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TESTS TO DETERMINE WHETHER A STOCK DIVIDEND IS TAXABLE INCOME

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The United States Supreme Court in *Eisner* v. *Macomber*,[1] decided in 1920, raised a question that has ever since given trouble to the courts, the Board of Tax Appeals, and the Internal Revenue Bureau What stock dividends issued by corporations to their stockholders constitute income to the stockholders and are taxable as such? In the particular instance a dividend of common stock was issued to holders of common stock. The majority of the Court held that such a stock dividend was not income and therefore could not be taxed under the Sixteenth Amendment, which authorized a tax on income from whatsoever source derived.

Mr. Justice Pitney quoted from an earlier opinion of the Court to the effect that a stock dividend takes nothing from the property of the corporation and adds nothing to the shareholder's interest. "What has happened," he said, "is that the plaintiff's old certificates have been split up in effect and have diminished in value to the extent of the value of the new." It "merely changed the evidence which represented that interest" Furthermore, he asserted that since the stock dividend in question was not income, Congress did not have power to tax it without apportionment.

Mr. Justice Holmes dissented on the ground that the word "income" in the Sixteenth Amendment should be read to cover such dividends, and that in his opinion this was the obvious understanding of its purpose. Mr. Justice Brandeis in his dissent went to great length in stating his objection to the majority view. On the analogy of a partner's interest in the partnership's gain for a year, he maintained that segregation of assets was not essential to corporate gain income of the shareholder. Further

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[1] 252 U.S. 189 (1920).

more, to exempt stock dividends would enable stockholders "to escape taxation on a large part of what is actually their income"

Congress and the Revenue Bureau accepted the decision as holding that no stock dividends were taxable as income and the revenue acts were amended to reflect this view. In the so-called Reorganization Cases[2] that shortly followed the Macomber Case, the Court called attention to the distinction between a stock dividend that causes no change in the shareholder's interest in the corporation and one where a change is worked. It was not, however, until 1936 that the Court was called upon to deal with a dividend that it regarded as income to the shareholder.

In *Koshland* v. *Helvering*[3] the Supreme Court held that dividends paid a preferred stockholder in common stock were income and not returned capital. Mr. Justice Roberts pointed out that the stock issued in the Macomber Case "was not income because, by its payment, no severance of corporate assets was accomplished and the pre-existing proportionate interests of the shareholders remained unaltered" He then held that since in the case before the Court the stock dividend gave the stockholder an interest different from what he had before, he had received a taxable income.[4]

This holding was confirmed the following year in *Helvering* v. *Gowran*[5] where an issue of preferred stock gave holders of common an interest in the corporation essentially different from that they held before the issue.

The question of whether all stock dividends are income and therefore taxable under the Sixteenth Amendment was considered in 1943 when an attempt was made to have the Court overrule its decision in *Eisner* v *Macomber* In *Helvering* v *Griffiths*,[6] the corporation having but one class of stock outstanding, gave a dividend in common stock identical with the stock on

[2] Marr v. United States, 268 U.S. 536 (1925), Cullinan v. Walker, 262 U.S. 134 (1923) United States v. Phellis, 257 U.S. 156 (1921), Rockefeller v United States, 257 U.S. 176 (1921).

[3] 298 U.S. 441 (1936)

[4] Following the decision in Koshland v. Helvering the Revenue Act of 1936 was made to read: "1. General Rule.—A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment."

[5] 302 U.S. 238 (1937).

[6] 318 U.S. 371 (1943).

which it was issued and the majority held it was not subject to an income tax under the Sixteenth Amendment for the reason that Congressional hearings on the revenue acts and the construction placed thereon by the Revenue Bureau did not show an intent to tax such stock dividends. An opinion was filed by Mr. Justice Douglas in dissent in which Mr. Justice Black and Mr. Justice Murphy joined. He believed that *Eisner* v. *Macomber* should be overruled as, to quote, "The wealth of stockholders normally increases as a result of the earnings of the corporation in which they hold shares. I see no reason why Congress could not treat that increase in wealth as 'income' to them"[7]

