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Dividends Paid with Notes Previously Charged Off

J. R. Plumb

RECENT CASES

DIVIDENDS PAID WITH NOTES PREVIOUSLY CHARGED OFF

Taxpayer bank, in previous years, charged off and was allowed deduction of notes as worthless. In the taxable year it declared a dividend in kind of such notes. A few days later the notes were endorsed to W. N. Price without recourse. Price, an employee of the bank, took charge of the notes and amounts thereafter collected were deposited in a special account designated "W. N. Price, Special". The debtors were not notified of the assignment and the notes when paid were marked with a stamp on which appeared the bank's name, but not the stockholders' names. The Commissioner determined a deficiency against the bank for the collections made in the taxable year. The Tax Court held the taxpayer was not taxable upon such recoveries. *Held,* that when the tax benefit for a bad debt is obtained, the debt loses its nature as capital, and becomes representative of that portion of the taxpayer's income which was not taxed. Reversed. *Commissioner of Internal Revenue v. First State Bank of Stratford,* 168 F. (2d) 1004 (C. C. A. 5th 1948).

A corporation ordinarily realizes no taxable income in connection with the declaration and payment of a dividend; the tax is confined to the recipient shareholder.[1]

Treasury Regulations[2] provide that no gain[3] or loss[4] is realized by a corporation from the mere distribution of its assets in kind in partial or complete liquidation, no matter how they may have appreciated or depreciated in value since their acquisition. And it has been held that no difference exists in principle between mere distributions of assets by corporations in dissolution and by those not in dissolution.[5] Where real property was transferred to a charitable organization for a period of one year, the rents and profits for the year were to be used for educational purposes, it was held that the thing granted was an estate or property interest and not future income earned by the grantor or settlor.[6]

One prominent writer states, "The general rule as to assignments of property and income is easy to state: An income producing fund or property can be

1. Where a dividend is paid in cash, no question of taxable income arises so far as the corporation is concerned. But if a dividend is declared in terms of money and paid in terms of property, a gain or loss may be realized thereon by the corporation. The effect hinges largely upon the wording of the resolution declaring the dividend. Commissioner of Internal Revenue v. Columbia Pacific Shipping Co., 77 F. (2d) 759 (C. C. A. 9th 1935); Interstate Realty Co. v. Commissioner of Internal Revenue, 25 B. T. A. 728 (1932); Bacon-McMillan Veneer Co. v. Commissioner of Internal Revenue, 20. B. T. A. 556 (1930).
2. Treasury Regulations 111, Sec. 29.22 (a)—20.
3. National Carbon Co. v. Commissioner of Internal Revenue, 2 T. C. 57 (1943); Virginia Beach Golf Course Annex Corporation v. Commissioner of Internal Revenue, 23 B. T. A. 1170 (1931); Estate of H. H. Timkin v. Commissioner of Internal Revenue, 47 B. T. A. 494 (1942).
4. First Savings Bank of Ogden, 60 App. D. C. 307, 53 F. (2d) 919, 82 A. L. R. 549 (1931).
5. Id. at 921.
6. United States v. First National Bank of Birmingham, 74 F. (2d) 360 (C. C. A. 5th 1934).

assigned; the income itself cannot be assigned. In the former case the income from the assigned fund or property is taxable to the assignee; in the latter it is not."[7]

In the eyes of the Tax Court, in instant case,[8] the property which produced the income was assigned—the tree and the fruit, regardless of the fact that they were no longer carried on the bank's books as live assets, the notes were property.[9] *General Utilities & Operating Co. v. Helvering*[10] stands as the leading case for the principle that a corporation derives no taxable gain from the distribution of its assets among its stockholders. However, in the instant case, the court held that income is being distributed rather than assets, the charged off debts no longer represented an asset except in the sense that any vested right to receive income is an asset. A similar line of reasoning was applied by the Fourth Circuit Court of Appeals[11] where a taxpayer contended that a recovery on debts charged off in prior years should be treated as capital gains. The court held that bad debts are ordinarily treated as operating expense of a business in arriving at net operating gain or loss and, consequently, a recovery on debts previously charged off is properly treated as income rather than as a return of capital.[12]

In an early Board of Tax Appeals case[13] the Board was presented with the question under slightly different circumstances. The taxpayer in a prior year had charged off an account of a bankrupt debtor. The bankrupt, by his will, provided that certain securities be set aside to pay the account owed the taxpayer. The taxpayer contended that the payment received was a gift and therefore not taxable. The Board did not discuss the tax consequences of having taken a bad debt deduction. They merely held that the testator didn't intend to make a gift, he intended to pay the debt.

