// THE
UNIVERSITY OF CHICAGO LAW REVIEW

VOLUME 4 FEBRUARY 1937 NUMBER 2

THE BOARD OF EDITORS

BYRON S. MILLER, *Editor-in-Chief*
BERNARD MELTZER } *Notes and Recent*
ROBERT D. MORGAN } *Cases Editors*
KENNETH BLACK
EDWARD D. FRIEDMAN
BENJAMIN GOULD
ELMER M. HEIFETZ
RICHARD H. LEVIN, *Legislation Editor*
GERALD RATNER, *Administrative Editor*
HARRY KALVEN, JR.
JACK W. LOEB
ROBERT I. LIVINGSTON
JAMES S. MARTIN
LESLIE H. WALD

E. W. PUTTKAMMER
Faculty Adviser

NOTES

USE OF STOCK DIVIDENDS TO AVOID UNDISTRIBUTED EARNINGS SURTAX

Unless the Supreme Court overrules or modifies its decision in *Eisner v. Macomber*[1] there is considerable likelihood that corporations will be unable to make any extensive use of stock dividends as a means of avoiding the undistributed earnings surtax. Since Congress enacted the provisions for the surtax in the Income Tax Act of 1936,[2] a number of corporations have adopted some means of avoiding liability for a large tax while retaining the earnings in the business. It seems generally acknowledged that the only available means of avoiding the tax are the following: (1) payment of a cash dividend;[3] (2) payment of a cash dividend, accompanied by an offering of the corporation's stock at a price equal to the amount of the dividend;[4] (3) payment of a cash dividend to owners of part-paid stock, accompanied by a call for the same amount as a

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

[2] Sec. 14, 49 Stat. 1655 (1936); 26 U.S.C.A. § 13a (1936). Hereafter this will be referred to as the Act; and all section references will be to this act unless otherwise noted.

[3] The Act provides a dividends-paid credit equal to the amount of dividends paid, § 27. This credit reduces the amount of the undistributed net income, which is the amount on which the surtax is levied.

[4] The Supreme Court justices were in agreement in the *Eisner* case that a cash dividend is taxable, regardless of the use which is subsequently made of it. The point has since been tacitly accepted.

payment on the stock;[5] (4) declaration of a dividend to be paid in cash or in stock of the corporation, at the recipient's option;[6] (5) payment of dividends in stock of the corporation or in stock rights under circumstances which make the dividend taxable in the hands of the recipient.[7] Of these, one of the most widely discussed and undoubtedly the simplest to employ if actually available is the payment of taxable stock dividends. The extensive payment of cash dividends involves too much depletion of cash reserves to suit the purposes of many corporations. Yet the alternatives which involve optional receipt of cash or stock are inconvenient devices. The amounts of stock to be taken remain indeterminate for some period, which may require expensive underwriting to insure an adequate cash reserve; and in order to avoid this difficulty by inducing most of the shareholders to accept stock in lieu of cash it may be necessary to make the stock offering extremely attractive.[8] Consequently, if the expedient of taxable stock dividends were practically available many corporations would undoubtedly make an extensive use of it. Up to the present time most corporations have adopted one of the other four means, possibly out of distrust of an untried device. However, some corporations did issue stock dividends before the close of the 1936 taxable year;[9] and since commentators have continued to discuss the possibility of a wide practical use of this method of shifting the tax burden, it may be useful to consider some of the difficulties which stand in the way of its employment by most corporations as they are at present capitalized. These are difficulties which, in the case of those corporations which have issued stock dividends, may give rise to litigation after the 1936 taxes have been assessed.

It seems obvious to most observers that the availability in practice of the stock dividend method of avoiding surtax liability depends in large part upon the possibility of issuing taxable dividends to common stockholders. In the case of corporations which *can* avoid the surtax through payment of dividends to their preferred stockholders, no difficulties are apparent. The decision in *Koshland v. Helvering*[10] and the provision for a dividends-paid credit on all taxable stock dividends issued solve the problem adequately. Yet it is signifi-

[5] This device is of little application in the United States, since very few corporations make use of part-paid stock. The practice is more common in England.

[6] This is taxable under § 115f (2).