The question whether any or all stock dividends are taxable as income depends upon the definition of income that one accepts. In the majority opinion in *Eisner* v *Macomber,* after referring to the definition of the term as used in two earlier decisions, i.e., as the gain derived from capital, from labor or from both combined, the Court elucidated upon its earlier definition as follows

> "Brief as it is, it indicates the characteristic and distinguishing attribute of income essential for a correct solution of the present controversy The Government, although basing its argument upon the definition as quoted, placed chief emphasis upon the word 'gain', which was extended to include a variety of meanings; while the significance of the next three words was either overlooked or misconceived. *'Derived*—from—*capital'*—'gain—derived—*from*—capital', etc. Here we have the essential matter: not a gain *accruing* to capital, not a *growth* or *increment* of value in the investment; but a gain, a profit, something of exchangeable value *proceeding from* the employed, and *coming in,* being *'derived',* that is, *received or drawn* by the recipient (the taxpayer) for his *separate* use, benefit and disposal;—*that* is income derived from property. Nothing else answers the description."[8]

The majority, therefore insisted that the shareholder must receive something he did not have before, that is, there must be a "realization" on his part, and there must be a severance or separation of the subject matter from the corporate assets, since the stockholder in the particular case had the same proportionate interest in the corporation after the stock dividend that he had before, there was no taxable dividend. The majority looked to the *effect* of the stock dividend to determine whether it was taxable income.

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[7] At page 409.
[8] At page 207.

The minority, on the other hand, held that accretions to capital are income and should be taxed as such. Furthermore, they would regard corporate gains as belonging to the shareholders and taxable to them as income. They would disregard the corporate entity idea and tax the shareholder on the corporate income just as partners are taxed on partnership income. The Supreme Court has thus far adhered to the majority definition of "income" In the words of Professor Powell, the Supreme Court "has willed and disposed of the constitutional issue. Gain is not income in the constitutional sense until it is 'derived' or 'drawn from' that in which it has been inhering."[9]

Granted, then, that some stock dividends are taxable as income and some are not, what test can one apply to determine whether a particular stock dividend comes within the taxable group? At the start, it must be noticed that the word "dividend" is not always used in the same way As Judge Manton pointed out in *Commissioner* v *Forhan Realty Corporation:*[10]

> " 'Dividend' includes many distributions which are not taxable under the Revenue Act, such as dividends out of capital or earnings or profits accumulated before March 1, 1913. By this section[11] Congress was dealing with dividends not technically known as such, but having the effect of dividends. Under such circumstances, it was correct to refer to 'taxable dividends' to distinguish them from other distributions which in common phrase are referred to as dividends, but which are non-taxable because of the source or form of their distribution."

The majority, in laying down a test in *Eisner* v. *Macomber* as to whether a stock dividend is taxable income, considered the effect of the dividend on both the shareholder's interest and on the corporate organization. To be taxable a stock dividend must effect (1) a severance of assets from the corporation, and (2) an

[9] Powell, *Income from Corporate Dividends,* 35 HARV. L. REV. 363, 366 (1922).

[10] 75 F 2d 268, 269 (1935)

[11] Code Section 112 (c) (2). If a distribution made in pursuance of a plan of reorganization is within the provisions of paragraph (1) of this subsection but has the effect of the distribution of a taxable dividend, then there shall be taxed as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be taxed as gain from the exchange of property.

alteration of the pre-existing proportionate interests of the stockholders.[12] To quote from the opinion.

> "The essential and controlling fact is that the stockholder has received nothing out of the company's assets for his separate use and benefit; on the contrary, every dollar of his original investment, together with whatever accretions and accumulations have resulted from employment of his money and that of the other stockholders in the business of the company, still remains the property of the company, and subject to business risks which may result in wiping out the entire investment. Having regard to the very truth of the matter, to substance and not to form, he has received nothing that answers the definition of income within the meaning of the Sixteenth Amendment."[13]

