Taxation -- Income Tax -- Determination of Whether Corporate Withdrawals Constitute Loans or Dividends

Gaither S. Walser

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acts which applied to only one county in the state to be general laws rather than local ones.

Dixon was followed in 1940 by a decision\textsuperscript{22} holding an act setting up a county physician and quarantine officer in Madison County to be of a local nature pertaining to health and sanitation and therefore unconstitutional. Within the past eight years, the court has held invalid acts allowing Winston-Salem and Forsyth County to consolidate their public health agencies and departments,\textsuperscript{23} prohibiting a county board of education from expending more than $2,000 for extending water or sewer systems to a new school,\textsuperscript{24} allowing construction and operation of toll roads and bridges in a five county area,\textsuperscript{25} and setting up a racing commission in Morehead City.\textsuperscript{26} All of these were found to be invalid under article 2, section 29 because they were local acts applicable only in a limited territory and were within the subject matter in which such local legislation is prohibited. It is interesting to note that the court relied on these recent decisions to support its position in the present case even though the amendment has been in effect since 1917. None of these cases attempts to distinguish the earlier cases with which they would appear to conflict.

In analyzing the principal case, one arrives at two conclusions. The first is that Orange County could successfully prevent Sunday racing by having the legislature pass an act similar to that passed for Wake County invoking the state police power to enforce such a ban. The second, and more important conclusion is that the court appears to have settled upon a more definite interpretation of this amendment. The cases decided since 1940 have been substantially uniform in holding that an act is local if it is applicable only to a limited area and the restricted subject matter has been broadened to include many areas which were formerly excluded. We can no doubt look forward to more decisions invalidating acts within this area.\textsuperscript{27}

LAURENCE A. COBB

Taxation—Income Tax—Determination of Whether Corporate Withdrawals Constitute Loans or Dividends

The 1954 Internal Revenue Code defines the term "dividend" as "any distribution of property made by a corporation to its stockholders

\textsuperscript{22} Sams v. Board of Comm'rs, 217 N.C. 284, 7 S.E.2d 540 (1940).
\textsuperscript{23} Idol v. Street, 233 N.C. 730, 65 S.E.2d 313 (1951).
\textsuperscript{24} Lamb v. Board of Educ., 235 N.C. 377, 70 S.E.2d 201 (1952).
\textsuperscript{25} Coastal Highway v. Coastal Turnpike Authority, 237 N.C. 52, 74 S.E.2d 310 (1953).
\textsuperscript{26} Taylor v. Carolina Racing Ass'n, Inc., 241 N.C. 80, 84 S.E.2d 390 (1954).
—(1) out of its earnings and profits accumulated after February 28, 1913, or (2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.\textsuperscript{1}

It is elementary that a dividend is taxable as income to the recipient, while a loan carries no tax consequences. In determining the factual question\textsuperscript{2} of whether a particular withdrawal is a loan or a taxable dividend, the intent of the parties is the most important factor.\textsuperscript{3} In determining this question there is no set rule of thumb or standard available. However, in attempting to get at the substance of the transaction the courts usually rely on various well established criteria. An analysis of the criteria used is necessary in order to evaluate a fact situation and deduce with a reasonable degree of certainty the tax treatment that will be accorded it.

1. **Purpose of the Withdrawal.** Whether or not a withdrawal is used for a legitimate business purpose is usually important in the court's determination of whether a withdrawal is a loan or a dividend. A legitimate business purpose has been found in the transferring of an indebtedness from an outside source to the taxpayer's corporation\textsuperscript{4} or for acquisition of stock in a closely held corporation.\textsuperscript{5} Where the loan was used to purchase a farm for the exclusive use of the stockholder\textsuperscript{6} or

\textsuperscript{1} INT. REV. CODE OF 1954, § 316(a). The 1939 code contained substantially the same provision. INT. REV. CODE OF 1939, § 115(a), 52 STAT. 496.

\textsuperscript{2} Victor Shaken, 21 T.C. 785 (1954); Al Goodman, Inc., 23 T.C. 288 (1954); Carl L. White, 17 T.C. 1562 (1952). In William D. Bryan, P-H 1957 T.C. Mem: Dec. ¶ 57180 at 686-57, the court stated: "The question of whether the amount withdrawn by the petitioner from the corporation was a dividend or a loan is one of fact, to be determined from the surrounding facts and circumstances, and particularly with reference to petitioner's intent at the time of the transaction."

\textsuperscript{3} In Harry E. Wiese, 35 B.T.A. 701 (1937), aff'd, 93 F.2d 921 (8th Cir.), cert. denied, 304 U.S. 562 (1938), where the taxpayer was the sole stockholder, the court of appeals said: "The significant fact in the present case was the intent of the petitioner when he took the money, whether he took it for permanent use in lieu of dividends or whether he was then only borrowing." 93 F.2d at 923. Accord, Anketell Lumber & Coal Co. v. United States, 76 Ct. Cl. 210, 1 F. Supp. 724 (1932); Trinchera Timber Co., 13 B.T.A. 934 (1928). Where there was an intent to repay, the withdrawals were held to be loans. A. J. Dalton, P-H 1957 T.C. Mem. Dec. ¶ 57020; Walter Freeman, P-H 1957 T.C. Mem. Dec. ¶ 57014; Carl L. White, 17 T.C. 1562 (1952); Irving T. Bush, 45 B.T.A. 609 (1941); George S. Groves, 38 B.T.A. 727 (1938); Moses W. Taitoute, 38 B.T.A. 32 (1938); Gomez v. Johnson, 8 B.T.A. 52 (1927).

