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RECENT INCOME TAX TRENDS IN STOCK DIVIDEND CASES

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Within the last six years the United States Treasury Department has moved from the view that *all* dividends in the form of stock of the issuing corporation were not taxable to a direct attack on the venerable decision of *Eisner v. Macomber*.[1] Oddly enough, the Treasury Department was jostled out of its lethargy through the persistent[2] and successful contentions of a taxpayer that a dividend on preferred stock paid in the form of common stock represented income within the meaning of that term as used in the Sixteenth Amendment.[3] In the case in which that contention was made, it was the Commissioner of Internal Revenue who was contending that the common stock when received as a dividend on the preferred stock was nontaxable and accordingly that a portion of the cost or other basis of the preferred stock should be appropriately apportioned to the common stock received as a dividend,[4] leaving a reduced cost or other basis to be used in determining capital gain on the sale of the preferred stock. The Supreme Court held that the common stock dividend on the preferred stock was income and could not be treated as a return of capital.[5]

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[1] 252 U. S. 189, 40 Sup. Ct. 189 (1920).

[2] The idea had its sponsors before but no case reached the Supreme Court after 1921. See *infra* note 65.

[3] This was the contention upheld in Koshland v. Helvering, 298 U. S. 441, 56 Sup. Ct. 767 (1936). See also Gowran v. Helvering, 302 U. S. 238, 58 Sup. Ct. 154 (1937), *rehearing den.* 302 U. S. 781, 58 Sup. Ct. 478 (1938); *cf.* Pfeiffer v. Helvering, 302 U. S. 247, 58 Sup. Ct. 159 (1937). There had been prior efforts but they were not so persistent.

[4] The petitioner contended: (a) that the dividends she received were not stock dividends exempt from taxation under the revenue act (the year involved being 1930), and (b) that, if exempted under the revenue act, the dividends were none the less income and therefore could not be treated as returns of capital in computing capital gain or loss on the redemption of the preferred stock.

The Supreme Court states the position of the Commissioner of Internal Revenue as follows:

> "The respondent answers that the distributions were stock dividends because made in the capital stock of the corporation and come within the plain meaning of the provisions exempting stock dividends from income tax; accordingly the Treasury regulations have consistently and continuously treated them as returns of capital, and required the original cost to be apportioned between the shares originally acquired and those distributed as dividends to obtain the cost basis for the calculation of gain or loss."

[5] The result reached in this decision as applied to 1936 and subsequent years is clearly sound. It is doubtful whether the Treasury Department previously would have opposed this view if it had not been faced by the dilemma created through the statutory exemption of stock dividends over the period from 1921 to 1935 which freed from tax, at the time of receipt, the value of the stock received.

Following the *Koshland* decision, the Treasury Department was quick to grasp the unreality of a statutory provision specifically exempting from the income tax *all* stock dividends irrespective of whether such dividends diluted or reduced the cost or other basis of the original stock. Accordingly, the Treasury Department recommended, in connection with the Revenue Act of 1936, that Congress eliminate the then existing provision that "a stock dividend shall not be subject to tax,"[6] and that in lieu thereof a provision be inserted reading as follows:[7]

> "*General Rule.*—A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution."

When the *Koshland* bomb burst upon unsuspecting tax experts and the Treasury Department, an effort was made to read into the statutory exemption of stock dividends, as it existed in the acts from 1921 to 1934, both inclusive, a proviso that the exemption was intended to apply only to a stock dividend of the character involved in *Eisner v. Macomber*,[8] that is, a dividend in common stock on common stock, with only one class of stock outstanding. Of course, such arguments were urged by the Treasury Department with some embarrassment since it had in practice over a considerable period of years applied the statute broadly to all stock dividends and had not attempted to limit the exemption to the type involved in *Eisner v. Macomber*.[9] This controversial question was rendered academic as to stock dividends distributed after 1936 by the change in the statute which made the taxability of every distribution depend on whether such distribution constituted income to the

[6]See 1934, 1932, and 1928 Acts, § 115 (f); 1926, 1924, and 1921 Acts, § 201 (a). This specific provision exempting stock dividends was included for the first time in the 1921 Act and followed a ruling by the Treasury Department that "stock dividends" were not taxable [see T. D. 3052, 3 CUM. BULL. 38 (1920)]. The reports of the Ways and Means Committee and the Senate Finance Committee dealing with the 1921 Act state that the act "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*, 252 U. S. 189." See *Ways and Means Committee Report No. 350*, 67th Cong., 1st Sess., 1939-1 (Part 2) CUM. BULL. 168; see also *Senate Finance Committee Report No. 275*, 67th Cong., 1st Sess., 1939-1 (Part 2) CUM. BULL. 181.

[7]This provision was included in the statute. See 1936 Act, § 115 (f) (1). See *Ways and Means Committee Report No. 2475*, 74th Cong., 2d Sess., 10; *Finance Committee Report No. 2156*, 74th Cong., 2d Sess., 18. This provision has been retained in the Internal Revenue Code and the 1938 Act. See INT. REV. CODE § 115 (f).

See also Reg. 103, § 19.115-7; Reg. 101, Art. 115-7; Reg. 94, Art. 115-7, formerly incorporated in T. D. 4674. XV-2 CUM. BULL. 53 (1935).

As to stock rights, see Reg. 103, § 19.22(a)-8; Regs. 101, 94, Art. 22(a)-8.

[8]See *supra* note 1.

[9]See the early statement of position in T. D. 3052, 3 CUM. BULL. 38 (1920).

shareholder within the meaning of the Sixteenth Amendment to the United States Constitution.[10]

Since the amendment to the statute in 1936, any lawyer or tax adviser who has had the temerity to give an unqualified opinion as to the taxability or nontaxability of a dividend in the form of stock of the distributing corporation has been very courageous indeed, as the following discussion will indicate.[11]

Beginning with the enactment of the Sixteenth Amendment in 1913,[12] and the enactment of the Revenue Act of 1913,[13] there has been a continuing effort to define the meaning of the term "income" as used in the Sixteenth Amendment and to fix the particular taxable year in which such income may be said to have been realized sufficiently to justify its taxation. Controversies occasioned by the receipt of stock dividends would have furnished additional occasions for judicial development of the income concept had it not been for the statutory exemption of all stock dividends over the period from 1921 to 1935.[14]

In its broad aspects the basic conflict engendered by the *Koshland* decision, and the subsequent amendment of the revenue act in 1936, involves the issue whether the recognition of income should be accelerated so as to fall in the year of the receipt of the stock dividend or be deferred so as to fall in the year of the sale or other distribution of the original stock or of the stock received as a dividend.

In 1921 when the provision exempting stock dividends was inserted in the statute, the tendency of Congress was to defer the recognition of income in cases where the taxpayer received something in a form other than cash, particularly where it did not clearly appear that the property received substantially altered his interest. In addition to including a provision exempting stock dividends, the 1921 Act changed the previously existing "exemption" provisions relating to reorganizations so as to postpone the recognition of gain.[15] In the cases covered by these statutory provisions the question of

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[10]As to the question of the basis to be used for stock acquired in prior years, see INT. REV. CODE § 113 (b) (1) (D) (1939); see also Alvord and Biegel, *Basis Provisions for Stock Dividends under the 1939 Revenue Act* (1940) 49 YALE LAW J. 841; Eichholz, *The Revenue Act of 1939 and the Basis of Stock Dividends and Rights* (1940) 40 COL. L. REV. 404.

[11]In *Perkins v. Endicott Johnson Corp.*, decided May 6, 1942, the Circuit Court of Appeals for the Second Circuit advanced the interesting suggestion that the lower federal courts had a duty to follow any new "doctrinal trend" evidenced by the United States Supreme Court in its decisions.

[12]Ratified February 25, 1913.

[13]October 3, 1913.

[14]The provision in the 1921 to 1934 Acts proved to be simple only as it affected the question of tax liability on *receipt* of the stock dividend; it did not cover tax liability on the *disposal* of the stock dividend or of the original stock on which the dividend was declared.

[15]For example, the 1921 Act for the first time provided that no gain or loss shall be

realization of gain was not important since even if realized it was not recognized. The battle of acceleration versus deferment has continued, both in Congress and in the courts, ever since the inclusion of these provisions in the 1921 Act, and has been influenced to some extent by general business and fluctuating economic conditions.[16]

Assuming that the present temper and inclination of Congress and of the courts is toward acceleration of income, it is still necessary to recognize that in order that there be an acceleration or recognition of gain or income, such income must come into existence; that is, there must be a *realization* of

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recognized "When any such property held for investment, or for productive use in trade or business (not including stock-in-trade or other property held primarily for sale), is exchanged for property of a like kind or use." 1921 Act, § 202 (c) (1). By comparison, the 1918 Act in § 202 (b) had provided that "When property is exchanged for other property, the property received in exchange shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value, if any. . . ." *Cf.* Reg. 45, Art. 1563, which was more liberal than the statute.

The 1921 Act also provided for the first time in § 202 (c) (3) for the non-recognition of gain or loss where property was transferred to a corporation and the transferor was immediately thereafter in the control of the person transferring the property. There is no similar provision in the 1918 or prior acts, but the regulations promulgated thereunder (Reg. 45, Art. 1566) provided that: "Where property is transferred to a corporation in exchange for its stock, the exchange constitutes a closed transaction and the former owner of the property realizes a gain or loss if the stock has a market value, and such market value is greater or less than the cost or fair market value as of March 1, 1913 (if acquired prior thereto) of the property given in exchange. . . ." Similarly the provisions dealing with exchanges in connection with reorganizations were broadened so as to result in increased postponement of the tax on gain or loss. See in this connection, 1921 Act, § 202 (c) (2). *Cf.* 1918 Act, § 202 (b).