The Supreme Court has apparently ceased to look to the effect that the stock dividend has on the corporate structure or finances in determining whether a stock dividend is taxable as income and confines its examination to seeing what effect the dividend has on the stockholder's interest. The Sprouse and Strassburger Cases[14] show this to be the fact. In the former case, a corporation having only voting and non-voting common stock outstanding, distributed non-voting common as dividends to voting and non-voting common shareholders. It was held the dividend was not taxable since interests of the holders of the voting stock were not altered. In the second case, by charter amendment a dividend in cumulative non-voting preferred stock was delivered to the holder of the common stock. The stockholder's interest was not changed as a result of the distribution and consequently the dividend was not taxable income. The Supreme Court agreed with the dissenting judge in the court below that there must be a change in the stockholder's proportionate interest in the corporation's net assets in order to have what is known as a "realization" of income.[15]

The Board of Tax Appeals has stated the rule in a slightly different way In *Kelly Trust*[16] it said that "the test of whether the stock dividend redeemed in the tax years was or was not income under the Sixteenth Amendment is whether the stockholders received an interest substantially different in character or

[12] See Commissioner v. Tillotson Mfg. Co., 76 F 2d 189, 190 (1935).
[13] 252 U.S. 189, at 211.
[14] 318 U.S. 604 (1943).
[15] 124 F 2d 315 (1941).
[16] 38 B.T.A. 1014 (1938).

extent from that previously held." The Board there found that a dividend in preferred to holders of common, who could not dispose of their interests except collectively before the dividend but who could dispose of the preferred after its issue, produced an interest substantially different from what they held before and rendered the dividend subject to the income tax. The Board approved the test as stated in *Kelly Trust* in deciding *Keister* v. *Commissioner*[17] where a dividend in non-voting common stock to holders of voting stock and non-voting common was held taxable to holders of the voting common stock, also a dividend of non-voting preferred stock to holders of voting common and to holders of non-voting common, was a taxable dividend to both classes.

Authorities in the field of corporate taxation have sought to clarify the test as to what stock dividends are taxable as income and what are not. It seems worthwhile to consider some of the better known rules they have laid down.

The late Dean James Parker Hall stated the test in these brief words "Has he (the shareholder), as a result of the transaction, obtained a new interest in property, differing either (1) in kind, or (2) in extent from that which he had before?"[18] Professor James, of the University of Chicago Law School, after considering the two tests laid down by the Circuit Court in the *Tillotson Case*,[19] namely (1) severance of assets from the corporation, and (2) alteration of the pre-existing proportionate interest of the stockholders, says

> "The other rule which has been derived from the Macomber, Koshland, and Gowran Cases is that the test of constitutionally taxable income in a stock dividend is whether the shareholder receives any interest *substantially different in character or extent* from that previously held. The Treasury Department has apparently, although not quite clearly, adopted this second test."[20]

His solution of the problem would be to have the Supreme Court eliminate the principle of constitutional tax exemption upon stock dividends.

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[17] 42 B.T.A. 484 (1940).

[18] James, *The Present Status of Stock Dividends Under the Sixteenth Amendment*, 6 UNI. OF CHI. L. REV. 215 (1938).

[19] James, *supra*, note 18.

[20] James, *supra*, note 18, at 221.

Professor Magill of Columbia University emphasizes the necessity of "realization" by the shareholder from capital in determining whether a stock dividend is taxable income. To use his own words.

> "(2) An examination of the constitutional question confirms the conclusion that a stock dividend is not income. Income, to be taxable, must be realized. A stock dividend is not a realization of income; it is 'merely bookkeeping that does not affect the aggregate assets of the corporation or its outstanding liabilities; it affects only the form, not the essence, of the "liability" acknowledged by the corporation to its own shareholders, and this through a readjustment of accounts on one side of the balance sheet only, '"[21]

Judge Clark, former dean of the Yale Law School, in commenting on the Macomber Case soon after the decision was rendered, said.

> "Now it would seem clear that mere general appreciation in value of capital should not be deemed income so long as it is unrealized to the owner, and this is the distinction attempted to be made by the government under the present income tax law which purports to tax profits from sale of capital items."[22]

He concludes that the decision in *Eisner* v *Macomber* seems correct.[23]

Mertens, in an article published in the Cornell Law Quarterly in 1942,[24] lays down five rules for determining tax liability on receipt of stock dividends.