\textsuperscript{4} William D. Bryan, P-H 1957 T.C. Mem. Dec. ¶ 57180. The sole stockholder borrowed money from the corporation to pay off a debt that he incurred in financing the corporation and gave a note for the amount to the corporation. The court held there was a genuine intent to repay a valid loan even though later he was unable to repay and redeemed his stock for the cancellation of the debt.

\textsuperscript{5} Isadora Benjamin Estate, 28 T.C. — (1957).

\textsuperscript{6} Gene O. Clark, P-H 1957 T.C. Mem. Dec. ¶ 57129. There were two stockholders who made withdrawals from the corporation in the exact proportion to their hold-
merely to provide for his personal living expenses the court found no legitimate business purpose and held the withdrawals to be dividends. However, the fact that a withdrawal is for personal use is not always conclusive.

2. Formality of a Promissory Note. The giving of a promissory note by the stockholder who makes the withdrawal is often considered by the courts as evidence that the withdrawal was intended to be a loan. But it has been held that no note was necessary where other factors justified a finding that the parties intended to treat the withdrawal as a loan. In other cases the formality of a note was ignored and the substance of the transaction merited the holding that the withdrawals were dividends.

3. Other Formalities of the Transaction. The fact that a dividend is not formally declared has no effect on the question of whether the withdrawal will be treated as a dividend for the obvious reason that the very point at issue is whether the withdrawal is to be deemed a "constructive dividend," i.e., one not actually declared by the corporation. Even if it is illegal under state law for a stockholder or officer to borrow from the corporation it may still be considered a valid loan for tax purposes. It is damaging to the stockholder's position if his withdrawals are not treated as capital assets on the corporation's books. On the other hand if they are treated as assets on the corporation's books, it seems to be influential in determining that the withdrawal is a loan.

4. Repayment of the Withdrawal. Where a withdrawal has been partially or wholly repaid, it is in favor of the taxpayer's position that it was a bona fide loan. If there has been no repayment, it is evidence

ings for the purchase of farms for personal use. Even though a note was given and was carried on the books as a "Note Receivable," the withdrawals were held to be dividends.


A. J. Dalton, P-H 1957 T.C. Mem. Dec. ¶ 57020 (withdrawals used for taxpayer's personal benefit); Walter Freeman, P-H 1957 T.C. Mem. Dec. ¶ 57014 (withdrawals used to pay off gambling debts).


Rollin C. Reynolds, 44 B.T.A. 342 (1941).


that the purported loan was actually a dividend. However, the court will ignore the fact of repayment where it was made after the taxpayer learned of the government's intention to treat the withdrawal as a dividend. The fact that the taxpayer has a running account and the amount varies from time to time will usually be to his advantage, and even where withdrawals are used to pay personal gambling debts the periodical reduction of the balance may be important in deciding that they are loans.

5. **Payment of Interest.** When the stockholder making the withdrawal is charged interest, and especially where he pays substantial interest, this will be instrumental in the court's finding that there was an intent that the withdrawal be a loan. It has been considered that where there was no interest this was a factor that pointed toward a finding that the withdrawals were dividends. There are some cases, however, where other factors justified calling the withdrawal a loan even though no interest was charged.

6. **Withdrawals in Ratio to Stockholdings.** Where the withdrawals made by the stockholders were in proportion to the amount of stock that each stockholder owned, it was considered evidence of a constructive dividend. Where the withdrawals were not in proportion to holdings, the court relied on this in deciding that they were loans instead of dividends. However, in other cases the courts have said that there is no need that the loans be proportionate to the shares held or even that all the stockholders participate in order for them to be considered a dividend. If the amount of withdrawals varies annually with the earnings

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18 Regensberg v. Commissioner, 144 F.2d 41 (2d Cir. 1944). For cases where solvency of the taxpayer was considered in favor of the taxpayer, see A. J. Dalton, P-H 1957 T.C. Mem. Dec. ¶ 57020; Al Goodman, Inc., 23 B.T.A. 288 (1954); Rollin C. Reynolds, 44 B.T.A. 242 (1941); Moses W. Faitoute, 38 B.T.A. (1938). But see Fred C. Niederkrome, P-H 1956 T.C. Mem. Dec. ¶ 56255, where $20,000 was borrowed from 1945 to 1956 and never repaid, and the taxpayer was always in a position to repay. The "loan" was held to be a dividend.