[16]In the earlier history of the administration of the income tax statutes, Congress in postponing recognition of gain in connection with exchanges and reorganizations was probably influenced by the fact that an acceleration of gains carried with it an acceleration of deductible losses. In recent years, the Treasury Department and Congress have not been hampered by this parallelism since they have solved the dilemma by taxing the gains but disallowing the losses either in whole or in part, or allowing them only as an offset against comparable gains.

Deferment has certain disadvantages to revenue in the case of gains. For example, a gain deferred might never be taxed should the deferment continue up to and beyond the date of death of the taxpayer. This assumes that the income tax statute does not permit taxation of the decedent in the year prior to his death of the increment in value or the difference between the value of property in his possession at the time of his death and its cost or other basis to him. In the enactment of the income tax statutes and their administration, no effort has been made to date to reach such "income."

Acceleration as applied to stock dividends means that the income is taxable in full, like any other dividend, but if the increment in value of the stock were taxed on its sale it would be treated as a capital gain taxable only in part. Furthermore, if such taxable stock dividend uses up part of the assets for which the stockholder paid on acquiring his stock, loss might well result on the sale of the stock, which loss would be allowable only in part, if at all, while the dividend income would have been taxed in full.

The present tendency is to limit further the right to take capital losses against ordinary income. A strict theory of acceleration of income in stock dividend eases would catch the stockholder in a pincer movement. If *Eisner v. Macomber* is completely overthrown, it might very well result in the complete abandonment of the use of stock dividends except as part of a statutory recapitalization.

"income" within the meaning of that term as used in the Sixteenth Amendment. Once it is realized, it may then be recognized for tax purposes and be taxed.

Classification of "Stock Dividends"

In any general consideration of stock dividends, it is necessary to keep in mind that there are many different kinds of "stock dividends." There may be, for example, (1) a distribution of stock of another corporation, (2) a distribution of preferred stock of the issuing corporation to common stockholders, both classes of stock being outstanding, and vice-versa, (3) a distribution of non-voting common stock of the issuing corporation to its voting common stockholders, both classes being outstanding and both classes sharing equally in all rights and preferences except voting, (4) a distribution of voting common stock of the issuing corporation to non-voting common stockholders, both classes being outstanding, and (5) a distribution of common stock of the issuing corporation to its common stockholders, only one class of stock being outstanding.

There are, of course, many other kinds of stock dividends, but the foregoing illustrate the principal types. In type (1) there is effected a distribution of assets of the issuing corporation and the courts have not been greatly troubled in reaching the conclusion that such a distribution is taxable.[17] Type (2) is now freely recognized as taxable and as giving rise to realized income in the year of receipt of the new stock.[18] While there is no actual separation of assets from the corporation, there is, in such case, its equivalent through the change in the proportionate interest of the stockholder in such assets evidenced by the new stock. There is also a change in the character and extent of the stockholder's interest in the corporation so that not only does he end up with different evidences of his pre-existing interest, but also the sum of the new and old interests is different from what he had before. Accordingly, we can apply substantially all the different tests for determining whether a dividend in stock is taxable and still come out with the same answer. The same cannot be said as to types (3), (4), and (5). The different tests give

[17]Such a distribution is not a true stock dividend but a distribution in specie of a portion of the assets of the distributing company, and the question of liability for tax is determined by the same rules as are applicable to the distribution of a like value in money. See Peabody v. Eisner, 247 U. S. 347, 38 Sup. Ct. 546 (1918). *Cf.* Southern Pacific Co. v. Lowe, 247 U. S. 330, 38 Sup. Ct. 540 (1918).
The reorganization non-recognition provisions of early statutes introduced certain complications which are generally not existent today.

[18]See, *e.g.*, Koshland v. Helvering, 298 U. S. 441, 56 Sup. Ct. 767 (1936), in which the essential principle is enunciated, although the case involved the question of basis and not of liability for tax on receipt of the stock dividend.

you different answers, and the problem presented by stock dividends of these types is to determine which is the proper test to apply.

Selection of the Proper Test

Essentially, the choice lies among one of the following tests for determining whether income has been realized:

(a) Has there been a separation of assets from the corporation? This is what has become known as the "segregation" or "separation" test.

(b) Does the distribution result in a change in the pre-existing proportionate interest of the stockholder in the assets of the corporation? This has become known as the "proportionate interest" test.

(c) Does the distribution result in a change in the intrinsic value of the stockholders' holdings?

(d) Does the distribution affect the aggregate holdings of other stockholders?

(e) Are the new certificates received "alike in what they represent?" This may be referred to roughly as the "something different from what the stockholder had before" test.

These tests spring essentially from the language in certain early decisions of the United States Supreme Court interpreting the 1909 to 1918 Acts; principally the following: *Peabody v. Eisner,*[19] *United States v. Phellis,*[20] *Rockefeller v. United States,*[21] *Cullinan v. Walker,*[22] *Weiss v. Stearn,*[23]

[19]247 U. S. 347, 38 Sup. Ct. 546 (1918). The Court held in this case that an extra dividend declared by a railroad company after the 1913 Act became effective was taxable to the shareholders, notwithstanding that it was paid in property acquired and surplus accumulated prior to the effective date of the act. The dividend here was partly in cash and partly in stock of another company.

[20]257 U. S. 156, 42 Sup. Ct. 63 (1921). In this case it would appear that there was both common and preferred stock outstanding and that the dividend to the common stockholder was in common stock of another company.

[21]257 U. S. 176, 42 Sup. Ct. 68 (1921). Stockholders of the Prairie Oil & Gas Co. caused a company to be organized in the state of Kansas called Prairie Pipe Line Co. to which certain of its assets were transferred in consideration for the entire capital stock of the new company, to be distributed pro rata to the stockholders of the Prairie Oil & Gas Co. There was also another transfer involved, not here material.

[22]262 U. S. 134, 43 Sup. Ct. 495 (1923). In this case the stockholder owned an interest in the Farmers' Petroleum Company, a Texas corporation, with a capital stock of $100,000. In 1915 the company was dissolved and the taxpayer became one of the trustees in liquidation. In 1916 the trustees organized two new Texas corporations. To each of these corporations the trustees transferred one-half of the assets held by them. From each they received $1,500,000 par value of its bonds and $1,500,000 par value of its stock, being the total issues. The trustees also organized under the laws of Delaware a third company which was a holding company. To this company the trustees transferred the $1,500,000 of stock of each of the new Texas corporations, and from it they received $3,000,000 of its stock. All of these securities the trustees transferred pro rata among the persons who had been stockholders in Farmers' Petroleum Company. The Commissioner had assessed a tax on the difference between the cost to the taxpayer of his stock

Marr v. United States.[24]

These early Supreme Court decisions, promulgated to some extent before the decision in *Eisner v. Macomber*,[25] but largely thereafter, fall into two broad groups:

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investment in Farmers' Petroleum Company and the value of the stock and bonds received by him. The taxpayer attempted to distinguish the *Phellis* and *Rockefeller* cases on the ground that there the distributed stock of the new corporation was technically a dividend paid out of surplus, but that here the segregation was not of that character. The Court points out, however, that the gain which, when segregated, becomes income legally subject to the tax "may be segregated by a dividend in liquidation, as well as by the ordinary dividend." Of course, a dividend in liquidation would ordinarily contemplate an exchange. It was probably for this reason that the Commissioner offset cost against the amount received.

[23] 265 U. S. 242, 44 Sup. Ct. 490 (1924). In this case the stockholders delivered certificates representing the entire capital stock of the National Acme Manufacturing Company, the old corporation, to a depositary. Eastman, Dillon & Company also deposited $7,500,000 with the depositary. Thereupon a new company was organized and took over the assets of the old one, issuing to the depositary its entire authorized capital stock. The old corporation was dissolved. Eastman, Dillon & Co. got $12,500,000 of the certificates representing one-half of the stock of the new company. The owners of old stock got their pro rata part of the new certificates, together with the $7,500,000 cash received from Eastman, Dillon & Co. The Supreme Court held that the old stockholders sold one-half their interest for cash and exchanged the remainder without gain for the same proportionate interest in the transferred corporate assets and business.

It appears from the report in the lower court, that the old par value was $100 per share, whereas the stock of the new company was $50 par value (although actually valued at $30 per share), the stock having been increased at a rate of 5 to 1. Accordingly there were ten $50 shares of the new for each $100 share of the old stock. Obviously this must have meant that the capitalization of the new company was substantially larger than that of the old company.

[24] 268 U. S. 536, 45 Sup. Ct. 575 (1925). In this case the taxpayer and his wife owned preferred and common stock of General Motors Company of New Jersey. In 1916 they received, in exchange for this stock, preferred and common stock in different amounts from the holders of the old company of General Motors Corporation of Delaware. The Commissioner taxed the difference between the cost of the New Jersey corporation stock and the value of the stock in the Delaware corporation. The case arose under the 1916 Act. The preferred stock of the New Jersey corporation was 7% stock and both the preferred and common had a par value of $100. The New Jersey corporation had accumulated from profits a large surplus. The New Jersey organized the Delaware corporation with an authorized capital of $20,000,000 in 6% non-voting preferred stock and $82,000,000 in common stock; all shares being of the par value of $100. The Delaware corporation made the following offer for exchange of securities to stockholders in the New Jersey corporation: For every share of common stock of the New Jersey corporation, five shares of common stock of the Delaware corporation; for every share of the preferred stock of the New Jersey corporation, one and one-third shares of preferred stock of the Delaware corporation. Certain of the new stock which was not used for the purpose of this exchange was sold. Following the acquisition of the stock, the Delaware corporation dissolved the New Jersey corporation.

[25] 252 U. S. 189, 40 Sup. Ct. 189 (1920). *Cf.* Towne v. Eisner, 245 U. S. 418, 38 Sup. Ct. 158 (1918) (involving the 1913 Act), and U. S. v. Philadelphia B. & W. R. Co., 262 Fed. 188 (E. D. Pa. 1920) (involving the 1909 Act).

