

BASIS PROVISIONS FOR STOCK DIVIDENDS UNDER THE 1939 REVENUE ACT

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PRIOR to 1936, administrative regulations had long provided that, in the case of a stock dividend, the original stock's basis was to be allocated between that stock and the dividend stock for purposes of determining gain or loss on the subsequent disposition of either. The *Koshland* case invalidated these regulations.¹ It held that the original stock's basis could not be reduced by any amount attributable to the dividend stock. The *Gowran* case then held that the dividend stock had a "zero" basis.²

At once considerable confusion resulted. Taxpayers and the Treasury had, over a long period, acted in reliance on these administrative provisions. Now each would be adversely affected tax-wise: the taxpayer, where he had disposed of the original stock and still retained the dividend stock; the Treasury, in the converse situation. Moreover, serious legal questions arose as to whether the effect of those decisions might be narrowed by statutory provisions not considered in those cases.³ Strained constructions were thus offered as to other sections of the Revenue Act. Doubts arose as to the contemplated scope of statutory provisions conceived in the first instance for an entirely different purpose.

As a result, Congress at the last session took up the task of clarifying the basis provisions for stock dividends. The problems presented were not simple. It was necessary in the first instance to decide on a proper rule of general application for the future. Congress could choose one of three possible rules: (1) allocate the old stock's basis between it and the dividend stock; or (2) give the dividend stock a "zero" basis; or (3) reduce the old stock's basis by the fair market value of the dividend stock.

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1. *Koshland v. Helvering*, 298 U. S. 441 (1936).

2. *Helvering v. Gowran*, 302 U. S. 238 (1937).

3. The *Koshland* and *Gowran* cases related to the Revenue Act of 1928. It was thought that § 113(b)(1)(D) of the 1932 and subsequent Revenue Acts, requiring an adjustment to basis by reason of tax-free distributions, might offer the solution. [See discussion *infra* p. 850 *et seq.*] § 115(d) of the 1928 and subsequent Acts also required a reduction of basis by reason of capital distributions. It was possible that, if properly presented in litigation, stock dividends might be regarded within this category. Finally, there was the possibility of arguing that some stock dividend transactions constituted recapitalizations, and therefore statutory reorganizations. REVENUE ACTS OF 1928 and 1932, § 112(i)(1)(C); REVENUE ACTS OF 1934, 1936 and 1938, § 112(g)(1)(C). The express statutory provisions for an allocation of basis in those cases would then be applicable. REVENUE ACTS OF 1928, 1932, 1934, 1936 and 1938, § 113(a)(6).

It was also necessary to validate those transactions consummated in the past in reliance upon the then applicable regulations. This could be accomplished merely by ratifying prior Treasury regulations. But fairness required a series of exceptions in the retroactive application of this rule. Cases had been settled or disposed of either by court decisions or closing agreement on some basis other than those regulations. These should not now be reopened. Finally, it was necessary to integrate the new provisions with the old. It would have to be made clear that existing provisions of possible application⁴ yielded in favor of the statutory scheme expressly adopted for the stock dividend basis problem.

The Revenue Act of 1939 attempted the solution to these problems. But it required three pages of detailed, technical, complicated statutory provisions. To determine how well this attempt succeeded is the purpose of this Article. In making this evaluation, however, it is necessary: first to present, by way of background, the problems which the highly articulated statute was designed to solve; second, to explain the complex provisions adopted as the solution to these problems; and third, to consider the possible omissions in, and the new problems created by, the solution.

I. BACKGROUND

The history of the taxable status of stock dividends under the federal income tax statutes reveals a progressive endeavor on the part of Congress to keep pace with the Supreme Court's ever-changing concept of income.

At first, the Revenue Acts were silent with respect to the taxability of stock dividends. Hence the Treasury attempted to tax them under the provisions of the act taxing corporate dividends in general.⁵ But the Supreme Court held that a stock dividend of common stock paid to common stockholders was not income within the meaning of the Act.⁶ It indicated, however, that there might be a difference in the scope of the term "income" as defined in the statute and as used in the Constitution.⁷ Congress then specifically provided that a "stock dividend shall be considered income, to the amount of its cash value."⁸ The Supreme Court promptly held that a dividend paid in common stock to a common stockholder was not income within the meaning of the Sixteenth Amend-

4. As, *e.g.*, INT. REV. CODE § 113(b) (1) (D) and § 115(d) (1939).

5. REVENUE ACT OF 1913, § II B.

6. *Towne v. Eisner*, 245 U. S. 418 (1918).

7. *Id.* at 425. Mr. Justice Holmes in the decision of the Court stated: "But it is not necessarily true that income means the same thing in the Constitution and the act." See also dissent of Holmes, J., in *Eisner v. Macomber*, 252 U. S. 189, 219 (1920).

8. REVENUE ACT OF 1916, § 2(a). The Revenue Act of 1918 also provided for a tax on dividends and defined a dividend as any corporate distribution "whether in cash or in other property or in stock of the corporation." REVENUE ACT OF 1918, §§ 213 and 201(a).

ment.⁹ Although *Eisner v. Macomber* involved only the taxation of a dividend declared in common stock to a common stockholder, the Treasury gave the decision a broader interpretation. It ruled that where a corporation transfers a part of its surplus to capital account and issues new stock therefor to its stockholders, such stock is not income to them.¹⁰ No distinction was made as to the type of stock so issued—whether preferred on common, common on preferred, preferred on preferred, or otherwise.¹¹ To complement this provision, the Treasury also indicated the method of determining the basis of the original and dividend stocks for purposes of computing gain or loss on the sale thereof: where the dividend stock was of a different character or preference, the cost of the original stock was to be allocated over both classes of stock in accordance with the respective value of each class of stock at the time the dividend was issued.¹²

Congress, in the Revenue Act of 1921, attempted to follow *Eisner v. Macomber*, and provided that: "A stock dividend shall not be subject to tax . . ."¹³ The Treasury construed this provision broadly: "Stock issued by a corporation as a dividend does not constitute taxable income to a stockholder in such corporation, . . ."¹⁴

Soon after the passage of the 1921 Act, the Supreme Court, in a series of cases involving corporate reorganizations, pointed out the distinction between a stock dividend which worked no change in the corporate entity, the same interest in the same corporation being represented after the distribution by more shares of precisely the same character, and a dividend where there had been a change of corporate identity or a change in the nature of the shares issued as a dividend so that the proportional interest of the stockholder after the distribution was essentially different from his former interest.¹⁵ Nevertheless the Treasury's

9. *Eisner v. Macomber*, 252 U. S. 189 (1920). For contemporary comments criticizing the decision, see Seligman, *Implications and Effects of the Stock Dividend Decision* (1921) 21 COL. L. REV. 313; Warren, *Taxability of Stock Dividends as Income* (1920) 33 HARV. L. REV. 885. See also Clark, *Eisner v. Macomber and Some Income Tax Problems* (1920) 29 YALE L. J. 735.

10. T. D. 3052, 3 CUM. BULL. 38 (1920).

11. See O. D. 801, 4 CUM. BULL. 24 (1921), where it was stated that: "A stock dividend paid in true preferred stock is exempt from tax the same as though the dividend were paid in common stock; . . ."

12. T. D. 3059, 3 CUM. BULL. 38 (1920).

13. REVENUE ACT OF 1921, § 201(d). The Congressional committee stated that this provision "modifies the definition of dividends in existing law by exempting stock dividends from the income tax, as required by the decision of the Supreme Court in *Eisner v. Macomber* . . ." H. R. REP. NO. 350, 67th Cong., 1st Sess. (1921) 8; SEN. REP. NO. 275, 67th Cong., 1st Sess. (1921) 9.

14. U. S. Treas. Reg. 62, Art. 1548.

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

construction of the statute remained unaltered.¹⁶ Correlatively, the Department maintained during this period that if the dividend stock was of a character or preference materially different from the original stock, the cost of the latter should be apportioned between both stocks in accordance with their respective fair market values at the date of issuance of the stock dividend.¹⁷

The problem seemed settled. And it was — for almost fifteen years. There was, of course, the difficulty of distinguishing between a true stock dividend and a cash distribution,¹⁸ *i.e.*, whether a transaction constituted a distribution of cash with an option to apply the dividend to the purchase of stock;¹⁹ or, whether there was a prearrangement among the stockholders to apply the cash for the stock.²⁰ But stock dividends, as such, were regarded as non-taxable.

Then, after fifteen years of apparent certainty in the taxation of stock dividends, the Supreme Court specifically held that a dividend in common stock to preferred stockholders constituted taxable income under the Constitution.²¹ The Court did not decide at that time whether Congress, in the successive Revenue Acts since 1921, had intended to tax such dividends when received. The decision did hold, however, that on the sale of the original stock (in the *Koshland* case, preferred stock) the Treasury Department was without power to prescribe by regulation that an adjustment to the cost of that stock was warranted by reason of the common stock received as a dividend.²²

16. U. S. Treas. Reg. 65 and 69, Art. 1548; U. S. Treas. Reg. 74 and 77, Art. 628; U. S. Treas. Reg. 86, Art. 115-8.

17. U. S. Treas. Reg. 62, Art. 1548; U. S. Treas. Reg. 65 and 69, Art. 1599; U. S. Treas. Reg. 74 and 77, Art. 600; U. S. Treas. Reg. 86, Art. 113(a)(12)-1.

18. See MAGILL, *TAXABLE INCOME* (1936) 41-45.

19. In such event, the dividend was held taxable. See Appeal of Langenback, 2 B.T.A. 777 (1925). *Cf.* Lonsdale v. Comm'r, 32 F. (2d) 537 (C. C. A. 8th, 1929), *cert. denied*, 280 U. S. 575 (1929).

20. In that event, the dividend would be non-taxable. *Irving v. United States*, 44 F. (2d) 246 (Ct. Cl. 1930); *Jackson v. Comm'r*, 51 F. (2d) 650 (C. C. A. 3d, 1931); *United States v. Mellon*, 281 Fed. 645 (C. C. A. 3d, 1922); and *Alfred A. Laun*, 26 B.T.A. 764 (1932).

21. *Koshland v. Helvering*, 298 U. S. 441 (1936).

22. In this connection, the Court apparently overlooked the legislative history of § 113(a)(9) of the 1928 Act pursuant to which the regulations involved had been promulgated. When the corresponding provision was introduced for the first time in the 1924 Act [§ 204(a)(9)], the Committee on Ways and Means stated: "Paragraph (9) also covers the case of a distribution by a corporation of a stock dividend and provides that the basis of the old stock shall be apportioned between that stock and the stock received as a dividend. This rule is in accordance with the construction adopted by the department and by the courts of the existing law." H. R. REP. No. 179, 68th Cong., 1st Sess. (1924) 18. See also SEN. REP. No. 398, 68th Cong., 1st Sess. (1924) 19.

It is arguable, however, that this language had reference only to distributions of stock made pursuant to a statutory reorganization, inasmuch as the section in question:

Again Congress acted to meet this latest indication by the Court as to the scope of the constitutional term "income" in connection with stock dividends. It provided that:

"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 to the Constitution."²³

Even after the *Koshland* case, there was uncertainty as to whether the stock dividend was actually taxable under the respective Acts from 1921 to 1934, inclusive, and, if not, what the basis of the dividend stock was. These problems were soon resolved. In the *Gowran* case,²⁴ the Supreme Court held that the unmistakable command of the statute was to exempt all stock dividends; that the cost of the dividend stock to the stockholder receiving it was zero; and that the entire proceeds from the sale of the dividend stock were taxable.

II. THE PROBLEMS

Paradoxically, while the *Koshland* and *Gowran* cases settled some difficult legal problems, they left in their wake a host of new ones:

First, what was the taxable status of stock dividends under the Acts prior to 1921 (when the statute attempted to tax *all* stock dividends) and what was the proper basis of such stock?

Second, what adjustments were to be made in the case of stockholders who had disposed of either their original or dividend stock prior to the *Koshland* and *Gowran* decisions and had computed gain or loss thereon in accordance with the now invalid regulations relating to basis?

Third, did Section 113(b)(1)(D) of the 1932, 1934 and 1936 Acts²⁵ affect the determination in the *Gowran* decision for stock held after December 31, 1931?

(a) referred specifically only to distributions made pursuant to § 203(c) (1924 Act); the latter section dealt exclusively with distributions arising out of reorganizations, whereas ordinary stock dividends were treated separately in § 201(f);

(b) applied only to distributions made after December 31, 1923, from which time distributions pursuant to a reorganization could be made tax-free, while ordinary stock dividends were tax-free from the very first income tax act; and

(c) was dropped in 1934 when § 203(c) (§ 112(g) in the 1928 and 1932 Acts) was also dropped, although ordinary stock dividends remained non-taxable under § 115(f) until 1936.

23. REVENUE ACT OF 1936, § 115(f)(1). See H. R. REP. No. 2475, 74th Cong., 2d Sess. (1936) 10; and SEN. REP. No. 2156, 74th Cong., 2d Sess. (1936) 18.

24. *Helvering v. Gowran*, 302 U. S. 238 (1937). See also *Helvering v. Pfeiffer*, 302 U. S. 247 (1937). These cases involved the taxation of stock dividends under the Revenue Act of 1928.

25. This section requires an adjustment to the basis of property for distributions which were tax free under the law applicable to the year of such distribution.