19 M. Jack Crispin, 32 B.T.A. 151 (1935).


25 Rollin C. Reynolds, 44 B.T.A. 342 (1941); Herman M. Rhodes, 34 B.T.A. 212 (1936); Kate C. Ryan, 2 B.T.A. 1130 (1925).

26 Hub Cloak and Suit Co., P-H 1956 T.C. Mem. Dec. ¶ 56196. In Henry F. Mitchell, 16 B.T.A. 1297 (1929), withdrawals were made by all of the shareholders except one who did not participate.
and surplus the court will consider this as evidence tending to show that they should be treated as dividends.\textsuperscript{27}

It appears from the more recent cases that there may be a slight trend in favor of the taxpayer in deciding whether a particular withdrawal will be considered a dividend or a loan. An example of the older and more restrictive attitude of the courts is \textit{Ben R. Meyer}.\textsuperscript{28} The taxpayer there made withdrawals from a subsidiary of the parent corporation in which he was a stockholder, gave a note bearing four percent interest, and made some repayments. When the subsidiary became insolvent, he set up a trust to repay the withdrawals. In holding that the withdrawals constituted dividends, the court seemed to rely strongly on the fact that the withdrawals were used for personal living expenses and that the stockholders were insolvent. However, in the more current case of \textit{A. J. Dalton}\textsuperscript{29} the withdrawals were for personal use, no note was given, no interest was charged, and the taxpayer had insufficient assets to repay at the time; nevertheless the court found there was a bona fide intent to borrow and an obligation to repay and held that the withdrawals were loans. Similarly in the \textit{John Hamilton Perkins}\textsuperscript{30} case there were two stockholders each owning fifty percent of the stock. They “borrowed” the money to pay off their personal debts, later executing their notes but paying no interest. Perkins bought out the other shareholder’s stock after the shareholder had repaid the corporation the amount he had “borrowed.” He then liquidated the corporation and treated the outstanding note as part of his “liquidating dividend.” The entire transaction took only about two years, but the court found that the withdrawal was a valid loan.

If there is any reason for the trend of the decisions, it is probably because the courts recognize the real business purpose and financial advantage in borrowing from one’s own corporation rather than recognized lending institutions.\textsuperscript{31} The conclusion that the taxpayer’s position is being upheld should not lull any prospective debtor into a sense

\textsuperscript{27} See Albert Bittens, 2 B.T.A. 535 (1925), where the court stated that the withdrawals had no relation to earnings or surplus and held them to be loans rather than dividends. See also C. W. Murchison, 32 B.T.A. 32 (1935), where the taxpayer was sole owner of the corporation and the withdrawals varied in accordance with the net earnings. \textit{Held}, dividends. \textit{But see} Walter Freeman, P-H 1957 T.C. Mem. Dec. \S 57014, at 57-63, where the withdrawals were substantially the same as the current income or accumulated earnings and profits. The court nevertheless found that they were not dividends, stating that the taxpayer repaid part of the withdrawals and that “after considering all of the evidence we have concluded that the withdrawals were intended as loans \ldots .”

\textsuperscript{28} 45 B.T.A. 228 (1941).

\textsuperscript{29} P-H 1957 T.C. Mem. Dec. \S 57020.


\textsuperscript{31} Isadora Benjamin Estate, 28 T.C. — (1957); William D. Bryan, P-H 1957 T.C. Mem. Dec. \S 57180.
of security, because the courts are still prone to look through the form of a transaction to its real substance. The taxpayer would be well advised to consider carefully the above mentioned factors which influence the courts in deciding cases. No one factor is usually conclusive in deciding a case, but certainly the more consideration the stockholder gives to each, the greater the possibility that he will not be caught in a tax trap.

Gaither S. Walser

Torts—Negligence—Last Clear Chance

A recent North Carolina case involving the doctrine of "last clear chance" seems to have been decided contrary to a long line of unbroken precedents. The case was this:

The defendant was driving down an unpaved public road at eight-thirty p.m. The evidence favorable to the plaintiff showed the road at the place in question was straight and virtually level for a distance of two to three hundred feet, and that there were no obstructions to vision. The plaintiff was lying in the road asleep, between and parallel to two ruts which were in the road. The defendant approached the plaintiff with his lights on low beam and did not see him until approximately twenty-five feet away. He first thought the plaintiff's body was a box or the like, and did not recognize it as a human being until five or six feet away. The defendant's car passed over the plaintiff, straddling him with its wheels, but the oil pan on the car struck the plaintiff in passing, inflicting serious injuries. The defendant stopped twenty-five feet beyond the place where the plaintiff was lying.

The defendant's motion for nonsuit at the trial below was granted, and on appeal it was affirmed, the court holding in a four to three decision that the doctrine of last clear chance was inapplicable on the facts.

It is proposed in this Note to look briefly at the background of the doctrine of last clear chance, after which an attempt will be made to deduce from the North Carolina cases the principles underlying the law of last clear chance in North Carolina. Finally, the principal case will be examined in the light of these principles.

The doctrine of last clear chance is well-established in North Carolina, as in most common law jurisdictions. Although it is stated