

REPORTS

OF THE

JOINT COMMITTEE ON INTERNAL
REVENUE TAXATION

SIXTY-NINTH CONGRESS

PURSUANT TO

SECTION 1203 (b) (6), REVENUE ACT OF 1926

DIVISION OF INVESTIGATION

VOL. 1—PART 3

REPORT ON EVASION OF SURTAXES BY
INCORPORATION (SECTION 220)

Printed for the use of the Members of the Committee

NOTE.—These reports have been submitted to the Chairman
and ordered printed by him, but have not yet been
approved by the full Committee



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REPORT ON EVASION OF SURTAXES BY INCORPORATION (SECTION 220)

CONGRESS OF THE UNITED STATES,
JOINT COMMITTEE ON INTERNAL REVENUE TAXATION,
Washington, January 22, 1927.

To the Members of the Joint Committee on Internal Revenue Taxation:

There is transmitted herewith copy of a report from the division of investigation of our committee entitled "Evasion of surtaxes by incorporation" (sec. 220).

The report as prepared by Mr. Parker meets with my general approval. I would especially call your attention to the fact that if this section of the act is not enforced in the manner intended by the Congress then the equity of our income-tax system breaks down.

How corporations with a large surplus may escape all tax, by manipulating the investment of such surplus, and how the stockholders of such corporations may also escape surtaxes, if section 220 is not enforceable, is shown in the report and is very instructive.

I should be glad of your comments on this matter.

Very truly yours,

WM. R. GREEN,
Chairman Joint Committee on Internal Revenue Taxation.

HON. WILLIAM R. GREEN,
*Chairman Joint Committee on Internal Revenue Taxation,
House Office Building, Washington, D. C.*

MY DEAR CHAIRMAN: The study of the subject of that section of the revenue acts entitled "Evasion of surtaxes by incorporation," as contained in the acts of 1918, 1921, 1924, and 1926 under section 220, leads to the following conclusions, which will be discussed in detail in the body of this report:

1. Not one dollar in taxes has been collected from this provision of the revenue acts from 1918 to the present time.

2. The bureau appears to be in doubt as to the constitutionality of section 220 of the revenue act of 1918 and has evidently pursued the policy of not pressing these cases rather than forcing them into the courts for a decision on such constitutionality. It results that up to October 1, 1926, only one case involving the 1918 act had reached the point of being scheduled for hearing before the Board of Tax Appeals.

3. Under the 1921 act the bureau, apparently, holds that an investment company has unlimited need of accumulated profits. Therefore the very worst class of corporations evading surtaxes by

incorporation are escaping the additional taxes provided under section 220. Apparently the definition given a "mere holding company" by the bureau is so limited as to include practically no corporation whatever.

4. The prospect of making these provisions effective under the 1924 and 1926 acts is somewhat better. Up to October 1, 1926, however, only five cases have had assessment proposed under the 1924 act. Assessment has not been proposed for any case under the 1926 act.

5. It is apparently not the policy of the bureau to invoke the provisions of section 220, under any of the acts, in the case of large and closely held corporations which have accumulated an enormous surplus, and which invest these accumulations in the expansion of their business or the purchase of related industries.

6. If section 220 is not enforced, any corporation with a large surplus can so manipulate its investment that the corporation itself will escape the payment of any tax, even as its stockholders escape surtaxes.

HISTORY OF THE PROVISIONS ENTITLED "EVASION OF SURTAXES BY INCORPORATION"

This provision was first introduced, as to its fundamental idea, in the revenue act of October 3, 1913, under section II-A, subdivision 2. (See Exhibit A attached.)

In the revenue act of 1916, and also in this act as amended in 1917, there is a similar provision providing for an additional tax on unreasonable accumulation of profits. (See Exhibit B attached.)

It should be noted that in this report the operation and effect of the provision up to the year 1918 will not be specifically treated, for the reason that the records concerning the individual cases under this section for these long past dates are not readily available. It is important to note, however, that the essence of the provision as included in the more recent acts was contained in the first income tax law. This shows that this provision was not created solely as the result of such evasion during the period of high surtax rates, as certain arguments of the general counsel of the Bureau of Internal Revenue would lead us to suppose.

Section 220 of the revenue act of 1918 is quoted in full in Exhibit C attached. This provision provided in brief that if any corporation, through the medium "of permitting its gains and profits to accumulate instead of being divided" enables its stockholders to escape surtax which would have been payable if such gains had been distributed, then the stockholders shall be taxable on such gains and profits as should have been distributed to them.

When the revenue act of 1921 was enacted, section 220 was revised in such a manner as would make the additional tax fall on the corporation instead of on the individual stockholder. Section 220 of the revenue act of 1921 is quoted in Exhibit D attached.

When the passage of the revenue act of 1924 was under consideration it was pointed out that certain corporations which had large net profits, and which did not distribute these profits, nevertheless could not be assessed the additional tax provided under section 220. This came about through the fact that the principal income of many of

these corporations was derived from dividends on stock of domestic corporations; and, therefore, as such dividends are deductible from gross income in arriving at net income, there was no net income left on which to apply the additional tax, as the law expressed such tax in the terms of a percentage of net income. Accordingly the act of 1924 provides that the term "net income" as used in section 220 means the net income as defined in the other portions of the law, increased by the amount of dividends received from the stock of domestic corporations. The text of the 1924 act may be found in Exhibit E attached.

The revenue act of 1926 changes the act of 1924 only by giving to the stockholders the right to include in their income the distributive share of the undivided profits of the corporation, instead of permitting the additional tax to be assessed against the corporation.

Section 220 of the revenue act of 1926 is quoted in full below:

EVASION OF SURTAXES BY INCORPORATION

SEC. 220. (a) If any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be levied, collected, and paid for each taxable year upon the net income of such corporation a tax equal to 50 per centum of the amount thereof, which shall be in addition to the tax imposed by section 230 of this title and shall (except as provided in subdivision (d) of this section) be computed, collected, and paid upon the same basis and in the same manner and subject to the same provisions of law, including penalties, as that tax.

(b) The fact that any corporation is a mere holding or investment company, or that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax.

(c) When requested by the commissioner, or any collector, every corporation shall forward to him a correct statement of such gains and profits and the names and addresses of the individuals or shareholders who would be entitled to the same if divided or distributed, and of the amounts that would be payable to each.

(d) As used in this section the term "net income" means the net income as defined in section 232, increased by the sum of the amount of the deduction allowed under paragraph (6) of subdivision (a) of section 234, and the amount of the interest on obligations of the United States issued after September 1, 1917, which would be subject to tax in whole or in part in the hands of an individual owner.

(e) The tax imposed by subdivision (a) of this section shall not apply in respect of any taxable year if all the shareholders of the corporation include (at the time of filing of their returns) in their gross income their entire distributive share, whether distributed or not, of the net income of the corporation for such year. Any amount so included in the gross income of a shareholder shall be treated as dividends received. Any subsequent distribution made by the corporation out of the earnings or profits for such taxable year shall, if distributed to any shareholder who has so included in his gross income his distributive share, be exempt from tax in the amount of the share so included.

THE INTENT OF THE CONGRESS IN ENACTING SECTION 220

The Congress recognized in framing section 220 that a corporation, either closely held or controlled by men of considerable wealth, could be organized or availed of in a manner which would permit such individuals to escape the surtaxes which would fall upon them where a normal distribution of profits was made.

For example, suppose a corporation to have a net income of \$1,000,000 per annum. The stock of the corporation is entirely

owned by a man and his two sons. While there is no reasonable need of accumulating this \$1,000,000 profit, nevertheless, by doing so the individual stockholder will save a large sum in surtax if they distribute simply enough money upon which to live. It was the purpose, then, of the Congress to put such a tax upon this unreasonable accumulation of profits as would cause no loss in revenue to the Government, whether such distribution of profit was made or not.

It is the opinion of your investigating division that the Congress intended to make the provisions of section 220 sufficiently broad in scope to be effective wherever there was an unreasonable accumulation of undivided profits in any case whatsoever.

The inclusion of the words "mere holding or investment company" in the revenue acts was for the purpose of making sure that this type of corporation would not escape the additional tax. It was not for the purpose of excluding any other corporation which might also make unreasonable accumulations of profits.

Investigation of the proposed assessments under section 220 and conferences with the general counsel's office lead us to the conclusion, however, that it is not the intention of the Bureau of Internal Revenue (as shown by cases handled and decision and opinions of the general counsel herein discussed) to make the application of section 220 as contained in the 1926 act as broad in its scope as was plainly the intention of the Congress.

For example, the large corporation which accumulates an enormous surplus and distributes comparatively small dividends is held by the bureau as exempt from this provision, if it uses such accumulated profits in plant expansion, or any investments in related industries.

We have before us figures of a certain corporation which is owned entirely by one family, as follows:

Year	Net income	Dividends paid
1922.....	\$138,556,008	\$13,811,600
1923.....	115,884,461	None.
1924.....	131,945,287	14,674,825
1925.....	138,841,498	16,401,275

It is seen from the above figures that this corporation in the last four years has distributed something less than 10 per cent of its net income during this period. It is our opinion that an accumulation such as this is within the scope of section 220 of the revenue act of 1926. This is not the opinion of the bureau.

It may be argued that the distribution of these enormous profits, which were in this case used in the expansion of the business and in the purchase of related industries, would be an obstacle to the progress of industry, which is so desirable. The answer to this argument, at least in this particular case, is that such a distribution would be a deterrent to progress only to the extent of the amount of money paid in surtax to the Government. This surtax should certainly be paid if there is to be an equitable distribution of the burden of income tax upon our citizens. There is nothing to prevent the stockholders in this corporation from reinvesting the distributed profits in the business after the payment of the surtaxes.

The loss in revenue to the Government by such an accumulation of undivided profits as cited above is very large. In the four years, on the figures which we have given, if the net income of this corporation had been distributed the Government would have received approximately \$168,000,000 more in tax than it did in fact receive from the distribution actually made.

It can be seen from the above, therefore, that this question of the scope of section 220 of the revenue act of 1926 and of the former acts is a most important one if, in the case of one corporation alone, it may amount to a sum of \$168,000,000 over a period of four years.

APPLICATION OF SECTION 220 BY THE BUREAU OF INTERNAL REVENUE

The procedure for applying section 220, as followed by the bureau, is approximately as follows:

The revenue agent on making a field examination, and the reviewing officer on reviewing the revenue agent's report in Washington, may suggest that section 220 is applicable to the case in hand.

The file is then forwarded to the rules and regulations section of the Income Tax Unit in Washington, whose duty it is to make a report or memorandum addressed to the general counsel, either recommending an assessment of the additional tax provided in section 220 or recommending that this section shall not be applied.

This recommendation, together with the file, is then forwarded to the general counsel's office, which office, after examining the case, notifies the rules and regulations section of their approval or disapproval of this recommendation.

In case the general counsel approves of the application of section 220, a letter is prepared for the commissioner's signature notifying the taxpayer of the proposed assessment of this additional tax. This letter gives an opportunity for the taxpayer to protest such action and it is the uniform policy of the general counsel's office in such cases to grant a hearing on this question.

In case the general counsel's office decides that section 220 shall not be applied, then the file of the case is returned to audit for closing in the usual manner. (For a description of present procedure, see bureau mimeograph attached, Exhibit F.)

There is no way to determine in how many cases the application of section 220 may have been considered in the mind of the field agent or of the reviewing officer. We do know that exactly 78 cases had reached the rules and regulations section of the Income Tax Unit up to October 1, 1926.

Inasmuch as only 78 cases had reached the rules and regulations section from 1918 up to October 1, 1926, and as this is the first point in the bureau where this matter is given serious study, it has been thought best to prepare a chart of these 78 cases which would show the complete history of the application of section 220 down to October, 1926.

Attached hereto is a "List of cases considered under section 220 of the revenue acts of 1918, 1921, and 1924 up to October 1, 1926." (Exhibit G.) This list includes all the cases upon which the bureau has even considered applying the provisions of this section of the acts up to the date mentioned. The examination of these cases brings

out the astonishing fact that not one dollar of revenue has ever been collected to date from the tax provided for by section 220 of the revenue acts.

Of these 78 cases, a study of the list shows that the Income Tax Unit itself has adjudged 26 cases as not coming within the scope of the 220 provision, leaving thus only 52 cases on which they have recommended assessment of the additional tax.

The record of action by the rules and regulations section of the Income Tax Unit, and the action by the general counsel's office shows that the bureau has had difficulty in carrying out the intent of the Congress as expressed by section 220 of the revenue acts of 1918, 1921, and 1924.

The summary on the following page shows how late the bureau's action has been on the 52 cases noted above:

Status of section 220 cases in the Bureau of Internal Revenue

Year in which additional tax was assessed	Total number of cases	Number of these cases awaiting hearing before general counsel	Number of cases thrown out by general counsel after hearing	Number of these cases in which additional tax has been sustained by general counsel after hearing	Revenue acts involved				
					1918	1918 and 1921	1921	1921 and 1924	1924
1919.....	None.	-----	-----	-----	-----	-----	-----	-----	-----
1920.....	None.	-----	-----	-----	-----	-----	-----	-----	-----
1921.....	None.	-----	-----	-----	-----	-----	-----	-----	-----
1922.....	None.	-----	-----	-----	-----	-----	-----	-----	-----
1923.....	5	1	3	1	4	1	-----	-----	-----
1924.....	6	-----	6	-----	5	-----	1	-----	-----
1925.....	13	10	2	1	-----	9	4	-----	-----
1926.....	28	28	-----	-----	2	8	13	4	1
Total.....	52	39	11	2	11	18	18	4	1

From the summary on the preceding page a fair picture is presented of the way in which the bureau has administered section 220. The outstanding features of this picture are as follows:

1. Not \$1 in taxes has as yet been collected by the bureau through the application of this section of the act.

2. In only two cases has the application of this section by the Income Tax Unit been sustained by the general counsel's office after hearings with the taxpayer. (These cases are expected to go to the Board of Tax Appeals.)

3. One of these two cases involved the 1918 act, the other the 1921 act.

4. In only 13 cases out of the 52 has the general counsel rendered a decision after hearing taxpayer's protest.

5. Out of these 13 cases the taxpayer has been sustained in 11 cases and the Income Tax Unit in only 2.

6. Thirty-nine cases are still pending in the general counsel's office.

7. The yearly record of action—5 cases in 1923, 6 cases in 1924, 13 cases in 1925, 28 cases in 1926—shows that apparently this provision has not been enforced very actively. (It should be noted that three out of five 1923 cases have been thrown out by the general

counsel, and also that all six of the 1924 cases have been thrown out.)

9. Twenty-eight cases out of 52, or over half, have had assessment proposed in the first nine months of the current year. Ten of these cases involve the 1918 act.

It must be admitted from the above evidence that the enforcement of this provision is not satisfactory from our interpretation of the intent of the Congress as to the scope of section 220.

