax levied on a dividend of common stock issued pro rata to outstanding common was not within the power given by the Sixteenth Amendment, and that such a tax was unconstitutional.[12] The pithy dissent of Mr. Justice Holmes in the *Macomber* case used the same "common understanding" approach as was employed by Mr. Justice Moss in the instant case; Mr. Justice Brandeis filed a more lengthy and highly persuasive dissent, employing the same approach.[13] The opinion of Mr. Justice Moss contains two suggestions, however, that a dividend of common on common would not be embraced by the holding in the instant case. First, the Court stressed the fact that preferred was involved in the case at bar, taking judicial notice of its characteristics. Thus, at the least, the Court has a path open to distinguish the *Roper* case if the more difficult case should come before it. Second, and of more immediate practical effect, the Court relied upon the admin-

9. CODE OF LAWS OF SOUTH CAROLINA, 1952 § 65-251.
10. Roper v. South Carolina Tax Commission, 231 S. C. 587, 599, 99 S. E. 2d 377, 383 (1957).
11. Opinion of South Carolina Tax Commission, August 29, 1938, CCH South Carolina State Tax Reporter, par. 10-354.84.
12. Under Art. I, Sec. 2, cl. 3 and Art. I, Sec. 9, cl. 4 of the original Constitution, requiring apportionment for the levy of direct taxes.
13. The Holmes dissent is at 252 U. S., 219; the Brandeis dissent at 252 U. S., 220.

istrative interpretation of the statute by the Tax Commission, and that interpretation has consistently held a dividend of common stock on common to be nontaxable.[14] Unless the Tax Commission should change this policy, the common on common problem will not be presented.

Estate Tax — "Conclusive Presumption" of Contemplation of Death

In the *Crawford* case[15] the Supreme Court held unconstitutional the "contemplation of death" provision of the South Carolina inheritance tax.[16] Within three years prior to his death a decedent had made several gifts to his son, daughter, son-in-law and daughter-in-law. The Tax Commission construed the quoted statute to require the inclusion of such gifts in the taxable estate, regardless of the motivation of the gifts and regardless of whether they were in fact in contemplation of death. The executors of the decedent and the beneficiaries of the gifts contended that the statute as so construed was unconstitutional, citing the *Schlesinger*[17] and *Donnan*[18] decisions of the Supreme Court of the United States. The South Carolina Court held that the phrase "shall be considered" created a conclusive or irrebuttable presumption.[19] Citing the

14. *Supra* note 11.
15. 232 S. C. 113, 101 S. E. 2d 267 (1957).
16. CODE OF LAWS OF SOUTH CAROLINA, 1952 § 65-464, 1957 Cumulative Supplement, Vol. 6, p. 64: "Transfers of property by gift or deed between parties related by blood or marriage, made and completed within three years prior to death and without an adequate valuable consideration, shall be considered as taxable transfers under this article made in contemplation of death." The 1953 Amendment changed the period of time from five to three years.

Following the Crawford decision, the General Assembly amended the statute to remove the constitutional objection found therein by the Court. The amended text, ACTS AND JOINT RESOLUTIONS, SOUTH CAROLINA, 1958, p. 1680, reads:

> Section 65-464. Transfers of property, either by direct or indirect gift, deed or other conveyance made and completed between parties related by blood or marriage within three years prior to date of death of the transferor without an adequate valuable consideration, shall, unless taxpayer establishes before the Commission facts to the contrary, be construed prima facie to have been made in contemplation of death and shall be taxable under this Article.

17. Schlesinger v. State of Wisconsin, 270 U. S. 230 (1926).
18. Heiner v. Donnan, 285 U. S. 312 (1932).
19. Despite more than a half century of objection from professors of the law of evidence, who argued that the so-called "conclusive presumption" is not a presumption at all, but a rule of law, 9 WIGMORE, EVIDENCE § 2492; 4 id. § 1353 (1940), courts and lawyers continue to employ the term. Use of the term "presumption" leads to the erroneous reasoning that the statute "precludes the ascertainment of the truth in respect of that requisite upon which liability is made to rest," Mr. Justice Sutherland in Heiner v. Donnan, 285 U. S., 328 (1932). The correct analysis

Schlesinger and *Donnan* decisions, the brief opinion of Mr. Chief Justice Stukes continues:[20]

> These decisions speak for themselves and need no discussion. In the first cited a statute which prescribed that transfers of property within six years of death "shall be construed" to have been in contemplation of death was held invalid; and in the second, transfers within two years of death "shall be deemed and held to have been made in contemplation of death" met the same fate. . . .
>
> Upon consideration we are constrained to agree with the construction of the statute by the Commission, whereby it becomes invalid under the cited authorities and others which may be found in the annotation in 75 A. L. R. 544, 547. Supplementary annotations appear in 120 A. L. R. 170, 184, and 148 A. L. R. 1051, 1056. . . .