> "1. Where the stock dividend is not of precisely the same character and there is more than one type of stock outstanding at the time of distribution, if the stock dividend changes the rights of the stockholder in relation to the corporation through a change in the proportionate interest of the stockholder in or with relation to the assets of the corporation, there is a realized gain to the extent of the earnings deemed to have been distributed
>
> "2. If the effect of the stock dividend is to change the interest of the stockholders in the corporation by changing the 'proportionate interests' of the several classes of stockholders as against each other, then there may be a taxable distribution, even though the stockholders retain the same proportionate interests in the net assets of the corporation.

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[21] Magill, *Realization of Income Through Corporate Distributions,* 36 COL. L. REV. 519, 525 (1936).

[22] *Eisner* v. *Macomber and Some Income Tax Problems,* 29 YALE L. J. 735, 738 (1920).

[23] *Ibid.*

[24] *Recent Income Tax Trends in Stock Dividend Cases,* 27 CORN. L. Q. 449, 472 (1942).

> "3. Where there is but one class of stock outstanding, there is no taxable dividend upon the receipt by the stockholder of a new class of stock which gives the recipient evidence of certain preferences in the distribution of earnings, even though the new preferred stock is cumulative or does not carry voting rights.
>
> "4. If the corporation distributes its obligations, such as a bond or note to stockholders, there is a realized gain since the stockholders then have received the equivalent of a distribution of assets of the corporation.
>
> "5. In all cases in order that there be a taxable *dividend* there must be a 'distribution' of earnings or its equivalent."

The learned writer also gives five tests for determining whether there has been a realization of income, which may be summarized as follows Consider (a) whether there has been a separation of assets from the corporation, (b) whether the distribution results in a change in the proportionate interest of the shareholder, (c) does the issue change the intrinsic value of his holdings? (d) does it affect holdings of other stockholders? and (e) are the new certificates "alike in what they represent"?[25]

He seems to agree with the majority view in *Eisner* v. *Macomber*, for he says there must be a "realization" of income and this requirement is met only where in addition to a capitalization or segregation of earnings, there is a change in the stockholder's proportionate interest in the corporation.[26]

Professor Rottschaffer of the University of Minnesota Law School says it may be taken as definitely settled that no stock dividend is income within the Sixteenth Amendment unless it effects an essential change in the pre-existing proportionate interests of the stockholders.[27] In speaking of the Griffiths, Sprouse, and Strassburger Cases, he observes

> "Suffice it to say that under them realization is present whenever the distribution alters the recipient's pre-existing proportionate interest in the corporation, and is present in the case of only such stock dividends as produce that effect."[28]

All these tests when carefully analyzed seem to come down to practically the same test which can be put into the words of Mr. Justice Roberts when speaking for the Court in *Koshland* v.

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[25] *Ibid*, at p. 454.
[26] *Ibid*, at p. 458.
[27] *Present Taxable Status of Stock Dividends in Federal Law*, 28 MINN. L. REV. 106, 117 (1944)
[28] *Ibid*, at 171.

Helvering he referred to the holding in *Eisner* v. *Macomber* as follows " Where a stock dividend gives the stockholder an interest different from that which his former stockholdings represented he receives income."[29]

The criticism brought against the holding in *Eisner* v *Macomber*—that a stock dividend that works no change in the stockholder's interest in the corporation is not taxable as income—comes from an acceptance of the proposition that accretions to capital should be recognized as income. If this view were to be accepted, it should not be confined to the increase in value of a stockholder's interest in a corporation. It should apply to all capital again. One holding stocks and bonds would be called upon each year to calculate his loss or gain on them as the market rose or fell. Such a tax law would be practically impossible to administer. Since we do not follow this plan generally there is no good reason for trying to apply it when a corporation issues new certificates to its stockholders which certificates are merely evidence that their interests in the company will be called twice as many shares, for instance, as were named in the old certificates.

It is also to be noted that Mr. Justice Brandeis and those following his view find no difficulty in sweeping aside the corporate veil and treating corporate income as income of the stockholder. It is fundamental that courts will not look behind the corporate veil except in case of fraud or something akin thereto.

There can be but little doubt that the view of taxable income taken in the Macomber Case is in keeping with that held by most lawyers and that those who would have the decision overruled have a long, hard road ahead of them.

[29] *Supra* note 3 at 446.