NOTES ON COMPANY No. 27

In order to bring out the bureau's interpretation of section 220 of the various acts, it will be important to discuss, briefly, certain typical cases selected from Exhibit G. Company No. 27, shown in this exhibit, is typical of the case where the bureau has been unable to apply the provisions of section 220 of the revenue act of 1921. In this case we have an individual who is the principal stockholder of a manufacturing concern. He incorporates a holding company and turns over to it a large portion of the stock which he holds in the manufacturing concern. This holding company then has as its principal duty the receiving of dividends from the manufacturing company. All of its income is derived from dividends of the stock of domestic corporations and therefore it has no net taxable income, and there is nothing upon which to apply the 25 per cent additional tax provided for in the 1921 act. No criticism can be made of the bureau's action in such a case, but it is certain that large payments of surtax were legally evaded during the years 1921, 1922, and 1923 by this device.

The pertinent facts in the above case are as follows:

1. The president of the holding corporation owns 253 shares of the company's stock out of a total of 260 shares. He also owns the entire issue of preferred stock, amounting to 5,000 shares.

2. The holding company was incorporated December 14, 1922.

3. This holding company had a gross income for 17 days of its existence in 1922, amounting to \$305,746.65, consisting of dividends received on the stock of domestic corporations amounting to \$305,487.50 and other income amounting to \$259.15.

4. After deducting the amount received as dividends on the stock of domestic corporations, this company had no net taxable income remaining, and there was no way in which to secure the additional tax.

5. No dividends were declared by this company in 1922 or 1923.

In this case there is no question that an unreasonable accumulation of profits is being made, and that the president of the corporation is escaping surtax. However, he is making a legal evasion of such surtax and we believe the bureau to be correct in its decision in this case. It is to be hoped that this corporation can be reached under the 1924 and 1926 acts.

NOTES ON COMPANY No. 18

There is another type of case which exemplifies the bureau's attitude in applying section 220 upon large corporations which accumulate enormous profits and invest same in the expansion of their own business. Company No. 18 shown on the chart entitled "Exhibit G" is a case in point.

The increase in earned surplus for the years under consideration is as follows:

	Increase in earned surplus
1918-----	\$5, 879, 918
1919-----	28, 079, 972
1920-----	12, 623, 718

At the end of 1920 the total capital and surplus of the corporation amounted to \$74,900,000. Dividends amounting to \$16,000,000 were paid on December 31, 1921.

The Solicitor of Internal Revenue ruled in this case that inasmuch as the inventory accounts were increased and the plants were expanded, the above accumulation of surplus was not unreasonable. Without questioning the legal competency of the decision of the Solicitor of Internal Revenue, in this case, we do believe that this class of corporation violates the intent of the Congress as expressed in section 220 as an unreasonable accumulation of profits. It is again pointed out that if a reasonable distribution of profits had been made and the surtax paid by the individuals, the individuals could still have reinvested the remainder of the dividends after taxes in the business and that therefore the prosperity and growth would not have been seriously affected.

It might be pointed out that at the close of the year 1921, this company had investments in Liberty bonds, Canadian Government bonds, and stock of domestic corporations amounting to approximately \$77,000,630. The precedent set in the above case would appear to be convincing of the fact that the bureau does not consider accumulation of profits, in a large manufacturing enterprise, to be unreasonable, if such profits are invested in the business or even if they are invested in securities of other corporations, provided some excuse is given for the ultimate need of the money which these securities represent.

Another type of company which the bureau holds to be exempt from the provisions of section 220 is the investment company. We are not in agreement with the idea of the general counsel's office in this matter and are therefore reporting rather fully the case of Company No. 11, shown in Exhibit C attached.

NOTES ON COMPANY NO. 11

Attached hereto is a copy of a communication from the Solicitor of Internal Revenue to the commissioner dated December 10, 1925 (see Exhibit H), in regard to the application of section 220 to the tax case of Company No. 11.

This communication sustains the taxpayer in his protest against the application of section 220 of his case for the years 1919, 1920, and 1921 by the Income Tax Unit.

It appears that the finding of the solicitor's office in this matter is not in conformity with the statute or the intent of same, and that if such arguments are to prevail the provisions of section 220 of the revenue acts of 1918 and 1921 will be rendered null and void.

Company No. 11 was incorporated on April 7, 1916, with an authorized capital stock of \$100,000. Mr. "X" turned over his stock in said company in equal shares to his wife and four children,

retaining only three shares in his own possession, to qualify him to act as a director.

The annual profits of this company for the years under consideration were as follows:

1919-----	\$220, 125. 59
1920-----	286, 417. 74
1921-----	313, 639. 69
Total-----	820, 183. 02

During the same period cash dividends were declared only in the year 1920 in the amount of \$50,000.

The undistributed profits for the three-year period amounted, therefore, to \$770,183.02.

The rules and regulations section of the Income Tax Unit recommended the application of section 220 of the respective acts to the case of this taxpayer. This recommendation was approved by the solicitor, but same was reversed and the taxpayer's arguments sustained upon a verbal hearing before the solicitor.

It is the final opinion of the solicitor which is attached hereto and with which we take issue specifically as follows:

TIME OF INCORPORATION

The solicitor states that—

The company was incorporated considerably prior to the enactment of the revenue act of 1916 on September 8, 1916, which marked the beginning of the enactment of the revenue acts carrying high surtax rates. Manifestly the case is not one of an individual who upon the advent of high surtaxes formed a corporation to hold his personal securities, while retaining the ownership of its capital stock.

This argument of the solicitor in favor of the taxpayer appears to have no proper foundation for two reasons.

First. The revenue act of 1913 contained a provision (see Section II-A, subdivision 2) providing for a tax on undistributed profits in such a case, showing, as is clearly evident, that such a company as this would benefit even under low surtax rates if some means were not provided for taxing undistributed profits.

Second. The time of organization of the company is not a factor, as both the revenue acts of 1918 and 1921 exclude this ground of defense by the following clear and explicit wording, "If any corporation, however created or organized, is formed or availed of."

The above shows that it was the intent of Congress, as accurately expressed in the statute, to make no exception of a company formed prior to the enactment of high surtax rates, as long as said company was availed of for the purpose of escaping surtax.

EMPLOYMENT OF UNDISTRIBUTED PROFITS

The solicitor states as follows in the attached memorandum (Exhibit H):

That the undistributed earnings were used by the company in its investment business is shown by the fact that its cash account as of the end of each of the years in question was less than \$50,000; and as of December 31, 1919, was only \$9,739.39. It can not be denied that there was an active employment of the accumulated profits to promote the business purposes of the company. The

company used a substantial portion of its profits in safeguarding its investments in certain close corporations which, in order to increase their facilities, looked to their few stockholders, among others "Company No. 11," to supply the required capital. Under all the circumstances the company can not be said to have accumulated its profits beyond the reasonable needs of its business.

The above arguments appear to be unfounded. As a matter of fact, the business of this company consisted in making all the profit possible by investment in stocks, bonds, and mortgages and reinvesting the accumulated profits instead of distributing same to its few stockholders, all of whom would have been subject to surtax.

What is the significance of the low cash balance carried? Simply that the company was in no producing business, nor any business on which sudden cash demands could possibly be made. A simple reinvestment of undistributed profits in interest-paying securities is certainly no defense in the matter of an unreasonable accumulation of profits. If the company had made \$10,000,000 a year, it would have still found no difficulty in reinvesting same in a similar manner. We submit that the low cash balance noted by the solicitor is no reasonable argument against the application of section 220.

The solicitor further states, as quoted above, that a certain amount of profits had to be reinvested in certain closely held companies to protect investments already made.

The facts in this case do not confirm this statement as being controlling. On page 3 of the solicitor's memorandum attached, it will be noted that investments in municipal bonds for the years in question were as follows:

Year	Amount	Increase
1919.....	\$358, 022. 10	
1920.....	576, 934. 18	\$218, 912. 08
1921.....	995, 819. 15	418, 884. 97

Now in 1920 the company increased its investment in municipal bonds \$218,912.08, and its profits in that year was \$286,417.74. In 1921 it increased its investment in municipal bonds \$418,884.97, and its profit in that year was \$313,639.69.

Can it be seriously contended that this investment of undivided profits in municipal bonds was necessary in order to "safeguard its investments in certain close corporations"? We think not, especially as in all these years there were ample reserve funds in United States securities in excess of \$500,000 in every year.

MERE HOLDING COMPANY

The solicitor states that—

It can not be said that "Company No. 11" was a "mere holding company" or that its gains and profits were permitted to accumulate beyond the reasonable needs of its business during any of the years in question. That the company was not "a mere holding company" seems beyond peradventure.

The above statement does not appear to be supported by the main facts in the case.

If the business of this company is to make the greatest possible profit and avoid the payment of tax itself, and avoid the payment

of surtax by its few stockholders, then and only then can this company be judged to have reasonable need of its undistributed profits in its business.

We believe that this company is a "mere holding company" as defined in the law. Over 90 per cent of its assets are at all times in stocks and bonds of other corporations, municipalities, and governments, and in mortgages. Only a normal change in investment is shown. The company is not engaged in stock brokerage or any other like business. Moreover, such changes as are made in its investments show a policy of safe and sure profits and low taxes.

The corporation itself has a small taxable net income, due to its tax-exempt securities and its large domestic dividends.

CONCLUSION

If the principles laid down in this case are correct, we believe that the provisions contained in the revenue acts of 1918 and 1921 may as well be declared null and void. Few companies will show any more direct violation of the acts.

It might be noted that the two cases which will go to the Board of Tax Appeals involving section 220 of the revenue acts of 1918 and 1921 are, in our opinion, much weaker than this case, inasmuch as they are both producing and manufacturing companies with more excuses for an accumulation of profit.

NOTES ON COMPANY No. 66

Referring again to the chart shown in Exhibit G we will consider the case of Company No. 66. This case is typical of a company which has long been organized and which has pursued the uniform policy of declaring no dividends and of reinvesting all its profits in the business. The Solicitor of Internal Revenue holds in such a case that the provisions of section 220 of the revenue act of 1918 can not be applied. We are not in agreement with this decision which is contained in full in Exhibit I. The main facts in this case may be stated as follows:

1. The company was incorporated in 1900, practically all of its stock was owned by one man whom we will designate as Mr. "X."

2. This company from the date of its incorporation up to and including 1920 never paid any cash dividends.

3. The increase in surplus for each of the calendar years, 1918, 1919, and 1920, was as follows:

	Annual increase in surplus
1918-----	\$349, 457
1919-----	198, 308
1920-----	221, 626

4. The total surplus at the end of the year of 1920 amounted to \$3,124,860.

5. The business of the corporation has been confined principally to dealings and investments in real estate, ships, and corporation stocks and bonds.

6. The amount of money in savings account at the end of the years in question is as follows:

	Amount of savings account
1918.....	\$201, 113
1919.....	216, 970
1920.....	225, 490

7. The investment in Liberty bonds and United States Treasury certificates in 1918 amounted to approximately \$207,400. During the year 1919 additional Government securities were purchased in the sum of \$79,709.

It is our opinion that this company was a holding company within the meaning of the revenue act of 1926. The solicitor apparently holds it to be an investment company as distinguished from "a mere holding company." The fact remains that this corporation was only engaged in holding and accumulating the profit from stocks, bonds, and other property. It does not appear that this company was a producing concern.

The fact that such a company has never paid any dividends and has followed the consistent policy of reinvesting its large earnings in securities or other property does not, in our opinion, prevent such a corporation of being availed of in the manner which will allow the principal stockholder to escape surtax. We would again point out that if dividends were paid there is nothing to prevent such principal stockholder from reinvesting such dividends, after the payment of the surtax, in the business.

Having discussed briefly several typical cases where the bureau does not see fit to apply the provisions of section 220 we will now discuss the two cases where they have finally decided to do so.

NOTES ON COMPANY No. 15

The case of Company No. 15 is important in connection with our study of the operation and effect of section 220 of the various revenue acts for the following reasons:

1. It is the only case involving the revenue act of 1918 which has progressed to the point of going to the Board of Tax Appeals.
2. It will be in fact a test case on the 1918 act.

A consideration of the facts in this case leads us to the following conclusions:

(a) It will be 1928, 10 years after the passage of the 1918 act, before we may hope to have a decision on section 220 of the 1918 act.

(b) If the provisions of the act are upheld as constitutional, not over a dozen taxpayers in the United States will be assessed this tax, and hundreds of taxpayers who should have paid this tax will escape through the delay of the bureau and the statute of limitations.

(c) The bureau is going before the Board of Tax Appeals with a case which they should win, but which is less suitable for a test case than some of those cases in which they have refused to assess the tax on hearings within the bureau.

The main facts in connection with Company No. 15 are as follows:

The company was incorporated on November 2, 1900. Its capital stock is entirely held by John Doe, sr., and his two sons, John Doe, jr., and Peter Doe.

For the years 1918 to 1920 the increase in the earned surplus of the corporation was as follows:

	Increase in earned surplus
1918-----	\$83, 312. 15
1919-----	210, 311. 21
1920-----	187, 867. 94

During this period no dividends were paid by the corporation.

A large amount of the surplus of the company was employed in making short-term loans and in investments in real estate and securities having no apparent connection with the business of manufacturing beds.

The amounts employed in such loans and investments at the close of each of the years in question was as follows:

	Amount in loans and investments
1918-----	\$125, 000
1919-----	312, 600
1920-----	565, 000

The general counsel of the Bureau of Internal Revenue has sustained the Income Tax Unit in a proposed assessment of tax against the stockholders of the company under the provisions of section 220 of the revenue act of 1918.

The cases were listed with the Board of Tax Appeals on July 21, 1926.

DISCUSSION

In our opinion the decision of the general counsel in this case is perfectly proper.

Inasmuch, however, as this case is in the nature of a test case it would be important to select one as clear and strong as possible.

It appears that this case is not so suitable for a test case as would be the case with Company No. 11, already described, and others which have not been sustained by the general counsel.

Attention is drawn to the fact that this corporation is a manufacturing company and not "a mere holding company," or even an investment company.

The general counsel's opinion on this case is attached hereto under Exhibit J.

The other case involving section 220 and which will be heard before the Board of Tax Appeals is that of Company No. 57.

NOTES ON COMPANY NO. 57

While it was originally proposed to assess this company additional taxes for the years 1920, 1921, and 1922 under the provisions of section 220, the solicitor finally ruled that the company was liable for such additional taxes only for the year 1922. The provisions of section 220 of the revenue act of 1921 are therefore involved.

The main facts in connection with this case may be summarized as follows:

1. The company was incorporated in 1911 and is engaged in the manufacture and sale of playing cards.
2. The stock of the company is closely held, its president, Mr. "X," owning 899 out of the 1,000 shares outstanding.