[7] A dividends-paid credit equal to the market value of the shares or rights distributed is provided in § 27 (e). For a general discussion of these devices, see Graham, The Undistributed Profits Tax and the Investor, 46 Yale L.J. 1 (1936).

[8] A further difficulty appears in the fact that an unduly attractive option may be held not a bona fide option but a pure stock dividend which is non-taxable. See note 27 *infra*.

[9] See note 11 *infra*.

[10] 298 U.S. 441 (1936). Dividends on non-participating preferred stock paid in common stock were held to constitute income to the stockholders for the reason that the dividend stock represented a new interest in the corporation, different from the interest represented by the preferred holdings.

cant that no extensive use of stock dividends on preferred stock took place near the close of the 1936 tax period, and that nearly all corporations which issued stock dividends for the express purpose of avoiding the tax issued preferred stock to their common stockholders.[11] The chief reasons for this fact are rather apparent. It seems clear that any method, to be practicable, must create a dividends-paid credit nearly equal to the total taxable net income of the corporation. Yet non-participating preferred stock cannot absorb a large proportion of the net earnings of most going concerns; since it is limited in dividends to a fixed amount and no more, and this amount seldom equals the whole of the corporation's earnings for the year. Consequently, unless the corporation is capitalized largely on preferred stock and makes only a moderate return on its capital, or unless its earnings are so small that its net income is barely more than enough to pay the preferred dividends, the dividends paid to the preferred shareholders will not adequately handle the surtax problem. Where participating preferred stock is outstanding, this difficulty may be less acute; but this type of stock is not in extensive use, and in the few cases in which this type of stock is outstanding there are two obstacles: (1) the dividend on participating preferred may not be taxable;[12] and (2) the common stockholders must be given dividends along with the preferred in the "distribution" of the entire net income. As a practical matter, therefore, it seems that unless a taxable stock dividend on common stock is available most corporations must use some other method of shifting their tax burden.

While it is fairly clear that any stock dividend issued to a non-participating preferred shareholder will be taxable under the reasoning of the *Koshland* case, discussed *infra*, it appears to most writers that stock dividends on the common stock will not be taxable except in the case in which a corporation having both preferred and common stock outstanding pays a dividend in preferred. This opinion is based upon an examination of the leading stock dividend cases. It has long been held that common stock issued as a dividend on common stock is not taxable as income.[13] The certificates owned by a common stockholder have been held to represent a certain undivided proportionate interest in the enterprise as a whole, and not an interest in the corporate assets.[14] Conse-

[11] For example, action declaring dividends in preferred stock was taken by the Caterpillar Tractor Co. and the Chesapeake & Ohio Railway. See Comm. & Fin. Chron. 2201, 2360, 2669 (1936). On October 21, 1936, the Greyhound Corporation of Chicago voted a dividend on the common stock payable in preferred on December 21 to stock of record December 10, calling at the same time for redemption on January 1, 1937, of all outstanding preferred stock. Chicago Daily News, October 21, 1936.

[12] See the discussion of this type of stock at p. 321 *infra*.

[13] Eisner v. Macomber, 252 U.S. 189 (1920).

[14] According to Mr. Justice Pitney in the Eisner case, 252 U.S. 189, 208, the common shareholder's certificate shows that he or his assignors have contributed capital to the enterprise and that he is entitled: (1) to have the property of the company devoted to the attainment of the common objects; (2) to an interest in the enterprise proportionate to his capital; (3) to vote at stockholders' meetings; (4) to receive a proportionate share of dividends when

quently when more common stock is issued to the stockholder in proportion to his original holdings he still has exactly the same proportionate interest in the whole enterprise as he had before the dividend; his new and old certificates together represent neither more nor less rights than the original certificates. Yet it has also been held that a dividend on non-participating preferred stock paid in common stock is taxable.[15] Here the stockholder in effect obtains a new set of rights in the corporate enterprise, apart from those which he previously had, and in addition to them.[16] While his gain is quite evidently not at the expense of the corporation but at the expense of the common stockholders—since the dividend reduces the proportionate interests of all common stockholders but separates nothing from the corporate assets—yet the test of income is gain to the stockholder and not loss to the corporation.[17] Consequently the newly acquired set of rights, which in no sense conflicts with or dilutes any previous rights which the stockholder had, may reasonably be treated in the same manner as any other newly acquired property having a market value. For similar reasons it seems clear that a dividend on non-participating preferred paid in preferred constitutes taxable income.[18] On the other hand there is authority for the opinion that preferred stock issued as a dividend on common stock, where only common was previously outstanding, is not taxable income to the common stockholder.[19] The common stockholder receiving preferred shares does seem to get some new interest: the right to precede the com-

declared; (5) to receive a proportionate share of the assets on dissolution. Short of liquidation or dividend declarations, the stockholder has no right to withdraw any part of the capital or profits of the enterprise; his interest pertains not to any part of the assets but to the entire business.