Once it was decided that the notes were purely potential income and not property,[14] the court was on safer ground. "The power to dispose of income is

7. 2 Paul and Mertens, The Law of Federal Income Taxation 25 (1934).
8. First State Bank of Stratford v. Commissioner of Internal Revenue, 8 T. C. 831 (1947).
9. The Commissioner was undaunted by the court's ruling. Within five months after the Tax Court ruled against him and before it was reversed by the Circuit Court of Appeals, he determined a deficiency against The First State Bank of Matador, P-H 1947, T. C. Mem. Dec. Serv. L. C. 47, 259 (1947). The facts were identical. The Stratford case was followed.
10. 296 U. S. 200, 56 Sup. Ct. 185, 80 L. Ed. 154 (1935).
11. Helvering v. State Planters Bank & Trust Co. 130 F. (2d) 44, 143 A. L. R. 333 (C. C. A. 4th 1942).
12. Bad debts are, under well-established accounting practices, recognized as operating expenses of the business and deductible as such in arriving at the net operating gain or loss for the periods involved. 1 Finney, Principles of Accounting 37 (1934).
13. Excelsior Printing Co. v. Commissioner of Internal Revenue, 16 B. T. A. 886 (1929).
14. In National Bank of Commerce of Seattle v. Commissioner of Internal Revenue, 115 F. (2d) 875 (C. C. A. 9th 1940), where smaller banks transferred their assets, including charged off notes, to the taxpayer it was held that the loans became capital assets in the taxpayer's hands, and recoveries made thereafter were income within the broad meaning of Sec. 22(a) of the Internal Revenue Code, 26 U. S. C. A. Sec. 22(a).

equivalent to ownership of it."[15] Earned incomes are taxed to and must be paid by those who earn them.[16] In applying the distinction between assignments of income-producing property and assignments of income it is "uniformly held that they are not so much concerned with the refinements of title as with the actual command over the income which is taxed and the actual benefit for which the tax is paid."[17]

It would seem that this question could be more satisfactorily answered by legislation than by judicial interpretation. Deductions for worthless debts for income tax purposes is in the nature of a privilege rather than a right.[18] It has been held that when a taxpayer claims and is allowed an income deduction for a bad debt, he impliedly consents to be taxed in respect to future recoveries, whether or not it is actually income he is estopped to object.[19] This implied consent should be made an express consent by amendment to the code and made to apply to all charged off defts, no matter whose hands they are in at the time of collection. The closing of this loophole by legislative enactment would prevent strained reasoning, as in this case, that notes are not property. The case should be given a narrow interpretation and not applied to other choses in action.[20]

J. R. PLUMB

RIGHT OF PRIVACY LIMITED

The Saturday Evening Post published an article entitled "Never Give a Passenger a Break", a satire on taxicab drivers in Washington, D. C. The article indicated that the drivers cheated their passengers by use of the complicated zone fare system and failed to give satisfactory service. The article was illustrated by a picture of plaintiff, a woman who operates a taxicab in Washington, D. C. Plaintiff sued for libel and breach of privacy. *Held,* that (1) plaintiff's complaint stated a good cause of action in libel, and that (2) the publication of a photograph of a private person without his consent, unless by reason of his position or achievements he has become a public character, constitutes a violation of the right of privacy for which an action for damages will lie. *Peay v. Curtis Publishing Company, 78 F. Supp. 305 (D. C., 1948)*

The right of privacy was first recognized as a distinct and separate right in 1890, in an article by Samuel D. Warren and Louis D. Brandeis.[1] The courts of New York were the first to consider the right and rejected it upon the grounds of

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15. Helvering v. Horst, 311 U. S. 112, 118, 61 Sup. Ct. 144, 147, 85 L. Ed. 75, 131 A. L. R. 655, 658 (1940). However, by way of dictum the court also said that rent from a lease,—or a crop raised on a farm after the leasehold or the farm had been given away, would not be income to the donor.
16. Lucas v. Earl, 281 U. S. 111, 50 Sup. Ct. 241, 74 L. Ed. 731 (1930).
17. Harrison v. Schaffner, 312 U. S. 579, 581, 61 Sup. Ct. 759, 761, 85 L. Ed. 1055 (1941).
18. Sec. 23(k) (1) Internal Revenue Code, 26 U. S. C. A. Sec. 23(k) (1), provides that reasonble reserves may be set up and deductions taken.
19. Philadelphia National Bank v. Rothensies, 43 F. Supp. 923 (E. D. Pa. 1942).
20. Although the court didn't point up the fact, it appeared that the Commissioner's deficiency determination did not include recoveries for which no tax benefit had been obtained.

1. Warren and Brandeis, The Right to Privacy, 4 Harv. L. Rev. 193 (1890).