3. The book profits of the company for the years in question were as follows:

	Book profits
1920 -----	\$67, 712
1921 -----	44, 070
1922 -----	179, 965

4. Dividends were paid as follows:

	Dividends
1920 -----	\$5, 000
1921 -----	10, 000
1922 -----	15, 000

The company maintained that it operated in a leased building and will eventually build a building of its own. It also claimed it will need a large surplus in case of a price war with a certain other large playing-card company.

The solicitor's ruling in this case is contained in Exhibit K.

A study of this case leads us to the conclusion that the additional tax provided for in section 220 of the revenue act of 1921 should be applied for the year 1922, as per the solicitor's decision.

It does not appear that this case is as suitable for a test case as some of the cases already discussed where the solicitor has failed to apply the provisions of section 220.

This company is a manufacturing company and not "a mere holding company," as specifically designated in the law.

CASES WHICH HAVE NEVER BEEN CONSIDERED BY THE BUREAU IN CONNECTION WITH SECTION 220

It appeared probable from the fact that no tax had ever been collected under the provisions of section 220 and also on account of the comparatively few cases reported (a total of 78 cases) that by investigation we could find a number of cases which should have been considered under the provisions of this section by the bureau.

It was of course impossible in a reasonable time to find any great number of such cases but we have found a sufficient number to indicate that there has been no comprehensive effort on the part of the employees of the bureau to make section 220 of the various acts effective.

Attached to this report under Exhibit L will be found a list of cases with certain facts in relation thereto, which in our opinion should have been considered by the bureau in connection with section 220.

Reference to this exhibit shows that a very considerable number of cases were readily found which should at least have been investigated under section 220. The most important of these cases will now be discussed, all being actual cases, name of taxpayer only being deleted.

NOTES ON COMPANY No. 101

Company No. 101 was incorporated December 14, 1909, its stock being entirely owned by John Doe and his four sisters. It is a mere holding corporation having no other business than the collection of income from stock, bonds, tax exempt securities, and real estate. By far the greater portion of its income is derived from dividends on the stock of domestic corporations.

The years 1918, 1919, and 1920 having been audited by the bureau, it will be sufficient to consider the taxes of the company for these years.

In the table below will be found an analysis of the tax returns of Company No. 101 for the years 1918 to 1921, inclusive. (The year 1921 is added to show the continuance of its policy of dividend distribution.)

Analysis of tax returns, Company No. 101

	1918	1919	1920	1921
Income:				
Interest on United States obligations (not exempt)	\$365.00	\$7,381.01	\$858.04	\$876.40
Interest from other sources	6,495.93		6,680.43	9,516.32
Rents	2,938.34	4,241.93	7,729.37	8,552.86
Miscellaneous income	27.55		2,578.74	649.56
Appreciation realized (cost March 1, 1913, value)			3,515.40	
Interest on United States obligations (exempt)	1,413.24	4,445.64	4,215.08	3,504.97
Other nontaxable income			365.84	518.82
Dividends on domestic corporations	65,894.61	53,797.66	115,865.20	41,391.25
Profit (+) or loss (-) on sale of capital assets	-2,210.00	+11,971.64	-2,346.90	-1,761.50
Dividends from foreign corporations			787.50	262.50
Total gross income	76,924.67	81,847.88	140,248.70	63,511.67
Deductions:				
Expenses, etc.	356.97	823.90	820.46	2,461.25
Interest	1,511.47	996.74		
Taxes (except Federal)	2,097.66	2,731.07	4,763.41	3,393.04
Depreciation	500.00	817.08	750.50	250.00
Total deductions	4,466.10	5,368.79	6,333.87	6,104.29
Net profit	72,458.57	76,479.09	133,914.83	57,407.39
Nontaxable income:				
Interest on United States obligations	1,413.24	4,445.64	4,215.08	3,504.97
Other nontaxable income			365.84	518.82
Domestic dividends	65,894.61	53,797.66	115,865.20	41,391.75
Appreciation realized (cost to March 1, 1913, value)			3,515.40	
Total nontaxable income	67,307.85	58,243.30	123,961.52	45,415.54
Net taxable income	5,150.72	18,235.79	9,953.31	11,991.85
Tax paid	334.28	1,623.58	709.53	911.55
Surplus beginning of year	414,066.77	464,884.13	512,355.43	622,524.51
Surplus end of year	464,884.13	512,355.43	622,524.51	622,524.51
Increase in surplus	50,817.36	47,471.30	110,169.08	
Dividends paid in cash	20,085.83	28,673.51	22,122.17	55,000.00

Reference to the analysis above shows the net profit of Company No. 101 for the years in question to be as follows:

	Net profits
1918	\$72,458.57
1919	76,479.09
1920	133,914.83
1921	57,407.39

During the same period the dividends paid were as follows:

	Dividends
1918	\$20,085.23
1919	28,673.51
1920	22,122.17
1921	55,000.00

It is apparent from the above that the distribution of dividends in the year 1921 was nearly equal to the profit and that the application of section 220 to that year could not be sustained.

For the years 1918, 1919, and 1920, however, we have a total net profit for the three years of \$282,852.49, while for the same period we have dividend distribution of only \$70,880.91, or, in other words, only 25 per cent of the profits were distributed.

It appears evident that this company is "a mere holding company" and that "the gains and profits are permitted to accumulate beyond the reasonable needs of the business." The revenue act of 1918 makes either of these conditions "prima facie evidence of a purpose to escape the surtax."

The increase in surplus from January 1, 1918, to December 31, 1920, amounts to \$208,457.74.

That the provisions of section 220 of the revenue act of 1918 have been disregarded by both the field forces and the reviewing officer of the bureau is apparent from the following quotation taken from the revenue agent's report on this company dated May 16, 1923:

"Company No. 101" has accumulated most of its income since date of incorporation and has paid dividends only for family expenses, therefore the family has avoided paying surtaxes on most of its income, but there seems to be no provision under the act of 1918 where this can be taxed.

This revenue agent recognized the fact of "evasion of surtaxes by incorporation" without apparently being aware of the existence of section 220 in the law.

It is clear that this case comes squarely under the provisions of section 220 of the revenue act of 1918.

NOTES ON COMPANY NO. 102

Company No. 102 was incorporated in 1908. Its stock is all held in one family. Its principal source of income is from rents and domestic dividends.

The net income of this corporation, before the deduction of dividends received, was as follows for the years 1920 to 1924, inclusive:

	Net income
1920-----	\$84, 078
1921-----	139, 843
1922-----	210, 784
1923-----	41, 101
1924-----	98, 200

Dividends paid to the stockholders by this corporation during the same years were as follows:

	Dividends
1920-----	\$57, 500
1921-----	91, 998
1922-----	0
1923-----	0
1924-----	0

This company has never been considered by the bureau in connection with section 220.

It is apparent, however, that in spite of large earnings during the years 1922, 1923, and 1924, the policy of paying no dividends in these years has enabled its stockholders to escape payment of surtaxes.

Reference to Exhibit L will show that this company had a taxable net income, in each of the three years mentioned, and therefore it would be possible to apply the provisions of the 1921 act as well as those of the 1924 act.

We believe the bureau has erred in not applying the provisions of section 220 to this case.

NOTES ON COMPANY No. 103

This company was incorporated in 1916. It is not a large corporation, but it would appear that a reasonable distribution of the profits has not been made, as the company is a "mere holding company."

The greater portion of the income of this company is derived from dividends on the stock of domestic corporations. The remainder is derived from the profits on the sale of such securities.

The pertinent facts in relation to this company, for the years in question, are as follows:

Year	Domestic dividends received	Total gross income	Net taxable income	Net income before domestic dividends	Cash dividends paid
1923.....	\$21,095	\$21,409	¹ \$3,012	\$18,083	-----
1924.....	24,292	30,206	3,437	27,729	\$7,647
1925.....	23,635	34,809	9,317	32,952	7,000
Total.....	69,022	86,424	9,742	78,764	14,647

¹ Deficit.

It will be noted that this company, in the three-year period stated, distributes only 20 per cent of its profits. The increase in surplus during this period is about \$46,000.

In our opinion this company should have been investigated in connection with section 220 for all three of the years shown.

NOTES ON COMPANY No. 104

This company was incorporated in 1916. We will consider the accumulation of profits by this company for the years 1919 to 1921, inclusive.

The principal income of the company was originally derived from rentals, but in the latter years such income was evidently invested in stock of domestic corporations until in 1921 the income from this latter source is nearly as large as the income from rentals.

For the three years noted the total domestic dividends received amounted to \$299,428; total gross income to \$1,397,128; net taxable income to \$447,663; the net income before deduction of domestic dividends to \$747,091; and no dividends of any kind were paid during this period.

The increase in surplus amounted to \$541,571, and it would appear that this is an unreasonable accumulation of earnings especially in view of the fact that such surplus was largely invested in the stock of domestic corporations.

The bureau, however, has never considered this the case in connection with the application of section 220.

NOTES ON COMPANY No. 112

Company No. 112 was incorporated under the laws of the State of Delaware in 1919 by two individuals, who pooled their interests in order to form the corporation.

The greater part of the income is derived from the dividends on the stock of domestic corporations. Certain figures of the company for the years 1921 to 1924, inclusive, were examined.

From this examination it appears that in the above-mentioned four-year period the domestic dividends received amounted to \$352,731; total gross income to \$386,573; total net income to \$9,638; total net income before domestic dividends to \$362,501; and total cash dividends paid out to \$169,133.

This company, then, in the four-year period paid out something less than one-half of its profits in dividends. It is our opinion that this company should have been assessed the additional tax provided for in section 220 for the years 1921, 1922, and 1924.

There was no taxable net income in 1923, and therefore this tax could not be assessed for that year. This company has never been considered by the bureau in connection with section 220.

The other companies on the list in Exhibit L show similar instances where the bureau has failed to apply the provisions of the act which we are now discussing.

It will be sufficient, however, to discuss this exhibit as a whole rather than to discuss each of the remaining cases separately.

NOTES ON AGGREGATE FIGURES (EXHIBIT L)

Composite figures arrived at by totaling the columns in connection with the 18 companies shown in Exhibit L are worthy of a short discussion.

The total figures show domestic dividends received amounting to \$6,059,430; total gross income to \$32,303,784; total net income before deduction of domestic dividends to \$16,395,071; cash dividends paid to \$1,908,849.

The composite figures therefore on these 18 cases show that out of the real profits \$16,395,071 only \$1,908,849 has been distributed and become subject to surtax; or, in other words, about 12 per cent. Practically all of the companies are mere holding or investment companies, and yet the bureau, up to October 1, 1926, has never considered any of these cases in connection with the application of section 220.

It must be concluded therefore that the system which has been practiced by the bureau in administering this section of the revenue acts is far from being effective.

The above 18 cases represented only a few weeks' investigation on the part of this division, while the bureau has been eight years in considering 78 cases.

It may also be mentioned in addition to the above list of 18 cases we have certain facts on some 50 further cases which might properly come under the provisions of section 220 but which we have not reported for the lack of complete details.

THE IMPORTANCE OF SECTION 220

A study of what is being accomplished by certain taxpayers in evading taxes shows that if section 220 of the various revenue acts is not enforced, then the equity of the whole income law breaks down.

To show this fact we will prove that it is possible for the corporation with a large surplus not only to evade the surtax which might be imposed on its stockholders, but also it is possible for this corporation to evade the normal corporation tax, if the provisions of section 220 be not enforced.

This proposition will be proved first by a hypothetical case, and second, by the figures in an actual case.

HYPOTHETICAL CASE

Suppose corporation A has a taxable net income of \$60,000 per annum arising from the manufacture of nails; this corporation is owned by three individuals who have no other means of livelihood, and therefore the corporation distributes all of its profits that its stockholders may live.

In this event under the 1926 act there will be a tax due the Government of \$8,100 from the corporation. In addition to the corporation tax the three stockholders will pay a surtax amounting to \$660.

Now suppose that corporation B has a similar net income from the manufacture of nails, amounting to \$60,000 per annum, and also that it has a surplus invested in the stock of domestic corporations which bring it a further income from dividends of \$60,000.

While this company has an income of \$120,000 per annum, nevertheless its net income will only be \$60,000, as the domestic dividends of \$60,000 are deductible for tax purposes.

The corporation then will pay a tax of \$8,100 and the three individuals who composed the corporation will pay no tax if no distribution of profits is made.

Now, suppose that corporation C has the same net income from the manufacture of nails as did corporation A and B, an amount of \$60,000 per annum, and suppose it invests its surplus in the stock of domestic corporations which brings it a further income from dividends of \$60,000. The corporation then borrows from a bank by depositing this stock as collateral and with the borrowed money buys more domestic corporation stock which brings it in an additional income of \$60,000. We now have the net income from the business amounting to \$60,000 and dividends from the stock of domestic corporations amounting to \$120,000, making a total of \$180,000.

In arriving at the net taxable income of this corporation we will deduct the domestic dividends of \$120,000 and interest paid the bank of \$60,000, leaving no net taxable income.

This corporation then will pay no taxes as a corporation, and if a distribution of profits is not made the stockholders will pay no surtaxes.

The above is shown in tabular form as follows:

Corporation A

Net income from business.....	\$60, 000
Corporation tax at 13½ per cent.....	8, 100
Surtax on three stockholders.....	660
Total tax.....	8, 760

Corporation B

Net income from business.....	\$60, 000
Dividends on stock of domestic corporations.....	60, 000
Total.....	120, 000
Deduct domestic dividends.....	60, 000
Net taxable income.....	60, 000
Tax.....	8, 100
No distribution of profits; no surtax.	

Corporation C

Net income from business.....	\$60, 000
Domestic dividends.....	120, 000
Total.....	180, 000
Deduct:	
Interest paid bank on loan secured by collateral.....	60, 000
Domestic dividends.....	120, 000
Total deductions.....	180, 000
Net taxable income.....	0
Corporation tax.....	0
Surtax with no distribution of profit.....	0

We may conclude, therefore, from the above hypothetical case that this manipulation of surplus avoids the payment of a corporation tax, and if the provisions of section 220 are not enforced the stockholders at the same time can avoid the payment of surtaxes.

To show that the above manipulation is actually being accomplished by certain companies, we give in the following table figures of an actual case covering a period of years, name of company only being deleted.