There is a discussion of the dissenting opinion of Mr. Justice Holmes and Mr. Justice Brandeis in the *Eisner v. Macomber* ease in an article by Roswell Magill, *Realization of Income* (1936), 36 Col. L. Rev. 519, 527. Mr. Magill points out that the British courts have approved the conclusion of the majority, see Commissioners of Inland Revenue v. Blott [1921] 2 A. C. 171.

The taxation of stock dividends is discussed in the following early articles: *Taxability*

(1) Dividend cases involving distributions in kind (including distributions in liquidation),[26] and
(2) Reorganization cases involving either receipt of new securities or an exchange of old securities for new securities.[27]

If this grouping is kept in mind it is easier to understand the present conflict as to the proper test to apply.

The Supreme Court, at an early date, disposed of the suggestion[28] that there was no taxable gain where the stock originally held prior to the dividend was worth precisely the same amount on the market as the combined old and new stock after the dividend. Although no increase in the value of the taxpayer's aggregate holdings results from the operation, the question of taxability depends not on the equivalence in value at the time of the transaction, but on whether there is the equivalent of cash received by the stockholder[29] or a realization of increment in value over the original cost or other basis.

While it is assumed generally that the separation test need no longer be met,

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of Stock Dividends as Income, by Prof. Edward H. Warren, 33 HARV. L. REV. 885 (1920); *Income from Corporate Dividends,* by Prof. Thomas Reed Powell, 35 HARV. L. REV. 363 (1921); and see 36 HARV. L. REV. 1032 (1923); 31 HARV. L. REV. 787, 805 (1918); 34 HARV. L. REV. 307 (1920); 7 VA. L. REV. 134 (1920); 20 MICH. L. REV. 522, 682 (1922) (discussing Massachusetts and English rules).

Although not subject to the same constitutional limitations as is the federal government in this field, states have generally followed the lead of the federal statute and exempted stock dividends from income taxation, either by express provision or by administrative practice. See Ralph R. Neuhoff, *Gross Income and Deductions Under State Income Tax Laws,* 22 IOWA L. REV. 185 (1937).

[26]See Peabody v. Eisner, *supra* note 19; Rockefeller v. U. S., *supra* note 21; Eisner v. Macomber, *supra* note 1.

[27]U. S. v. Phellis, *supra* note 20; Cullinan v. Walker, *supra* note 22; Weiss v. Stearn, *supra* note 23; Marr v. U. S., *supra* note 24. See, however, note 33, and the Court's reference to dividends in the *Phellis* case.

[28]This is test (c) above.

[29]In U. S. v. Phellis, 257 U. S. 156, 42 Sup. Ct. 63 (1921), the Court of Claims [56 Ct. Cls. 157 (1921)] had found for the taxpayer, holding that the distribution was, in effect, a stock dividend not taxable as income on the authority of *Eisner v. Macomber* and not within the rule of *Peabody v. Eisner,* since the new and old securities were worth no more than the stockholders' original shares prior to the dividend. The Supreme Court, in reversing the Court of Claims, found that there had been a receipt of assets of exchangeable value available for separate use since there was an adequate surplus; accordingly, the distribution of the stock of the DuPont, Del. corporation to the stockholders of the DuPont, N. J. corporation was taxable as a dividend. In this case there was both common and preferred stock outstanding and the dividend to the common stockholders was in the common stock of another company.

It is frequently difficult to distinguish between cases involving distribution of stock of another corporation and instances which involve distribution in connection with reorganizations. Subsequently, in this article, the effect of the provisions in the present statute permitting deferment of recognition of gain or loss on exchanges in connection with recapitalizations of corporations will be more fully discussed. *Cf.,* for example, Rockefeller v. U. S., 257 U. S. 176, 42 Sup. Ct. 68 (1921); Cullinan v. Walker, 262 U. S. 134, 43 Sup. Ct. 495 (1923).

that would seem to be true only when we think of the test as requiring a physical transfer of corporation assets to the stockholder. In its more limited sense, there must be some "separation" involved in any dividend distribution. It is obvious that if we disregard the segregation or separation test entirely,[30] we are losing touch with the ordinary indicia of a dividend, namely, that it represents a distribution of the earned surplus of the distributing corporation. Logically, a dividend involves a distribution either of cash or of other assets of the distributing corporation. Such assets may include stock or securities of another corporation. Accordingly, a distribution in kind is properly equivalent to a distribution of cash, but in both instances there is implicit an act of distribution which takes away certain assets of the corporation and places such assets in the hands of the stockholders.

But dividends are not necessarily limited to physical distributions of assets. There may be a constructive distribution of assets as well as an actual distribution, and on this theory it is possible to justify treating as a dividend a "distribution" of the distributing corporation's stock. The *Koshland*[31] and *Gowran*[32] cases illustrate such a distribution. Where this principle applies, the distribution is taxable only to the extent that there are earnings available for dividends.[33] Where this is done, the stockholder has, in effect, and speak-

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[30]This is test (a) above. Early misconception as to the scope of *Eisner v. Macomber* undoubtedly arose from undue reliance on the necessity of a direct or physical severance of assets as a condition to taxability. The Supreme Court is of the opinion that its decisions in U. S. v. Phellis, *supra* note 20; Rockefeller v. U. S., *supra* note 21; Eisner v. Macomber, *supra* notes 1 and 25; and Marr v. U. S., *supra* note 24, were a sufficient warning of the fallacy of this assumption. See Mr. Justice Roberts' opinion in Koshland v. Helvering, *supra* note 3.

[31]See *supra* note 3.

[32]Helvering v. Gowran, 302 U. S. 238, 58 Sup. Ct. 154 (1937), *petitions for rehearing denied*, 302 U. S. 781, 58 Sup. Ct. 154.

[33]The fact that there were sufficient earnings available has been emphasized in most of the dividend cases. For example, in U. S. v. Phellis, 257 U. S. 166, 42 Sup. Ct. 63 (1921), the Court said: "The precise amount [of surplus] is not important, except that it should be stated that it was sufficient to cover the dividend distribution presently to be mentioned." It is also stated therein that:

"It is the appropriate function of a dividend to convert a part of a surplus thus accumulated from property of the company into property of the individual stockholders; the stockholder's share being thereby released to and drawn by him as profits or income derived from the company. That the distribution reduces the intrinsic capital value of the shares by an equal amount is a normal and necessary effect of all dividend distributions —whether large or small and whether paid in money or in other divisible assets—but such reduction constitutes the dividend none the less income derived by the stockholder if it represents gains previously acquired by the corporation. . . . The possibility of occasional instances of apparent hardship in the incidence of the tax may be conceded. . . . It thus appears that in substance and fact, as well as in appearance, the dividend received by claimant was a gain, a profit derived from his capital interest in the old company, not in liquidation of the capital, but in distribution of accumulated profits of the company."

In Rockefeller v. U. S., 257 U. S. 176, 42 Sup. Ct. 68 (1921), the oil company there involved had a surplus in excess of the stated value of its pipe line and of the par value ing in terms of equivalents, received a cash dividend out of earned surplus and returned the same to the corporation as additional capital. But when we speak of a distribution in the form of stock of the issuing corporation which does not represent either a direct distribution out of surplus or a transfer of surplus to capital we use an incorrect nomenclature in referring to this transaction as a dividend.

Such a "constructive dividend", in order to be taxable, must meet the challenge of the Sixteenth Amendment which implicitly requires a *realization* of *income* as a *sine qua non* of tax liability. In the writer's opinion, where stock of the distributing corporation is received, this challenge is met only where, in addition to a capitalization or segregation of earnings, there is a change in the stockholder's proportionate interest in the corporation.[34] A change in the character or extent of the stockholder's interest is not alone sufficient. But, at this time, such a conclusion represents a statement of personal opinion and there is considerable support for the proposition that a change merely in the character or extent of the stockholder's interest is a sufficient basis for finding that there has been a realization of income as a result of the stock distribution.

Recent cases have furnished evidence of the battle between conflicting advocates of the disproportionate interest test and those holding that the test is whether the stockholder has, after the stock dividend, something different or different evidences of his interest than he had before such distribution. The latter point of view holds that differences in the characteristics of stock received and that originally held (such as preferences in assets and dividends or in the right to vote) when realized by the stockholder, may warrant recognition of income to the stockholder receiving the stock dividend.[35] In other words, advocates of this point of view argue that if the stock distributed as

of the total stock of the corresponding pipe line company "so that the transfer of the pipe lines and the distribution of the stock received for them left the capital of the respective oil companies unimpaired and required no reduction in their outstanding issues." The distribution was held to be, in effect, a dividend out of the accumulated surplus. The Court stated:

". . . The distribution, whatever its effect upon the aggregate interests of the mass of stockholders, constituted in the case of each individual a gain in the form of actual exchangeable assets transferred to him from the oil company for his separate use in partial realization of his former indivisible and contingent interest in the corporate surplus. . . ."

See also the comments of Judge Learned Hand in the District Court's decision in the *New York Trust Co. v. Edwards* and *U. S. v. Rockefeller* cases reported in 274 Fed. 952 (S. D. N. Y. 1921). See also Weiss v. Stearn, *supra* note 23; Sprouse v. Comm., 122 F. (2d) 973 (C. C. A. 9th, 1941).

[34]This view, in the writer's opinion, follows the underlying theory of the majority of the Court in Eisner v. Macomber, 252 U. S. 189, 40 Sup. Ct. 189 (1920).

[35]See, *e.g.*, the decision of the Board of Tax Appeals in John M. Keister, 42 B.T.A. 484 (1940), which was reversed *sub nom.* Sprouse v. Commissioner, 122 F. (2d) 973 (C. C. A. 9th 1941).

a dividend differs in nature, character, or extent from that held by the stockholder, evidences new rights against the corporation, or constitutes different evidence of his previous existing or inchoate rights, the stockholder derives income.[36] This school of thought emphasizes as a test the "essentially different character" of the interests or the evidences thereof after the distribution of stock, as contrasted with such interests existing prior thereto.

