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I. INCOME TAX—DIFFERENCE BETWEEN VALUE OF ORIGINAL INVESTMENT AND LIQUIDATION AND REDEMPTION VALUE

Five cases involving a construction of sections 67-2602[1] and 67-2609[2] of the income tax statute (Hall Income Tax) were consolidated for one opinion in the *Gallagher* case.[3] Two of the cases involved the redemption of shares by the issuing corporations; the other three involved the liquidation of corporations, with a surrender of shares and distributions of assets. The Commissioner, in all of these situations, imposed an income tax on the amount constituting the difference between the original investments in the shares and the sum received in liquidation or redemption. The Commissioner argues that although these amounts may not have been dividends in the strict sense, nevertheless they were made up of earned surplus as that term was defined in *Lawrence v. McFarland*;[4] and under section 67-2609 of the statute "earned surplus shall not be considered as capital, and shall be taxed as income when and in whatever manner it may be distributed . . . ."[5]

The Tennessee Supreme Court began its discussion of the Commissioner's argument by noting that article II, section 28 of the Tennessee Constitution provides that the legislature shall have the power to levy a tax upon incomes derived from stocks and bonds. The court then cited section 67-2602 of the statute to illustrate that the tax is levied upon incomes "derived by way of dividends from stocks . . . ."[6] Section 67-2609 was read in *pari materia* with section

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1. TENN. CODE ANN. § 67-2602 (1956).
2. TENN. CODE ANN. § 67-2609 (1956).
3. Gallagher v. Butler, 378 S.W.2d 161 (Tenn. 1964).
4. 209 Tenn. 376, 354 S.W.2d 78 (1962); Hartman, *State & Local Taxation—1962 Tennessee Survey*, 16 VAND. L. REV. 865, 874 (1963).
5. TENN. CODE ANN. § 67-2609 (1956).
6. TENN. CODE ANN. § 67-2602 (1956).

67-2602, and to avoid any possible conflict between them, the court said that section 67-2609 should be so read so as to tax earned surplus only when distributed "by way of dividends." Thus, the amounts received by way of redemption and liquidation were treated as though received from sales of the stock to third parties, resulting in capital gains which are not taxable under the Tennessee income tax.[7]

In holding these distributions not taxable as dividends, the Tennessee court aligned itself with what is probably the weight of authority on this question. The courts of Georgia,[8] Iowa,[9] and Oregon[10] have dealt with this problem under statutes similar to Tennessee's and have all agreed that distributions in redemption or liquidation are not to be treated as dividends. The reasoning of the Iowa court is particularly interesting and seems to be that adopted by the Tennessee court. That court stated that when a shareholder surrenders his stock in liquidation for a share of the assets, he receives exactly what his stock is worth. He is in a sense merely getting property that he already owns—an exchange of one form of personal property for another, thereby realizing a capital gain.[11] The difficulty with this line of reasoning is that part of what a shareholder receives in a liquidation distribution will in some cases be earned surplus or accumulated income, which if distributed as a regular dividend, would be taxable.

The Tennessee court's decision seems to be consistent with the position taken in the federal Internal Revenue Code that liquidation distributions are to be treated as sales of the stock, not as dividends, and are therefore to receive the preferred capital gains treatment.[12] Only certain redemptions, however, are treated as sales, the rest are taxed as dividends.[13] It should be noted that where all of a particular shareholder's stock is redeemed, it is treated as a sale or exchange. Under the federal taxing statute such distributions are still taxed, though at lower rates; while under the Tennessee statute if the distributions are held to be capital gains, they apparently escape taxation altogether.