The opinion of the Court falls short of intellectual satisfaction in two respects. First, although it is clear that the Court is striking down the statute as a denial of due process of law,[21] nowhere does the Court indicate whether it is basing its holding on the State Constitution, the Federal Constitution, or on both.[22] Since the Tax Commission did not seek certiorari

of the constitutional problem faced by the courts in this type of case is that set forth by Chief Justice Vinje of Wisconsin in the Schlesinger case, 199 N. W., 953 (headnotes 5, 6 and 7). The legislature has admitted power to levy a tax on the transfer of property at death, and admitted power to tax under such a statute gifts made in contemplation of death and with an intention of avoiding the death tax. The question is whether it is arbitrary and unreasonable to the extent of a failure of due process for the legislature to provide that for gifts within three years (or some greater or shorter period) of the death of the deceased, actual contemplation of death is irrelevant, and all such transfers will be caught by the tax. To repeat, such a statute creates a rule of law that once the transfer is proved to be within three years of death, the mental attitude of the transferor becomes irrelevant, and the property transferred is subject to the tax. The legislature justifies such a provision on the argument that without such a rule, the difficulties of proof of contemplation of death are so great that practical administration of the statute requires the strict rule. Such a finding of the administrative department of the state, adopted and approved in the statute by the legislature, should not be lightly cast aside by the Court.

20. Crawford v. South Carolina Tax Commission, 232 S. C. 113, 114-115, 101 S. E. 2d 267, 268 (1957).

21. The Schlesinger case struck down under the Fourteenth Amendment due process clause the provision of a Wisconsin statute providing that transfers within six years prior to death "shall be construed to have been made in contemplation of death," although the Supreme Court of Wisconsin had upheld the provision, Ebeling's Estate, 169 Wis. 432, 172 N. W. 734, 4 A. L. R. 1519 (1919); Re Schlesinger, 184 Wis. 1, 199 N. W. 951 (1924). Heiner v. Donnan struck down a similar provision of the federal estate tax as violating the due process clause of the Fifth Amendment.

22. S. C. CONST. art. I, § 5 (1895) contains a due process clause. If the decision of the Court rests on this Section, there would be an inde-

in the Supreme Court of the United States,[23] but moved rather to amend the statute to remove the objectionable language, this question perhaps is academic. But a second and more fundamental consideration remains, whichever Constitution the Court had in mind as the basis for its decision. The cases cited by the Court are looked upon as of doubtful legitimacy even in the jurisdiction of their birth;[24] later cases have rejected their underlying premises.[25] Experience with the federal statute has indicated, as stated by the late Randolph Paul, that the rebuttable presumption provision "has been productive of litigation but not of revenue,"[26] and the existence of the South Carolina statute is some evidence of like experience in this state. In short, three decades of reasoning and experience with the problem have confirmed the views expressed in dissent by Mr. Justice Holmes in the *Schlesinger* case:[27]

> . . . . If the time were six months instead of six years I hardly think that the power of the state to pass the law would be denied, as the difficulty of proof would warrant making the presumption absolute; and while I should not dream of asking where the line can be drawn, since the great body of the law consists in drawing such lines, yet when you realize that you are dealing with a matter of

pendent state ground for the decision and hence no reviewable federal question even though the Court also struck down the statute under the fourteenth amendment to the Constitution of the United States. Minnesota v. National Tea Co., 309 U. S. 551 (1940).

23. Presumably certiorari would lie only if the decision of the Supreme Court of South Carolina holding the provision unconstitutional were based solely on the fourteenth amendment to the Constitution of the United States. See note 22 *supra*.

24. LOWNDES & KRAMER, FEDERAL ESTATE AND GIFT TAXES (1956) states, at p. 19, "It seems clear that the prevailing test today of the constitutionality of a tax upon an inter vivos transfer under the federal estate tax is the penumbra theory. Although Heiner v. Donnan has never been explicitly overruled, the reasoning of the majority of the court in that case has been so undermined by the later decisions that its continued validity is certainly suspect."

25. Helvering v. City Bank Farmers Trust Company, 296 U. S. 85 (1935) (Federal estate tax provision including in the gross estate property in an inter vivos trust revocable by the deceased grantor only in conjunction with a person holding a substantial adverse interest, upheld over Fifth Amendment attack, Court adopting the penumbra theory); Helvering v. Bullard, 303 U. S. 297 (1938) (Federal estate tax provision including in the gross estate property transferred subject to a reserved life estate, upheld on same theory).

26. Hearings Before House Ways and Means Committee, 77th Congr., 2d Sess., on Revenue Revision of 1942, p. 91; cited, BITTKER, FEDERAL INCOME, ESTATE AND GIFT TAXATION (Cases and Materials) 1059 (1955).

27. 270 U. S. 229, 241. Mr. Justice Brandeis and Mr. Justice Stone concurred in the opinion of Mr. Justice Holmes.

degree you must realize that reasonable men may differ widely as to the place where the line should fall. I think that our discussion should end if we admit, what I certainly believe, that reasonable men might regard six years as not too remote. Of course many gifts will be hit by the tax that were made with no contemplation of death. But the law allows a penumbra to be embraced that goes beyond the outline of its object in order that the object may be secured. A typical instance is the prohibition of the sale of intoxicating malt liquors in order to make effective a prohibition of the sale of beer. . . . In such cases, and they are familiar, the 14th Amendment is invoked in vain. . . .