Fourth, what effect does a constitutionally taxable²⁶ but statutorily tax-free dividend have on corporate earnings or profits?²⁷

(a) *Stock dividends prior to the 1921 Act.*²⁸ The impact of the *Koshland* case on *Eisner v. Macomber* was to limit the effective scope of the latter decision and to confine it strictly to its facts.²⁹ Accordingly, the provisions of the 1916 and 1918 Revenue Acts specifically taxing stock dividends must now be regarded as invalid only to the extent that they attempt to include constitutionally tax-free dividends within in-

26. The term "constitutionally taxable" is used herein to avoid the circumlocution of describing this type of distribution as one which is taxable as income under the Sixteenth Amendment. As indicated by the Court in *Eisner v. Macomber*, 252 U. S. 189 (1920), all distributions might be taxable by apportionment.

27. It has been held that a constitutionally tax-free dividend is not a distribution of earnings or profits and so does not diminish the corporation's earnings or profits. *Nolde v. United States*, 64 Ct. Cl. 204 (1927), *cert. denied*, 276 U. S. 634 (1928). However, while the distribution of a constitutionally taxable dividend may, by statute, be free of tax to the stockholder at the time of receipt, it does constitute a corporate distribution and may effect a reduction in the corporation's accumulated earnings or profits. See *Helvering v. Gowran*, 302 U. S. 238, 244 (1937). For instance, under prior law where a distribution of stock pursuant to a reorganization, without the surrender by the stockholder of his stock, was permitted free of tax [REVENUE ACTS OF 1924 and 1926, § 203(c); REVENUE ACTS OF 1928 and 1932, § 112(g)] it was deemed necessary to specify in the statute that earnings or profits were not diminished by such a distribution. REVENUE ACTS OF 1924 and 1926, § 203(g); REVENUE ACTS OF 1928 and 1932, § 112(h). See REVENUE ACT OF 1934, § 115(h). To resolve the question stated above, Congress acted immediately after the *Koshland* decision had indicated that some stock dividends were taxable under the Constitution. In the 1936 Act it was provided that such stock dividends shall not be considered a distribution of earnings or profits. REVENUE ACT OF 1936, § 115(h). See also REVENUE ACT OF 1938, § 115(h). In what appears to be a masterpiece of wishful thinking (too often resorted to by the experts who draft the reports), the Committee Report states that this rule is already part of existing law, but "the recommended amendment is desirable in the interest of greater clarity." SEN. REP. NO. 2156, 74th Cong., 2d Sess. (1936) 19. While such a provision operates fairly where the basis of the old stock is allocable to the old and the new stock, it has an anomalous result on the corporation where the stockholder uses a zero basis for the dividend stock. If the basis of the old stock is allocated, the theory is that there has been no real distribution of corporate earnings but that the stockholder's interest in the firm is now represented by the dividend and the original stocks. On the zero basis theory, however, there is no doubt that a distribution is made but the tax to the stockholder on the fair market value of the distribution is merely postponed. Yet in the latter instance, while the stockholder will in effect pay a tax on the distribution when he disposes of the stock, the corporation will never be able under the present provisions of § 115(h) to reduce its earnings and profits by the amount of that distribution.

28. Under *Towne v. Eisner*, 245 U. S. 418 (1918) the Revenue Acts from 1913 to 1915, inclusive, must be regarded as extending tax exemption to stock dividends since the applicable statute for that period was silent with respect to the taxation of such dividends. The problems of basis for stock dividends received in that period under the *Koshland* and *Gowran* cases are, therefore, the same as those arising in the period when the statute specifically exempted dividends. This will be discussed *infra* p. 860.

29. MAGILL, TAXABLE INCOME (1936) 67.

come.³⁰ Under these circumstances, the tax consequences of the receipt of a constitutionally taxable stock dividend during the period from 1916 to 1921 were as follows: the stock dividend should have been included in gross income at the time of its receipt. No adjustment should have been made to the basis of the original stock by reason of the receipt of such dividend. If the stock dividend had been disposed of, the basis for computing gain or loss thereon should have been its fair market value at the time of the receipt. If the original stock had been disposed of, the basis for computing gain or loss thereon should have been the cost basis of such stock. However, prior to the *Koshland* decision, neither the Treasury nor the taxpayers anticipated the limitations on the scope of *Eisner v. Macomber*. Accordingly, many taxpayers receiving constitutionally taxable stock dividends during this period did not pay a tax on them at that time,³¹ and probably made adjustments to the basis of the original stock by reason of the stock dividend.

The holding in the *Koshland* case to the effect that some stock dividends were taxable under the Constitution upset this treatment of the dividend — and in most instances operated to the detriment of the Treasury. For example, if a taxpayer retained the dividend stock and sold the original stock prior to the *Koshland* decision, the taxpayer's gain was increased or his loss correspondingly decreased on that sale because the basis of the original stock was adjusted by reason of the receipt of the stock dividend. But on the subsequent sale of the dividend stock after the *Koshland* case (or in a period still open when *Koshland* was decided), the gain or loss would be computed using the fair market value of stock at the time of receipt. Thus the taxpayer would get the benefit of the full fair market value of the dividend stock as a basis on its sale, although that amount was never reflected in his income at the time of the receipt and although the basis of the original stock was only partially reduced.³²

30. A statute may be invalid as applied to one state of facts, and yet valid as applied to another. *DuPont v. Comm'r*, 289 U. S. 685, 688 (1933); and *Dahnke-Walker Co. v. Bondurant*, 257 U. S. 282, 289 (1921). Section 900 of the Revenue Act of 1916 and § 1402 of the Revenue Act of 1918 provide that if any clause, sentence, paragraph or part of the respective Act is held to be invalid, the decision shall not otherwise invalidate the Act but shall be confined to the part thereof directly involved in the controversy in which such judgment has been rendered. This provision has been stated more precisely in the later statutes: "If any provision of this Act, or the application thereof to any persons or circumstances, is held invalid, the remainder of the Act, and the application of such provisions to other persons or circumstances, shall not be affected thereby." REVENUE ACT OF 1938, § 902.

31. Taxpayers probably included such dividends in income at the time of receipt in accordance with the mandate of the statute that *all* stock dividends were taxable. Following *Eisner v. Macomber*, a great many of these taxpayers secured refunds whether the dividend was constitutionally taxable or tax free.

32. This might be illustrated, concretely, as follows: suppose a common stockholder received in 1918 a preferred stock dividend having a fair market value of \$100. The

Similarly, if a taxpayer retained the original stock and sold the dividend stock prior to the *Koshland* decision, the taxpayer's gain would be increased or his loss decreased because the dividend stock would have taken some part of the original stock's basis rather than the fair market value to which it was entitled. However, on the sale of the original stock after the *Koshland* case, the stockholder would be entitled to use the original basis of that stock unadjusted by reason of the stock dividend.³³

In the absence of specific legislation covering this problem, the Treasury faced a loss in revenue. It could not rely upon its oft-resorted-to estoppel doctrine against the taxpayer. As stated by the Court in the *Salvage* case, since the income was not included in the year of its receipt because of an "innocent mistake of law [and] there was no false representation of fact; nothing gave support to the claim of estoppel."³⁴ Furthermore, the Government could not claim that a zero basis should be used on the sale of the dividend stock under the theory of the *Gowran* decision. The Court in the latter case was dealing with a dividend which was tax free under the statute to the stockholder on its receipt. The "cost" of such stock to the stockholder was zero. But the "cost" of a stock dividend which is taxable under the statute is its fair market value whether or not that dividend was actually included in gross income at the time of receipt.³⁵

Nor could it possibly be contended in this instance that Section 113 (b)(1)(D) of the 1932 and subsequent Revenue Acts was applicable. That section provided that a proper adjustment was to be made in the case of stock for the amount of distributions previously made which, under the law applicable to the year in which the distribution was made,

common stock had a cost basis to the stockholder of \$100 but after the receipt of the dividend was worth \$200. The \$100 cost basis was allocated between the common and preferred stocks in the respective ratio of 2 to 1, thus giving the common stock a basis of \$66+ and the preferred stock a basis of \$33+. Suppose further that the common stock was then sold in 1928 for \$100 and the stockholder paid a tax on the \$33+ gain. In 1936, the stockholder sold the preferred stock for \$100 but paid no tax since he was entitled to use as a basis the fair market value of the stock at the time of the receipt, *i.e.*, \$100. Thus while the total cost of both stocks was \$100 and the total consideration received was \$200—resulting in a gain of \$100 to the stockholder—he has paid a tax on only \$33+.

33. More specifically, the result in this case would be as follows: suppose in the situation assumed in note 32 *supra*, the preferred stock was sold for \$100 in 1928. The stockholder would have paid a tax on a \$66+ gain. In 1936, the stockholder sold the common stock for \$100. He would pay no tax thereon since he would be entitled to use the original basis of that stock, *i.e.*, \$100. Here, too, the net gain from both sales was \$100 but a tax was paid on only \$66+.

34. *Helvering v. Salvage*, 297 U. S. 106 (1936), *aff'g*, 76 F. (2d) 112 (C. C. A. 2d, 1936). See also Maguire and Zimet, *Hobson's Choice and Similar Practices in Federal Taxation* (1935) 48 HARV. L. REV. 1281.

35. See *Daisy M. Ward*, 29 B.T.A. 1251, 1254 (1934); *Estate of Edwin D. Metcalf*, 13 B.T.A. 236 (1928), *aff'd*, 32 F. (2d) 192 (C. C. A. 2d, 1929).

either were tax free or were applicable in reduction of basis. Neither of these conditions exists in this instance. Here, under the law applicable to the year in which the stock dividend was issued, the dividend was *not* tax free. And, according to the *Koshland* case, there was no statutory authority under the law applicable to those years for applying the distribution to reduce the basis of the original stock.³⁶

Finally, the provisions of Section 820 of the Revenue Act of 1938 would offer no protection to the Treasury in this instance, for no such adjustment is permitted in respect of any taxable year beginning prior to January 1, 1932.³⁷ And, in the situation under consideration at this point, the erroneous omission from gross income took place in a taxable year during the period from 1916 to 1921. Thus the Government found itself "across the barrel" as a result of the *Koshland* decision and some specific legislation was necessary to protect it.

(b) *Stock dividends received between 1921 and 1936.* It is now clear that under the Revenue Acts in effect for the taxable period 1921 to 1935, inclusive, *all* stock dividends were received tax free (whether or not such dividends were constitutionally taxable), that the basis of a constitutionally taxable stock dividend was zero³⁸ and that the original stock's basis was not to be adjusted by reason of the stock dividend.³⁹ In the case of a taxpayer who had disposed of both the dividend stock and the original stock in a taxable year prior to 1932, the correct tax treatment was obvious: if the year in which the original stock had been disposed of was still "open," the principle of the *Koshland* case was applicable; if the year in which the dividend stock had been sold was still "open," the principle of the *Gowran* case was applicable. However, this treatment might produce tax consequences in these instances, which would prove inequitable to either the Government or the taxpayer.

For example, the Treasury would be adversely affected tax-wise where both stocks had been sold, gain or loss computed thereon by allocating the original basis between both stocks in accordance with the applicable regulations and, after the statute of limitations had expired for the year in which the dividend stock had been sold, the taxpayer asserted that, pursuant to the *Koshland* case, the entire original basis was available for determining gain or loss on the original stock.⁴⁰ In the converse

36. The much neater question of whether § 113(b) (1) (D) is applicable to the stock dividend issue arises in connection with the period from 1921 on when the statute *did* make such dividends tax free. This problem is considered *infra* pp. 851-853.

37. REVENUE ACT OF 1938, § 820(f). That there may be prohibitions of substance in addition to limitations of time as to the applicability of the section in the stock dividend situation will appear *infra* p. 853 *et seq.*

38. See note 24 *supra*.

39. *Koshland v. Helvering*, 298 U. S. 441 (1936).

40. The tax advantage to the taxpayer is obvious in this case: assume the stockholder had common stock with a cost basis of \$100 and received in 1926 a preferred stock:

situation, the taxpayer would be treated inequitably where the statute of limitations had expired for the year in which the original stock had been sold. In that instance, the Government would contend — with equal propriety — that, pursuant to the *Gowran* case, the dividend stock had a zero basis and that the entire proceeds on that sale were taxable.⁴¹ In the case of a taxpayer who either received a stock dividend between 1932 and 1936, or who, having received a stock dividend between 1921 and 1936 disposed of either the original stock or the dividend stock between 1932 and 1936, there were — after the *Koshland* and *Gowran* cases — serious legal difficulties in addition to the possible inequities to the taxpayer and the Government.

Foremost in this connection were the tax consequences to be accorded Section 113(b)(1)(D) of the 1932 and subsequent Revenue Acts. Section 113(b) provided that with respect to the basis of property:

“(1) *General Rule.* — Proper adjustment in respect of the property shall in all cases be made —

* * * * *

“(D) in the case of stock . . . for the amount of distribution previously made which, under the law applicable to the year in which the distribution was made, either were tax-free or were applicable in reduction of basis (not including distributions made by a corporation, which was classified as a personal service corporation under the provisions of the Revenue Act of 1918 or 1921, out of its earnings or profits which were taxable in accordance with the provisions of section 218 of the Revenue Act of 1918 or 1921).”