The second school of thought adheres more closely to the proportionate interest test, that is, whether the distribution effects a change in the proportionate interest of the stockholder. There are grounds for treating the distribution as a taxable stock dividend[37] if it results in a difference in the

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[36]Compare the language in Peabody v. Eisner, 247 U. S. 347, 38 Sup. Ct. 546 (1918), referring to Towne v. Eisner, 242 Fed. 702 (S. D. N. Y. 1917), in which it is said:

"The latter case has since been reversed (245 U. S. 418, 38 Sup. Ct. 158, 62 L. ed. ——), but only upon the ground that it related to a stock dividend which in fact took nothing from the property of the corporation and added nothing to the interest of the shareholder, but merely changed the *evidence* which represented that interest." (Italics added.)

In Charles F. Mitchell and Cora B. Mitchell, 45 B.T.A. 300 (1941), there was a distribution of preferred stock to the holders of common stock. At the time the corporation had outstanding only common stock. The corporation declared a stock dividend of both common and preferred stock on the outstanding common stock so that each holder of the outstanding common stock would receive two shares of common and three shares of preferred for each share of common stock then owned by him. Apparently, the only issue raised in this case was as to the receipt of the preferred stock, notwithstanding that the stockholders also received common stock in the same distribution. In this case it would appear that there was a surplus of approximately $350,000 at the time of the distribution of the stock, although it does not appear how much of this amount was capitalized by reason of the common and preferred stock dividends. Within two weeks of the distribution the company amended its charter to increase its authorized capital stock by $300,000, consisting solely of common stock, and pursuant to prior agreement, the corporation issued common stock, share for share, for the preferred which had been issued as a stock dividend two weeks before. In holding that the receipt of the preferred did not give rise to a taxable dividend, the Board treated the preferred as though it were essentially common stock in view of the agreement of the stockholders subsequently to exchange such stock for common stock. In other words, it was treated as falling squarely within the facts of Eisner v. Macomber.

Cf. Sylvie R. Griffiths, B.T.A. Memo, Op., Docket No. 110035, March 3, 1942, in which the *Commissioner claimed that a distribution of common stock to common stockholders, with only one class outstanding, was taxable as a dividend. Cf.* also, David Bruckheimer, 46 B. T. A. 32, involving distributions of treasury stock.

[37]In Sprouse v. Commissioner, 122 F. (2d) 973 (C. C. A. 9th 1941), the court reversed the Board and remanded the case for further proceedings in order to determine whether the proportionate interests of the stockholders changed by reason of the distribution of non-voting stock to the holders of voting and non-voting common stock. Apparently, a 10% stock dividend in non-voting common stock capitalized earnings amounting to $121,680.43. It was considered that the distribution of the non-voting common stock was equivalent to a distribution of $121,680.43. The Circuit Court of Appeals stated that if the voting common stockholders received the same proportion of the distribution which the par value of the voting common stock bore to the par value of the non-voting common stock, then the recipient stockholder had no "income" (in this case the fair market value of the stock distributed was found to be the same as the par value thereof); but that if such stockholders received a different proportion, such stockholders would have derived "income" as a result of the stock dividend.

Certiorari was granted in the *Sprouse* case, May 11, 1942. See also, related case, receiving stockholder's proportionate interest in the corporation, either because: (1) he has, after the dividend, a different interest in the corporation assets (because of a difference in the amount of such interest or a preference he may receive over other interests in the corporation), or (2) there is a resulting increase in his right to dividends, or (3) a change as to the management and control of the corporation, or (4) a change in his relation to other stockholders with respect to any other rights he may have in the enterprise (as manifested by his ownership of shares of stock). In such cases, the stock dividend may represent a realization of income at the time of its receipt.

The Board of Tax Appeals quite recently adopted the "substantially different" test; the Circuit Courts of Appeals, however, have differed in their acceptance of this test. For example:

(1) The Board of Tax Appeals has held that a dividend of preferred stock to common stockholders was taxable in a case where prior to such stock dividend only common stock had been outstanding.[38] This decision was appealed, but the appeal was subsequently withdrawn.

(2) The Board has held that a dividend in the form of non-voting common stock to persons having voting common stock was taxable where the distributed non-voting common stock was divided between non-voting and voting common stockholders.[39] The Board was reversed, however, by the Circuit Court of Appeals for the Ninth Circuit.

(3) The Board has held that a dividend in non-voting preferred stock to the holders of voting and to the holders of non-voting common stock was taxable.[40]

In both the *Keister*[41] and *Kelly Trust*[42] cases, the proportionate interest

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Keister v. Commissioner, — F. (2d) — (C. C. A. 2d 1942), *reversing and remanding Board decision* (Prentice Hall Tax Service, 1942, ¶ 62.646).

[38]Frank J. and Hubert Kelly Trust, 38 B.T.A. 1014 (1938), subsequently appealed and appeal withdrawn, 106 F. (2d) 1002 (C. C. A. 8th 1939), because of the effect of § 214 of the 1939 Act, amending INT. REV. CODE § 113(b)(1)(D) (1939). See also the subsequent Board decision in Emil H. Strassburger, 43 B.T.A. 1209 (1941), *aff'd* Emil H. Strassburger v. Comm., 124 F. (2d) 315 (C. C. A. 2d 1941), *cert. granted,* May 11, 1942. See also, Alfred E. Stern, 46 B. T. A. 51.

Cf. Allen H. Lambert v. Comm., 120 F. (2d) 101 (C. C. A. 9th 1941) *rev'g* 42 B.T.A. 438 (1940), which turned primarily on the proper treatment to be given to an optional cash or stock dividend. The dividend involved was in the form of preferred stock to common stockholders. Apparently both classes were outstanding.

[39]John M. Keister, 42 B.T.A. 484 (1940), *rev'd sub nom.* Sprouse v. Comm., 122 F. (2d) 973 (C. C. A. 9th 1941). The case was remanded, however, to the Board. See *supra* note 37.

[40]John M. Keister, *supra* note 39. This conclusion of the Board was not appealed. The Circuit Court of Appeals probably would have affirmed the Board as to this distribution.

[41]See *supra* notes 37, 39.

[42]See *supra* note 38.

of all stockholders was the same before and after the distribution.[43] Under comparable circumstances, both the Board[44] and the United States Court of Claims[45] had previously held that there was no realization of income. The recent decisions of the Board in the *Keister* and *Kelly Trust* cases accordingly represent a shift from the "proportionate interest" test to the "substantially different" test. The Board of Tax Appeals seems to feel that the *Koshland* case requires this switch from the "proportionate interest" test to one accepting mere "proliferation of existing interests" as leading to a realization of income.

In the *Keister* case, the Board attempts to dispose rather summarily but indirectly of the earlier decision of the United States Court of Claims in the *Chapman* case, by stating that the denial of *certiorari* by the Supreme Court[46] is not to be given any significance since it was prior to the decision of the Supreme Court in *Koshland v. Helvering*.[47] It is obvious, however, that the Board is departing from the proportionate interest rule or, stating it more

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[43]While the stockholder in the *Kelly Trust* case had his inchoate interest in preferred dividends before the distribution, reflected afterwards in specific preferred stock certificates, this is not truly a change in proportionate interests.

[44]The Board's decisions in the *Kelly Trust* and *Keister* cases are at variance with its earlier decision in Pearl B. Brown, Exec., 26 B.T.A. 901 (1932), *aff'd* 69 F. (2d) 602 (C. C. A. 7th 1934), *cert. denied* 293 U. S. 570, 55 Sup. Ct. 81 (1934), in which there was one class of stock outstanding, the charter being subsequently amended to provide for preferred stock, and such preferred stock being issued in 1922 to the common stockholders as a stock dividend. In this case the Commissioner claimed that it was a stock dividend, and the Board, Member Sternhagen writing the opinion, agreed. In the opinion Member Sternhagen states:

"Judged by its purpose and operation, and laying aside the directors' designation of a stock dividend in the resolution of December 15, 1922, the issue of 1922 was, in our opinion, a stock dividend. It was an increase of capitalization and a proportionate distribution among existing shareholders of new certificates reflecting their unchanged interests in the corporation—a mere proliferation of existing interests. At the moment of change, each shareholder's proportionate rights were absolutely and relatively the same, except that each in the same ratio had preferred as well as common shares, a difference without significance here. These are the essential characteristics of a stock dividend—those which have always given point to the cases in which the question has arisen, . . ."

The Board reached its earlier decisions in the cases of Alfred A. Laun, 26 B.T.A. 764 (1932), and Pearl B. Brown, Exec., 26 B.T.A. 901 (1932) and Frances Elliott Clark, 28 B.T.A. 1225 (1933), *aff'd* 77 F. (2d) 89 (C. C. A. 3d 1935), on the ground that in those cases no preferred stock was outstanding when the preferred stock in question was distributed as a dividend or in partial exchange for common stock. Accordingly, it said there was no severance of assets from the parent corporations and no alterations of pre-existing proportionate interests of the stockholder but only "a mere proliferation of existing interests."

[45]Chapman v. U. S., 63 Ct. Cls. 106 (1927), *cert. denied* 275 U. S. 524, 48 Sup. Ct. 18 (1927). See *infra* note 92.

[46]See *supra* notes 45, 92. The Board might better have suggested that denials of certiorari have, in any event, only very limited significance.