The "X" Holding Company, analysis of returns

[Incorporated September 25, 1911]

	1918	1919	1920	1921	1922	1923	1924
Income:							
Interest on United States obligations (not exempt).....				\$2, 473			
Interest from other sources.....	\$47, 585	\$282, 978	\$237, 066	261, 304	\$179, 889	\$264, 941	\$273, 754
Miscellaneous income.....							39, 445
Dividends from domestic corporations.....	520, 577	673, 184	651, 112	1, 199, 099	1, 919, 839	3, 151, 080	2, 051, 350
Profit or loss on sale of capital assets.....					2, 480	14, 000	14, 000
Total gross income.....	570, 162	956, 162	888, 178	1, 462, 876	2, 102, 208	3, 430, 021	2, 378, 549
Deductions:							
Expenses, etc.....	8, 458	12, 529	17, 351	46, 417	144, 854	18, 381	133, 937
Interest.....	311, 000	546, 928	570, 554	591, 765	507, 079	465, 909	455, 628
Taxes (except Federal).....	425	425	425	11, 888	16, 063	6, 807	425
Total deductions.....	319, 883	559, 882	588, 330	650, 070	667, 996	491, 097	589, 990
Net profit.....	250, 279	396, 280	299, 848	812, 806	1, 434, 212	2, 938, 924	1, 788, 559
Nontaxable income: Domestic dividends.....	520, 577	673, 184	651, 112	1, 199, 099	1, 919, 839	3, 151, 080	2, 051, 350
Net taxable income.....	1270, 298	1276, 904	1351, 264	1386, 293	1 485, 627	1 212, 156	1 262, 791
Tax paid.....	None.	None.	None.	None.	None.	None.	None.
Surplus beginning of year.....			2,763,433	3, 659, 826	3, 572, 911	5, 003, 667	7, 618, 835
Surplus end of year.....			3,059,826	3, 572, 911	5, 003, 667	7, 618, 835	2 3 180, 149
Adjustment in surplus:							
Reserve for liability as guarantor.....							2, 228, 080
Investment account (intangible value for which common stock was issued).....							7, 000, 000
Total assets beginning year.....					18, 915, 435	19, 111, 537	20, 541, 361
Total assets end of year.....					19, 111, 537	20, 541, 361	14, 690, 808
Dividends paid in cash.....						320, 000	400, 000

¹ Loss.² Deficiency.³ For practical purpose surplus in 1924 is \$9,047.31.

The above company is a closely held corporation, the majority of its stock being held by one banker and his wife. There was no distribution of profits except in the years 1923 and 1924, and even in these years the distribution was insignificant in comparison with the profits.

In the seven-year period from 1918 to 1924, inclusive, this company has made a net profit of \$7,920,908; the corporation has never paid one dollar of tax during this period. Moreover, surtaxes have been paid only on \$720,000, representing tax distribution of less than one-tenth of the above-mentioned total of net profit.

There has been no taxable net income in any year and it is plain that the bureau could not assess the additional tax provided for in section 220 for the years 1918 to 1923, inclusive. We trust they will be able to do so for the year 1924, although we have no assurance that such will be the case. The above actual case does show how taxes are being legally evaded and it is obvious if the provisions of section 220 be not enforced they will continue to be evaded in a like manner.

We will give one more actual case which will show rather more closely how the deductions for interest in connection with loans on collateral will reduce an actual net profit to a loss for tax purposes.

The Y company

	1923
Interest received.....	\$1, 764
Profit from sale of capital assets.....	23, 024
Dividends.....	147, 008
Total gross income.....	171, 796
Deductions, interest (total deductions).....	50, 608
Net profit.....	121, 188
Nontaxable income, dividends.....	147, 008
Net taxable income (loss).....	25, 820
Assets beginning of year.....	2, 394, 770
Assets end of year.....	2, 401, 542
Surplus beginning of year.....	1, 298, 959
Surplus end of year.....	1, 420, 148

The above figures show that practically the entire income of this company arises from dividends of domestic corporations or profits from the sales of such securities. Items of interest paid out amounting to \$50,608 show that a considerable sum of money has been borrowed and reinvested in securities.

This company made a net profit for the year 1923 of \$121,188 but had no net taxable income and paid no corporation tax. It made no distribution of its profits and hence no surtaxes were paid the Government on the operation of this company.

CONCLUSION

We must conclude from the above discussion that section 220 of the revenue acts of 1919 and 1921 has not been enforced to the extent intended by the Congress. There seems to be some possibility that the revenue acts of 1924 and 1926 will be enforced in a restricted manner in this connection.

It is not evident that the bureau intends to assess the additional tax in the case of large operating corporations which are able to invest their enormous earnings in their own business or related industries.

It is possible to replace section 220 by other provisions which will effect the result desired more automatically. We believe that such a change should be given serious consideration.

Respectfully submitted.

L. H. PARKER,
Chief Division of Investigation.

EXHIBIT A**SECTION II-A, SUBDIVISION 2, REVENUE ACT OF OCTOBER 3, 1913**

For the purpose of this additional tax the taxable income of any individual shall embrace the share to which he would be entitled to the gains and profits, if divided or distributed, whether divided or distributed or not, of all corporation, joint-stock companies, or associations however created or organized, formed or fraudulently availed of for the purpose of preventing the imposition of such tax through the medium of permitting such gains and profits to accumulate instead of being divided or distributed; and the fact that any such corporation, joint-stock company, or association, is a mere holding company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business shall be prima facie evidence of a fraudulent purpose to escape such tax; but the

fact that the gains and profits are in any case permitted to accumulate and become surplus shall not be construed as evidence of a purpose to escape the said tax in such case unless the Secretary of the Treasury shall certify that in his opinion such accumulation is unreasonable for the purposes of the business.

EXHIBIT B

SECTION 3, REVENUE ACT OF 1916 (SAME IN ACT AS AMENDED OCTOBER 3, 1917)

ADDITIONAL TAX INCLUDES UNDISTRIBUTED PROFITS

SEC. 3. For the purpose of the additional tax, the taxable income of any individual shall include the share to which he would be entitled of the gains and profits, if divided or distributed, whether divided or distributed or not, of all corporations, joint-stock companies or associations, or insurance companies, however created or organized, formed or fraudulently availed of for the purpose of preventing the imposition of such tax through the medium of permitting such gains and profits to accumulate instead of being divided or distributed; and the fact that any such corporation, joint-stock company or association, or insurance company is a mere holding company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business, shall be *prima facie* evidence of a fraudulent purpose to escape such tax; but the fact that the gains and profits are in any case permitted to accumulate and become surplus shall not be construed as evidence of a purpose to escape the said tax in such case unless the Secretary of the Treasury shall certify that in his opinion such accumulation is unreasonable for the purposes of the business.

EXHIBIT C

SECTION 220, REVENUE ACT OF 1918

PROFITS OF CORPORATIONS TAXABLE TO STOCKHOLDERS

SEC. 220. That if any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its stockholders or members through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, such corporation shall not be subject to the tax imposed by section 230, but the stockholders or members thereof shall be subject to taxation under this title in the same manner as provided in subdivision (e) of section 218 in the case of stockholders of a personal-service corporation, except that the tax imposed by Title III shall be deducted from the net income of the corporation before the computation of the proportionate share of each stockholder or member. The fact that any corporation is a mere holding company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business, shall be *prima facie* evidence of a purpose to escape the surtax; but the fact that the gains and profits are in any case permitted to accumulate and become surplus shall not be construed as evidence of a purpose to escape the tax in such case unless the commissioner certifies that in his opinion such accumulation is unreasonable for the purposes of the business. When requested by the commissioner, or any collector, every corporation shall forward to him a correct statement of such gains and profits and the names and addresses of the individuals or shareholders who would be entitled to the same if divided or distributed, and of the amounts that would be payable to each.

EXHIBIT D

SECTION 220, REVENUE ACT OF 1921

EVASION OF SURTAXES BY INCORPORATION

SEC. 220. That if any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its stockholders or members through the medium of permitting its gains and profits

to accumulate instead of being divided or distributed, there shall be levied, collected, and paid for each taxable year upon the net income of such corporation a tax equal to 25 per centum of the amount thereof, which shall be in addition to the tax imposed by section 230 of this title and shall be computed, collected, and paid upon the same basis and in the same manner and subject to the same provisions of law, including penalties, as that tax: *Provided*, That if all the stockholders or members of such corporation agree thereto, the commissioner may, in lieu of all income, war-profits, and excess-profits taxes imposed upon the corporation for the taxable year, tax the stockholders or members of such corporation upon their distributive shares in the net income of the corporation for the taxable year in the same manner as provided in subdivision (a) of section 218 in the case of members of a partnership. The fact that any corporation is a mere holding company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business, shall be *prima facie* evidence of a purpose to escape the surtax; but the fact that the gains and profits are in any case permitted to accumulate and become surplus shall not be construed as evidence of a purpose to escape the tax in such case unless the commissioner certifies that in his opinion such accumulation is unreasonable for the purposes of the business. When requested by the commissioner, or any collector, every corporation shall forward to him a correct statement of such gains and profits and the names and addresses of the individuals or shareholders who would be entitled to the same if divided or distributed, and of the amounts that would be payable to each.

EXHIBIT E

SECTION 220 (a), (b), (c), AND (d) REVENUE ACT OF 1924

EVASION OF SURTAXES BY INCORPORATION

SEC. 220. (a) If any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be levied, collected, and paid for each taxable year upon the net income of such corporation a tax equal to 50 per centum of the amount thereof, which shall be in addition to the tax imposed by section 230 of this title and shall (except as provided in subdivision (d) of this section) be computed, collected, and paid upon the same basis and in the same manner and subject to the same provisions of law, including penalties, as that tax.

(b) The fact that any corporation is a mere holding or investment company, or that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be *prima facie* evidence of a purpose to escape the surtax.

(c) When requested by the commissioner, or any collector, every corporation shall forward to him a correct statement of such gains and profits and the names and addresses of the individuals or shareholders who would be entitled to the same if divided or distributed, and of the amounts that would be payable to each.

(d) As used in this section the term "net income" means the net income as defined in section 232, increased by the sum of the amount of the deduction allowed under paragraph (6) of subdivision (a) of section 234, and the amount of the interest on obligations of the United States issued after September 1, 1917, which would be subject to tax in whole or in part in the hands of an individual owner.

EXHIBIT F

SUBMISSION OF INFORMATION RELATING TO APPLICATION OF SECTION 220, REVENUE ACTS OF 1921, 1924, AND 1926

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C., November 2, 1926.

Supervising Internal Revenue Agents and Internal Revenue Agents in Charge:

In order that cases involving the application of section 220 of the revenue acts of 1921, 1924, and 1926 may be handled more expeditiously, it is necessary to

secure uniformity of action in the revenue agents' field divisions. With this in view, it is desired to call the attention of all internal-revenue agents to the regulations and rulings under section 220 of the revenue acts of 1921, 1924, and 1926, to the information desired by the bureau in determining the application of those sections, and to the procedure to be followed in submitting such information.

The regulations of the department under the provisions of section 220 of the revenue acts of 1921, 1924, and 1926 are contained in articles 351 to 353 of regulations 62, 65, and 69, respectively. Attention is also invited to I. T. 1289 (C. B. I-i, p. 218), I. T. 1572 (C. B. II-1, p. 139), I. T. 1668 (C. B. II-1, p. 138), and S. M. 2273 (C. B. III-2, p. 187).

It is to be noted from the above-mentioned regulations and rulings that section 220 of each act is designated to discourage the formation or use of a corporation for the purpose of preventing the imposition of the surtax upon its shareholders by means of permitting its gains and profits to accumulate instead of being distributed in the form of dividends. Prima facie evidence of a purpose to escape the surtax exists where a corporation is a mere holding or (under the revenue acts of 1924 and 1926) a mere investment company, or where the gains or profits are permitted to accumulate beyond the reasonable needs of the business, and it is also to be noted that an accumulation of gains and profits is unreasonable if not required for the purposes of the business, in view of all the circumstances of the case. In other words, that an accumulation of gains and profits is unreasonable is a question of fact to be determined in each particular case.

In every case where the balance sheets and other available records indicate that section 220 may be applicable, it is necessary that full information be submitted to the bureau in order to enable a correct determination of the case to be made. Among the items which should be covered are (1) whether or not the corporation is a holding or investment company; (2) whether or not the corporation is closely held, and if so, the amount, if any, of the stockholder's withdrawals included in the accounts and notes receivable; (3) kind of business engaged in by the corporation; (4) a brief history of the corporation from its date of incorporation, including the purposes for which incorporated and the activities which have been engaged in; (5) an analysis of the surplus of the corporation since 1917; (6) an analysis of the income (both taxable and non-taxable) received by the corporation for each taxable year; (7) the amount of dividends distributed by the corporation in each year; and (8) the basis for the agent's recommendation that section 220 is applicable to the case. The items mentioned are not all inclusive and do not preclude the submission of any other facts which are deemed to be pertinent.

Inasmuch as the application of section 220 involves the fact that the taxpayer has earned certain profits during a given year and has made undue accumulation thereof, it is essential that all questions relating to the net income itself be decided prior to the determination that the taxpayer is subject to the provisions of section 220. The information and data relating to section 220 should, therefore, be incorporated in the examining officer's letter of transmittal to the supervising internal-revenue agent or internal-revenue agent in charge, which letter, as provided in the internal-revenue agent's manual, is not furnished the taxpayer. Any necessary statements or tabulations in support of the agent's recommendation may be submitted as an inclosure with such letter of transmittal in order that they will not be forwarded to the taxpayer with a copy of the revenue agent's report.

Under the system of handling section 220 cases, which has been in effect since 1923, the opinion of the general counsel of the Bureau of Internal Revenue is obtained in each case prior to the determination that section 220 should be applied, and the taxpayer's only hearing in the bureau with respect to the application of section 220 is before the office of the general counsel. Accordingly, no conferences will be held with taxpayers in the field or in the offices of the supervising internal-revenue agents and internal-revenue agents in charge for the purpose of discussing the features of a case which might bring it within the provisions of section 220.

All inquiries made in regard to this mimeograph should refer to the number of this mimeograph and the symbols IT:E:F.

D. H. BLAIR, *Commissioner*.

EXHIBIT G

List of cases considered up to October 1, 1926, under section 220 of the revenue acts of 1918, 1921, and 1924

Company	Date of organization	Business	Years in which involved	A approximate number of shareholders	Action taken by rules and regulations section	Action taken by general counsel (formerly solicitor)	Present status	Reasons for final action
Company No. 1...	Dec. 28, 1924	Manufacturing railway car movers and specialties.	1922 1923 1924	1.....	Applied for 1922, 1923, and 1924 and sent to general counsel.	Approved by general counsel Apr. 13, 1926.	Protest of taxpayer sent to general counsel May 14, 1926.	
Company No. 2...	Aug. 12, 1920	Holding (rental properties).	1920 1921	1.....	Applied for 1921 and sent to general counsel.	Approved by general counsel Aug. 6, 1925.	Protest of taxpayer sent to general counsel May 14, 1926; file received from general counsel Sept. 13, 1926, for consideration of the years 1922 and 1923.	
Company No. 3...	1912	Manufacturing brass and wire cloth for paper mills.	1921 1922 1923	5.....	Applied for 1921, 1922, and 1923 and sent to general counsel.	Approved by general counsel June 11, 1926.	Protest of taxpayer sent to general counsel July 22, 1926.	Dividend paid for 1920 and balance of net earnings for that year reflected in merchandise inventory: Dividends paid during 1921 and 1922 were in excess of total net earnings for those years.
Company No. 4...	Apr. 3, 1889	Wholesale jewelry...	1920 1921 1922	Not shown	Not recommended for 1920, 1921, or 1922.	Approved by general counsel and file returned to audit Jan. 30, 1926.		
Company No. 5...	July 9, 1918	Holding (investment securities).	1920 1921	1.....	Applied for 1920 and 1921 and sent to general counsel.	Sent to general counsel Nov. 30, 1925.	Pending with general counsel.	
Company No. 6...	Apr. 15, 1916	Holding (leasehold on office building and investment securities).	1921 1922 1923	2.....	Applied for 1921, 1922, and 1923 and sent to general counsel.	Approved by general counsel Mar. 31, 1926.	Protest of taxpayer sent to general counsel May 3, 1926.	
Company No. 7...	Dec. 7, 1915	Leaseholds on oil properties.	1918 1919 1920 1921	4.....	Not recommended for 1918, 1919, or 1920.	Approved by general counsel and file returned to audit Nov. 2, 1923.		Dividends paid during the years 1918 to 1920, inclusive, were in excess of statutory net income for those years.
Company No. 8...	1913	Sales agent for automobiles.	1920 1921	1.....	Applied for 1920 and 1921 and sent to general counsel.	Approved by general counsel Nov. 19, 1925.	Protest of taxpayer sent to general counsel Jan. 4, 1926.	