Several questions arose with respect to the pertinence of this section in the problem under consideration. Was the section applicable at all

dividend. At that time, the fair market value of the common stock was \$100, and of the preferred stock was \$200. In accordance with the regulations [U. S. Treas. Reg. 69, Art. 1599] the \$100 cost basis was apportioned between the common and preferred stocks in the respective ratio of 1 to 2, thus giving the common stock a basis of \$33+, and the preferred stock a basis of \$66+. In 1929, the taxpayer sold the dividend stock for \$100, and paid a tax on the gain of \$33+. In 1931, the taxpayer sold the original stock for \$100 and paid a tax on the \$66+ gain. Because of other adjustments to the 1931 return, this year remained “open” until after the decision of the Supreme Court in the *Koshland* case. Accordingly, instead of a \$66+ gain on the sale of the original stock in 1931, there would be no gain, since, under the *Koshland* decision, no adjustment to the original stock would be permitted on account of the stock dividend. Here, there has been a total gain to the stockholder of \$100, and yet he has paid a tax on only \$33.33.

41. The tax detriment to the taxpayer in this situation is equally clear. Suppose, in the case considered in note 40 *supra*, that the original stock had been sold in 1927 for \$100, and a tax paid on the \$66+ gain, computed in accordance with the applicable regulations. Then in 1931 the dividend stock was sold for \$100 and a tax paid on the \$33+ gain computed in accordance with those regulations. If 1931 were still “open” when the *Gowran* case was decided, the dividend stock would have a zero basis and the entire proceeds on that sale would be taxable. In this instance, there has been a gain to the taxpayer of only \$100 and yet he has paid a tax on \$166.

to the stock dividend basis problem? If it was, did it have any application to the dividend stock as well as to the original stock? Moreover, what type of adjustment was "proper" within the meaning of the section?

First. The section was designed to meet an entirely unrelated situation—namely, to close the gap in the 1921 Act relating to the distribution of earnings and profits accumulated prior to March 1, 1913.⁴² Moreover, it was adopted when the generally accepted view was that, under *Eisner v. Macomber*, all stock dividends were constitutionally exempt from tax and the basis had to be apportioned between the original and dividend stocks.

Nevertheless, while Section 113(b)(1)(D) was enacted for this limited purpose and at a time when the *Macomber* decision was regarded as applicable to all stock dividends, such considerations would not justify a court "in departing from the unmistakable command embodied in the statute."⁴³ Here the terms of the section are sufficiently broad to embrace other tax-free distributions including the stock dividends under consideration. The adjustment is to be made under the statute "in all cases" for the amount of distributions previously made which under the law applicable to the year in which the distribution was made were tax free. Certainly no cavil can now be had with the proposition that a constitu-

42. H. R. REP. No. 708, 72d Cong., 1st Sess. (1932) 21 *et seq.*; SEN. REP. No. 665, 72d Cong., 1st Sess. (1932) 29. See also 2 PAUL AND MERTENS, LAW OF FEDERAL INCOME TAXATION (1934) §§ 18,185-18,192. The situation in this respect was, as follows: under the 1921 Act, a distribution of earnings and profits accumulated prior to March 1, 1913, was tax free [REVENUE ACT OF 1921, § 201(b)], but there was no specific provision similar to that relating to the distribution of capital [REVENUE ACT OF 1921, § 201(c)] which required such distribution to be applied against, and reduce the basis of the stock in connection with which the distribution had been made. The Revenue Act of 1924 added a provision for the adjustment of basis in the case of tax-free distributions [REVENUE ACT OF 1924, § 201(b)], but this provision was held applicable only to such distributions made in a taxable year subject to the 1924 Act. *Louis D. Newman*, 9 B.T.A. 158 (1927). Section 201(b) of the 1926 Act and § 115(b) of the 1928 Act were held to be similarly circumscribed. *G. C. M. 6717*, IX-1 CUM. BULL. 179 (1930). The 1928 Act attempted to "plug the loophole" by providing that the basis should be reduced by the amount of previous distributions to the extent provided under the law applicable to the year in which made. REVENUE ACT OF 1928, § 111(b)(3). But this begged the question since there was no certainty that the 1921 Act did require a reduction of basis. Under such circumstances, the Board held that, in the absence of a specific statutory provision, the cost of the stock—unadjusted for any distribution out of pre-March 1, 1913, earnings and profits made prior to January 1, 1924—was to be used as the basis in computing gain upon the subsequent sale of the stock. See *Carolyn S. McLean*, 4 B.T.A. 487 (1926); and *Stuart W. Webb*, 5 B.T.A. 366 (1926). It was to remedy this highly localized situation—entirely foreign to the stock dividend question—that § 113(b)(1)(D) was enacted in the Revenue Act of 1932.

43. *Helvering v. Gowran*, 302 U. S. 238, 242-243 (1937). The principle should be applied with care and only where the statute is unequivocally clear.

tionally taxable stock dividend is a *distribution*.⁴⁴ Nor can it now be denied that under the law applicable to the year in which such distributions were made, — *i.e.*, under the successive Revenue Acts from 1921 to 1934 inclusive — such distributions were *tax free*.⁴⁵ Insofar as stock dividends constitute income which could have been taxed, but which either by legislative grace or because of lack of legislative prescience were exempt, they are analogous to the distributions out of earnings and profits accumulated prior to March 1, 1913⁴⁶ — to which Section 113-(b)(1)(D) clearly applies. Furthermore, there is only one stated exception to the all-inclusive language of the section, namely, distributions by personal service companies under certain defined conditions. Accordingly, the statutory language of Section 113(b)(1)(D) is so explicit in this connection that recourse to its legislative history would seem prohibited.⁴⁷

However, the Circuit Court of Appeals for the Eighth Circuit held recently, in *Frank J. and Hubert Kelly Trust et al. v. Commissioner*,⁴⁸ that the section is not applicable at all to the stock dividend situation. In that case, the taxpayer contended that the basis of the dividend stock (7%, cumulative, non-voting, redeemable preferred stock) should not be zero — notwithstanding the decision of the Supreme Court in the *Gowran* case — since Section 113(b)(1)(D) of the Revenue Act of 1934 was applicable. The circuit court of appeals, in holding the section inapplicable, drew a distinction between income arising in the form of current earnings on the operation of a capital asset (ordinary income) and income arising in the form of gain on the sale or other disposition of such an asset (capital gain) — which, in the opinion of the court, are materially different in fundamental nature and are treated differently in the provisions of the Revenue Acts. This difference was apparently regarded by the court as precluding the one type of income from affecting the measurement of the other. Since the distinction is recognized in the Revenue Acts, the court concluded that Sections 111, 112 and 113, providing for the measurement of *capital gain* on the sale of stock, made no allowance for adjustment by reason of *ordinary income* in the form of dividends either in stock or cash.

The soundness of this reasoning is highly doubtful. The primary and declared function of Section 113(b)(1)(D) was to provide an adjust-

44. *Koshland v. Helvering*, 298 U. S. 441 (1936); *Helvering v. Gowran*, 302 U. S. 238 (1937).

45. REVENUE ACT OF 1921, § 201(d); REVENUE ACTS OF 1924 and 1926, § 201(f); REVENUE ACTS OF 1928, 1932 and 1934, § 115(f). See note 24 *supra*.

46. *Lynch v. Hornby*, 247 U. S. 339 (1918).

47. *Helvering v. City Bank Farmers Trust Co.*, 296 U. S. 85 (1935). This caveat is resorted to usually to support a pre-determined construction contrary to the declared intent of Congress.

48. Decided July 19, 1939. Opinion withdrawn Aug. 4, 1939, 106 F. (2d) 1002.

ment to basis by reason of the tax-free distribution of earnings and profits accumulated prior to March 1, 1913.⁴⁹ This is "ordinary income" within the classification of the court just as much as a taxable stock dividend.⁴⁹ Yet there is no question as to the applicability of Section 113(b)(1)(D) in that instance. Moreover, the court overlooked other instances in the statute involving a receipt of ordinary income which Congress decided to treat as a capital transaction and to require merely an adjustment to basis — as, *e.g.*, distributions by a corporation of stock or securities to stockholders upon a reorganization (during the period from 1924 to 1934) or distributions out of depletion reserves based on discovery value (during the period from 1924 to 1932).⁵¹ However, whether or not the court's reasoning is correct in holding Section 113(b)(1)(D) entirely inapplicable to the stock dividend issue, it is obvious that the Government and taxpayer alike were faced with uncertainty in attempting to rely on that section to bridge the hiatus in the law left by the *Koshland* and *Gowran* decisions.

Second. Even if Section 113(b)(1)(D) were ultimately held to be applicable to the stock dividend question, it is doubtful whether that section offers a complete solution of the problem. It should be noted that it provides merely for adjusting the basis of the original stock and makes no provision as to any adjustment in respect of the dividend stock. Nor may the dividend stock be brought within the scope of the section by construing the term "adjustment" as synonymous with terms "apportionment" and "allocation." Although the term "adjustment" may have a meaning analogous to the terms "apportionment" and "allocation" in the broad generic sense,⁵² the terms have developed quite opposite meanings for purposes of the Act. The term "adjustment" appears most prominently at Section 113(b)(1). Apparently as there used, that term connotes the reduction of the original stock's basis by the fair market value of the distribution. The legislative history of Section 113(b)(1)(D) reveals this was the contemplated method of adjustment for the items included in that paragraph.⁵³ Moreover, in other cases within the

49. See p. 850 *supra*.

50. *Lynch v. Hornby*, 247 U. S. 339 (1918).

51. Both discussed *infra* p. 855.

52. Webster defines the term "adjustment" as: "The calculation and settlement of the several shares to be had or borne by various parties in respect of a liability, claim, loss, or *payment to be divided among them*. A means, as a mechanism, by which things are adjusted *one to another*." (Italics supplied). Under this definition, it may be contended that the statutory term "adjustment" embraces the tax concepts of "allocation" and "apportionment" so that it would be permissible to divide among the old and the new stocks (*i.e.*, allocate or apportion) the cost basis of the old stock.

53. When the provision was inserted in the law, it was stated: "The 1928 act required the basis of stock to be reduced by distributions which, under the law when made, were applicable against basis. The new bill, in subparagraph (D), requires, in addition, that

scope of Section 113(b)(1) in which an adjustment is prescribed, the item mentioned is applied against and reduces to that extent the basis of the property involved.⁵⁴

On the other hand, the terms "apportionment" and "allocation" have been used in an entirely different sense under the Act. Those terms appear in Section 113(a).⁵⁵ In construing the term "apportionment" the Supreme Court stated: "To apportion is to 'divide and assign in just proportion', 'to distribute among two or more a just part or share to each' . . ."⁵⁶ And where the statute used the term, the original basis has been divided between the old property and the new in accordance with some just and equitable formula.

Finally, the fact that where the term "adjustment" is used, it is geared only in terms of adjusting the original stock (without any reference to the corresponding adjustment to the dividend stock), while the terms "apportionment" or "allocation" are coupled with a specific reference to both items, is significant. Such a divergence in drafting sections so proximate in the 1932 Act as Section 113(a)(6), (9) and Section 113(b)(1)(D) compels a conclusion that the meaning of the term "adjustment" in the latter section is different from that of "apportionment" or "allocation" in the former provisions.

The applicability of Section 113(b)(1)(D) to the dividend stock as well as to the original stock has been considered by the Board of Tax Appeals. The Board held that the section did not, by its terms, specify an adjustment to the dividend stock.⁵⁷ In addition to the argument based on the inapplicability of the language of Section 113(b)(1)(D) to the

basis be reduced by distributions which were free of tax when made." H. R. REP. NO. 708, 72d Cong., 1st Sess. (1932) 22; SEN. REP. NO. 665, 72d Cong., 1st Sess. (1932) 29. The adjustment made in the case of distributions out of pre-March 1, 1913, earnings and profits has always been that of reducing the original stock's basis by the amount of such distributions, whether in cash or in kind.

54. For example, § 111(b)(2) of the 1928 Act provided that the "basis shall be diminished by the amount of the deductions for exhaustion, . . ." etc. In the 1932 Act, this provision became part of § 113(b)(1) and the reduction of basis was referred to as a "proper adjustment." The Committee reports reveal that no change in meaning was intended by the shift from the term "diminished" to the term "adjustment" in the section. Cf. also § 111(b)(3) of the 1928 Act which was also incorporated in § 113(b)(1)(D) of the 1932 Act.

55. In § 113(a)(9) of the Revenue Act of 1932, it is specified that if stock or securities were distributed to the taxpayer in connection with a tax-free distribution pursuant to a reorganization "the basis in the case of the stock in respect of which the distribution was made shall be *apportioned*, under the rules and regulations prescribed by the Commissioner with the approval of the Secretary, between such stock and the stock or securities distributed." A similar use of the term "allocated" is made in § 113(a)(6) of the Revenue Act of 1932.

56. *Manhattan Gen'l Equipment Co. v. Comm'r*, 297 U. S. 129, 134 (1936).