In holding that such distributions were not dividends, and not taxable under the Hall Income Tax, the Tennessee court appears to be retreating from the position taken in the *Lawrence* case that earned surplus is everything in excess of the original capital investment in

7. 378 S.W.2d at 164.
8. Oxford v. Cuter, 216 Ga. 821, 120 S.E.2d 298 (1961).
9. Lynch v. State Bd. of Assessment & Review, 228 Iowa 1000, 291 N.W. 161 (1940).
10. Kelly v. Galloway, 156 Ore. 301, 66 P.2d 272 (1937).
11. Lynch v. State Board of Assessment & Review, *supra* note 9.
12. INT. REV. CODE OF 1954, § 331(a).
13. INT. REV. CODE OF 1954, § 302.

the corporation. The logical deduction from this position would support the Commissioner's argument that anything that the shareholder gets back in excess of the par value of the stock is earned surplus and was therefore taxable as income under section 67-2609. The Tennessee court adopted the *Lawrence* definition from a Massachusetts decision,[14] and the Massachusetts court had indeed carried this position to its ultimate conclusion and held that liquidation distributions received in excess of the original capital investment are taxable as dividends.[15] The Massachusetts holding has, however, been limited to some extent by an amendment to the Massachusetts taxing statute which expressly provides that distributions made in connection with cancellations or redemptions shall not be taxable as dividends.[16]

Decisions on this same problem from other jurisdictions under similar taxing statutes are helpful but not controlling. The outcome of such cases as were here presented must ultimately depend upon the wording of the Tennessee statute. When the exact words of the statute are examined, it appears that the Commissioner's arguments for imposing the tax were persuasive. Section 67-2602 states that the income tax shall be imposed upon "incomes derived by way of dividends from stocks. . . . ,"[17] but it does not state that the tax shall be imposed only upon incomes derived by way of dividends. Section 67-2609 could reasonably be read to broaden section 67-2602 so as to tax earned surplus distributed other than by way of dividends. As the court has now interpreted section 67-2609, all independent meaning has been read out of the provision "but all other distributions out of earned surplus shall be taxed as income when and in whatever manner made. . . ."[18] The court did not discuss the possible inferences to be drawn from the 1963 amendment to section 67-2609 nor did it state whether two of the liquidations and one of the redemptions had been made before or after the amendment. The Commissioner, in his brief,[19] argued convincingly that when the legislature amended the statute in 1963, it recognized that the statute applied to distributions of earned surplus by way of stock dividend, liquidation, or otherwise, and merely intended to qualify and further define that application.[20]

14. Commissioner of Corporations & Taxation v. Filoon, 310 Mass. 374, 38 N.E.2d 693 (1941); Trefry v. Putnam, 227 Mass. 522, 116 N.E. 904 (1917).
15. Follett v. Commissioner of Corporations & Taxation, 267 Mass. 115, 166 N.E. 575 (1929).
16. MASS. ANN. LAWS ch. 62, § 1(g) (1964).
17. TENN. CODE ANN. § 67-2602 (1956).
18. TENN. CODE ANN. § 67-2609 (Supp. 1964).
19. Brief for Petitioner, p. 34, Gallagher v. Butler, *supra* note 3.
20. For an extensive analysis of the possible inferences to be drawn from the amendment, see Gifford, *Business Associations—1964 Tennessee Survey*, 18 VAND. L. REV. 1069 (1965).

II. EXCISE TAX—APPORTIONMENT OF EARNINGS BY DOMESTIC CORPORATION

The case of *Roane Hosiery, Inc. v. King*[21] concerned the attempt of a Tennessee corporation to avail itself of the apportionment formulae of the Tennessee excise tax statute,[22] where the tax is measured by taxpayer's net income. The corporation, Roane Hosiery, was engaged in the manufacture of hosiery in Tennessee, has its principal place of business in this state, and is qualified to do business only in Tennessee. In 1960 and 1961, Roane Hosiery acquired all of the stock of a Delaware corporation qualified to do business in New York and changed the name of this corporation to Roane Hosiery Sales, Inc. Roane Hosiery officers and directors constituted a majority of the sales corporation's board of directors, and the hiring and salaries of the corporation's personnel were subject to Roane Hosiery's approval.

In 1961, the tax year here in question, practically all of Roane Hosiery's products were sold through the Delaware corporation, most of the sales apparently being in New York where the Delaware corporation was authorized to do business. All sales orders taken by that corporation were subject to Roane Hosiery's approval and the Delaware corporation represented only Roane Hosiery. In making its excise tax return for 1961, the Tennessee corporation sought to use the apportionment formulae prescribed by Tennessee Code Annotated sections 67-2702 to 2712 where the taxpayer is doing business in Tennessee and elsewhere. The Commissioner refused to allow apportionment, claiming that Tennessee could properly tax all the net income from this multistate operation since the corporation was not doing business outside Tennessee.