Company No. 9...	Apr. 5, 1920	Underwriting and dealing in investment securities.	1920 1921	Not shown	Not recommended for 1920, 1921, 1922, or 1923.	Approved by general counsel and file returned to audit Jan. 27, 1926.		Dividends paid on consolidated net income: 1920, 62 per cent; 1921, 62½ per cent; 1922, 83 per cent; 1923, 38½ per cent. Increase in surplus to capital stock outstanding: 1920, 1,084 per cent; 1921, 2.69 per cent; 1922, 8 per cent; 1923, 8 per cent.
Sub. No. 1		do	1922					
Sub. No. 2		Holding title to real estate.	1923					
Company No. 10...	Oct. 15, 1918	Holding (investment securities and real estate).	1922 1923	3.....	Applied for 1922 and 1923 and sent to general counsel.	Approved by general counsel July 1, 1926.	Protest of taxpayer sent to general counsel Aug. 3, 1926.	
Company No. 11...	Apr. 7, 1916	Investment securities.	1918 1919 1920 1921	6.....	Applied for 1918, 1919, 1920, and 1921.	Approved by general counsel Oct. 30, 1924.	Protest of taxpayer sent to general counsel Dec. 4, 1924. Protest of taxpayer sustained by general counsel Dec. 10, 1925.	Organized prior to the enactment of the revenue acts carrying high surtax rates. The company used a substantial portion of its profits in safeguarding its investments in certain close corporations which in order to increase their facilities looked to their few stockholders to supply the required capital.
Company No. 12...	Mar. —, 1917	Holding (investment securities).	1921	2 (family)	Applied for 1921		Certification letter of the commissioner mailed Apr. 5, 1926. Memorandum to audit, dated Apr. 5, 1926, signed by chief, rules and regulations section and deputy commissioner and file returned to audit same date to protect running of statute for 1921.	Corporation had a statutory net loss for 1921 after deducting the amount of dividends received on stock of other domestic corporations.
Company No. 13, sub. (a).	Apr. 25, 1917	Holding (investment securities and real estate).	1921	3 (family)	Not recommended	Approved by general counsel and file returned to audit July 20, 1926.		
Company No. 14...	1914	Manufacturing	1922 1923	3.....	Applied for 1922 and 1923 and sent to general counsel.	Approved by general counsel Sept. 8, 1925.	Protest of taxpayer received in office of general counsel Sept. 23, 1925.	

List of cases considered up to October 1, 1926, under section 220 of the revenue acts of 1918, 1921, and 1924—Continued

Company	Date of organization	Business	Years in which shareholders	Approximate number of shareholders	Action taken by rules and regulations section	Action taken by general counsel (formerly solicitor)	Present status	Reasons for final action
Company No. 15.	Nov. 2, 1900	Manufacturing (iron beds, castings, etc.).	1918 1919 1920	3 (family)	Applied for 1918, 1919, and 1920 and sent to general counsel.	Approved by general counsel July 7, 1923.	Protest of taxpayer denied by general counsel, Mar. 11, 1924.	No dividends declared or paid; net earnings invested in stocks of other domestic corporations and also loaned to individuals.
Company No. 16.	Nov. 2, 1900	do.	1921 1922 1923	3 (family)	Applied for 1921, 1922, and 1923.	Approved by general counsel Sept. 4, 1926.	File being held in rules and regulations section pending receipt of taxpayers protest.	
Company No. 17.	July 22, 1916	Holding (investment securities).	1918 1919 1920 1921	1	Applied for 1918, 1919, 1920, and 1921.	Approved by general counsel July 2, 1925.	Protest of taxpayer sent to general counsel Aug. 22, 1926.	
Company No. 18.	July 1, 1914	Manufacturing and selling automobiles and parts.	1918 1919 1920 1921	Not shown	Applied for 1918, 1919, and 1920; not applied for 1921.	Approved by general counsel Oct. 6, 1923.	Protest of taxpayer sustained by general counsel May 17, 1924, and file returned to audit.	Taxpayer submitted evidence showing that its undivided profits were invested in inventories and held for investment in plant additions.
Company No. 19, sub. of Company No. 18.	Nov. 27, 1917	Purchasing and selling real estate and mortgages.	1918 1919 1920 1921	do.	Applied for 1918, 1919, 1920, and 1921.	do.	do.	Accumulation of earnings and profits not unreasonable for the purpose of the business.
Company No. 20, sub. of Company No. 18.	April, 1914	Purchasing agent, plumbing and heating material for Company No. 18.	1918 1919 1920 1921	do.	Not applied for 1918, 1919, 1920, or 1921.	do.	do.	Net earnings for each of the years 1918 to 1921, inclusive, were only nominal.
Company No. 21.	1916	Financial and holding.	1920 1921 1922	5 (family)	Applied for 1921; not applied for 1920 or 1922.	Approved by general counsel Mar. 9, 1926.	Protest of taxpayer sent to general counsel Apr. 3, 1926.	
Company No. 22.	Oct. 1, 1915	Manufacturing.	1918 1919 1920 1921 1922 1923	Not shown	Not applied for any of the years 1918 to 1923, inclusive.	Approved by general counsel and file returned to audit Mar. 11, 1925.		Total amount of dividends paid during the years 1916 to 1919, inclusive, exceeded the total net earnings for those years. Audit of taxpayer's returns for subsequent years not completed, but 1923 edition of Poor's and Moody's Manual on Industrials shows that fairly reasonable dividends were paid during each of such years.

Company No. 23, sub. of Company No. 22.	June 4, 1918	Holding (investments).	1918 1919 1920 1921 1922 1923	1	do.	Approved by general counsel and file returned to audit Sept. 20, 1924; affirmed by memorandum of March 11, 1925.	-----	Parent company not subject to surtax on any dividends it might have received from this company and the failure to distribute the surplus of the latter company does not bring the case within the purview of section 220 of the 1918 and 1921 acts.
Company No. 24, sub. of company No. 22.	Not shown.	Not shown.	1918 1919 1920 1921 1922	-----	do.	Approved by general counsel and file returned to audit Sept. 20, 1924.	-----	File was returned to audit pursuant to suggestion of general counsel in order to investigate and resubmit in connection with the parent company.
Company No. 25.	May 27, 1920	Holding (investment securities).	1923 1920 1921 1922 1923	4 (family)	Applied for 1920, 1921, 1922, and 1923.	Approved by general counsel July 1, 1926.	Protest of taxpayer received in office of general counsel July 29, 1926.	
Company No. 26.	May 1, 1901	Grain consignment and buying and selling of grain futures for customers on boards of trade.	1921 1922	4	Applied for 1920, 1921, and 1922 (fiscal years)	Approved by general counsel Sept. 10, 1925.	Protest of taxpayer sent to general counsel Oct. 27, 1925.	
Company No. 27.	Dec. 14, 1922	Holding (investment securities).	1922	1	Not applied for 1922.	None	File returned to audit Sept. 21, 1926.	
Company No. 28.	Mar. 5, 1913	do.	1919 1920 1921	8 (family)	Applied for 1919, 1920, and 1921.	Approved by general counsel May 6, 1925.	Protest of taxpayer sustained by general counsel and file sent to audit Jan. 7, 1926.	
Company No. 29.	Dec. 14, 1922	Holding.	1922 1923	4 (family)	Not applied for 1922 or 1923.	Approved by general counsel Sept. 20, 1926.	File returned to audit Sept. 20, 1926.	

Corporation had no taxable net income, its entire income being derived from dividends on stocks of other domestic corporations. (Audit requested to forward the taxpayer's returns and R. A. K. covering years 1923 and 1924 when same are received.) Substantial dividends paid during 1919 and 1920 and the amount of earned surplus was strikingly small as compared to total assets; company had no taxable net income for 1921. (Sec. 220 originally applied to prevent running of statute for 1919.) Corporation had no taxable net income, its entire income being from interest on bonds and dividends on stocks of other domestic corporations.

List of cases considered up to October 1, 1926, under section 220 of the revenue acts of 1918, 1921, and 1924—Continued

Company	Date of organization	Business	Years involved	Approximate number of shareholders	Action taken by rules and regulations section	Action taken by general counsel (formerly solicitor)	Present status	Reasons for final action
Company No. 30	Mar. 19, 1921	Holding (residence, auto, and security investments).	1921	5 (family)	Not applied for 1921	Approved by general counsel Apr. 28, 1924.	File returned to audit Apr. 28, 1924.	After deducting the amount of dividends received on the stocks of other domestic corporations, taxpayer had a statutory net loss.
Company No. 31 and sub.	Apr. 16, 1917	Dealing in investment securities.	1921	1	Not applied for 1921; sent to general counsel Aug. 7, 1926.	Pending	-----	
Company No. 32	Nov. 5, 1919	Holding (investment securities).	1920 1921 1922	5 (family)	Applied for 1920, 1921, and 1922; not applied for 1923.	Approved by general counsel July 1, 1926.	Protest of taxpayer received in office of general counsel July 29, 1926.	
Company No. 33	Apr. 3, 1909	Manufacturing and selling wrapping paper, paper bags, and boxes.	1920 1921	4 (family)	Applied for 1920 and 1921.	Approved by general counsel Feb. 6, 1926.	Protest of taxpayer sent to general counsel Apr. 2, 1926.	
Company No. 34	May 29, 1922	Holding (investment securities).	1922	1	Not applied for 1922	Approved by general counsel Sept. 20, 1926.	File returned to audit Sept. 20, 1926.	After deducting the amount of dividends received on the stock of other domestic corporations, taxpayer had net income subject to tax. (Corporation was dissolved in 1923.)
Company No. 35	1905	Holding (real estate and investment securities).	1921	3 (family)	Applied for 1921	Approved by general counsel June 20, 1925.	Protest of taxpayer sent to general counsel Aug. 3, 1925.	
Company No. 36	Feb. 27, 1920	Holding (investment securities).	1922 1923 1924	1	Applied for 1923. Not applied for 1922 or 1924.	Approved by general counsel Sept. 3, 1926.	File being held in rules and regulations section pending receipt of taxpayer's protest.	
Company No. 37	1902	Shipbuilding until August, 1921, when name was changed and charter amended authorizing the buying and selling of securities.	1921 1922 1923 1924 (1)	Not shown	Applied for 1921. Not applied for 1922, 1923, or 1924.	Approved by general counsel Mar. 15, 1926.	Protest of taxpayer sent to general counsel Apr. 14, 1926. File returned to audit Aug. 19, 1926, for determination of taxpayer's true income for 1921 in accordance with the general counsel's instructions.	

Company No. 38.	Not shown.	Not shown.	1923	do	Apparently not applicable for 1923.	None.	File returned to audit on Sept. 11, 1926. Requested that when the field examination of the taxpayer for the years 1921 to 1924, inclusive, is completed, the returns and revenue agent's report be submitted to the rules and regulations section for consideration. Protest of taxpayer sustained by general counsel and file returned to audit Feb. 23, 1926.
Company No. 39.	Sept. 8, 1897	Manufacturing (fire-clay products).	1919 1920 1921	3	Applied for 1919, 1920, and 1921.	Approved by general counsel Oct. 15, 1925.	Taxpayer submitted evidence showing that its gains and profits were accumulated primarily for the purpose of purchasing additional fire-clay acreage and erecting thereon a fire-clay manufacturing plant.
Company No. 40.	July 9, 1891	Tannery.	1922 1923 1924	4 (family)	Applied for 1922, 1923, and 1924.	Approved by general counsel Sept. 27, 1926.	
Company No. 41.	Dec. 23, 1922	Trading in stocks.	1923 1924	4	Not applied for 1923 or 1924.	Approved by general counsel and file returned to audit May 5, 1926.	
Company No. 42.	Dec. —, 1923	Not shown.	1924	Not shown	None.		
Company No. 43.	June 1, 1913	Flour milling.	1920 1921 1922 (1)	do	Applied for 1920, 1921, and 1922.	Approved by general counsel Sept. 10, 1925.	The evidence disclosed that taxpayer's principal source of income is derived from trading in stocks, and that the amount earned to that purpose was used for that purpose and not for investment purposes.
							1924 file returned to audit Sept. 3, 1926, with instructions that when a field audit is made for 1924 and 1925 the files for both years be submitted to rules and regulations section for consideration. Protest of taxpayer sent to general counsel Oct. 13, 1925.

1 Fiscal year.

List of cases considered up to October 1, 1926, under section 220 of the revenue acts of 1918, 1921, and 1924—Continued

Company	Date of organization	Business	Years involved	Approximate number of shareholders	Action taken by rules and regulations section	Action taken by general counsel (formerly solicitor)	Present status	Reasons for final action
Company No. 44.	Not shown.	Wholesale and retail lumber.	1922 1923 1924	4 (family)	Applied for 1922, 1923, and 1924.	Approved by general counsel Sept. 24, 1926.	File being held in rules and regulations section pending receipt of taxpayer's protest.	
Company No. 45.	Dec. 17, 1915	Holding (improved realty and investment securities).	1922 1923 (1)	2 (family)	Applied for 1922 and 1923.	Approved by general counsel Feb. 2, 1926.	Protest of taxpayer sent to general counsel Mar. 10, 1926.	
Company No. 46.	July 15, 1912	Holding (interests and investments of Mr. "X" in timber and lumber business).	1920 1921	6	Applied for 1920 and 1921.	Approved by general counsel Sept. 24, 1926.	File being held in rules and regulations section pending receipt of taxpayer's protest.	
Company No. 47.	Sept. 17, 1907	Managing properties of Mr. "X", deceased.	1920 1921	Not shown	do	Approved by general counsel Apr. 30, 1926.	Protest of taxpayer sent to general counsel May 4, 1926.	
Company No. 48.	1897	Manufacturing (railway head-lights).	1919 1920 1921	do	Not applied for 1919, 1920, or 1921.	Approved by general counsel and file returned to audit Aug. 12, 1924.		Not a holding or investment company. Amounts carried to surplus each year in excess of dividends paid deemed to be not unreasonable for purposes of the business.
Company No. 49.	Jan. —, 1895	Manufacturing (proprietary medicines, extracts, toilet articles, etc.).	1921	9	Applied for 1921.	Approved by general counsel Apr. 13, 1926.	Protest of taxpayer sent to general counsel May 22, 1926.	1922, 1923, and 1924 returns of taxpayer in field for an investigation.
Company No. 50.	Sept. —, 1912	General contracting (construction of buildings).	1921 1922 1923 1924	2	Applied for 1924; not applied for 1921, 1922, or 1923.	Approved by general counsel May 27, 1926.	Protest of taxpayer sent to general counsel June 21, 1926.	
Company No. 51.	1890	Retail 10-cent store.	1920 1921	1	Applied for 1920 and 1921; sent to general counsel May 15, 1926.	File is now in general counsel's office, where several conferences have been held with the taxpayers' representatives.		