57. *Frank J. & Hubert Kelly Trust et al.*, 38 B.T.A. 1014 (1938); *Albert E. Smith*, 39 B.T.A. 80 (1939).

dividend stock, the Board suggested some doubts as to the constitutionality of the section if it were sufficiently inclusive. In that connection, the Board stated that there is "considerable risk that the true doctrine of the *Koshland* case may be to prevent apportioning to the dividend stock any part of the capital basis, even though expressly so directed by Congress, on the ground that 'in effect it converts an income tax into a capital levy'"⁵⁸

The Board's fear seems to be groundless in this respect. It is probably more accurate to regard the quotation from the *Koshland* case as dictum. This statement has subsequently been construed by the Supreme Court as invalidating the apportionment of part of the original stock's basis to the dividend stock, *not under all circumstances*, but only because in this instance it was without statutory authority.⁵⁹ Moreover, there has never been any question as to the validity of other statutory provisions requiring an adjustment of basis by reason of a tax-free distribution of income. Two instances stand out:

1. In the case of a tax-free distribution of stock or securities pursuant to a plan of reorganization,⁶⁰ the basis of the stock in respect of which the distribution was made was to be apportioned between such stock and the stock or securities distributed.⁶¹ Such distributions, either of the corporation's own stock,⁶² or of stock in another corporation, would, in the absence of the statutory exemption, constitute taxable income to the recipient.⁶³ Yet the Supreme Court had no difficulty sustaining the statutory provision requiring the apportionment of the basis of the original stock between both the original stock and the stock distributed pursuant to the reorganization.⁶⁴

2. Mining royalties afford another instance of a valid statutory provision which has required a reduction of basis by the amount of a tax-free distribution. Such royalties are income to the recipient,⁶⁵ but allowance is made under the statute for depletion⁶⁶—and to that extent

58. Frank J. & Hubert Kelly Trust *et al.*, 38 B.T.A. 1014, 1019 (1938).

59. See *Helvering v. Gowran*, 302 U. S. 441 (1936); *M. E. Blatt Co. v. United States*, 305 U. S. 267, 279 (1938). See also (1937) 25 CALIF. L. REV. 499.

60. REVENUE ACTS OF 1924 and 1926, § 203(c); REVENUE ACTS OF 1928 and 1932, § 112(g).

61. REVENUE ACTS OF 1924 and 1926, § 204(a)(9); REVENUE ACTS OF 1928 and 1932, § 113(a)(9).

62. This would occur where the statutory reorganization took the form of a recapitalization. REVENUE ACTS OF 1924 and 1926, § 203(h)(1)(C); REVENUE ACTS OF 1928 and 1932, § 112(i)(1)(C).

63. As to the corporation's own stock, see *Koshland v. Helvering*, 298 U. S. 441 (1936). As to stock in another corporation, see *Peabody v. Eisner*, 247 U. S. 347 (1918); cases cited *supra* note 15.

64. *Manhattan Gen'l Equipment Co. v. Comm'r*, 297 U. S. 129 (1936).

65. REVENUE ACT OF 1938, § 22(a) and corresponding provisions of prior Acts.

66. REVENUE ACT OF 1938, § 23(m) and corresponding provisions of prior Acts.

the royalty is free from tax.⁶⁷ The statute also provides in this instance — exactly as does Section 113(b)(1)(D) — that proper adjustment shall be made to the basis of the recipient for depletion to the extent allowed under the revenue laws.⁶⁸ The constitutionality of such an adjustment has always been assumed, without any question, by the Supreme Court.⁶⁹ Yet the exemption of part of the royalty income for depletion — like the exemption of stock dividends and of distributions out of pre-March 1, 1913 earnings — is said to be purely a matter of legislative grace.⁷⁰

However, even if all doubts are resolved as to the constitutionality of the method prescribed in Section 113(b)(1)(D) as applied to stock dividends, nevertheless, the section is available to but a limited degree — namely, in prescribing an adjustment only to the original stock. For example, if the original stock was disposed of prior to 1932 and the dividend stock was retained after 1932, Section 113(b)(1)(D) would not permit the necessary adjustment.

Third. Another defect was obvious in Section 113(b)(1)(D) as the solution to the stock dividend basis problem. Just what was meant by the “proper adjustment” authorized by the statute? Did the term “adjustment” merely prescribe the reduction of the original stock’s basis by the fair market value of the dividend stock; or did it permit some leeway in the amount by which the original stock’s basis was to be reduced, depending on the facts in the particular case?

As indicated above, the traditional method of adjusting stock in the case of the types of distributions clearly within the scope of the section has been to apply the fair market value of such distribution against the basis of the old stock. Accordingly, this would probably be the “proper adjustment” contemplated by the section in the case of stock dividends — assuming the latter fell within the section. However, it is possible that there is some “give” in the term “proper” so as to warrant adjustments other than a strict reduction of the original stock’s basis by the fair market value of the dividend stock. Some hint of this elasticity in the section was given in the Board’s decision in the *Kelly Trust* case. It was there pointed out that when a case arose in which the distribution of the original stock was involved “a reference to ‘proper adjustment’ may be the justification for treating that situation, when it arises, with such fairness as the facts involved may require.”⁷¹

67. *Burnet v. Harmel*, 287 U. S. 103 (1932).

68. REVENUE ACTS OF 1924 and 1926, § 202(b)(2); REVENUE ACT OF 1928, § 111(b)(2); and REVENUE ACTS OF 1932, 1934, 1936 and 1938, § 113(b)(1)(B).

69. See, e.g., *Burnet v. Thompson Oil & Gas Co.*, 283 U. S. 301 (1931).

70. *Helvering v. Mountain Producers Corp.*, 303 U. S. 376 (1938); *Burnet v. Thompson Oil & Gas Co.*, 287 U. S. 301, 304 (1938); *Stanton v. Baltic Mining Co.*, 240 U. S. 103 (1916). It is most difficult, however, to distinguish this case from a true return of capital. MAGILL, *TAXABLE INCOME* (1936) 317.

71. *Frank J. & Hubert Kelly Trust et al.*, 38 B.T.A. 1014, 1019 (1938).

For example, suppose the dividend stock was sold in 1932 and the gain or loss thereon was measured by using as a basis some part of the original stock's basis allocated to the dividend stock in accordance with the provisions of the regulations now regarded as invalid. Then in 1934 the original stock was sold and the taxpayer claimed that the basis should be unadjusted by any amount apportioned to the dividend stock on the earlier sale. With respect to the original stock's basis, the Board might hold that it should be adjusted only by so much of the tax-free distribution which had escaped tax on the sale of the dividend stock (rather than by the fair market value of the distribution). Such an adjustment might be regarded as "proper" in that instance.⁷²

This array of the doubts arising with respect to the applicability of Section 113(b)(1)(D) to the stock dividend basis problem was not designed to pose a series of insolubles. Obviously, each could have been resolved in due time by definitive judicial opinions. But these doubts revealed the inadequacy of that section as an administrative technique for coping with the problem at the present time. The experience of taxpayers and Government alike in the prior history of the stock dividend question was not conducive to having either of them place too sanguine a reliance on the section.

Nor was any solution to this problem provided by that ingenious product of the 1938 revenue draftsmen — Section 820 of the Revenue Act of 1938. For example, suppose a taxpayer received a stock dividend in 1932. He sold the dividend in 1934, computing gain or loss thereon by attributing to the dividend stock a portion of the original stock's basis in accordance with the regulations then in force. Then in 1938 he sold his original stock and claimed the entire cost of that stock as the basis, in accordance with the *Koshland* case. If this position were sustained by a final determination,⁷³ would any adjustment⁷⁴ have been permitted with respect to the dividend stock?

In the first place, Section 820(b)(5) would not require as an adjustment the inclusion of the fair market value of the dividend stock in income in the year of receipt, since under the applicable revenue statute such stock dividends were tax free on receipt.⁷⁵ Accordingly, with respect to that item there was not an erroneous omission from the gross income of the taxpayer in that year (1932) — one of the conditions precedent for an adjustment under the section. Moreover, if the taxpayer's posi-

72. This conclusion would represent a middle ground between the taxpayer's argument that under the *Koshland* decision no adjustment is warranted to the basis of the original stock, and the Government's argument that under § 113(b)(1)(D) the basis of the original stock should be reduced by the entire fair market value of the dividend stock.

73. As defined in § 820(a) of the 1938 Revenue Act.

74. As defined in § 820(b)(5) of that Act.

75. See *Helvering v. Gowran*, 302 U. S. 238 (1937).

tion on the sale of the original stock were sustained, an adjustment would apparently not be required with respect to the sale of the dividend stock in 1934. Since the latter stock had, under the *Gowran* case, a zero basis, it is arguable that the basis of the original stock did not depend upon either the receipt or the sale of the dividend stock.⁷⁶ Under these circumstances, a complete statutory solution was necessary if certainty and equitable treatment were to be afforded the Government and taxpayers with respect to the stock dividend basis problem.

III. THE SOLUTION

The solution to the stock dividend basis problem, adopted by Congress in Section 214 of the Revenue Act of 1939, was "designed to afford a clear and unequivocal statutory basis with respect to both past and future taxable years for the rule of allocation upon which taxpayers, the Treasury Department, and Congress have alike relied."⁷⁷

The section does two things. First, it lays down as amendments to the Internal Revenue Code a series of rules with respect to the allocation of the basis of the original or dividend stock applicable to taxable years beginning after December 31, 1938.⁷⁸ Then it applies those rules for the allocation of basis to the Revenue Act of 1938 and prior Revenue Acts.⁷⁹ The entire section thus forms a unified scheme — operating retroactively as well as prospectively — whereby complete equity is achieved regardless of when the dividend or the original stock is sold.⁸⁰ This solution seemed most desirable since it restores the status quo on the stock dividend basis problem to the situation in effect prior to the *Koshland* and *Gowran*

76. Maguire, Surrey and Traynor, *Section 820 of The Revenue Act of 1938* (1939) 48 YALE L. J. 719, 768, n. 176. The application of Section 820 to the converse situation is interesting: Suppose a constitutionally tax-free dividend had been erroneously included in income at receipt. On the subsequent sale of the original stock, it was determined that the stockholder should reduce the basis of that stock by the portion properly allocable to the dividend stock. This would seem to be a proper instance for making an adjustment under § 820(b)(5) in respect of the amount erroneously included in the gross income of the stockholder in the year the dividend was received. See Kent, *Mitigation of the Statute of Limitations in Federal Tax Cases* (1939) 27 CALIF. L. REV. 109, 110-111. In such a case, the basis of the original stock must be apportioned between the dividend and original stocks. *Eisner v. Macomber*, 252 U. S. 189 (1920); and *Miles v. Safe Deposit Trust Co.*, 259 U. S. 247 (1922). Accordingly, the erroneous inclusion of gross income in the year the dividend was received was made in respect of a transaction upon which such basis (*i.e.*, the basis of the original stock) depends. There thus seems to be a relationship between the prior inclusion of income and the subsequent determination of basis, which is absent in the "zero" basis case considered in the text.

77. H. R. REP. NO. 855, 76th Cong., 1st Sess. (1939) 21. See also SEN. REP. NO. 648, 76th Cong., 1st Sess. (1939) 3-4.

78. REVENUE ACT OF 1939, § 214(a), (b), (c), (d).

79. REVENUE ACT OF 1939, § 214(e) and (f).

80. H. R. REP. NO. 855, 76th Cong., 1st Sess. (1939) 23.

decisions. It has the advantage of requiring little, if any, administrative readjustment. It prevents inequitable treatment to the taxpayer who has disposed of his stock on the basis of the former regulations. It minimizes the possible loss of revenues to the Treasury from the shift in position by taxpayers. And it provides a sound rule for the future. Section 214 will now be considered in detail.

Section 214 (a), (d) and (e)

Section 214(a) of the Revenue Act of 1939 amends the Internal Revenue Code by adding to Section 113(a) thereof, the provisions relating to the determination of the basis of property, a new paragraph (19).⁸¹ This states the set of rules operative in this instance prospectively. Subparagraph (A) of the new provision gives the general rule; subparagraphs (B), (C) and (D) give the exceptions to the general rule. The section refers to the stock acquired by a stockholder in a corporation in a distribution by such corporation as "new stock;" it refers to the stock in respect of which such distribution was made as "old stock." In a taxable year beginning after December 31, 1938, the following rules are thus applicable with respect to the determination of the old and the new stock's basis:

General Rule. If the new stock was acquired by a taxpayer after February 28, 1913, then the adjusted basis of the old stock shall be allocated between the new stock and the old stock under regulations to be prescribed by the Commissioner of Internal Revenue with the approval of the Secretary of the Treasury.⁸² This rule of allocation is to be applicable, with certain stated exceptions in subparagraphs (B), (C) and (D), to all cases where the new stock was acquired in a taxable year beginning before January 1, 1936, whether or not such new stock was constitutionally tax-free or constitutionally taxable; and to new stock acquired in a taxable year beginning after December 31, 1935, only if such distribution was constitutionally tax-free.⁸³

81. INT. REV. CODE § 113(a)(19)(A), (B), (C), (D).

82. T. D. 4938, INT. REV. BULL. No. 39, at 16 (1939), with respect to § 214 of the 1939 Act contains substantially the same provisions for the application of the allocation principle to the old and the new stocks as were promulgated prior to the *Koshland* decision. Cf. T. D. 4938, § 20B.3 with, *e.g.*, U. S. Treas. Reg. 86, Art. 113(a)(12)-1 (made applicable to stock dividends by Art. 22(a)-8).

83. T. D. 4938, § 20B.1, see note 82 *supra*. The general rule would, of course, have no application to new stock acquired in a taxable year beginning after Dec. 31, 1935, which was constitutionally taxable to the stockholder upon its receipt. Under § 115(f)(1) of the Revenue Acts of 1936 and 1938 and of the Internal Revenue Code, such stock dividends are taxable upon their receipt, the new stock's basis is its fair market value at the distribution date, and the old stock retains its basis without allocation by reason of the distribution.

It should be noted that the general rule in the new law provides for the allocation of basis for constitutionally tax-free stock dividends received either before or after January 1, 1936. While the principle of allocation is undoubtedly applicable to such stock dividends even in the absence of statute,⁸⁴ some question might arise as to the particular method of allocation to be used in a given case. The application of the principle of allocation to this instance was thus probably made the basis of an explicit statutory provision in order to give the Commissioner authority to prescribe the particular rules and regulations for allocating the basis of the old stock in this type of case.