In upholding the Commissioner, the Tennessee Supreme Court relied upon the *John Owenby* case[23] for the proposition that in order to use the apportionment formulae the taxpayer must prove that its earnings are being taxed by another state. Since the corporation had not shown that its activities in New York and elsewhere were subject to taxation in those states, it was not entitled to apportion its earnings. The court also seemed to rely upon the *John Owenby* case in holding that since Public Law 86-272[24] precludes taxation of Roane Hosiery by other states, Tennessee could levy upon the unapportioned earnings of the corporation.

The analysis and criticism of the Tennessee court's decision in the the *John Owenby* case[25] is applicable to the instant case; therefore,

21. 381 S.W.2d 265 (Tenn. 1964).
22. TENN. CODE ANN. §§ 67-2707 to -2712 (1956).
23. John Owenby Co. v. Butler, 211 Tenn. 366, 365 S.W.2d 33 (1963).
24. 73 Stat. 555 (1959), 15 U.S.C. § 381(c) (Supp. V, 1963).
25. (Emphasis added.) The writer has criticized the *John Owenby* case elsewhere.

only a few additional comments are necessary here. The court does not set out sufficient facts for an adequate determination of whether or not the Roane Hosiery corporation's contacts with other states, through its subsidiary sales corporation, were sufficient to exclude it from the scope of Public Law 86-272, but the corporation argues that its contacts with New York, at least, were such that it could be taxed by that state. The Tennessee Supreme Court, however, stood by its misguided *John Owenby* interpretation of Public Law 86-272 that by virtue of that statute Tennessee can tax all activities of a multi-state business which cannot be reached by other states. Here again, "Tennessee taxing authority is permitted to reap where Tennessee clearly has not sown."[26] Although the statement of facts is inadequate, it seems apparent that New York could constitutionally tax the activities of the Tennessee corporation under the doctrine of the *Northwest-Stockham* case.[27] If this is true, the corporation would be subjected to the risk of a multiple tax burden not borne by local business, a situation held unconstitutional as a violation of the commerce clause.[28]

Construing the Tennessee statute which provides for apportionment, the *Roane Hosiery* opinion by Chief Justice Burnett concludes that "if the corporation could, and did, show that it was doing business *and paying a tax on the business done in another state,* then this appointment formula would apply."[29] In the writer's opinion, the Court has made a pure judicial graft upon the plain words of the Tennessee statute which sets forth the conditions when the taxpayer is entitled to use the apportionment formula. Section 67-2706 of the Tennessee Code provides that when the taxpayer is "doing business in Tennessee and elsewhere the net earnings shall be apportioned. . . ."[30] It will be observed that this statute does not contain Chief Justice Burnett's judicially imposed extra requirement that the taxpayer must also show that he is "paying a tax on the business done in another state" before the apportionment formula can be used.

III. EXCISE TAX—MEANING OF "EARNINGS" FOR CORPORATE TAX PURPOSES

The case of *Genesco, Inc. v. Butler*[31] involved a determination of

See Hartman, *State and Local Taxation—1963 Tennessee Survey,* 17 VAND. L. REV. 1150 (1964).

26. *Id.* at 1153.
27. Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450 (1959).
28. Central R.R. v. Pennsylvania, 370 U.S. 607 (1962) (property tax); J. D. Adams Mfg. Co. v. Storen, 304 U.S. 307 (1938) (gross receipts tax).
29. Roane Hosiery, Inc. v. King, 381 S.W.2d 265, 268 (Tenn. 1964).
30. TENN. CODE ANN. § 67-2706 (1956).
31. 377 S.W.2d 133 (Tenn. 1964).

what constitutes "earning" within the meaning of the Tennessee excise tax on corporate earnings.[32] In 1945, Genesco established a retirement trust to implement a retirement plan for its employees and in 1951, 1952, 1953, and 1957, it contributed to the trust property having a depreciated value of 257,693 dollars and a fair market value of 1,442,650 dollars. The Commissioner permitted the corporation to deduct the fair market value of the property from its earnings as a business expense in reporting its tax in the years when the contributions were made, but in 1961, he assessed against the corporation an additional tax of 32,298 dollars. Of this amount 30,676 dollars represented a tax on the difference between the cost and the fair market value of the property transferred to the trust. This amount, alleged the Commissioner, constituted earnings to Genesco which were realized when the appreciated property was transferred to the trust, and which had never been taxed to the corporation. Genesco paid the assessment under protest and sued to recover it.