[47]This, of course, ignores the true fact that the *Chapman* case is directly at variance with the Board's decision in the *Keister* case.

accurately, is applying a broader test of taxability. Since the stockholders in the *Kelly Trust* case owned all of the stock, there being only common stock outstanding, they, in effect, owned the entire corporation and their proportionate interests were not in any way varied by their receipt of preferred stock. After the distribution, they merely had different evidences of the same interest in the corporation. The same is true in the *Keister* case, where both the voting and non-voting common stockholders had non-voting common stock divided among them. There was, as the Board had said with reference to the *Brown, Laun,* and *Clark* cases, merely "a proliferation of existing interests." In the *Kelly Trust* case the Board disposes of its prior decisions in the *Brown, Laun,* and *Clark* cases,[48] and incidentally of its reasoning therein, on the following grounds, among others: (1) such cases were decided before the Supreme Court decision in the *Koshland* case; (2) these decisions "may well have proceeded from the acceptance as controlling of an interpretation of *Eisner v. Macomber* which though it later proved to be erroneous had been assumed for many years by legislative and administrative officials alike;"[48a] (3) the holdings were mere dicta since all dividends on stock were exempt under the revenue acts up to and including the 1934 Act.

These explanations lack force and conviction, and the only reasonable explanation of the difference met in the early and later decisions of the Board is that the Board is persuaded that the decisions in the *Koshland* and *Gowran* cases lay down an entirely new set of principles for determining whether there has been income in the constitutional sense upon the receipt of a dividend in stock. Of course, those cases did no such thing. They simply took the problem off the shelf where the inertia and the erroneous assumptions of taxpayers and the Treasury Department had put it in 1921, and gave the controversy a fresh start in 1936. Phoenix but rose again.

It will be recalled that in the *Koshland*[49] case the only question involved was whether a dividend in common stock to holders of preferred stock was taxable where both classes of stock were outstanding at the time.[50] There is nothing in the language of the opinion which compels the acceptance of the rule expressed by the Board in the *Kelly Trust* and *Keister* cases. The Supreme Court in the *Koshland* case, as it did in *Eisner v. Macomber,* used

[48]See *supra* note 44.

[48a]38 B.T.A. 1014, 1018 (1938).

[49]The scope of the decision must be considered in the light of the general principle that cases involving questions of constitutional limitations must be limited to the precise issue before the court.

[50]As indicated above, the court, in effect, held the distribution to be income, which result follows from the application of the "proportionate interest" test, see *supra* notes 4, 5, 18. The actual question was one of basis on disposition of the stock and not one of liability for tax on receipt of the stock.

several phrases any one of which separated from its general context, according to one's particular bias or preference, might be selected as expressing the correct principle to be followed. For example, the Supreme Court in the *Koshland* case states as follows:[51]

> "* * * Soon after the passage of that act, this court 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 such a dividend where there had either been changes of corporate identity or a change in the nature of the shares issued as dividends whereby the proportional interest of the stockholder after the distribution was essentially different from his former interest. * * * (citing United States v. Phellis, 257 U. S. 156; Rockefeller v. United States, 257 U. S. 176; Cullinan v. Walker, 262 U. S. 134; Marr v. United States, 208 U. S. 536).
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> "* * * Under our decisions the payment of a dividend of new common shares, conferring no different rights or interests than did the old, the new certificates, plus the old, representing the same proportionate interest in the net assets of the corporation as did the old, does not constitute the receipt of income by the stockholder. On the other hand, where a stock dividend gives the stockholder an interest different from that which his former stock holdings represented he receives income. The latter type of dividend is taxable as income under the Sixteenth Amendment. * * *"

If one reads the *Koshland* opinion as a whole it seems reasonably clear, in the light of the specific problem presented in that case, that the Court is adhering to the "proportionate interest" test and not the "substantially different" test. The Court suggests that, in determining whether the stockholder has received something different, *both* the old and the new stock must be considered together. The Court also refers to a proportional interest "in the net assets of the corporation," and says further that the "proportional interest" should be reviewed to see if *it* is essentially different after the distribution of stock. The Board, however, in the *Keister* case has apparently, although not specifically, pounced on the statement in the *Koshland* opinion that:

> "On the other hand, where a stock dividend gives the stockholder *an interest* different from that which his former stock holdings represented he receives income. The latter type of dividend is taxable as income under the Sixteenth Amendment."[52] (italics added)

[51]298 U. S. 441, 56 Sup. Ct. 767 (1936).

[52]The Board suggested that by the receipt of the dividend each holder of voting common stock received "an interest different from that which its former stock holdings represented." Standing alone, the sentence is vague and largely without meaning. If the two sentences are read together, however, it is apparent that when the Supreme Court

In its opinion in the *Keister* case, the Board suggests that: "The non-voting common stock was not 'of precisely the same character' as the stock previously held by them." This view would use as a test a change in the *evidences* of the taxpayer's interest in the corporation. By the use of this language, the Board adopts what might be called the "negative" test and says, in effect, that a dividend in stock is taxable unless it "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."[53] Acceptance of that view would essentially make all stock dividends taxable except a dividend in stock of precisely the same character, where only one class was previously outstanding, since only then could it be said that the issuance of the stock dividend worked no change in the corporate entity and that the stockholder had the same interest in the corporation after the dividend as before, his interest being represented by more shares of stock of precisely the same character.[54] To point out, as the Supreme Court did in the *Koshland* case, that a stock dividend of the *Eisner v. Macomber* type was very different from one where there had either been changes of corporate identity (as in the *Phellis*,[55] *Rockefeller*,[56] *Walker*,[57] and *Marr*[58] cases) or a change in the

is speaking of an interest different from that which the stockholder had before the distribution, it means that the new certificates plus the old certificates are to be viewed as an entirety in determining whether the stockholder has different rights or interests in the net assets of the corporation. The Court does not seem to be referring to the evidences of such interest, but rather to the interest itself.

[53]The Board has not gone so far as to hold that an increased number of certificates alone, such as in an "Eisner v. Macomber dividend", gives rise to a realization of income. See *supra* note 36.

[54]In a stimulating article entitled *The Present Status of Stock Dividends Under the Sixteenth Amendment*, in 6 U. OF CHI. L. REV. 215 (1939) by George F. James, Assistant Professor of Law, University of Chicago Law School, it is suggested:

". . . Should the result and reasoning of the *Kelly Trust* case be considered correct there is no place to draw the line short of the requirement that the distributed stock be of precisely the same character as that previously held. Any other distribution gives an interest of different *character*. And even this does not constitute a complete test. If holders of stock distributed and stock previously held (although the two are of precisely the same character) enjoy any rights prior to rights enjoyed by other classes of stock, or if they gain any advantage by the distribution relative to holders of other classes, an interest of different *extent* has been received. *Eisner v. Macomber* is in effect restricted to a dividend of common stock on common stock with no other fully participating interest outstanding. Thus the substantial change test limits *Eisner v. Macomber* as a precedent to its very facts, leaving the rest of the field controlled by the *Koshland* and *Gowran* cases; the *Tillotson* test does the opposite:

". . . Any distribution of new securities, unless the distributed securities be of precisely the same class as those in respect of which the distribution is made, and unless the distribution leaves unchanged the relative position of holders of different classes of stock, is subject to income tax within the rule of *Eisner v. Macomber*."

[55]U. S. v. Phellis, 257 U. S. 156, 42 Sup. Ct. 63 (1921). See *supra* note 20.

[56]Rockefeller v. U. S., 257 U. S. 176, 42 Sup. Ct. 68 (1921). See *supra* note 21.

[57]Cullinan v. Walker, 262 U. S. 134, 43 Sup. Ct. 495 (1923). See *supra* note 22.

[58]Marr v. U. S., 268 U. S. 536, 45 Sup. Ct. 575 (1925). See *supra* note 24.

nature of the shares issued as dividends *whereby the proportionate interest of the stockholder after the distribution was essentially different from his former interest,* obviously is not equivalent to a statement that any stock dividend which was not made up of shares of precisely the same character as the old shares would give rise to realized income.

Although the Board in the *Keister* case refers to the Commissioner's argument that the voting shares and the non-voting shares represent different property rights and that holders of the non-voting shares might have transferred them without in any way disturbing the distribution of voting control, it does not seem to stress that factor in its opinion. However, that element was stressed in the Board's subsequent opinion in the *Kelly Trust* case.[59]

In the *Kelly Trust* case the Board states that the test of taxability is whether the stockholder received an interest *substantially different in character or extent from what he had previously held.* In essence, the Board's opinion in the *Kelly Trust* case[60] was that before the stock dividend, the stockholders had proportionate rights in the income of the corporation, in the powers of control, and in the proceeds of liquidation upon dissolution, which rights could be disposed of collectively but could not be severed. Accordingly, before the distribution, the stockholder's interest must include the right to transfer all the incidents of ownership, but only collectively and not individually; after the dividend in preferred stock, the stockholder's interest in the corporation became, to some extent, transferable in part, whereas before it could be disposed of only as a whole.[61] In this situation the Board finds a substantial alteration in the interest of the stockholder justifying a conclusion that income has been realized and should be recognized. In this case, the emphasis of the Board again is on the differences in the *evidences of stock ownership.*[62] Since the holders of the common stock (being the only class of

[59]38 B.T.A. 1014 (1938).

[60]Subsequently appealed to the Circuit Court of Appeals, which appeal was, however, withdrawn on stipulation of the parties. See *supra* note 38.

[61]The Board points out that after the preferred stock was issued the stockholders could then dispose of a part of their interest in the earnings and assets of the corporation without in any way disturbing the distribution of voting control, or they could retain their preferred stock as representing a property interest and divest themselves of powers of management.

[62]The Circuit Court of Appeals for the Second Circuit affirmed the Board [43 B.T.A. 1209 (1941)] in the case of *Emil H. Strassburger v. Comm.,* 124 F. (2d) 315 (C. C. A. 2d 1941), holding that there was taxable income in a case which involved a distribution of cumulative 7% preferred stock, declared out of surplus accumulated subsequent to February 28, 1913, to the owner of the common stock of a corporation which had only common stock outstanding. The opinion places emphasis upon the "rearrangement of corporation capitalization" and the fact that the receipt of the preferred stock "did change the *character* of his corporate ownership." Reference is made to such factors as the rights of the preferred stock, the priority as to dividends, and a preference on liquidation of the corporation; and that these rights could be disposed of without affect-

stock outstanding) owned the entire interest in the corporation and since the preferred stock was distributed in proportion to the common stock, the stockholders after the stock dividend had the same interest in the net assets of the corporation as they had before. This necessarily must be true since the common stockholders, through their power of management, had the capacity at any time to adjust the evidences of their rights in the corporation; and so long as their proportionate interest did not change, they would have no more when they concluded such adjustment than they had before. They would merely have different evidences of their rights.