The principle of allocation under the general rule would also seem applicable to those stock dividends received in the period from 1916 to 1921 which were taxable both under the Constitution and under the applicable Revenue Act. As indicated above,⁸⁵ a stock dividend of this type should have been returned as income at the time of receipt to the extent of its fair market value. However, in many instances this was not done because the decision in *Eisner v. Macomber* was regarded as preventing the taxation of *all* stock dividends under the Constitution. To prevent a double benefit to those stockholders—resulting from the omission of the fair market value of the new stock from gross income in the year of receipt and the use of the fair market value of the new stock as its basis on future disposition—the general rule now provides for an allocation of basis. The provision is academic to a great extent in this instance. There are probably few taxpayers who received stock dividends in the 1916–1921 period who still have either security at this late date. However, the comparable provision in Section 214(e) relating to prior taxable years will be of considerable importance in this connection.

By a nicety of draftsmanship, the general rule is also made applicable to new stock which was received in a distribution where the stockholder had an option to receive money or other property instead of such stock.⁸⁶ The principle of allocation is now applied to the determination of the basis of the new and the old stock if the “property was acquired by a shareholder in a corporation and consists of stock in such corporation, or rights to acquire such stock, . . .” It should be noted that the distribution is not characterized as a stock dividend. From the 1921 Act to the 1934 Act, when the statute exempted stock dividends,⁸⁷ the difficulty was in determining whether a particular corporate distribution

84. See *Eisner v. Macomber*, 252 U. S. 189 (1920); *Miles v. Safe Deposit Co.*, 259 U. S. 247 (1922).

85. See pp. 846–847 *supra*.

86. See H. R. REP. NO. 885, 76th Cong., 1st Sess. (1939) 23.

87. REVENUE ACT OF 1921, § 201(d); REVENUE ACTS OF 1924 and 1926, § 201(f); REVENUE ACTS OF 1928, 1932 and 1934, § 115(f).

constituted a stock dividend within the meaning of that section if the taxpayer had some form of an option to receive cash or other property in lieu of the stock.⁸⁸

Section 214(a) of the 1939 Act definitely avoids stating the proposition in terms of a legal concept as, for example, "stock dividends." It refers, instead, to the factual content of the distribution, *viz.*, "property was acquired" which "consists of stock in such corporation." Thus, irrespective of whether prior to such acquisition the stockholder could have elected to receive cash in lieu of the stock or whether he did receive cash which he *eo instante* used to "purchase" stock in the corporation, or whether any of the other deviations from the conventional corporate stock dividend were resorted to, if the stockholder "ended up" with stock in the corporation, he would seem to fall within the scope of the new Section 113(a)(19)(A) of the Internal Revenue Code.⁸⁹ And it will only be necessary to consider the situation in the light of the tax treatment previously accorded the transaction by the parties: if the distribution was not included in gross income as a dividend at the time of receipt, then the general rule applies; if it was included, then one of the exceptions to the general rule, stated in the other subparagraphs of Section 113(a)(19), is applicable.

While the principle of allocation is applicable not only to a dividend in stock but also to one in stock rights, the application of the principle may be different in the stock right case for there have been several changes in the prior administrative treatment of rights. The Treasury first took the position with respect to rights that the entire amount realized from the sale of rights subscribed to for stock was income, but no income was realized from the exercise of the right to subscribe.⁹⁰ Following the decision of the Supreme Court in *Miles v. Safe Deposit & Trust Company of Baltimore*,⁹¹ the regulations were amended to provide that if the rights related to stock of the same character and preference as the stock with respect to which the rights had been issued, then (a) if the stockholder exercised his right the basis was to be the cost of the old stock plus the subscription price divided by the total number of the old and the new shares covered by the right; (b) if the stockholder sold the rights, gain or loss on that sale would be determined by comparing the sum of the sale price of the right plus the subscription price with the basis which would have been applicable under (a) to the new stock if the stockholder had exercised his right. The gain in the latter instance,

88. See MAGILL, TAXABLE INCOME (1936) 41-45.

89. The regulations interpreting §214, however, apparently ignore the possibilities of the section in this regard and the administrative provisions revert to considering the section in terms of "an issue of stock dividends." See T. D. 4938, §20 B.1, note 82 *supra*.

90. U. S. Treas. Reg. 45 and 62, Art. 39.

91. 259 U. S. 247 (1922).

however, was not to exceed the proceeds from the sale of the right. And if this limitation was applicable, then the basis of the old stock was to be determined as if no right had been issued. If the rights related to stock of a different character or preference than the stock with respect to which they were issued, then the principle of allocation regarded as applicable to the determination of the basis of stock dividends was to apply.⁹²

Under the regulations applicable to the Revenue Act of 1926, this position was further modified by the Treasury. It was provided that if the rights were to subscribe to stock of substantially the same character or preference as the stock with respect to which the rights were issued, then (a) if the stockholder sold his rights, the basis of the old stock was to be apportioned between the rights and the stock in proportion to their respective fair market values at the time the rights were issued; (b) if the stockholder exercised his rights, the basis for determining gain or loss on the old stock was the same as under (a), and the basis of the stock acquired by exercising the rights was that part of the cost of the old stock assigned to the rights plus the subscription price. If the rights were to subscribe to stock materially different in character or preference from the stock with respect to which the rights were issued, the basis for the old stock and the rights were to be determined in accordance with the principle then regarded as applicable to determining the basis of stock dividends.⁹³ The Department then ruled that the significant date in connection with stock rights was January 1, 1925:⁹⁴ stock rights acquired prior to that date were to be treated in accordance with the provisions of Regulations 45. 62 (amended) and 65; stock rights acquired after that date were to be treated in accordance with the provisions of the later regulations which were not to be applied retroactively.⁹⁵ Moreover, from 1928 on, taxpayers could, at their option, either treat the entire proceeds on the sale of the rights as gain or else use an allocated basis.⁹⁶

The 1939 Act made no particular distinction with respect to the application of the general rule in the case of rights acquired either prior or subsequent to January 1, 1925. However, the Act did provide that the "allocation [was] to be made under regulations which shall be prescribed

92. U. S. Treas. Reg. 45, Art. 39, as amended by T. D. 3402, I-1 CUM. BULL. 63 (1922); U. S. Treas. Reg. 62, Art. 39, as amended by T. D. 3403, I-1 CUM. BULL. 64 (1922); U. S. Treas. Reg. 65, Art. 39.

93. U. S. Treas. Reg. 69, Art. 39; U. S. Treas. Reg. 74 and 77, Art. 58; U. S. Treas. Reg. 86, 94 and 101, Art. 22(a)-8.

94. The date with respect to which the Revenue Act of 1926 was to take effect. REVENUE ACT OF 1926, § 286.

95. T. D. 4018, VI-1 CUM. BULL. 36 (1927), as amended by T. D. 4185, VII-1 CUM. BULL. 59 (1928).

96. See discussion p. 863 *infra*.

by the Commissioner with the approval of the Secretary."⁹⁷ In the regulations issued thereunder, the distinction has been maintained with respect to the method of determining basis for rights acquired prior and subsequent to January 1, 1925.⁹⁸ In view of the explicit Congressional intent to validate the prior Treasury regulations of long standing with respect to the stock dividend basis question,⁹⁹ the retention of this distinction in treatment of stock rights depending on the date of acquisition would seem to be a valid exercise of the Commissioner's authority to promulgate regulations under the new law.

First Exception to General Rule. Subparagraph (B), which states the first exception to the general rule, relates solely to the treatment of stock rights. It provides that where stock rights were sold in a taxable year beginning prior to January 1, 1939, and the entire proceeds of such sale were entered in gross income for that year the basis of the old stock shall be determined without reference to the allocation rule provided for in subparagraph (A).

Because of practical difficulties in allocating the old stock's basis in the case of some stock rights, the Treasury has from 1928 on granted taxpayers an option with respect to determining gain or loss on the sale of stock rights: the taxpayer could either include the entire proceeds from the sale of such rights in gross income for the year of sale, in which event the basis of the old stock would be the same as though the rights had not been issued; or the taxpayer could allocate to the stock rights a part of the old stock's basis.¹⁰⁰ This option was not available with respect to stock rights sold prior to 1928.¹⁰¹ The Commissioner had also ruled that once the option was exercised the taxpayer was bound thereafter.¹⁰²

The validity of the option and its binding effect on a taxpayer who had exercised it was unquestioned until recently. In *Continental Bank and Trust Company of New York v. United States*,¹⁰³ the court refused

97. INT. REV. CODE § 113(a)(19)(A), as amended by REVENUE ACT OF 1939, § 214(a); REVENUE ACT OF 1939, § 214(e)(1).

98. T. D. 4938, § 20B.4(a), note 82 *supra*, relates to rights acquired after Dec. 31, 1924, and § 20B.4(b) relates to rights acquired prior to Jan. 1, 1925—both restating in substantially the same form the prior regulations applicable to these situations.

99. See H. R. REP. No. 855, 76th Cong., 1st Sess. (1939) 5.

100. U. S. Treas. Reg. 74 and 77, Art. 580; U. S. Treas. Reg. 86, 94 and 101, Art. 22(a)-8. The provisions of regulations 94 and 101 relate only to stock rights which are not constitutionally taxable as income since the Revenue Acts of 1936 and 1938 and the Internal Revenue Code provide that stock rights are taxable *on receipt* to the extent permitted by the Sixteenth Amendment. REVENUE ACTS OF 1936 and 1938, and INT. REV. CODE § 115(f)(1).

101. G. C. M. 7021, VIII-2 CUM. BULL. 77 (1929).

102. G. C. M. 10170, XI-1 CUM. BULL. 15 (1932).

103. 19 F. Supp. 15 (S. D. N. Y. 1937).

to recognize as valid the option provided for in the regulations and to hold the taxpayer to his election. In that case, a taxpayer had elected to include the entire proceeds from the sale of stock rights in gross income for the year of the sale. When the old stock was sold in a later year, the taxpayer determined gain or loss by using as the basis the cost of the old stock reduced by the amount apportioned to the stock rights, and filed a claim for refund for the year in which the stock rights had been sold.

The court sustained the taxpayer's claim for refund. It held that under the *Miles* case a stock right of itself does not constitute income but that only so much of the proceeds of the right upon its sale as represented a realized profit over the cost of the right to the stockholder constituted taxable income. The court went on to point out that Sections 111(a) and 113(a) of the 1928 Act provided that the gain from the sale of the property shall be the excess of the amount realized over the cost of the property. Accordingly, it concluded that the portion of Article 58 of Regulations 74 which granted an option to include the entire proceeds from the sale in gross income was invalid since it exceeded and was inconsistent with the law, citing, among others, the *Koshland* case.¹⁰⁴

It should be noted that the court found no specific basis provision applicable to stock rights other than the general provisions of Sections 111(a) and 113(a) referring to the "cost" of property as the basis thereof, and thus concluded that the cost of stock rights was not zero but must be determined by the allocation principle. Yet in the *Gowran* and *Koshland* cases, the Supreme Court in dealing with stock dividends concluded that such basis provisions, namely, Sections 111(a) and 113(a), militated against the use of the allocation principle but required instead the use of a zero basis as "cost." If the decision of the district court was correct in analogizing stock rights to stock dividends, as indicated in the *Miles* case,¹⁰⁵ and if the rights were to acquire stock of a different character or preference than the stock with respect to which such rights were issued,¹⁰⁶ then the conclusion of the court as to the use of an allocated basis rather than a zero basis would seem to be diametrically opposed to that reached in the *Koshland* and *Gowran* cases.

104. A similar conclusion was reached by the Board in *Walter E. Buck*, 40 B.T.A. 536 (1939), where the rights were issued to the common stockholders to subscribe to additional common stock.

105. See *Ramapo Inc. v. Comm'r*, 84 F. (2d) 986 (C. C. A. 2d, 1936). But *cf. Palmer v. Comm'r*, 302 U. S. 63, 71 (1937), where Mr. Justice Stone stated that "the mere issue of rights to subscribe and their receipt by stockholders is not a dividend." If stock rights do not under any circumstances constitute taxable income as indicated by the Court's decision in the *Palmer* case, the analogy between stock rights and stock dividends is no longer tenable.

106. It does not appear from the reported decision just what type of stock could be acquired.

Under the 1939 Act, the principle of allocating the old stock's basis between the old stock and the stock rights is the only proper rule applicable to stock rights sold in a taxable year beginning after December 31, 1938. In view of the availability of stock rights tables,¹⁰⁷ the practical difficulties of allocation no longer appear formidable, and the option to use a zero basis for the stock rights will no longer be available in the case of rights sold after that date.¹⁰⁸ However, it is only fair that taxpayers who, in the past have elected to use the option of a zero basis for the rights, should not be compelled to reduce the basis of their old stock because of the acquisition of such rights. Accordingly, the exception in subparagraph (B) to the general rule would permit the use of the zero basis for the stock rights sold in a taxable year beginning prior to January 1, 1939 where the taxpayer had so elected.¹⁰⁹ In that event, the taxpayer will not be required to reduce the old stock's basis by any amount attributable to the stock rights, and no part of the proceeds from the sale of such rights shall ever be excluded from gross income for the year of the sale.¹¹⁰ However, this exception to the general rule is inapplicable if the taxpayer before June 29, 1939,¹¹¹ asserted, either by a claim for refund or a credit or otherwise, that part of the proceeds on the sale of the stock rights should be excluded from gross income for the year of sale of such rights. In the latter event, the general rule providing for an allocation of basis of the old stock will be applicable.¹¹²

Second Exception to General Rule. Subparagraph (C) provides that the general rule shall not apply to new stock acquired in a taxable year beginning before January 1, 1936 if the taxpayer included as a dividend in gross income for such year an amount on account of such stock and such amount was not before June 29, 1939 excluded from the taxpayer's gross income for such year. It will be recalled that, prior to the decision of the Supreme Court in *Eisner v. Macomber*, the Revenue Acts of 1916 and 1918 purported to tax *all* stock dividends. Many taxpayers in strict

107. See stock right tables published in Sinclair, Murray & Co., Cap. Changes Serv.; and Prentice-Hall, Cap. Adjustments Serv.