The Tennessee Supreme Court conceded that Genesco would derive economic benefit from the transfers such as more harmonious labor relations and increased employee efficiency, but held that such benefits do not constitute earnings. The Tennessee court reasoned that the term "net earnings" in the Tennessee excise tax statute is to be taken in its usual and ordinary meaning; it should not be given a strained construction. Taken in its ordinary meaning, "net earnings" means income—some tangible profit to the taxpayer. Once these intangible benefits manifest themselves, through increased production or sales, in increased profits, then these can be taxed. Here, any benefits accruing to Genesco were intangible at best and did not constitute a realization of income upon which the excise tax could be levied.

The Tennessee court noted that the federal Court of Appeals for the Sixth Circuit, in *United States v. General Shoe Corp.*,[33] had held that the identical transactions did result in a taxable gain to the corporation. The court reasoned, however, that the Court of Appeals had made this characterization for purposes of applying the federal income tax on capital gains and that such a characterization was certainly not binding in a determination under a state excise tax, which must be made in accordance with state law.

The supreme court appears to have been justified in construing the excise tax statute so as not to include intangible economic benefits within "net earnings." No cases decided under the taxing statute have involved intangible benefits, and all of the cases relied

32. TENN. CODE ANN. §§ 67-2701 to -2715 (1956) (Emphasis added.)
33. 282 F.2d 9 (6th Cir. 1960).

on by the state involved some sort of tangible gain to the taxpayer.[34] In relying upon the cases[35] that hold "net earnings" should be given its ordinary meaning, the court was probably correct in stating that such a meaning does not include intangible economic benefits. Federal income tax laws aside, the ordinary business taxpayer generally does not conceive of intangible economic benefits as being income or earnings.

The Tennessee court was not bound to accept the Court of Appeals determination in *United States v. General Shoe Corp.* that the transactions resulted in a taxable gain to the taxpayer,[36] and it was perhaps well-advised in exercising its discretion not to incorporate such a rule into Tennessee law. This area of federal tax law is by no means clear and is far from being well-settled. Where property is sold or otherwise disposed of, the Internal Revenue Code, with a few exceptions, imposes a tax on the income realized from such sale or disposition.[37] The Internal Revenue Code section defining realization of income from such sales or dispositions states: "The amount realized from the sale or other disposition of property shall be the sum of any *money* received plus the fair market value of the *property* (other than money) received.[38] The circuit court, in the *General Shoe* case, brushed aside District Judge William E. Miller's reasoning that the corporation had received neither money nor property from the transfer to the trust, as required by the Code, and overruled his decision that the transfer had not resulted in a realization of gain to the taxpayer. In so doing, the court relied upon *International Freighting Corp v. Commissioner*,[39] a case from the Second Circuit involving a transfer of appreciated property similar to the one in the instant case. In that case, the court skirted the statutory requirements of a receipt of money or property by saying that the corporation had received a consideration for the transfer. The *International Freighting* case, with its doctrine of consideration, was based upon the concept of "money's worth" from *Commissioner v. Mesta*,[40]

34. Woods Lumber Co. v. MacFarland, 209 Tenn. 667, 355 S.W.2d 448 (1962); Southern Coach Lines, Inc. v. McCanless, 191 Tenn. 634, 235 S.W.2d 804 (1951); Southern Coal Co. v. McCanless, 183 Tenn. 457, 192 S.W.2d 1003 (1946); Memphis Doc & Forwarding Co. v. Fort, 170 Tenn. 109, 92 S.W.2d 408 (1936); National Life & Acc. Ins. Co. v. Dempster, 168 Tenn. 446, 79 S.W.2d 564 (1935).