The Board itself had said in the *Brown* case[63] that the creation of the preferred stock by the common stockholders (the latter being the only class of stock outstanding) would represent "a mere proliferation of existing interests." Other earlier decisions had also minimized the single difference of a change in evidence of stock interest.

In *Marr v. United States*,[64] the Supreme Court said of the stock dividend in *Eisner v. Macomber*,

> "It was as if the par value of the stock had been reduced, and three shares of reduced par value stock had been issued in place of every two old shares, that is, there was an exchange of certificates but not of interests."

In the Board's opinion in *Tillotson Manufacturing Co.*,[65] it is suggested:

> "* * * the characteristic which gives it immunity from tax, not alone

ing the voting control residing in the common stock. The Circuit Court of Appeals was careful to point out that: "Therefore the distribution is one of property rights of *variant character* from those which he previously owned, and as such, therefore, constitutes income which could be taxed."

The Circuit Court of Appeals in the *Strassburger* case conceded that: "The question is not free from doubt." Circuit Judge Chase dissented on the theory that in addition to "a change in the kind of shares of stock a stockholder has as a result of a dividend of stock on stock," there must also be "a change in his proportionate interest in the corporation's net assets in order to have what is known as a 'realization' of income."

Compare Lida E. Malone, 45 B.T.A. 305 (1941), holding that a stockholder who surrendered her stock under plans to reduce the outstanding capital stock and increase the surplus of the bank, and who received one share and a certain amount of cash for each two shares surrendered, did not sustain any deductible loss.

63 26 B.T.A. 901, 907 (1932). See also *supra* note 44.

64 268 U. S. 536, 45 Sup. Ct. 575 (1925). See *supra* note 24.

65 27 B.T.A. 913, 916 (1933). Speaking of the particular dividend there involved, which was a distribution of common shares to the preferred shareholders, both classes being outstanding, the Board states:

"Analyzing the facts in this proceeding in the manner prescribed in *Eisner v. Macomber*, *supra*, the want of essential similarity is immediately apparent. This was not a proportional redistribution of existing or inchoate rights. There was a substantial change in the shareholder interests not only of this petitioner but of all other shareholders as well. Whether the adventitious effect of this at any given time to any one shareholder be for better or worse may serve to measure the gain or loss, but it leaves under the statute, *Towne v. Eisner,* 245 U. S. 418, but also under the Constitution so long as the income tax is unapportioned, *Eisner v. Macomber,* 252 U. S. 189, is that it represents nothing new or different from the original investment but only a further subdivision of its tokens. * * * Whether there has been a tax-free stock dividend is to be determined not by the terms used but by an analysis of the legal effect of what was done in the name of a stock dividend."

In his dissenting opinion in the *Koshland* case,[66] which decision was subsequently reversed by the Supreme Court, Judge Denman discusses at some length the factors suggesting taxability. One of the points he mentions is the fact that Mrs. Koshland's voting power or interest in corporate capital could not be deemed the same, after a common stock dividend was issued to her (as a preferred stockholder), as it was before, stating that:

> "The effect of the common dividend was to increase both her interest or expectancy in the company's capital and to change her voting power in its management."

Adding that:

> "With regard to a difference of stock character arising from her increased voting power, the case of *Chapman v. United States,* 63 Ct. Cl. 106, *certiorari denied* 275 U. S. 524, 48 Sup. Ct. 18, 72 L. ed. 406, is not an adverse decision."

He suggests that in the *Chapman* case (in which the common stockholder received non-voting common stock) "it is plain that what he received was a mere dilution in share numbers of the same property" and that the situation is different where one who has had no voting power in his preferred receives

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the change no less substantial. This petitioner as a preferred shareholder not only enjoyed the benefits of its preference and the assurance which the provision for cumulative dividends might give, but it also was subject to the limitations of a fixed dividend and a contingent right to vote. By this dividend, it acquired new and separate rights of a common shareholder to participate in unlimited dividends and liquidations and unqualifiedly in the shareholders' meetings.

"While this did not take anything from the corporation nor anything directly from the other common shareholders except a proportionate part of the value of their shares, it is the petitioner's situation which is now being considered and the effect of the dividend upon its income alone. . . ."

The Board's decision was affirmed in 76 F. (2d) 189 (C. C. A. 6th 1935). This was a "basis" case in which the taxpayer contended that it did not need to allocate the basis between the stock held and the stock received since the stock dividend was taxable and therefore, upon the sale of the old stock, the entire basis could be used.

The *James H. Torrens* case, 31 B.T.A. 787 (1934), and the *Koshland* case were also basis cases.

The principles expressed in the *Tillotson* case were reaffirmed by the Board in August Horrman, 34 B.T.A. 1178 (1936).

[66] 81 F. (2d) 641 (C. C. A. 9th 1936).

that valuable right through the stock dividend. "His position is changed with reference to his power to control the corporate management."

In going over to the "substantially different" test, the Board not only is departing from its own prior decisions but does not give sufficient weight to the very significant fact that the doctrine of a "substantially different interest" was involved not in dividend cases but in connection with so-called exchange or reorganization cases.[67] This doctrine, as evolved in such cases, holds that a taxable gain is realized not only when the gain in value is represented by an interest in a different business, enterprise, or property but also when it is represented by an essentially different interest in the same business, enterprise, or property.[68] In its more extreme form it would find a change of interest in a change in the evidences of such interest. In those cases in which this test first originated the stockholder ordinarily was entitled to use as his cost basis the cost or other basis to him of his original stock, since there was an exchange of property.[69] The gain realized was limited to the difference between such cost and the value of the new or different interest acquired upon the reorganization. In the case of stock dividends, however, the "gain" will be equal to the fair market value of the new stock received without any offsetting cost,[70] assuming that the corporation has earnings and profits equal to the fair market value of the stock distributed.[71] This result should at least suggest some hesitancy in applying broadly to stock dividend cases the test of receipt of something "substantially different," applicable to exchanges.[72]

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[67]See *supra* notes 26, 27.

[68]See, for example, the Board's summary of this test in one of its early opinions in Commercial Trust Co., 8 B.T.A. 1138, 1147 (1927). See also the statement in U. S. v. Siegel, 52 F. (2d) 63 (C. C. A. 8th 1931), *cert. denied* 284 U. S. 679, 52 Sup. Ct. 140 (1931). See also 4 B.T.A. 186 (1926).

[69]See *supra* note 22. Distributions in kind of stock of another corporation are to be distinguished.

[70]This unfairness was undoubtedly recognized by the Court in Eisner v. Macomber, 252 U. S. 189, 40 Sup. Ct. 189 (1920). See statement of Mr. Justice Pitney, repeating from the opinion in Towne v. Eisner, 245 U. S. 418, 38 Sup. Ct. 158 (1918), that "If the plaintiff gained any small advantage by the change, it certainly was not an advantage of $417.450, the sum upon which he was taxed. . . ."

[71]It is obvious that in periods of depression following boom periods, in which a large proportion of the stock may have been acquired or changed hands, a large stock dividend would be inadvisable if such stock dividend were of the taxable type. In such cases the stockholders would ordinarily have a high cost basis and one in excess of the value of the stock in the taxable year. If a taxable stock dividend is received, the taxpayer would realize taxable income through the receipt of the stock dividend, although he would have a substantial unrealized loss on the original stock. It might in such cases be more economical for the stockholders if the changes desired were accomplished through a taxable exchange or readjustment of securities, or through a nontaxable recapitalization or reorganization.

[72]A swing to this concept in stock dividend cases would constitute a reversal of the prior trend toward postponement of recognition of increment in value evidenced by § 112 of the Internal Revenue Code. But this would be in accord with the recent tendency

Applicability of Non-Recognition Provisions of the Internal Revenue Code

The doctrine as to realization of income where the shareholder receives an interest substantially different in character or extent from that previously held, originally advanced in *Cullinan v. Walker,*[73] resulted in the inclusion by Congress in the 1921 Act[74] of statutory provisions postponing recognition of realized gain or loss arising from tax-free exchanges and reorganizations. Obviously, the intention of Congress was to postpone recognition of income and imposition of the tax where there was no real change in the interest of the stockholder, but merely a change "in form" which might, nevertheless, result in a tax under the principles expressed in the *Phellis* and *Rockefeller* cases.

Among the provisions so included were the counterparts of Section 112 (b) (2) and Section 112 (b) (3) of the Internal Revenue Code. Subsection (b) (2) provides for non-recognition of gain or loss on an exchange of common stock solely for common stock of the same corporation or on an exchange of preferred stock solely for preferred stock of the same corporation. Subsection (b) (3) provides, in part, for non-recognition of gain or loss on an exchange of "stock or securities" in a corporation a party to a reorganization solely in exchange for "stock or securities in such corpora-

to accelerate recognition of gain. The element of segregation or separation is relatively unimportant in the reorganization cases since the stockholder could offset his original capital or "cost" against the value of what he was deemed to have received in the exchange. The primary test in such cases is whether he has received something different from what he had before so as to bring into realization the income which was previously dormant. A dividend on the other hand contemplates a distribution by the corporation. It may be assumed that in the *Koshland* and *Gowran* cases the Supreme Court found the equivalent of this distribution in the charging of earnings and the crediting of capital inherent in the distribution of the stock dividend.