108. H. R. REP. No. 855, 76th Cong., 1st Sess. (1939) 22. See also T. D. 4938, § 20 B.4(a) (1), note 82 *supra*.

109. U. S. Treas. Reg. 45 and 62, Art. 39 as originally promulgated *required* the entire proceeds on the sale of rights to be included in income. Taxpayers who complied with those provisions would also fall within the scope of this exception to the general rule.

110. This provides a statutory basis for the optional treatment for past years and will prevent a shift in position by a taxpayer who had elected to use a zero basis on the sale of the rights—such as that resorted to by the taxpayers in *Continental Bank & Trust Co. v. United States*, 19 F. Supp. 15 (S. D. N. Y. 1937), and in *Walter E. Buck*, 40 B.T.A. 536 (1939).

111. The date of enactment of the Revenue Act of 1939.

112. The regulations do no more than paraphrase the statute on this point. T. D. 4938, § 20 B.7(a).

pursuance of the governing statute and the regulations promulgated thereunder included the fair market value of the dividend stock in gross income for the year of receipt and paid the tax thereon.¹¹³ If the explicit conditions of subparagraph (C) are met by such a taxpayer, this exception to the general rule will be applicable to his case. There is still another instance which might fall within the scope of this second exception to the general rule. The taxpayer and the Treasury had gone along on the assumption that the provisions of the Revenue Acts in effect from 1921 to 1936 exempted *all* stock dividends from tax. In 1933 the Board of Tax Appeals held that the statutory provision exempting stock dividends was only as broad as the constitutional limitation upon the taxation of such dividends and that a dividend of common stock to a preferred stockholder was taxable both under the Constitution and the statute.¹¹⁴ It was not until the decision of the Supreme Court in the *Gowran* case that the question was definitely settled and the statute in effect from 1921 to 1936 was held to exempt *all* stock dividends. However, there was a period from the *Tillotson* decision until the *Gowran* decision when the Bureau adopted a policy of treating constitutionally taxable stock dividends as income at the time of the receipt.¹¹⁵ Some taxpayers may have accepted the Bureau's position in this connection and returned as gross income in the year of receipt constitutionally taxable dividends received during the period from 1921 to 1936.

If a taxpayer in either of the instances considered above¹¹⁶ still has the new stock or the old stock and subsequently disposes of it, the basis

113. See, e.g., *Bigelow v. Bowers*, 5 F. Supp. 346 (S. D. N. Y. 1933), 68 F. (2d) 839 (C. C. A. 2d, 1934), *cert. denied*, 292 U. S. 656 (1934). In that instance, the taxpayer received a stock dividend in 1916 which he included in income for that year. He sold both the old and the new stock in 1918 for an amount less than the sum of the old stock's cost plus the par value of the new stock and claimed a loss in the amount of the difference. Following the decision in *Eisner v. Macomber*, the Commissioner, in 1923, reaudited the taxpayer's 1918 return, allocated the old stock's cost basis between the old and the new stocks and determined a gain rather than a loss on the sale in 1918. The statutory period for filing a claim for refund for 1916, the year in which the taxpayer had included the new stock in gross income, had expired in the meantime. The Commissioner's allocation of basis in 1918 was sustained as proper by the Court and no relief was afforded the taxpayer with respect to the barred year, 1916. The result in this case has been characterized as highly unfair. See Maguire and Zimet, *Hobson's Choice and Similar Practices in Federal Taxation* (1935) 48 HARV. L. REV. 1281, 1283; Kent, *Mitigation of Statute of Limitations in Federal Tax Cases* (1939) 27 CALIF. L. REV. 109, n. 111. While these provisions of § 214 make the general rule inapplicable in the *Bigelow* case—and thus render the Commissioner's action with respect to the year 1918 erroneous—the section does not include any remedial provisions to permit a refund for the barred year in which the old and new stocks were sold.

114. Cf. *Tillotson Mfg. Co.*, 27 B.T.A. 913 (1933), *aff'd*, 76 F. (2d) 189 (1935).

115. See the arguments made by the Commissioner in *H. C. Gowran et al.*, 32 B.T.A. 820 (1935) and Annie M. Pfeiffer, Memo Op., B.T.A., dated June 27, 1936.

116. The regulations give as examples a taxpayer who included the new stock in gross income either pursuant to § 201(c) of the 1918 Act, or as a result of the decision in the *Koshland* case. See T. D. 4938, § 20B.7(b), see note 82 *supra*.

of that stock will not be determined by the principle of allocation specified in subparagraph (A). Instead if the old stock is now sold, its basis will be cost unadjusted by any amount applicable to the new stock; if the new stock is sold, its basis will be its fair market value at the time of distribution.¹¹⁷

The application of subparagraph (C) might be noted in another case. Suppose a taxpayer received a stock dividend in the period from 1916 to 1921 and pursuant to the clear mandate of the statute returned the fair market value of the stock as gross income in the year of the receipt. Then the taxpayer sold the old stock and computed gain or loss on its original basis unreduced by any amount attributable to the new stock. The Bureau in reliance on *Eisner v. Macomber* later determined that for purposes of determining gain or loss on the sale of the old stock the original basis must be allocated to both the old and the new stocks even though the new stock had previously been reported as income. The taxpayer still retains at this date the new stock.¹¹⁸

Subparagraph (C) does not achieve complete equity in this situation, for it does not reopen the year in which the stock dividend was included in income and permit a refund of the tax on the amount so included. However, it does effect a partial restitution in such a case by permitting the use of the fair market value of the new stock at the time of its receipt as the basis on subsequent disposition. Thus if the dividend stock in this instance had been of a type which was constitutionally tax-free, then the taxpayer will be "made whole" at least to the extent that the fair market value of the new stock (now used as a basis) exceeds the part of the old stock's basis which would have been allocated to the new stock in strict compliance with *Eisner v. Macomber*.

If in the instance given above, the dividend stock had been received in the period from 1921 to 1936, and had been of a type which was constitutionally taxable then, the taxpayer will be restored to the extent that the fair market value of the new stock at the time of receipt (its basis under the amendment) exceeds the zero basis required by the *Gowran* decision for such stock and minus the amount of the old stock's basis which had erroneously been deducted from the old stock prior to the *Koshland* decision in determining gain or loss on the sale of that stock.¹¹⁹

117. See H. R. REP. NO. 885, 76th Cong., 1st Sess. (1939) 22. The regulations, however, provide that the basis of the new stock "shall be the amount equal to that at which such stock dividend or stock right was included in gross income for the year of its acquisition." T. D. 4938, § 20B.7(b), see note 82 *supra*. There may be a material difference between the latter figure and fair market value. The statute is silent in this respect.

118. This case is similar to *Bigelow v. Bowers*, 5 F. Supp. 346 (S. D. N. Y. 1933), except for the fact that the stockholder in this instance still retains the new stock. In *Bigelow v. Bowers*, both stocks had been disposed of in the same year.

119. This case may be illustrated more specifically. Suppose the cost of the old stock was \$100. A constitutionally taxable stock dividend was issued in 1928 having at that

Subparagraph (C) has also taken out of the general rule still another type of case. As indicated above, there has been considerable difficulty in distinguishing between a true stock dividend and a dividend in which the stockholder has a real option to take cash or stock. It has also been pointed out that Section 113(a)(19) seemed sufficiently broad to include a corporate distribution which consists of stock whether or not under the applicable decisions such a distribution would be regarded as a true stock dividend or an optional dividend.¹²⁰ In such a case subparagraph (A) provides for an allocation of basis under the general rule. However, if the stockholder included an amount on account of such stock in gross income for the year of receipt and such amount was not thereafter excluded from gross income for such year, subparagraph (C) permits the use of the amount so included in gross income as the basis of the new stock.¹²¹

It should be noted that subparagraph (C) does not apply where the new stock was received in a taxable year beginning after December 31, 1935. The statute therefore may not afford the necessary coverage in cases of this character. For instance, under the Revenue Acts in effect from 1936, all stock dividends are taxable to the extent permitted by the Sixteenth Amendment.¹²² Just what types of stock dividends are thus taxable income is not clearly settled.¹²³ It has also been specifically provided in the statute since 1936 that if a stockholder has an election to receive a distribution either in constitutionally tax-free stock or in

time a fair market value of \$50.00. The ratio of the fair market values of the old and the new stocks at that time is, respectively, 2 to 1. Thus on the principal of allocation the old stock has a basis of \$66+ and the new stock of \$33+. The old stock was sold in 1930 and gain or loss computed thereon, using an allocated basis. The taxable year 1928 remained open because of other items; and in 1933, following the *Tillotson* decision, the Bureau included in the taxpayer's gross income for 1928 the fair market value of the new stock. The statutory period for filing a claim for refund for that year expired prior to the decision of the Supreme Court in the *Gowran* case. The taxpayer now sells the new stock in 1939 after the enactment of the Revenue Act of 1939. His basis for the new stock under subparagraph (C) is \$50.00—its fair market value at the time of the receipt in lieu of zero which would have been the proper basis under the *Gowran* decision in the absence of a statutory provision. However, the taxpayer has used a \$66+ basis instead of the \$100 basis on the sale of the old stock. So his benefit under subparagraph (C) is \$50.00 (the difference between the \$50.00 basis and the zero basis) minus \$33+ (the amount erroneously deducted in the light of the *Koshland* case from the basis of the old stock)—or a net restitution to that taxpayer of \$17+.

120. See the discussion *supra* p. 860 *et seq.* under the general rule.

121. The regulations are silent with respect to this type of case under subparagraph (C), as well as under the general rule.

122. REVENUE ACTS OF 1936 AND 1938, and INT. REV. CODE § 115(f)(1) (1939).

123. The *Kelly Trust* case involved one of those borderline cases. There, only common stock was outstanding. A new class of preferred was distributed to the common stockholders. The stockholders thus held both stocks in exactly the same proportion. They contended this was not a constitutionally taxable dividend. The Board and the circuit court held that it was.

cash, property or constitutionally taxable stock, then the distribution will constitute a taxable dividend regardless of the medium in which paid.¹²⁴ This provision does not resolve the difficulty of determining whether a true option exists in a given case. Many of the factors presented in the old litigated cases might still cast considerable doubt on whether the taxpayer has an election within the meaning of this section.

Suppose, then, that after January 1, 1936 a taxpayer receives a distribution which consists of stock of doubtful taxability under the Constitution. Or, suppose that he receives, pursuant to some form of election, stock which is clearly constitutionally tax-free. He regards the distribution in the first instance as taxable within the meaning of Section 115(f)(1); or in the second instance as taxable under Section 115(f)(2). Accordingly, he includes the fair market value of the distribution in income for that year. Later the Bureau, either on its own initiative or pursuant to a court decision successfully maintained by another stockholder, determines that the stock dividend in the first case was not constitutionally taxable, or that the distribution in the second case was not received pursuant to a bona fide election; that either distribution should have been excluded from gross income in the year of receipt; and that the basis of the old and the new stocks should be determined by the allocation principle in accordance with the general rule in Section 113(a)(19)(A) of the Internal Revenue Code.¹²⁵ In the case of this particular taxpayer, however, the year in which the dividend was included in gross income is now barred. While subparagraph (A) is sufficiently all inclusive to provide for the application of the general rule in the case of a distribution of this character made after December 31, 1935, subparagraph (C) is not coterminous with subparagraph (A) in this respect and does not provide the necessary exception to the general rule where the taxpayer erroneously included in gross income the amount of the distribution received in a taxable year beginning after December 31, 1935.¹²⁶

Third Exception to General Rule. Subparagraph (D) makes the rule of allocation inapplicable where either the old or the new stock was sold or otherwise disposed of in a taxable year beginning before January 1, 1936, and the basis was definitively ascertained by a method other than that of allocation. The determination recognized by the statute as binding in this respect must have been made by either (1) a decision of a court

124. REVENUE ACTS OF 1936 and 1938, and INT. REV. CODE § 115(f)(2) (1939).

125. If the new stock were received in a taxable year beginning before January 1, 1939, the basis provisions would be determined by the general rule in accordance with subparagraph (1) of § 214(e) of the Revenue Act of 1939 which is similar to § 113(a)(19)(A).

126. It may be that adequate safeguards are assured the stockholder in this situation by the provisions of § 820. See note 76 *supra*.

or (2) a decision of the Board of Tax Appeals or (3) a closing agreement — and must have become final before September 26, 1939.¹²⁷

The exception in subparagraph (D) is thus applicable to taxpayers who had disposed of their old stock and by one of the specified forms of final determination were permitted, pursuant to the *Koshland* decision, to use the original basis of the old stock unadjusted for any amount attributable to the new stock. It is applicable as well to taxpayers who had disposed of their new stock and by one of the specified forms of final determination were required, pursuant to the *Gowran* decision, to use a zero basis for the new stock. And it may also be applicable to some cases where the Bureau has applied Section 113(b)(1)(D) and the taxpayer has entered into a closing agreement consenting to such action.¹²⁸ (Section 113(b)(1)(D) was not applied in litigation).