Company No. 52...	1894	Manufacturing	1920 1921 1922	2 (family)	Applied for 1920, 1921, and 1922.	Approved by gen- eral counsel Apr. 28, 1926.	Protest of taxpayer sent to general coun- sel May 29, 1926.
Company No. 53...	Not shown...	Manufacturing paper (manufac- turing business now carried on by another corpora- tion; taxpayer is an investment company). Rolling iron until 1918, when it sold its plant and since that date has been engaged in making investments only.	1918 1919 1920	3	Applied for 1918; not applied for 1919 or 1920.	Approved by gen- eral counsel Feb. 16, 1924.	Protest of taxpayer sustained by general counsel; file re- turned to audit Nov. 7, 1924.
Company No. 54, sub. 1, Com- pany No. 53.	do	Furnishing opera- tors for Company No. 53; income for 1919 and 1920 was derived solely from investments.	1918 1919 1920	3	Not applied for 1918, 1919, or 1920.	do	Protest of taxpayer sustained by general counsel; file re- turned to audit Nov. 7, 1924.
Company No. 55, sub. 2, Com- pany No. 53.	do	Jobber in iron and steel.	1918 1919 1920	3	do	do	do
Company No. 56, sub. 2, Com- pany No. 53.	do	Jobber in iron and steel; income for 1919 and 1920 was derived solely from investments.	1918 1919 1920	3	Applied for 1918, not applied for 1919 or 1920.	Approved by gen- eral counsel Feb. 16, 1924.	Protest of taxpayer sustained by general counsel and file re- turned to audit Nov. 7, 1924.

1 Fiscal year.

Expenditures for 1919 ex-
ceeded actual income for
that year. Dividends paid
in 1920 in excess of net in-
come. In view of the
large amount of income
and excess profits taxes
paid by the taxpayer in
1918 on 1917 income and the
fact that taxpayer sus-
tained a net loss in 1919,
the reasonable needs of the
business warranted the
retention of 1918 net earn-
ings.

Increase in surplus for 1918,
1919, and 1920 too small to
justify the application of
sec. 220.

Increase in surplus for 1918,
1919, and 1920 too small to
justify the application of
sec. 220.

Failure of taxpayer to de-
clare or pay any dividends
in 1918 did not result in an
evasion of surtax inasmuch
as it was a subsidiary of
Company No. 53, and a
corporate stockholder is not
subject to tax upon divi-
dends received from an-
other corporation.

List of cases considered up to October 1, 1926, under section 220 of the revenue acts of 1918, 1921, and 1924—Continued

Company	Date of organization	Business	Years involved	Approximate number of shareholders	Action taken by rules and regulations section	Action taken by general counsel (formerly solicitor)	Present status	Reasons for final action
Company No. 57..	Dec. —, 1911	Manufacturing and selling playing cards.	1920 1921 1922	4.....	Applied for 1920, 1921, and 1922.	Mar. 10, 1925.....	Protest of taxpayer sustained by general counsel Mar. 4, 1926, with respect to the years 1920 and 1921, and denied as to 1922.	Taxpayer submitted evidence which disclosed that while a relatively small dividend was paid in 1920, there was a large increase in the merchandise inventory, and that a substantial dividend payment was made in 1921 although the net earnings for that year were considerably less than for 1920. The large net earnings for 1922 were invested in stocks and bonds. Taxpayer filed a petition with the United States Board of Tax Appeals on July 14, 1926.
Company No. 58..	Jan. 15, 1903	Retailing pianos, talking machines, etc.	1919 1920 1921 1922	1.....	Not applied for 1919, 1920, 1921, or 1922.	Approved by general counsel and file returned to audit June 2, 1926.	-----	Earnings applied in the purchase of new store buildings, alterations of old store building, and payment of mortgage.
Company No. 59..	Feb. —, 1910	Holding (investment securities and real estate).	1922	Not shown	Applied for 1922.....	Approved by general counsel Feb. 15, 1926.	Protest of taxpayer sent to general counsel Mar. 24, 1926.	Taxpayer submitted evidence showing that the larger portion of its earnings for 1918 and 1919 was actually used and invested in the business. Do.
Company No. 60..	Jan. 24, 1916	Underwriting, buying, and selling securities.	1918 1919	4.....	Applied for 1918 and 1919.	Approved by general counsel Jan. 7, 1924.	Protest of taxpayer sustained by general counsel and file sent to audit July 21, 1924.	
Company No. 61, sub. of Company No. 60.	Nov. 15, 1917	do.....	1918 1919	4.....	do.....	do.....	do.....	
Company No. 62..	Mar. 2, 1916	Manufacturing (clothing).	1921 1922 1923	5.....	Applied for 1921, 1922, and 1923.	Approved by general counsel Oct. 7, 1926.	File now in general counsel's office.	
Company No. 63..	1894	Manufacturing (shoes).	1920 1921 1922	8.....	Applied for 1920, 1921, and 1922.	Approved by general counsel July 21, 1926.	Protest of taxpayer sent to general counsel Aug. 17, 1926.	

Company No. 64.	July 12, 1920	Holding (investment securities).	1920 1921 1922 1923	3 (family).	Applied for 1920; not applied for 1921, 1922, or 1923.	Approved by general counsel Feb. 6, 1926.	Protest of taxpayer sent to general counsel May 14, 1926.	
Company No. 65.	1891	Manufacturing cereals, beverages and ice, and buying, selling, and holding real estate.	1918 1919 1920	3.	Applied for 1918, 1919, and 1920.	Approved by general counsel Jan. 5, 1924.	Protest of taxpayer sustained by general counsel and file returned to audit Sept. 20, 1924.	The comparatively small profit made and retained by the taxpayer during 1918, 1919, and 1920 were necessary to a successful conversion of its business. Taxpayer submitted evidence showing that its earnings for each of the years 1918, 1919, and 1920 were reinvested in the business.
Company No. 66.	1900	Dealings and investments in real estate, ships, and stocks and bonds.	1918 1919 1920	1.	do.	Approved by general counsel July 31, 1923.	Protest of taxpayer sustained by general counsel and file returned to audit July 21, 1924.	Profits for 1918 loaned to the two sole stockholders; taxpayer operated at a loss for 1919 and 1920.
Company No. 67.	1899	Iron works and shipyard.	1918 1919 1920	2.	Applied for 1918; not applied for 1919 or 1920.	Approved by general counsel and file returned to audit June 22, 1923.	No further record.	Evidence disclosed a large increased business in 1921 at a substantial decrease in the profit derived, and that the larger portion of the earnings for 1920 and 1921 was reflected in the merchandise inventory.
Company No. 68.	July 15, 1904	Dealer in china, artists' materials, and supplies.	1920 1921	Not shown	Not applied for 1920 or 1921.	Approved by general counsel and file returned to audit June 17, 1925.		
Company No. 69.	Apr. 1, 1920	Holding (real estate and investment securities.)	1920 1921	5.	do.	Approved by general counsel Sept. 10, 1925.	Protest of taxpayer sent to general counsel Nov. 27, 1925.	Taxpayer had no statutory net income for 1923 but paid a dividend during that year; entire net income for 1924 as defined by sec. 220 (d) was distributed to stockholders.
Company No. 70.	Dec. 27, 1922	Holding (investment securities).	1923 1924	1.	Not applied for 1923 or 1924.	Approved by general counsel and file returned to audit July 19, 1926.		Dividends paid during 1922 and 1923 were in excess of taxpayer's net income for those years. Corporation liquidated July 30, 1924. File forwarded to G. C. Sept. 21, 1926.
Company No. 71.	Dec. —, 1916 ²	Holding (securities and other property).	1922 1923 1924	1.	Not applied for 1922, 1923, or 1924.	Approved by general counsel and returned to audit Sept. 20, 1926.		
Company No. 72.	Feb. 14, 1912	Manufacturing celluloid brushes, combs, etc.; discontinued manufacturing business on Sept. 29, 1923.	1922 1923 1924	2.	do.	Sent to general counsel Sept. 21, 1926.		

² Dissolved July 30, 1924.¹ Fiscal year.

List of cases considered up to October 1, 1926, under section 220 of the revenue acts of 1918, 1921, and 1924—Continued

Company	Date of organization	Business	Years involved	Approximate number of shareholders	Action taken by rules and regulations section	Action taken by general counsel (formerly solicitor)	Present status	Reasons for final action
Company No. 73--	Sept. 25, 1923	Manufacturing celluloid brushes, combs, etc.	1924	2	Not applied for 1924.	Sent to general counsel Sept. 21, 1926.	-----	File forwarded to G. C. Sept. 21, 1926.
Company No. 74--	June 5, 1891	Manufacturing newspaper.	1920	3	Applied for 1920; not applied for 1921.	Approved by general counsel Apr. 5, 1923.	Protest of taxpayer to general counsel Apr. 29, 1926.	
Company No. 75--	1917	Retail shoe store.	1922 1923 1924	2 (family)	Applied for 1922, 1923, and 1924.	Approved by general counsel Mar. 10, 1925.	Protest of taxpayer sent to general counsel Apr. 16, 1926.	
Company No. 76--	July -- 1904	Importer and jobber of straw goods.	1922	3 (family)	Not applied for 1922.	Approved by general counsel and file returned to audit June 29, 1926.	-----	Evidence disclosed that a substantial dividend payment was made during 1922, and that the balance of the earnings for that year was used in the business.
Company No. 77--	Aug. 3, 1922	Investments for Mr. "X."	1923 1924 1925	3 (family)	Applied for 1923; not applied for 1924 or 1925.	Approved by general counsel Sept. 20, 1926.	File being held in rules and regulations section pending receipt of taxpayer's protest.	
Company No. 78--	May 3, 1917	Buying, selling, and holding investment securities.	1918 1919 1920 1921	3 (family)	Applied for 1919, 1920, and 1921, not applied for 1918 as barred by statute of limitations.	Approved by general counsel May 9, 1925.	Protest of taxpayer sustained by general counsel and file returned to audit July 26, 1926.	Taxpayer submitted evidence showing that at frequent times during the years from 1917 to 1923, various subsidiaries of the taxpayer were in precarious financial condition and that the surplus accumulated during those years was devoted exclusively to relieving the financial embarrassment of such subsidiaries and in stabilizing the entire financial structure of the taxpayers. A dividend was declared in 1923 and dividends have been declared consistently since that date.

EXHIBIT H

IN RE COMPANY No. 11

In the following quotation Company No. 11 is substituted for real name of company. Names of stockholders are also changed]

DECEMBER 10, 1925.

MR. COMMISSIONER: This office has had under consideration (1) the protest of the stockholders of Company No. 11 against the proposed application in their cases of section 220 of the revenue act of 1918 for the years 1919 and 1920, and (2) the protest of the company against the proposed application of the provisions of section 220 of the revenue act of 1921 to the company for the year 1921. Section 220 of the 1918 and 1921 acts provides for the imposition of certain taxes, in the one case against the stockholders and in the other against the corporation, where it appears that "any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its stockholders or members through the medium of permitting its gains and profits to accumulate instead of being divided or distributed."

The case was orally presented before this office at a hearing held on March 20, 1925.

According to the evidence adduced, Company No. 11 was incorporated on April 7, 1916, under the laws of Delaware, with an original authorized capital stock of \$100,000, divided into 1,000 shares of the par value of \$100 each. The company was organized by Mr. "X," who turned over to the company securities of the approximate value of \$3,000,000 in exchange for its capital stock of \$100,000. There was thus created on the books of the company a paid-in surplus of \$2,904,119.62. Immediately after the receipt of the stock of the newly formed company, Mr. "X" transferred the stock in equal shares to his wife, Mrs. "X," and his four children, Tom, Dick, Harry, and Mabel. He retained but three shares of the stock, doing so to qualify himself as a director of the company. It is to be noted that the stockholders of the company who are protesting the application of section 220 of the 1918 and 1921 acts are the wife and children of Mr. "X," none of whom had any property interest in the securities which were transferred to the company upon its organization; also that the company was incorporated considerably prior to the enactment of the revenue act of 1916 on September 8, 1916, which marked the beginning of the enactment of the revenue acts carrying high surtax rates. Manifestly the case is not one of an individual who upon the advent of high surtaxes formed a corporation to hold his personal securities, while retaining the ownership of its capital stock.

The assets of Company No. 11 consisted of railroad and corporation bonds, municipal bonds, mortgages, notes, and accounts receivable, corporate stock, United States Government securities, and a relatively small amount of cash. These assets were greatly diversified and were made up of a large number of different kinds and blocks of stocks, bonds, notes, etc. The company bought and sold all classes of securities, and consistently paid capital stock taxes on account of the carrying on of its investment business. The extent of the investment business carried on is indicated by the respective increase and decrease in the company's assets during the years in question. The increases in its assets, which were composed very largely of investments, were \$598,134.68 (1919), \$740,006.65 (1920), and \$545,554.72 (1921), respectively, as compared with decreases during the same periods in the amounts of \$378,009.09 (1919), \$503,588.91 (1920), and \$233,565.03 (1921). That the company was not "a mere holding company" seems beyond peradventure.