As long, however, as Eisner v. Macomber is the law, this reasoning alone would not justify a tax on the stockholder. He must have in addition "realized" a gain since only such realized gains represent income. If we are to apply the "substantially different interest" test in order to determine whether he has realized a gain, the transaction should be treated as though the stockholder had exchanged his property for other property, and accordingly, the gain should be measured by the difference between the cost of the property previously owned and the value of the property which he has after the exchange. Take, for example, a person who has purchased stock the day before the stock dividend. Assume the stock cost him $80 a share and that the value of the stock distributed is $25 a share and that after the distribution the original stock is worth $55 a share; this stockholder has not profited in any real sense from the stock dividend. In fact, by crystallizing and freezing earnings and profits into capital he has, in one sense, limited his prior rights in the corporation. In the suggested case he might be taxed on the value of the stock distributed; but if he is so taxed, it should only be because there has been a real distribution changing his previous relationship to the corporation or the other stockholders, and not simply because he has additional certificates evidencing the same interest as before.

[73]See *supra* notes 22, 23.

[74]1921 Act, § 202.

tion." A "reorganization" is defined in Section 112 (g) (1) as including a recapitalization.

If the applicability of these provisions to stock dividends is to be denied,[75] it must be on the grounds:[76] (1) that a stock dividend does not involve an exchange,[77] and that an exchange is a prerequisite under Section 112 (b) (2) (3),[78] and (2) that no "recapitalization" is involved.[79]

If the test of receiving something "substantially different," as applied in the exchange cases, is to be applied to stock dividend cases, there is some justification for treating the transaction as an exchange for the purpose of applying Section 112 (b) (2) and (3). The essential premise on which realization of the gain is predicated, under this test, is that as a result of the distribution, the stockholder has changed (often involuntarily) the character or extent of his interest in the corporation.[80] This is the doctrine of the "exchange" cases. If the receipt of new stock is to be treated as the equivalent of an exchange of old for new interests in determining whether gain has been *realized,* then it is not unreasonable to treat it as such in determining whether such gain should be *recognized.* Otherwise, the test should not be applied at all.[81]

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[75]Professor James in his article, *supra* note 54, suggests that these sections be circumvented, in effect, by a judicial determination that an exchange of stock "essentially equivalent to the distribution of a taxable (stock) dividend would be subject to tax in view of section 115(f) and despite section 112."

Cf. Ways and Means Committee Report No. 179, 68th Cong., 1st Sess., in which a stock dividend was spoken of as a type of recapitalization.

[76]An argument can be advanced either way from the fact that when § 115(f) was changed in the 1936 Act, eliminating the exemption of stock dividends, no change was made in §§ 112(b) (2) or 112(b) (3).

[77]In the *Kelly Trust* case a brief was filed by an attorney acting as *amicus curiae* suggesting that under the 1932 and prior acts, for example under § 112(g) of the 1928 Act, the distribution was nontaxable even though outstanding stock had not been recalled and reissued since the dividend was distributed pursuant to a reorganization without surrender of the old stock. This argument apparently was rejected by the Board. It also appears that a similar contention was advanced in the case of H. F. Asmussen, 38 B.T.A. 1533 (1938), *remanded on stipulation* 106 F. (2d) 992 (C. C. A. 8th 1939).

[78]Another possible argument is that § 112(b) (2), which says that an exchange of common stock for common stock of the same corporation in connection with a recapitalization is "tax exempt", relates only to instances where the stock is precisely of the same character *and* does not result in the stockholder receiving something which is substantially different in character or extent from what he had before. There would seem to be no true basis for such an argument based, as it is, entirely on inference. This argument would limit § 112(b) (2) to an exchange of common stock for common stock of precisely the same class or an exchange of preferred stock for preferred stock of precisely the same class. Even if we accept this argument as valid, it still falls short of excluding from this section receipt of additional common stock resulting in increased voting power in the recipient over other classes of stockholders, the stock being of precisely the same character.

[79]Accordingly, there is no exchange pursuant to a plan of reorganization.

[80]*Cf.* Ahles Realty Corp. v. Comm., 71 F. (2d) 150 (C. C. A. 2d 1934); I. T. 1152, I-1 CUM. BULL. 32.

[81]It is assumed that there has been no *actual* exchange.

Whether there is a "recapitalization" would depend in each case on the particular facts involved.[82]

The applicability of either Section 112 (b) (2) or 112 (b) (3) was not an issue in either the *Koshland* or *Gowran* case.[83] The results reached in those cases are not necessarily inconsistent with the view that either provision of the tax statute may be applicable in a proper case. Section 112 (b) (2), of course, would have been inapplicable in the *Koshland* and *Gowran* cases, on the facts involved, since there was not an exchange of common for common, or preferred for preferred. Section 112 (b) (3) was not pertinent since apparently there was no recapitalization involved or claimed.

Suggested Rules for Determining Tax Liability on Receipt of Stock Dividends

Expressing general principles in this turbulent field of income taxation is indeed a risky venture. The selection of the appropriate test is the keystone to any conclusion as to taxability. The writer's preferences have been indicated in the preceding part of this article and they are the basis for the following suggestions as to how the law *should be* interpreted.[84] The conclusions expressed are premised on the assumption that where two classes of stock are outstanding they are not held proportionately by the same stock-

[82]See Hyman v. Helvering, 71 F. (2d) 342 (App. D. C. 1934), *cert. denied* 293 U. S. 570, 55 Sup. Ct. 100 (1934); R. D. Walker, 34 B.T.A. 983; Chester A. Souther, 39 B.T.A. 197; C. H. Mead Coal Co. v. Comm., 72 F. (2d) 22 (C. C. A. 4th 1934); Kistler v. Burnet, 58 F. (2d) 687 (App. D. C. 1932); Walter F. Haass, 29 B.T.A. 900; 375 Park Avenue Corp., 23 B.T.A. 969; H. E. Muchnic, Adm., 29 B.T.A. 163; I. T. 2541, IX-2 CUM. BULL. 299; Albert E. Smith, 39 B.T.A. 80; G. C. M. 18536, 1937-1 CUM. BULL. 101; L. & E. Stirn, Inc., 39 B. T. A. 143; Clark v. Comm., 77 F. (2d) 89 (C. C. A. 3d 1935); H. Y. McCord, 31 B. T. A. 342; *cf.* Pearl B. Brown, Exec., 26 B. T. A. 901; Reg. 103, § 19.112(g)-2; Millicent T. Roelker, 39 B. T. A. 967: Helms Bakeries, 46 B. T. A. 43; Elizabeth Morainville, 46 B. T. A. 98.

See, Jacob Fischer, 46 B. T. A. 134, decided April 28, 1942 (holding tax free an exchange of common stock for new common and preferred stock). The Commissioner argued in this case that there could be no recapitalization within the meaning of that term as used in the taxing statute, unless the recapitalization was supported by a business purpose. *Cf.* Elizabeth B. Bass, 45 B. T. A. 1117.

[83]The "proportionate interest" test does not premise recognition of gain on any theory of exchange of interests for something different in character or extent, but primarily on the theory of a constructive distribution of earnings or profits. Accordingly, there is less reason to search for the equivalent of an exchange in the transaction. But the applicability of §§ 112 (b) (2) and 112 (b) (3) would not depend, it would seem, on whether the "proportionate interest" test or the "substantially different" test were used. Apparently in the *Keister* case recapitalization was not effected.

[84]No attempt is made here to state what the law is, since there is no universally accepted and fixed law as to tax liability on receipt of a dividend in stock. Almost every decision, except those in the *Koshland* and *Gowran* cases, is presently challenged as to its correctness. The Commissioner of Internal Revenue has sought even to tax a dividend of a character identical with that held to be nontaxable in Eisner v. Macomber. See *supra* note 36.

holders. Where the two classes of stock are held proportionately or identically, the same rules would apply generally as in the case where only one class of stock is outstanding.

1. Where the stock dividend is not of precisely the same character and there is more than one type of stock outstanding at the time of distribution, if the stock dividend changes the rights of the stockholder in relation to the corporation through a change in the proportionate interest of the stockholder in or with relation to the assets of the corporation, there is a realized gain to the extent of the earnings deemed to have been distributed. Any "distribution" is presumed to be out of earnings or profits,[85] and the fair market value of the stock distributed will be assumed, under this presumption, to represent the amount of earnings or profits per share which are distributed.[86] In other words, it is to be treated substantially the same as a distribution in money, or in kind.[87] If there are earnings available for taxable dividends equal to the value of the stock distributed, it should be immaterial whether the distributing corporation actually capitalizes the stock dividend on its books by charging earnings or surplus.

This type of distribution occurs, for example, where both common and preferred[88] are outstanding and preferred stock is issued to common stockholders.[89] Another example would be the issuance of common stock to

[85]INT. REV. CODE § 115 (b).

[86]There is a feeling of going "all around Robin Hood's barn", however, in attempting to reconcile § 115 (h); this latter section provides that a distribution by a corporation of its stock or securities shall not be considered a distribution of earnings or profits if no gain to the distributee is recognized from the receipt of such stock or securities. Can we lift the problem out of this merry-go-round by holding that the presumption in § 115 (b) as to source of distribution must first be applied, and that § 115 (h) does not come into consideration until after that has been done? It seems that, under our system of patching up the statute from time to time, both necessity and logic justify such an approach. The Supreme Court in the *Koshland* and *Gowran* cases was not stopped by this statutory dilemma.

[87]It is not necessary that there be an actual segregation or separation of assets from the corporation, nor is it necessary that something be received which is separately disposable. *Cf.* Hort v. Comm., 313 U. S. 28, 61 Sup. Ct. 757 (1941); Helvering v. Bruun, 309 U. S. 461, 60 Sup. Ct. 631 (1940).

[88]Nomenclature, such as "preferred stock", is, in these days of hybrid securities, often a dangerous staff to lean upon. Variations from the norm, in underlying factors or in rights and privileges adhering to the particular type of stock involved, must be given consideration in determining whether the ordinary rule will apply.