The provisions of subparagraph (D) were designed to insure that, in the few court or closing-agreement cases in which the basis of the old or new stock was determined by a method other than the allocation principle, the taxpayer involved would be enabled to recover his full cost — but no more — upon a subsequent sale or other disposition of the remaining class of stock.¹²⁹ To this end the Treasury now requires by regulation that in cases where the subparagraph is applicable, the basis for determining gain or loss for the remaining shares shall be fixed in a manner consistent with the prior determination.¹³⁰

No specific authorization to prescribe by regulation the method of determining the basis for such remaining shares appears in the statute. The regulation in this respect is thus merely interpretative, without the force and effect of law.¹³¹ Accordingly, there is a theoretical legal possibility that the soundness of the interpretation may be questioned. From a practical viewpoint, however, this possibility has little significance.

127. The ninetieth day after the date of enactment of the Revenue Act of 1939. This limitation will thus make the general rule applicable to the case of *Frank J. and Hubert Kelly Trust v. Comm'r*, 38 B. T. A. 1014 (1938), *aff'd*, C. C. A. 8th, July 19, 1939, and to the case of *Albert E. Smith*, 40 B.T.A. 80 (1939), which followed the *Kelly Trust* case. The opinions in these cases have been withdrawn.

128. For example, assume that a taxpayer received a stock dividend in 1932. In 1935 he sold the old stock. By a closing agreement between the taxpayer and the Treasury department it was determined that the fair market value of the new stock at the date of distribution should be applied against and reduce the original cost of the old stock in accordance with the provisions of § 113(b)(1)(D) of the Revenue Act of 1934 and that gain or loss on the old stock should be computed accordingly. If the new stock was disposed of in 1939, the general rule in subparagraph (A) of § 113(a)(19) would not be applicable since, by subparagraph (D), the basis for determining gain or loss on the sale of the old stock was ascertained by a method other than that of allocation.

129. H. R. REP. No. 855, 76th Cong., 1st Sess. (1939) 22.

130. T. D. 4938, § 20 B.7(c), see note 82 *supra*.

131. See Alvord, *Treasury Regulations and the Wilshire Oil Case* (1940) 40 COL. L. REV. 252.

If the regulation is not controlling as to basis, such cases as are excepted from the new statutory scheme by reason of subparagraph (D) will continue to be governed by prior law. Thus taxpayers whose basis as to one class of stock has been finally determined by litigation or closing agreement pursuant to the *Koshland* or *Gowran* rules will now have, by reason of those decisions, the full basis if the original shares remain and a zero basis if the dividend shares remain — precisely the result reached if the regulation is applied. Moreover, in the third type of case, that of the closing agreement applying Section 113(b)(1)(D), such agreements as a matter of administrative practice would invariably have fixed the basis for *both* the original and dividend shares by a method which would allow recovery of the full cost or other basis and no more.

It should be noted that subparagraph (D) applies only where a basis other than allocation was used on a prior sale of stock and that basis was determined by one of the three specified forms of final determination. However, the subparagraph is not, by its terms, applicable to a case where, on the prior disposition of stock, a basis other than allocation was used and such basis became final — not pursuant to one of the specified forms of determination — but by reason of the operation of the statute of limitations. For example, if on the prior disposition of old stock the full original basis for determining gain or loss thereon was used and the year in which such stock was sold became barred, the taxpayer would still be entitled to an allocated basis under subparagraph (A) with respect to the new stock. Conversely, if on the prior disposition of the new stock, a zero basis was used and the year of that sale became barred, the Treasury could assert the use of an allocated basis for the old stock under subparagraph (A). Or, if the application of Section 113(b)(1)(D) in determining the basis of the old stock was not made in a closing agreement and the year in which the old stock was sold became barred, the taxpayer would be subject to the provisions of subparagraph (A) with respect to the basis of the new stock. None of the exceptions to the general rule would seem to afford the necessary relief in this instance.¹³² It is possible, however, that this omission may not have been inadvertent. Such cases were extremely infrequent in view of the general acceptance of the validity of the regulation prior to the *Koshland* case and the recency of that decision.

132. Under subparagraph (A) the method of allocation is to be made "under regulations which shall be prescribed by the Commissioner with the approval of the Secretary." It may be arguable that the Commissioner can, under this subparagraph, control the extent to which the method of allocation shall be applied so as to reach an equitable result in the above cases which fall outside the scope of subparagraph (D). However, the possibility of such a power in the Commissioner was not asserted in the regulations issued under the section. T. D. 4938, § 20B.3, see note 82 *supra*. As to whether some relief in these cases might be available under § 820, see discussion *supra* 857-858.

An interesting case under subparagraph (D) arises where only *part*, and not all, of the new stock or the old stock was disposed of prior to January 1, 1936, and the basis was determined as specified in subparagraph (D) by a method other than that of allocation. Is subparagraph (D) applicable to that case; and to what extent? It might be contended that the statutory reference to "the new stock or the old stock" relates to the entire number of shares distributed as a dividend and to the total number of shares with respect to which such stock was distributed. Therefore, unless the *total* number of shares of either class was disposed of as described in subparagraph (D), it might be argued that these provisions were inapplicable and that the general rule was controlling. Such a result, however, is unnecessarily literal. The more reasonable interpretation is that "the new stock or the old stock" referred to in subparagraph (D) relates to *any part* of either stock disposed of in the described manner. Accordingly, if one-half of the dividend stock was so disposed of and a method other than allocation was used in determining the applicable basis, subparagraph (D) would seem to require a consistent treatment of basis for so much of the original stock as is attributable to that part of the stock dividend. The general rule would be applicable to the remainder of the old stock and the new stock. The same would be true in the converse situation where part of the original stock had been disposed of — that part of the dividend stock attributable to those original shares would be subject to subparagraph (D), the remainder to the general rule.

As indicated above, Section 214(a) sets forth the foregoing rules as an amendment to the Internal Revenue Code, namely, Section 113(a)(19). However, by Section 214(d), that amendment is only applicable to taxable years beginning after December 31, 1938. Section 214(e) of the Revenue Act of 1939 restates the above rules for purposes of the Revenue Act of 1938 and the prior Revenue Acts.¹³³ Subparagraph (1) of Section 214(e) is comparable to subparagraph (A) of Section 113(a)(19) relating to the general rule; and subparagraphs (2), (3), and (4) of Section 214(e) state the same exceptions to the general rule as appear in subparagraphs (B), (C), and (D) of Section 113(a)(19).

The retroactive provisions of Section 214(e) were designed to complement the prospective relief provided for in Section 214(a). Otherwise, complete equitable treatment to taxpayers and the Treasury would not have been assured in some cases.¹³⁴ However, the retroactive appli-

133. REVENUE ACT OF 1939, § 214(e).

134. Assume, for example, that a taxpayer received a stock dividend in 1932. In 1933, he sold the old stock and, under the regulations then regarded as applicable, gain or loss was computed by assigning to such old stock a part of the original basis determined under the allocation principle. In 1938 that taxpayer sold the new stock and, under

cation of the provisions under Section 214(e) raises a constitutional issue: does the fact that the section amends every Revenue Act since the adoption of the Sixteenth Amendment — thus reaching back 26 years — transgress the due process requirement of the Constitution? The test is whether in view of the nature of the tax and the circumstances in which it is laid the retroactive application is so harsh and oppressive as to violate the constitutional limitation.¹³⁵ In this connection, it is material whether the taxpayer could reasonably have anticipated the particular tax at the time he effected the transaction which later became the subject of the tax.¹³⁶

The application of Section 214(e) in the various situations might thus be considered. Where the taxpayers sold the original stock prior to the *Koshland* and *Gowran* decisions, using an allocated basis, Section 214(e) obviates the use of the "zero" basis for the dividend stock as required by the *Gowran* case. The section could hardly be regarded as harsh or oppressive in that instance. Where the taxpayer sold the dividend stock prior to the *Koshland* and *Gowran* decisions, using an allocated basis, the section forecloses using the entire original basis for the old stock as permitted by the *Koshland* case. But the provisions would not seem burdensome in this instance. The taxpayer is not being deprived of the recovery of any part of his basis. No element of surprise exists in that case since the statute merely validates the regulations on which he had previously relied in computing gain or loss on the dividend stock. Moreover, the section might be sustained in that case as an effort on the part of the legislature to cure a defect arising from the mistake of officers purporting to administer the law.¹³⁷

In the case of a taxpayer who disposed of the dividend and original stocks after the *Koshland* and *Gowran* decisions but before the 1939

the applicable decisions, was required to use a zero basis in computing gain or loss. Clearly such a taxpayer would not have recovered his entire cost tax-free. Conversely, in some cases the Treasury might be treated unfairly. Assume that in the case stated above the taxpayer had sold the new stock first and determined gain or loss thereon by assigning to such new stock a part of the old stock's basis determined under the allocation principle. In 1938, he sold the old stock and under the *Koshland* decision was permitted to use the entire original cost in computing gain or loss thereon without any adjustment for the part of that basis previously used in computing gain or loss on the sale of the new stock. Here the Treasury would not recover a tax on the full amount of the gain realized by the taxpayer.

135. *Nichols v. Coolidge*, 274 U. S. 531 (1927); *Coolidge v. Long*, 282 U. S. 582 (1931); *Blodgett v. Holden*, 275 U. S. 142 (1927); *Untermeyer v. Anderson*, 276 U. S. 440 (1928); cf. *Helvering v. Helmholtz*, 296 U. S. 93 (1935); *White v. Poor*, 296 U. S. 98 (1935).

136. *Milliken et al. v. United States*, 283 U. S. 15 (1931).

137. *United States v. Heinszen*, 206 U. S. 370 (1907); *Rafferty v. Smith*, *Bell & Co., Ltd.*, 257 U. S. 226 (1921); *Charlotte Harbor & Northern Ry. v. Wells*, 269 U. S. 8 (1922); *Graham v. Goodcell*, 282 U. S. 409 (1931); cf. *Hecht v. Malley*, 265 U. S. 144, 164 (1924).

Act, the situation is more difficult. The taxpayer may have relied on those decisions in determining his course of conduct. Now the 1939 Act prescribes an entirely different method of computing his gain or loss, which in view of the finality of the Supreme Court's decisions, he could not have reasonably anticipated. The harshness of the measure may result either from the taxation of gain at a higher rate or from the inability to offset an increased loss by any capital gain. The change was not justified because of any defect in the statute. Such a taxpayer would only recover his original cost—and no more. The Treasury would also get the tax on the full share of the gain. Nor is the statute merely curative of an administrative defect.¹³⁸ The prior regulations were not in force after the *Koshland* case and the Treasury did not attempt to enforce them during this period.

While these factors are material, it is doubtful whether the Supreme Court would find the statute invalid on the ground of retroactivity in the case above. No income tax act has ever been struck down on this ground.¹³⁹ For practical purposes the argument of retroactivity "is as dead as wager of law."¹⁴⁰ However, while the constitutional argument may not be availing, there would seem to be no basis, as a matter of legislative policy, for upsetting this case. The Treasury was adequately protected and the taxpayer acted in reliance on the decisions. This might well be the subject of a further exception to the general rule prescribed in Section 214(e)(1). With this possible exception, Section 214(a) and (e) afford a complete and equitable solution to the basis problem in the stock dividend cases.

Section 214(b)

In addition to the provisions of Section 214(a) and (e) which contain the statutory scheme as to the basis of the old and the new stocks, other provisions were necessary to assure that those sections were mutually exclusive from existing sections of the law.¹⁴¹ Section 214(b) of the

138. See generally, Paul, *Use and Abuse of Tax Regulations in Statutory Construction* (1940) 49 YALE L. J. 660.

139. See Ballard, *Retroactive Federal Taxation* (1935) 48 HARV. L. REV. 592, 597. See also the exhaustive collection of authorities in the dissenting opinion of Mr. Justice Brandeis in *Untermeyer v. Anderson*, 276 U. S. 440, 447-451 (1928). The Supreme Court has recently sustained a 1935 Wisconsin statute taxing dividends received in 1933 which under the prior law applicable to 1933 had been exempt. *Welch v. Henry*, 305 U. S. 134 (1938).

140. See Ballard, *Retroactive Federal Taxation* (1935) 48 HARV. L. REV. 592.

141. It should be noted that no amendment is made in § 214 of the Revenue Act of 1939 to § 113(b)(1)(D) of the Revenue Act of 1932 and of subsequent Revenue Acts, including the Internal Revenue Code. This would hardly seem necessary in view of the fact that if part of the basis of the old stock is allocated to the new stock no further adjustment of the old stock's basis on account of the tax-free distribution of the new stock would be proper. H. R. REP. No. 855, 76th Cong., 1st Sess. (1939) 23.

Revenue Act of 1939 amends Section 115(d) of the Internal Revenue Code so as to provide that the basis of the old stock shall not be reduced under that section by the amount of a distribution which is exempt from tax under Section 115(f)(1), relating to constitutionally tax-free stock dividends.

Section 115(d) formerly provided that if a distribution was not out of earnings and profits, it was applied against and reduced the basis of the stock; any excess of such distribution over basis was taxable as gain from the sale of property.