35. Bank of Commerce & Trust Co. v. Senter, 149 Tenn. 569, 260 S.W. 44 (1924); National Life & Acc. Ins. Co. v. Dempster, *supra* note 24; Woods Lumber Co. v. MacFarland, *supra* note 34.

36. CCH MANUAL ON TENNESSEE TAXES ¶ 10-301.45 (1937); Reply Brief of Commissioner of Finance & Taxation, p. 48, Southern Coach Lines, Inc. v. McCanless, *supra* note 34.

37. INT. REV. CODE OF 1954, § 61.

38. INT. REV. CODE OF 1954, § 1001(b).

39. 135 F.2d 310 (2d Cir. 1943).

40. 123 F.2d 986 (3d Cir. 1941), *cert. denied*, 316 U.S. 695 (1942). In this case,

a case which the Sixth Circuit had expressly refused to follow in *Commissioner v. Marshman*.[41] The Sixth Circuit, in disregarding Judge Miller's reasoning, seemingly has substituted an economic benefit theory of realization for the express statutory requirements of the receipt of money or property; and in so doing likely has contributed to the confusion surrounding the status of the requirements for realization of income.[42] In view of the somewhat tenuous reasoning in the *General Shoe* case, the differences in the taxing statutes and the unsettled state of the federal tax law in this area, the Tennessee Supreme Court was perhaps wise in declining to bring an economic benefit theory into the concept of net earnings under Tennessee law and in adhering to its traditional notion of a tangible gain or profit. From the standpoint of tax administration, the soundness of the economic benefit theory is difficult to follow. Once an economic benefit theory is adopted, a Pandora's box is opened: How is this benefit to be measured? What accounting procedures are to be used for determining its status in a corporation's financial structure? Are all such intangible economic benefits to be taxable? The expense of litigating these questions would probably more than exceed any additional revenue that might accrue from the importation of such a theory into the Tennessee excise tax.

the taxpayer transferred stock that had appreciated in value to his wife as part of a marital settlement accompanying an absolute divorce decree. The property conveyed was in full settlement of all the wife's claims for maintenance and support. The Commissioner asserted that to the extent of the difference between the original cost of the property and its fair market value at the date of transfer, the taxpayer had realized a capital gain. The court of appeals upheld this assertion. Although the taxpayer had not received any money or property in exchange for the transfer, he did receive an economic benefit; and the court relied on Helvering v. Horst, 311 U.S. 112 (1940), for the proposition that such a benefit constituted a taxable gain. The court said that the measurement of the gain presented no problem; it was the equivalent of the fair market value of the property transferred, since in the absence of evidence to the contrary, the wife's marital rights were evidently worth the property she accepted in releasing them. "We think that we may make the practical assumption that a man who spends money or gives property of a fixed value for an unliquidated claim is getting his money's worth." 123 F.2d at 988.

The court's reliance upon the *Horst* case seems misplaced. That case involved a gift of income, not a sale or disposition of property; and although much of the language is couched in terms of realization, the problem before the court was one of income-splitting, not realization. See Note, 47 VA. L. REV. 469, 472 (1961).

41. 279 F.2d 27 (6th Cir. 1960), *cert. denied*, 364 U.S. 918 (1960). In this case, the taxpayer-husband released an option to repurchase stock held by his wife as part of a marital settlement in a divorce action. The Commissioner, treating this case like Commissioner v. Mesta, *supra* note 40, asserted that the husband had realized a capital gain to the extent of the excess of the fair market value of the stock over its cost basis. The Court of Appeals for the Sixth Circuit held that there was no taxable gain and refused to adopt the reasoning of the Mesta case. The court held that even if the wife's marital rights were some form of property, because such rights are subject to so many uncertainties, they have no fair market value. Therefore, such economic gain to the taxpayer does not fall within the realization requirement of § 1001(b) and is not taxable.

42. See the excellent discussion of the confusion over the realization requirement of § 1001(b) in the Sixth Circuit and elsewhere in Note, *supra* note 40.