In the *Koshland* case, *supra* note 3, the Supreme Court states the question as follows: "The question is whether, under the Revenue Acts of 1926 and 1928, a taxpayer who purchases cumulative non-voting shares of a corporation upon which a dividend is subsequently paid in common voting shares must, upon a sale or other disposition of the preferred shares, apportion their cost between preferred and common for the purpose of determining gain or loss."

[89]See Gowran v. Comm., 87 F. (2d) 125 (C. C. A. 7th 1936), *aff'd, in effect, on this point, and rev'd on another point,* Helvering v. Gowran, 302 U. S. 238, 58 Sup. Ct. 154 (1937). In this case a dividend was declared from the surplus earnings of $14 a share

preferred stockholders where both common and preferred are outstanding.[90] A still further example might be the distribution of preferred stock to preferred stockholders when both common and preferred are outstanding.[91]

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on the common stock payable in preferred stock at its par value. The primary issue involved was as to what basis was to be used for the preferred stock. See also, Pfeiffer v. Comm., 88 F. (2d) 3 (C. C. A. 2d 1937), *aff'd on another point,* Helvering v. Pfeiffer, 302 U. S. 247, 58 Sup. Ct. 159 (1937).

In the Circuit Court's opinion in the *Gowran* case, it is stated that the dividend was constitutionally taxable, but was exempt under the statute on the theory that the statute exempted dividends in stock of all types. The *Gowran* case is discussed by Traynor, *Tax Decisions of the Supreme Court, 1937 Term,* 33 ILL. L. REV. 371 (1938).

The Board held in an early case arising under the 1928 Act that where both common and preferred shares are outstanding a dividend declared upon voting common stock and paid in the form of non-voting cumulative preferred shares was not a tax-free stock dividend. See James H. Torrens, 31 B. T. A. 787 (1934), *petition dismissed* (C. C. A. 2d 1936); McLaren, *Management of Capital Contributions under the Revenue Act of 1936,* 62 J. OF ACCOUNTANCY 334, 354 (1936).

In Albert E. Smith, 39 B. T. A. 80 (1939), *remanded on stipulation,* 107 F. (2d) 1020 (C. C. A. 6th, 1939), the Board held that where preferred stock, junior to the outstanding preferred stock, was received as a dividend on common stock, the basis for determining gain on the subsequent disposition of the stock received as a dividend is zero rather than an allocated portion of the basis of the common stock upon which the dividend was declared. The Board held that the junior preferred stock which was received represented income and was not a return of capital in whole or in part.

See discussion of the *Kelly Trust* case, *supra* note 43. See also (1939) 87 U. OF PA. L. REV. 346.

Cf. Oxford Paper Co. v. U. S., 52 F. (2d) 1008 (Ct. Cls. 1931), *supplemental opinion,* 56 F. (2d) 895 (Ct. Cls. 1932), involving exchange of bonds for preferred stock.

In the Board's decision in Tillotson Mfg. Co., 27 B. T. A. 913 (1933), the distribution involved was of common stock to preferred stockholders for the purpose of paying a dividend declared of $29.75 per share on each share of preferred stock; for this purpose the common stock was valued at $25 a share. The stockholder had included the common stock received in his taxable income at a total value of $242,685.53, using $31.38 a share, whereas the total declared dividend on his preferred stock was $193,375 (which is the total of $29.75 per share times his 6,500 shares). The actual question involved in this case was the basis to be used for the preferred stock on its subsequent disposition. The Board found that the distribution was taxable and therefore did not reduce the cost of the preferred. There was no necessity, however, for determining the amount of income subject to tax.

See also George T. Gerlinger, 39 B. T. A. 1241 (1939), *remanded,* 106 F. (2d) 997 (C. C. A. 9th 1939).

90This is the type of distribution which was involved in the *Koshland* case (a basis case) and in accordance with the views there expressed, that the distribution represented income to the stockholder, such a dividend undoubtedly would be held under the Code and under the 1938 and 1936 Acts to represent taxable income to the extent of the fair market value of the stock received.

In the *Koshland* case, the corporation had the option to pay cumulative dividends on its preferred stock either in cash or common stock.

91The basis for finding taxable income in the case of such a distribution is that following a distribution of the preferred stock the future earnings and the corporation's assets will be subjected to an additional preference in favor of the preferred shareholders. In other words, they would have something more after the distribution than they had before and the common stockholders, conversely, would have something less than they had before. An opinion similar to that expressed by the author in the text is noted by Mr. Magill in his work on TAXABLE INCOME, at page 48 (1936).

This type of exchange is illustrated in Helms Bakeries, 46 B. T. A. 43.

2. If the effect of the stock dividend is to change the interest of the stockholder in the corporation by changing the "proportionate interests" of the several classes of stockholders as against each other, then there may be a taxable distribution, even though the stockholders retain the same proportionate interests in the net assets of the corporation. For example, where there are two classes of stock outstanding, the shares of each class being entitled to vote, and one class receives a 100% stock dividend in the same stock carrying voting rights, there might be a realized gain.[92] Another example might be a stock dividend paid in voting common stock on non-voting common stock, with both preferred and common stock outstanding.[93]

3. Where there is but one class of stock outstanding, there is no taxable dividend upon the receipt by the stockholder of a new class of stock which gives the recipient evidence of certain preferences in the distribution of earnings, even though the new preferred stock is cumulative or does not carry voting rights. The contrary view is that by chewing out of the capital represented by the stock a new *evidence* of corporate rights, the original "capital" of the stockholder has been sufficiently changed to permit a determination that gain has been realized and should be recognized.[94] Under this theory, pushed far enough, it might also be considered that a distribution of common stock to common stockholders would represent a realized gain.[95] The argu-

[92]In a decision rendered in 1927 and therefore prior to the *Koshland* case, a stock dividend of common to common stockholders, where preferred was outstanding, was held nontaxable; Chapman v. U. S., 63 Ct. Cls. 106 (1927), *cert. denied,* 275 U. S. 524, 48 Sup. Ct. 18 (1927). See *supra* note 45.

[93]This distribution is different from that in the *Kelly Trust* case, *supra* note 38, in which there was a dividend in non-voting common stock to stockholders owning voting common stock, which distribution was held to be taxable. While the receipt of non-voting common stock would represent stock having inferior rather than superior rights, this was held not to make any difference since the test relied on by the Board was whether the stockholder received something different from what he had before, and something which he could dispose of separate and apart from the evidences of ownership held prior to the dividend.

In a note (1936) 36 Col. L. Rev. 1321, 1327, the taxability of such a dividend is predicted, on the theory that the privilege of voting may be a factor rendering the shareholder's interest substantially different.

[94]See *supra* notes 35, 36. In (1936) 36 Col. L. Rev. 1321, 1328, it is suggested that a common dividend on preferred, when only preferred stock is outstanding, would create a taxable dividend because it would give an unlimited right to share in earnings, where a qualified right so to share was held before.

See also, Leonard Dreyfuss v. Manning, Collector, — F. Supp. — (D. N. J.), decided March 24, 1942.

[95]However, in Koshland v. Helvering, 298 U. S. 441, 56 Sup. Ct. 767 (1936), it is said, by way of dictum, that "Under our decisions the payment of a dividend of new common shares, conferring no different rights or interests than did the old, the new certificates, plus the old, representing the same proportionate interest in the net assets of the corporation as did the old, does not constitute the receipt of income by the stockholder. On the other hand, where a stock dividend gives the stockholder an interest different from that which his former stock holdings represented he receives income.

ment is that such "change" might afford an appropriate time for tax "reckoning."[96] In such a case, the changes in character, extent, or evidences of the stockholder's interest should lead to recognition of gain, if at all, only on the theory that there was the equivalent of an exchange of stock, rather than a dividend distribution. If this were done, the distribution would then be the occasion for the realization and recognition of losses as well as of gains.

4. If the corporation distributes its obligations, such as a bond or note, to stockholders, there is a realized gain since the stockholders then have received the equivalent of a distribution of assets of the corporation.[97] A distribution to stockholders of a corporation's own bonds is taxable to the stockholders to the extent of the earnings or profits available for taxable dividends. The distribution of bonds does not capitalize surplus, but makes the stockholder a creditor of the corporation to the extent of the bonds received.

5. In all cases in order that there be a taxable *dividend* there must be a "distribution" of earnings or its equivalent.

The foregoing rules are subject to an exception in those cases which fall within the exchange and reorganization provisions of the statute [Sections 112 (b) (2) and 112 (b) (3)].

Before the turn of the present year, that is, before the thirtieth anniversary of modern income tax law, we probably will know with some certainty whether the foregoing rules fall on the right or the wrong side of the line. The Treasury Department is all set to blitz *Eisner v. Macomber*.[98]

The latter type of dividend is taxable as income under the Sixteenth Amendment. Whether Congress has taxed it as of the time of its receipt, is immaterial for present purposes." This, in effect, reaffirms the result in Eisner v. Macomber holding non-taxable a dividend of common on common, where only common stock is outstanding.

The Board recently has reaffirmed the result in the *Eisner v. Macomber* case in its decision in the *Griffiths* case, *supra* note 36.

[96] See also Roswell Magill, *Realization of Income Through Corporate Distributions* (1936) 36 COL. L. REV. 519.

[97] U. S. v. Fuller, 42 F. (2d) 471 (E. D. Pa. 1930), *in effect rev'g.* 7 B. T. A. 28 (1927); I. T. 1900, III-1 CUM. BULL. 82. See *supra* note 17.

[98] The government applied for and was granted *certiorari* in the *Sprouse* case on May 11, 1942, a previous order denying *certiorari* being vacated. See *supra* note 37. *Certiorari* was also granted on May 11, 1942, in the *Strassburger* case on request of the taxpayer. See *supra* note 38.

See also, *Griffiths* case, *supra* note 36, in which the Solicitor General has authorized an appeal. See also, T. D. 5110, amending Reg. 101, 94, Art. 115-7.