Since the 1936 Act, it has been provided that a stock dividend which was not constitutionally taxable shall not be regarded as a distribution out of earnings or profits.¹⁴² Thus if cumulative effect is given to Section 115(d) and (h) of the Internal Revenue Code, it might be argued (1) that a constitutionally tax-free stock dividend was not a distribution out of earnings or profits either accumulated since February 28, 1913 or of the current taxable year; (2) that, therefore, it was not a dividend within the meaning of Section 115(a); and (3) that it constituted a distribution within the scope of Section 115(d) which necessitated the reduction of the basis of the old stock by the amount of the stock dividend.¹⁴³

There would thus be in the Act conflicting provisions relating to the basis of constitutionally tax-free stock dividends: (1) the provisions of Section 113(a)(19) requiring the application of the allocation principle; and (2) the provisions of Section 115(d) which seemingly require the basis of the old stock to be reduced by the amount of the new stock. It was to clarify this situation that Section 214(b) of the 1939 Act amended Section 115(d) of the Internal Revenue Code by providing that the latter section shall not be applicable to a distribution which under Section 115(f)(1) is not treated as a dividend.¹⁴⁴

However, it should be noted that by Section 214(d) this amendment is applicable only to taxable years beginning after December 31, 1938 and does not make any amendment to Section 115(d) of the 1938 Act and the corresponding provisions of prior Revenue Acts. This might be of importance.

For instance, Section 115(d) of the Revenue Act of 1934 and the corresponding provisions of prior Acts required a reduction of basis

142. REVENUE ACTS OF 1936 and 1938, and INT. REV. CODE § 115(h).

143. It is probable that under *Eisner v. Macomber* the excess of the fair market value of the new stock over the basis of the old stock could not be taxed as "a gain from the sale or exchange of property" at the time of distribution as provided under Section 115(d). But the validity of that section would probably be sustained to the extent that the fair market value of the new stock did not exceed the basis of the old stock. INT. REV. CODE § 3802.

144. H. R. REP. No. 855, 76th Cong., 1st Sess. (1939) 23.

by the amount of a distribution which was not out of earnings or profits. Section 115(a) defined a "dividend" as a distribution out of earnings or profits accumulated after February 28, 1913. Section 115(f) merely provided that stock dividends were not taxable. However, Section 115-(h)(2) of the Revenue Act of 1936 provided that a distribution of stock whether *before, on, or after January 1, 1936* which "was not subject to tax in the hands of such distributee . . . because exempt to him under Section 115(f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act" shall not be considered a distribution of earnings or profits. Accordingly, a constitutionally taxable stock dividend made prior to 1936 was not a distribution out of earnings or profits, was includable within the scope of Section 115(d), and should have been applied against the basis of the old stock.

Of course, the statute now definitely provides under Section 214(e) that for taxable years prior to 1939 the principle of allocation shall be applicable to stock dividends. An argument might well be made that this provision, specifically relating to stock dividends—rather than the general provision of Section 115(d)—is controlling. However, a provision similar to Section 214(e) now also exists in the statute specifically relating to the basis of stock dividends for taxable years beginning after December 31, 1938. And, if a clarifying amendment to Section 115(d) of the Internal Revenue Code was deemed necessary for taxable years beginning after December 31, 1938, even though the statute also contained a specific provision as to the allocation of basis in the stock dividend cases, the failure to make a similar provision in prior years might be regarded as significant.

Section 214(c) and (f)

It was necessary in the 1939 Act to "round out" the basis treatment provided for therein with some provision as to the holding period applicable to the stock dividend. Accordingly, Section 214(c) and (f) of the Revenue Act of 1939 provides that, in the case of stock or stock rights received as a dividend where the basis of such stock or rights is determined by the allocation principle, the Commissioner may prescribe, in properly promulgated regulations that in determining the period under all the Revenue Acts for which a taxpayer has held such stock or rights, there shall be included the period prior to such distribution for which he held the stock upon which such distribution was made.¹⁴⁵

The period of time for which property has been held by a taxpayer is, of course, significant under our tax laws for purposes of determining whether on the sale or exchange of such property, the proceeds shall be treated as capital gains or losses or as ordinary income or losses. In connection with the holding period for stock dividends, the regula-

145. SEN. REP. No. 648, 76th Cong., 1st Sess. (1939) 5.

tions have consistently provided that the stock dividend was regarded as having been held for the same period as the old stock.¹⁴⁶ However, these provisions were based on the premise that stock dividends could not be taxed and that some part of the cost of the old stock should be apportioned between the old and the new stocks. This premise was part of the administrative scheme which was declared to be without statutory authority in the *Koshland* case. Accordingly, following that case, a related problem to the determination of the proper basis applicable to the stock dividend was that of determining the period for which such dividend had been held. In the *Gowran* case, it was held that the stock dividends had been held only from the date of distribution and that the holding period of the original stock was not applicable thereto.¹⁴⁷

The Court referred to Article 501 of Regulations 704 which provided that if the old stock had been held for more than two years, then both the old and the new stocks were to be considered capital assets. The Court went on to conclude that since this was based on the administrative provisions for apportioning the cost of the old stock between the old and new stocks, which was declared to be without statutory authority in the *Koshland* case, Article 501 of Regulations 74 was similarly without statutory authority.¹⁴⁸

The provisions of Section 214(c) and (f) of the 1939 Act modify this holding. If the rule of allocation was used in determining the basis of the new stock, then the holding period of the old stock is applicable in determining the period for which the taxpayer held the new stock.¹⁴⁹ However, if, in a taxable year beginning before January 1, 1936, the new stock was included in gross income or the new or the old stock was disposed of and the basis for determining gain or loss ascertained by a method other than the allocation rule, then the holding period of the old stock is not pertinent in determining the period for which the new stock is held.

The provisions of Section 214(c) and (f) also settled the question as to the proper holding period applicable to stock rights and to stock acquired by the exercise of such rights. The holding period applicable to such stock or rights was, under prior law, in considerable confusion. In *Miles v. Safe Deposit and Trust Company*,¹⁵⁰ the Supreme Court was dealing with rights to purchase the same kind or class of stock as that with respect to which the rights had been issued. The Court did not pass directly on the holding period applicable to such rights but held that

146. U. S. Treas. Reg. 62, 65 and 69, Art. 1651; U. S. Treas. Reg. 74 and 77, Art. 501; U. S. Treas. Reg. 86 and 94, Art. 117-3; and U. S. Treas. Reg. 101, Art. 117-4.

147. *Helvering v. Gowran*, 302 U. S. 238, 244 (1937).

148. *Id.* at 244, n. 2.

149. See T. D. 4938, § 20B.5, see note 82 *supra*.

150. 259 U. S. 247 (1922).

part of the old stock's basis should be apportioned to the rights since such rights must be regarded "as an increase inseparable from the old shares, not in the way of income, but as capital;" the new shares "if and when issued [must be treated] as indistinguishable legally and in the market sense from the old," and "the sale of the rights [should be regarded] as a sale of a portion of a capital interest that included the old shares."¹⁵¹

On the basis of this case, the Bureau had held consistently that where stock rights were *sold* (rather than exercised) there should be included in determining the period for which such rights were held the period for which the taxpayer held the stock with respect to which the rights were issued.¹⁵² The Board of Tax Appeals had also regarded the holding period of the old stock as applicable to the stock rights issued on that stock in determining gain or loss on the sale of such rights.¹⁵³ And this rule was regarded as applicable to stock rights whether on the sale of such rights, the taxpayer apportioned part of the old stock's basis to the rights,¹⁵⁴ or whether he reported as income the entire proceeds from the sale of the rights pursuant to the option contained in the regulations.¹⁵⁵

The situation was hardly so clear cut in connection with the determination of the holding period applicable to the stock acquired by the *exercise* of stock rights. The Bureau first held that where such stock rights were exercised, the stock so acquired was to have the same holding period as the stock with respect to which the rights had been issued.¹⁵⁶ The Board of Tax Appeals, however, disagreed in this respect and concluded that the holding period of the new stock began with the date of its acquisition (and not the date the old stock was acquired or even the date the stock rights were issued).¹⁵⁷ Following the Board's decision, the Bureau reversed its prior position and held that the holding period of the new stock began to run from the date of its acquisition.¹⁵⁸ On further consideration of this question, the Bureau modified its position and adopted a middle ground. It held that in computing the holding

151. *Id.* at 253.

152. G. C. M. 11645, XII-2 CUM. BULL. 117 (1933); G. C. M. 12942, XIII-1 CUM. BULL. 73 (1934).

153. Bradley W. Palmer, 32 B.T.A. 550 (1935), *acquiesced in by Comm'r on this issue*, XIV-2 CUM. BULL. 17 (1935); Samuel Insull, Jr., 32 B.T.A. 1070 (1935), *op. substituted for* 32 B.T.A. 567 (1935) *and modifying*, 32 B.T.A. 47 (1935).

154. *Lee v. Comm'r*, 76 F. (2d) 203 (C. C. A. 1st, 1935).

155. See note 153 *supra*.

156. I. T. 1786, II-2 CUM. BULL. 45 (1923).

157. Rodman E. Griscom, 22 B.T.A. 979 (1931); Ellen Ayer Wood, 29 B.T.A. 1050 (1934); May Rogers, 32 B.T.A. 1176 (1935).

158. G. C. M. 10063, X-2 CUM. BULL. 159 (1931); and I. T. 2609, X-2 CUM. BULL. 339 (1931), *revoking* I. T. 1786, note 156 *supra*.

period of the stock acquired by the exercise of rights, part of the new stock (which represented the rights) should be regarded as having been held as long as the old share was held, and part of the new stock (which represented a new capital contribution to the corporation) should be regarded as having been held from the date such new stock was acquired.¹⁵⁹ The Bureau, however, was still unsatisfied with its determination of this question and upon reconsideration reverted to the position that the new stock's holding period began with the date of its acquisition rather than with that of the old stock.¹⁶⁰

Then some of the Board decisions on this point were appealed. The Circuit Court of Appeals for the First Circuit held that part of the new stock acquired on the exercise of rights had been held for the holding period attributable to the new stock and part of the new stock had been held from the date the new capital was contributed.¹⁶¹ Thereafter, the Second Circuit¹⁶² and the Seventh Circuit reached a similar conclusion.¹⁶³ Following this, the Board in turn reconsidered its position, decided to reverse itself and followed the position of the First, Second and Seventh Circuits in this respect.¹⁶⁴ The Bureau, however, continued to regard the holding period of the new stock as beginning with the date of its acquisition.

Section 214(c) and (f) put a stop to the legal merry-go-round on this point. That section requires the tacking of the old stock's holding period to the stock rights where the basis of such rights is determined by the allocation principle. In the case of stock acquired by the exercise of such rights, those sections would also seem to require a tacking of the old stock's holding period to the new stock, to the extent that the allocation principle is applicable in determining the basis of such new stock.¹⁶⁵

However, it should be noted that the provisions do not achieve complete equity insofar as concerns those taxpayers who disposed of stock rights and under the then available option included the entire proceeds from the sale of such rights in gross income. Under prior law, it was recognized that the holding period of the old stock was applicable to rights, whether the entire proceeds of the sale were included in income

159. G. C. M. 11645, XII-1 CUM. BULL. 117, modifying G. C. M. 10063, *supra* note 158.

160. G. C. M. 12942, XIII-1 CUM. BULL. 73, revoking G. C. M. 11645, *supra* note 159. on this issue and reinstating G. C. M. 10063, *supra* note 158.

161. *Wood v. Comm'r*, 75 F. (2d) 364 (C. C. A. 1st, 1935).

162. *Macy v. Helvering*, 82 F. (2d) 183 (C. C. A. 2d, 1936).

163. *Insull v. Comm'r*, 87 F. (2d) 648 (C. C. A. 7th, 1937).

164. *Walter Fitch, Jr.*, 35 B.T.A. 537 (1937).

165. However, T. D. 4938, § 20B.5, *supra* note 82, is silent on this particular point relating to the holding period of stock acquired by the exercise of rights. It specifically provides for "tacking" only in the case of the rights.

or part of the old stock's basis was allocated to the rights.¹⁶⁶ Now, however, while the statute recognizes the inclusion of the entire proceeds on the sale of rights as proper for rights sold in a taxable year beginning before January 1, 1939,¹⁶⁷ the holding period of the old stock would not seem applicable to such rights since the basis was not determined by the allocation principle. And the taxpayer may not under the statute change his method of reporting such proceeds at this stage.¹⁶⁸ Accordingly, the holding period for such rights begins, under the present provisions, with the date they were issued to the taxpayer. The Commissioner may thus treat such proceeds, in years still "open," not as capital gain but as ordinary income.

Such taxpayers exercised an election when the benefit of the holding period was recognized as part of that election. Now, they are bound to their election while the attendant benefits are withdrawn. Obviously, this is a highly inequitable result. The failure of Congress to make adequate provision in this regard either may have been prompted by the difficulties in drafting an exception relating to this case, or may have been a *casus omissus*.

CONCLUSION

On the whole, Section 214 of the Revenue Act of 1939 represents a sound effort to bring some order out of a highly chaotic situation in the tax laws. It does this in a way designed to assure a large measure of fairness both to taxpayers and to the Treasury. Its minor omissions may well be attributed to the limitations of time in which the statute was carried through both houses of Congress.¹⁶⁹ Finally, the "hard cases" not covered by the section might well be the subject of future consideration by the Congress.

166. See note 153 *supra*.

167. INT. REV. CODE § 113(a)(19)(B) and REVENUE ACT OF 1939, § 214(e)(2).

168. The last clause of § 113(a)(19)(B) of the Internal Revenue Code provides that ". . . and no part of the proceeds of the sale of such new stock [rights] shall ever be excluded from the gross income of the year of such sale." § 214(e)(2) is similar.

169. This bill was introduced in the House on June 15, 1939 and became law on June 29, 1939.