The following is the comparative balance sheet of the company for the years in question:

	December 31		
	1919	1920	1921
ASSETS			
Railroad and corporation bonds	\$233, 272. 27	\$161, 683. 17	\$159, 683. 17
Municipal bonds	358, 022. 10	576, 934. 18	995, 819. 15
Mortgages, notes, and loans	476, 133. 48	230, 369. 73	184, 101. 73
Accounts and notes receivable	171, 532. 44	168, 227. 79	209, 013. 69
Stock of corporations	1, 797, 939. 58	2, 185, 594. 61	2, 082, 506. 68
Cash on hand	9, 739. 39	43, 208. 72	49, 133. 47
United States Government securities	625, 524. 00	541, 962. 80	541, 962. 80
Total	3, 672, 163. 26	3, 908, 581. 00	4, 222, 220. 69
LIABILITIES			
Surplus:			
Earned	429, 918. 05	650, 043. 64	386, 461. 38
Profit for year	220, 125. 59	286, 417. 74	313, 639. 69
Total	650, 043. 64	936, 461. 38	700, 101. 07
Dividends:			
Stock		500, 000. 00	
Cash		50, 000. 00	
Total dividends		550, 000. 00	
Balance	650, 043. 64	386, 461. 38	700, 101. 07
Paid in	2, 904, 119. 62	2, 904, 119. 62	2, 904, 119. 62
Total surplus	3, 554, 163. 26	3, 290, 581. 00	3, 604, 220. 69
Capital stock	100, 000. 00	100, 000. 00	600, 000. 00
Accounts payable	18, 000. 00	18, 000. 00	18, 000. 00
Total	3, 672, 163. 26	3, 908, 581. 00	4, 222, 220. 69

The books income of the company for 1919 was \$220,125.59, all of which was carried to surplus; for 1920 it was \$286,417.74; of which \$50,000 was distributed as a dividend and the balance of which was capitalized by the declaration of a \$500,000 stock dividend; and for 1921 it was \$313,639.69, of all which was carried to surplus. Thus the earnings for the 3-year period were \$820,183.02 as compared with \$50,000 distributed as a cash dividend. That the undistributed earnings were used by the company in its investment business is shown by the fact that its cash account as of the end of each of the years in question was less than \$50,000 and as of December 31, 1919, was only \$9,739.39. It can not be denied that there was an active employment of the accumulated profits to promote the business purposes of the company. The company used a substantial portion of its profits in safeguarding its investments in certain close corporations which in order to increase their facilities looked to their few stockholders, among others Company No. 11, to supply the required capital. The use made by the company of its funds was entirely within the powers granted by its charter which were extremely broad, the company's charter authorizing it to engage in practically any kind of business in which an individual might engage. From the time the company began business immediately after its incorporation through the years in question there was no change in the nature of the business carried on or the policies of the management. Under all the circumstances the company can not be said to have accumulated its profits beyond the reasonable needs of its business. Section 220 of the revenue acts of 1918 and 1921 is applicable only in cases where it is found that a corporation was formed or availed of for the purpose of preventing the imposition of the surtax upon its stockholders. In the absence of any direct evidence as to such a purpose, as in the instant case, the only possible basis for holding the section applicable is the provision of the section which reads:

"The fact that any corporation is a 'mere holding company,' or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax * * *."

But, as has already been pointed out, it can not be said Company No. 11 was "a mere holding company" or that its gains and profits were permitted to ac-

cumulate beyond the reasonable needs of its business during any of the years in question. Section 220 of the revenue act of 1924 contains a provision, not incorporated in any of the prior acts, to the effect that every investment company shall be considered *prima facie* as a corporation formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders. This provision is immaterial to the consideration of the instant case, being inapplicable except as to 1924 and subsequent taxable years.

For the reasons above stated, there being no basis for the finding that Company No. 11 was formed or availed of during 1919, 1920, or 1921 for the purpose of preventing the imposition of the surtax upon its stockholders, it must be concluded that the stockholders of the company are not subject to taxation under section 220 of the revenue act of 1918 for the years 1919 or 1920 and that the company is not subject to taxation under section 220 of the revenue act of 1921 for the year 1921. It is therefore recommended that the protests of the stockholders and of the company be sustained.

A. W. GREGG,
Solicitor of Internal Revenue.

Approved.

D. H. BLAIR, *Commissioner.*

EXHIBIT I

IN RE COMPANY NO. 66

[In the following quotation Company No. 66 is substituted for real name of company. Names of stockholders are also changed]

MAY 31, 1924.

MR. COMMISSIONER: This office has had under consideration the appeal of the stockholders of Company No. 66 from your certification that it had permitted its gains and profits for the years 1918, 1919, and 1920 to accumulate beyond the reasonable needs of its business and proposing to make an assessment under the provisions of section 220 of the revenue act of 1918.

Company No. 66 was incorporated in 1900 under the laws of the State of California for the purpose *inter alia* of engaging in and transacting "any and all kinds of business in which natural persons may lawfully engage." It was and is a close corporation, all of its stock except 20 qualifying shares being owned by Mr. "X." It began business in 1902 with an authorized capital of \$100,000, represented by 5,000 shares, and a paid-in surplus of \$530,052.14. The capital stock of the corporation was issued in exchange for real estate, interest in vessels, and stocks and bonds of other corporations.

Its activities have been confined principally to dealings and investments in real estate, ships, and corporate stocks and bonds. The corporation, ever since its organization, has followed a consistent policy of reinvesting its earnings therein instead of paying them out as dividends. In fact, no dividends have ever been paid by it. The corporation on January 1, 1918, had a surplus of \$2,355,467.78. Of this amount only \$201,113.41 consisted of cash, which was on deposit in a savings account, the balance being represented by real estate, interest in ships, and corporate stocks and bonds. At the end of 1918 the surplus of the corporation amounted to \$2,704,925.04, showing an increase for that year of \$349,457.26. The corporation's cash account during that year, as shown by its balance sheet, increased only \$7,815.20, which represented interest on the money in the savings account. Before the close of 1918 all of the current earnings had been reinvested in the business; the land account increased approximately \$11,000 and the investments in Liberty bonds and United States Treasury certificates amounted to approximately \$207,400.

On January 1, 1919, the surplus of the corporation amounted to \$2,704,925.04, all of which except \$208,928.61 (cash in savings account) was represented by stocks and bonds, real estate, and ships. The additions made to surplus during 1919 amounted to \$198,308.56. At the end of 1919 the cash account of the corporation amounted to \$216,970.07, showing an increase of \$8,041.46. Prior to the close of 1919 all of the current earnings of that year had been reinvested in the business. The corporation purchased during 1919 Liberty bonds and United States Treasury certificates in the sum of \$79,709.38.

At the beginning of 1920 the corporation's surplus amounted to \$2,903,233.60, all of which except \$216,970.07 (cash in savings account) was represented by

investments in real estate, ships, and stocks and bonds. At the close of 1920 the surplus of the corporation amounted to \$3,124,860.36, showing an increase during the year of \$221,626.76. The cash account of the corporation at the close of 1920 stood at \$225,490.43, showing an increase thereof for that year of \$8,520.36, representing interest from the money in savings account. All of the earnings for the year 1920, prior to the close thereof, had been reinvested in the business.

Section 220 of the revenue act of 1918 provides:

"That if any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its stockholders or members through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, such corporation shall not be subject to the tax imposed by section 230, but the stockholders or members thereof shall be subject to taxation under this title in the same manner as provided in subdivision (e) of section 218 in the case of stockholders of a personal service corporation, except that the tax imposed by Title III shall be deducted from the net income of the corporation before the computation of the proportionate share of each stockholder or member. The fact that any corporation is a mere holding company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax; but the fact that the gains and profits are in any case permitted to accumulate and become surplus shall not be construed as evidence of a purpose to escape the tax in such a case unless the commissioner certified that in his opinion such accumulation is unreasonable for the purposes of the business. When requested by the commissioner, or any collector, every corporation shall forward to him a correct statement of such gains and profits and the names and addresses of the individuals or shareholders who would be entitled to the same if divided or distributed, and of the amounts that would be payable to each."

The imposition of taxes under the foregoing section is warranted only when a corporation is "formed or availed of for the purpose of preventing the imposition of surtaxes upon the stockholders or members through the medium of permitting its gains and profits to accumulate instead of being divided or distributed." To "avail," according to Webster, means "to promote, assist, or turn to the advantage of," and "purpose" is defined as "an aim, intention, or as an object to be reached." Consequently, the application of the statute depends upon the two elements, (a) purpose or intention to escape the surtax, and (b) unreasonable accumulation of gains and profits. The mere fact that a corporation permits its gains and profits to accumulate "shall not be construed as evidence of a purpose" to escape the surtaxes unless it is certified by the Commissioner of Internal Revenue that in "his opinion such accumulation is unreasonable for the purpose of the business." It was certified by letter dated July 31, 1923, that the accumulation of gains and profits of the corporation for the years 1918, 1919, and 1920 was unreasonable for the needs of its business, and that such accumulation should be as evidence of a purpose to escape the surtaxes. The issues for each of the years, being practically identical, will be considered together.

The additions made to surplus during 1918, as heretofore stated, amounted to \$349,457.26, which is only approximately 14½ per cent of the capital and surplus of the corporation existing on January 1, 1918; during 1919 the additions made to surplus amounted to \$198,308.56, or only approximately 7½ per cent of the capital and surplus of the corporation existing at the beginning of that year. The additions made to surplus during 1920 amounted to \$221,626.76, or only approximately 4½ per cent of the corporation's capital and surplus existing at the beginning of 1920. The statute, in the opinion of this office, was not intended to prevent nor limit legitimate expansion. The facts in this case show that the corporation, since it began business, has had a steady growth and that its growth during the years herein involved was neither large nor phenomenal. There is nothing in the statute which compels a corporation to pay out its earnings, and the mere fact that a corporation reinvests all of its earnings in its business does not warrant the application of the statute. The earnings of the corporation during each of the years under consideration were reinvested in the business and were actually used to acquire additional property. Under these circumstances it is the opinion of this office that the accumulation of the earnings and profits of this corporation for these years was not unreasonable for the needs of its business within the meaning of the statute. The corporation since it began business has consistently followed the policy of reinvesting its earnings in its business. It has never paid dividends. This consistent

policy, carried on long prior to the enactment of the statute and not deviated from during the years under review, strongly disproves a purpose to escape the surtax.

It is, therefore, the opinion of this office that the great preponderance of evidence proves that the accumulations of its earnings and profits during 1918, 1919, and 1920 were not unreasonable for the needs of its business. The accumulations not being unreasonable for the needs of its business, there is no evidence to prove that the corporation had been availed of for the purpose of escaping the surtaxes. Consequently, it is recommended that the appeal of the taxpayers be sustained.

NELSON T. HARTSON,
Solicitor of Internal Revenue.

Approved June 30, 1924.

D. H. BLAIR, *Commissioner.*

EXHIBIT J

IN RE COMPANY No. 15

[In the following quotation Company No. 15 is substituted for real name of company. Names of stockholders are also changed]

MARCH 11, 1924.

MR. COMMISSIONER: This office had under consideration the appeal of the stockholders of Company No. 15 from the proposed assessment of additional taxes arising because the corporation had been availed of for the purpose of permitting its gains and profits for the years 1918, 1919, and 1920 to accumulate beyond the reasonable needs of its business in violation of section 220 of the revenue act of 1918.

Company No. 15 was incorporated under the laws of the State of Louisiana on November 2, 1900, with an authorized capital of \$10,000, which was increased on February 19, 1907, to \$100,000. Its capital stock has always been owned by John Doe, sr., and his two sons, John Doe, jr., and Peter Doe. No dividends have been paid by the corporation since the incidence of the income tax law, and so far as the evidence shows, none have ever been paid. For the taxable years 1918, 1919, and 1920 the increase in the earned surplus of the corporation amounted to \$83,312.15, \$210,311.21, and \$187,867.94, respectively.

It has always been the policy of the corporation to make short loans and investments in real estate and securities with the earned and paid-in surplus, which was not required for the immediate needs of the bed business. The acts of the corporation in making these loans and investments were ultra vires, as its charter stated that it is organized for the purpose of "manufacture and sale of iron beds, iron castings, hardware specialties, and other articles."

At the close of 1910 the loans and investments of the corporation amounted to approximately \$125,000, the amount of such loans and investments at the end of 1919 was approximately \$312,600 and at the close of 1920 approximately \$565,000. The paid-in surplus of the corporation at the beginning of 1918 amounted to only \$90,466.11 and at the end of 1920 to only \$201,390.53, all of which shows that the greater part of the loans and investments consisted of earned surplus. The earned surplus at the end of 1917 amounted to approximately \$416,000.

The existence of such a large surplus at the beginning of 1918 and the use to which it was put would, in the opinion of this office, make the accumulations of earnings and profits during the years 1918, 1919, and 1920 unreasonable within the meaning of section 220 of the revenue act of 1918. Indeed, the fact that the corporation was able to engage in these ultra vires pursuits with the profits not needed in the bed business precludes any other conclusion. Evidence was submitted to show that it had always been the policy of the corporation to utilize its spare earnings and profits in making loans and investments. This fact, however, can not prevent the application of section 220. It may be true that the acts of the corporation in accumulating its profits and earnings and retaining them, when not needed in the business, were not illegal until the statute made them so. However, one of the sources of the Government's revenue has been the corporate earnings received by stockholders. The statute was enacted not only to prevent the drying up of this source, but to compel all corporate earnings, rightfully belonging to stockholders, to bear their fair burden of taxation. When a corporation retains profits that it could prudently and legitimately distribute to the stockholders the provisions of section 220 have been violated. The facts in this

case show that the corporation could have prudently and legitimately paid dividends.

It was also contended by the taxpayers that the corporation was used to accumulate a family fortune and provide a living for its members, and that there was no intent to escape the surtaxes. This argument loses its force when it is considered that the corporation was a close family corporation. An unreasonable accumulation of earnings and profits by such a close corporation as "Company No. 15" in itself proves a violation of the section. This is especially true in view of its provisions making an unreasonable accumulation of profits prima facie evidence of a purpose to escape the surtax. The intent to escape the surtaxes must be ascertained from the acts and conduct of the taxpayers, and not from the hidden recesses of their minds. No dividends having been declared by the corporation during the best business years of its existence, and the large earnings from those years having been added to a large surplus, not needed nor used in the business, it is apparent that the corporation was "availed of for the purpose of preventing the imposition of the surtax upon its stockholders" in violation of section 220.

It is, therefore, recommended that the appeal be denied and that the taxes be assessed as proposed.

_____,
Solicitor of Internal Revenue.

Approved.

D. H. BLAIR, *Commissioner.*

EXHIBIT K

IN RE COMPANY No. 57

[In the following quotation Company No. 57 is substituted for real name of company. Names of stockholders are also changed]

FEBRUARY 12, 1926.

MR. COMMISSIONER: This office has had under consideration (1) the protest of Mr. "X," a stockholder of Company No. 57, against the proposed application in his case for the calendar year 1920 of the provisions of section 220 of the revenue act of 1918, and (2) the protest of Company No. 57 against the proposed application to the company for the calendar years 1921 and 1922 of the provisions of section 220 of the revenue act of 1921. Section 220 of the 1918 and 1921 acts provided for the imposition of certain taxes, in the one case against the stockholders and in the other against the corporation, where it appears that "any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax on its stockholders or members through the medium of permitting its gains or profits to accumulate instead of being divided or distributed."

A hearing was held before this office on April 23, 1925, at which time the contentions of the protestants were orally presented by their attorney, Mark Wisner, 292 Madison Avenue, New York, N. Y.

Company No. 57 was incorporated by Mr. "X" in December, 1911, under the laws of New Jersey, with an authorized capital stock of \$100,000, of which \$75,000 was issued in 1911 and the balance in 1912. The company was engaged in the business of manufacturing and selling playing cards and has been progressively prosperous. The stock of the company is closely held, its principal stockholder and president being Mr. "X," who during each of the years in question (1920, 1921, 1922) owned 899 of the 1,000 shares outstanding.

The following figures taken from data submitted by Company No. 57 are pertinent to the issues under consideration:

	1919	1920	1921	1922
Cash.....	\$3,303.95	\$18,242.80	\$43,443.38	\$36,542.08
Accounts receivable.....	67,868.03	46,532.68	69,322.95	95,841.987
Investments.....	53,300.63	75,124.00	141,550.25	315,973.55
Inventory.....	169,451.60	200,204.95	115,895.33	117,109.58
Machinery.....	103,460.23	107,363.06	113,689.81	122,872.73
Accounts payable.....	38,482.85	11,545.55	20,357.55	22,400.48
Depreciation reserve.....	67,685.67	83,160.06	96,759.35	112,309.92
Reserve for taxes.....	9,939.66	29,332.24	8,735.68	27,000.00
Capital stock.....	100,000.00	100,000.00	100,000.00	100,000.00
Surplus.....	186,791.95	249,504.28	283,575.09	448,540.71
Book profits.....		67,712.33	44,070.81	179,965.62
Dividends paid.....		5,000.00	10,000.00	15,000.00

It will be seen that the book profits of the company for 1920, 1921, and 1922 were \$67,712.33, \$44,070.81, and \$179,965.62, respectively, of which \$5,000 was paid out as dividends in 1920, \$10,000 in 1921, and \$15,000 in 1922. Thus \$62,712.33 was added to surplus in 1920; \$34,070.81 in 1921; and \$164,965.62 in 1922. In explanation of these additions to surplus the company calls attention to the history of the business enterprise, the conditions under which it operated, and the projects which were in contemplation.

According to the statements made it appears that the manufacture of playing cards is now controlled to the extent of about 80 per cent by the United States Playing Card Co., Cincinnati, Ohio, and its affiliated corporations; that until the last four or five years the field was controlled by that company to the extent of about 90 per cent; that one company after another in the playing-card business started only to pass out of existence after a futile attempt to compete with the United States Playing Card Co.; that Company No. 57 alone has succeeded in spite of the competition, holding its own with unknown brands against the United States Playing Card Co. with its long-established and well-known trademarked brands; and that the factory of Company No. 57 is a leased building, originally erected for the manufacture of rubber products, and poorly adapted from the standpoint of plant lay out to the manufacture of playing cards. This last point is stressed by the company. Company No. 57 claims that the inadequacy of its leased factory and the necessity of erecting a modern plant of its own with better facilities has long been realized, but that it was impossible to go forward with any plant during the war period. However, shortly after the war or about the middle of 1919 the advisability of acquiring a plant impelled the company to take steps to that end. An architectural engineer and real-estate specialist of Lake Placid, N. Y., was retained during the months of May, June, and July, 1919, to investigate sites for a modern factory with adequate storage space for raw material and stock in trade and to report on building and labor costs. This engineer made an investigation, drafted temporary plans for a factory, drew up templets of machinery to be installed, and estimated the cost of a new plant at approximately \$400,000, taking into consideration the war prices which still prevailed in 1919. The company decided to defer taking any action at the time, but consulted the engineer again in 1921 on the same matter. In substantiation of these facts the affidavit of the engineer, sworn to June 13, 1925, and the affidavit of a president of a national bank sworn to May 23, 1925, were submitted.

The first lease of Company No. 57 on the factory was made in 1912 and expired in 1917. The lease was renewed for five years, expiring in 1922. In that year the company negotiated with the lessor of the property for the replacement of the power plant at a considerable expense to the lessor. Other changes and additions to the factory were made, and a lease was made at an increased rental for a seven-year period. During the years 1920 and 1921 the company probably planned to build a plant of its own upon the expiration of its lease in 1922; in fact, it is stated that the engineer was called into consultation on that matter in 1921. However, it is evident in view of the events of 1922, the making of the new lease, the improvements made to the factory, etc., that all immediate plans for a new plant were given up in that year. This element of the case must be borne in mind in considering the operations of the company for the years in question.

In 1920 Company No. 57 earned \$67,712.33, of which \$5,000 was disbursed in dividends. While the dividend payment was comparatively small, a large amount of the \$62,712.33 balance was accounted for by the inventory, which was increased \$30,753.35 during the year, or from \$169,451.60 at the beginning of the year to \$200,204.95 at the end of the year. Investments were increased \$21,823.37. During 1921 the earnings dropped to \$44,070.81, of which nearly 23 per cent (\$10,000) was disbursed in dividends. These were the last years of the five-year lease on the factory, and plans for erecting a new plant were still under consideration. Under the circumstances this office does not believe a finding that the gains and profits of the Company No. 57 for 1920 or 1921 were permitted to accumulate beyond the reasonable needs of the business, or that the company was availed of during 1920 or 1921 for the purpose of preventing the imposition of the surtax upon its stockholders, can be supported.

The year 1922 presents a different situation. The earnings for the year were \$179,965.62, from which dividends of only \$15,000 were paid. The balance of the profits (\$164,965.62) was carried to surplus, and, together with an additional amount of \$9,457.68, was expended in making outside investments, entirely unrelated to the business. No part of the profits was either used or invested

in the business. At the beginning of 1922 the company's investments in bonds and other securities were carried at \$141,550.25, to which there was added during the year \$174,423.30, making a total of \$315,973.55. The only substantial changes in the company's accounts for the year were in the investment and surplus accounts. (See attached schedule for detailed changes in the company's accounts for 1920, 1921, and 1922.)

As has previously been stated, it was during the same year, 1922, that Company No. 57, after inducing its lessor to make certain improvements to the leased factory, took a lease for seven years at an increased rental. The mere assertion by the company that it was still planning to acquire its own factory can be given little, if any, weight in view of all the attendant circumstances. Equally indefinite and unconvincing is the suggestion that Company No. 57 needed a large surplus to insure it against a price war by the United States Playing Card Co. With no bonded indebtedness and with but a small amount of accounts payable, the company increased its surplus from \$283,575.09, 50 per cent of which was represented by securities of unrelated companies, at the beginning of 1922, to \$448,540.71, 70 per cent of which was represented by securities of unrelated companies, at the end of the year. What was the effect of this accumulation of gains and profits on the tax liability of Mr. "X," the principal stockholder? During 1922 he reported a net income of \$85,992.99, on which a surtax of \$16,297.20 was paid. If Company No. 57 had distributed as dividends the 1922 profits which it carried to surplus and invested in securities in the amount of \$164,965.62, the net income of its principal stockholder would have been \$234,297.08, on which the surtax would have been \$88,103.54. The company's action in permitting its gains and profits to accumulate during 1922 resulted in a decreased tax liability to Mr. "X" alone of \$71,811.34.

After due consideration of all the facts it is the conclusion of this office that the gains and profits of Company No. 57 were permitted to accumulate during the calendar year 1922 beyond the reasonable needs of the business, that the certification of the commissioner that such accumulation was unreasonable for the purposes of the business is adequately supported by the evidence, and that the company should be held to be subject for that year to the 25 per cent of additional tax imposed by section 220 of the revenue act of 1921 upon the net income of corporations formed or availed of for the purpose of preventing the imposition of the surtax upon their stockholders or members through the medium of permitting their gains and profits to accumulate instead of being divided or distributed.

It is therefore recommended that the protest of Mr. "X" against the proposed application in his case of the provisions of section 220 of the revenue act of 1918 for the year 1920 be sustained, and that the protest of Company No. 57 against the application to the company of the provisions of section 220 of the revenue act of 1921 be sustained as to the year 1921, but denied as to the year 1922.

A. W. GREGG,
Solicitor of Internal Revenue,

Approved:

D. H. BLAIR, *Commissioner.*

EXHIBIT L

Cases not considered by the bureau in connection with section 220 of the revenue acts

Name of company and date of incorporation	Year	Domestic dividends received	Total gross income	Net taxable income or deficit ¹	Net income plus domestic dividends	Tax paid	Dividends		Total assets	Surplus and undivided profits
							Cash	Stock		
Company No. 101, incorporated 1909.....	1918	\$65,895	\$76,925	\$5,151	\$71,046	\$334	\$20,086	-----	(2)	\$414,884
	1919	53,798	81,848	18,236	72,034	1,624	28,674	-----	(2)	512,355
	1920	115,865	140,249	9,953	125,818	1,710	22,122	-----	(2)	622,525
	1921	41,301	63,512	11,992	53,363	912	55,000	-----	(2)	622,525
Company No. 102, incorporated 1908.....	1920	20,700	269,369	63,978	84,378	6,066	57,500	-----	(2)	706,565
	1921	30,774	320,717	109,069	139,843	10,905	91,988	-----	(2)	815,980
	1922	87,154	445,220	123,630	216,784	15,454	-----	-----	(2)	1,181,106
	1923	32,850	360,322	8,751	41,101	-----	-----	-----	(2)	1,224,333
Company No. 103, incorporated 1922.....	1924	22,657	184,412	75,513	98,200	9,193	-----	-----	(2)	1,313,439
	1923	21,095	21,409	1,312	18,083	180	7,647	-----	(2)	39,116
	1924	24,202	30,206	3,437	27,729	-----	7,000	-----	(2)	65,008
	1925	23,635	34,809	9,317	32,952	-----	-----	-----	(2)	84,752
Company No. 104, incorporated 1916.....	1919	3,351	297,987	87,608	90,959	14,698	-----	-----	\$3,804,579	311,223
	1920	93,550	460,198	150,839	243,889	18,555	-----	-----	3,741,730	626,323
	1921	203,027	638,943	209,216	412,243	19,620	-----	-----	3,852,740	3,979,126
	1922	1,660,710	1,669,134	3,364	1,664,074	171	40,000	\$1,500,000	6,890,008	4,262,534
Company No. 105, incorporated 1919.....	1922	97,351	844,273	162,552	259,903	20,315	126,000	-----	7,754,129	4,262,719
	1923	127,713	897,366	242,742	370,455	30,343	126,000	-----	7,603,810	(2)
	1924	141,222	956,841	247,350	388,572	30,919	125,241	-----	3,094,795	1,338,779
	1922	1,860	273,484	106,378	108,138	13,285	-----	-----	4,418,092	2,126,289
Company No. 106, incorporated 1906.....	1923	27,737	372,526	168,971	191,708	21,121	-----	-----	4,307,301	(2)
	1924	53,562	462,390	191,250	521,952	23,806	-----	-----	976,161	475,212
	1922	84,765	107,777	20,463	105,228	2,306	105,228	-----	1,032,554	699,198
	1923	95,729	119,491	20,362	119,291	2,320	-----	-----	1,988,933	122,266
Company No. 107, incorporated 1922.....	1923	72,440	71,487	111,077	61,363	1,778	-----	-----	4,124,058	(2)
	1924	70,531	107,066	28,393	98,924	1,079	-----	-----	3,216,378	279,661
	1923	501,837	532,341	10,631	512,468	1,778	-----	-----	1,271,578	652,778
	1924	244,950	266,698	15,595	239,355	-----	-----	-----	1,621,512	(2)
Company No. 108, incorporated 1921.....	1924	89,721	366,318	259,791	340,512	32,474	20,000	-----	(2)	114,353
	1921	89,403	95,738	5,092	94,495	309	44,106	-----	(2)	153,603
	1922	106,215	112,829	2,450	108,665	27	44,106	-----	(2)	160,868
	1923	69,909	80,818	15,872	64,027	-----	36,755	-----	(2)	167,852
Company No. 109, incorporated 1916.....	1924	87,204	97,188	7,968	95,172	746	44,178	44,000	(2)	1,011,934
	1923	108,296	884,418	712,177	820,473	89,022	20,000	-----	2,617,495	3,202,860
	1924	135,598	339,894	186,192	331,790	23,274	-----	-----	(2)	(2)

¹ Deficit.² Not available.

Cases not considered by the bureau in connection with section 220 of the revenue act—Continued

Name of company and date of incorporation	Year	Domestic dividends received	Total gross income	Net taxable income or deficit ¹	Net income plus domestic dividends	Tax paid	Dividends		Total assets	Surplus and undivided profits
							Cash	Stock		
Company No. 114, incorporated 1904	1922	\$12,207	\$2,044,535	\$335,783	\$947,990	\$116,973	\$6,000	-----	\$35,676,109	\$725,235
	1923	25,646	2,518,908	1,358,957	1,384,603	169,870	6,000	-----	41,652,092	931,014
	1924	49,354	3,082,617	1,638,431	1,687,785	204,804	6,000	-----	48,583,586	(²)
Company No. 115, incorporated 1919	1922	-----	535,135	262,237	262,237	32,780	30,000	-----	3,961,923	2,961,923
	1923	-----	587,424	298,173	298,173	37,272	30,000	-----	4,515,436	3,407,936
	1924	-----	845,813	512,241	512,241	64,030	30,000	-----	5,529,524	(²)
Company No. 116, incorporated 1923	1923	30,615	3,143,059	783,524	814,139	97,066	2,490	-----	13,489,798	6,635,295
	1924	32,379	3,267,207	692,158	724,537	86,520	161,946	-----	7,051,997	2,446,837
Company No. 117, incorporated 1887	1920	357,763	1,271,767	36,804	394,567	2,175	240,000	-----	9,723,992	2,667,893
	1921	338,518	1,328,280	103,969	442,487	11,047	240,000	-----	8,825,892	2,634,510
	1922	344,690	1,288,598	181,304	595,994	22,663	240,000	-----	(³)	5,436
	1918	9,992	16,811	1,446	11,432	-----	-----	-----	(³)	15,076
	1919	11,539	20,781	1,205	9,234	-----	-----	-----	(³)	20,693
	1920	16,470	17,970	11,794	5,736	-----	-----	-----	(³)	34,384
	1921	19,206	25,755	2,650	21,236	8	-----	-----	(³)	67,640
	1922	23,000	45,150	5,571	31,171	446	-----	-----	(³)	31,611
	1923	59,676	61,171	1,540	38,136	-----	-----	-----	(³)	118,051
	1924	45,588	94,059	29,078	74,606	3,635	-----	-----	(³)	-----
Grand total	-----	6,059,430	32,303,784	10,064,511	16,395,071	1,242,725	1,908,849	\$1,544,000	-----	-----

¹ Deficit.

² Not available.

³ Capital stock increased \$50,000 in 1923.