[15] Koshland v. Helvering, 298 U.S. 441 (1936).

[16] As a preferred shareholder, the stockholder was entitled (1) to receive a fixed amount per share in dividends each year, and to have the dividends accumulate until paid; (2) to receive a fixed amount out of the assets of the corporation on liquidation. After the dividend he still has exactly the same rights, and in addition the right to vote at meetings, to receive a certain proportion of all dividends declared to the common stockholders, and to receive a certain proportion of the assets available on liquidation to the common stockholders.

[17] This is evidently the import of the two tests of income suggested in the Eisner case. The first is the severance of something from the assets of the corporation for the separate use of the shareholder; the second is a change in the proportionate interest of the shareholder in the corporate enterprise. The one is based on a loss to the corporation and a corresponding gain to the stockholder; the other on gain to the shareholder regardless of the effect upon the corporation itself.

[18] A preferred dividend paid on non-participating preferred stock will always carry an additional set of independent rights having some value. These additional rights would become valueless to the shareholder only if in the event of a future liquidation the amount of assets available for distribution was not more than the total amount of the preference of the preferred stock outstanding before the dividend.

[19] Commissioner v. Brown, 69 F. (2d) 602 (C.C.A. 7th 1934), *cert.* denied, 293 U.S. 570 (1934); Horrman v. Commissioner, 34 B.T.A. —, Dec. 9500 (C.C.H.), Oct. 21, 1936. But *cf.* Regulations 94, art. 115–7 (1936).

mon stockholders in sharing both dividends and assets. Yet all these advantages are over himself as a common stockholder. There exists no other class of stockholders at whose expense the common stockholders can possibly have gained; and since the corporation has not assumed any additional obligation to its stockholders, the entire "gain" has been at the expense of the stockholders themselves. The likelihood of serious dispute on any of these types of dividends is not great; so that in practice the disputes, if any, will probably center upon the payment of preferred stock to the common stockholders of a corporation having stock of both kinds outstanding. Disputes over the taxability of a dividend in common on participating preferred stock are less likely; because the objections available in the preferred-on-common situation apply with somewhat less force, and because the type of stock is uncommon.

The preferred-on-common dividend assumes practical importance not only because it is the one type of dividend on common stock which gives the recipient some semblance of a new interest, but also because most corporations do have both preferred and common stock outstanding. The preferred-on-common dividend would be one of the most advantageous to such corporations. It is usually true that where the management holds most of the common stock, preferred stock is rather widely distributed to the public. If the earnings are large the management must either distribute common to the preferred, which will dilute its own interests; or it must distribute preferred and offset the creation of additional preferences ahead of its common by issuing preferred to itself. On the other hand, if it is the common which is widely held, it will be necessary to distribute a preferred-on-common dividend in order to obtain a sufficient dividends-paid credit by the stock dividend method. Consequently it seems that the possibility of a widespread use of taxable stock dividends to avoid surtax liability depends very largely upon the possibility of issuing preferred stock as a taxable dividend to the common stockholders. There are serious obstacles, however, to a conclusion that such a dividend constitutes taxable income.

If the function of this note were to predict what the Supreme Court would in fact do if the case were presented, we should have to take account of the fact that the Treasury Department,[20] the Board of Tax appeals,[21] and most commentators are of the opinion that the preferred-on-common dividend is taxable income;[22] and we should have to consider the probability that the Court would yield to the expediency of allowing corporations to avoid the sur-

[20] 70 Treas. Dec. no. 7 (Int. Rev. 4674), art. 115-3 example (3) (1936).

[21] Annie M. Pfeiffer, B.T.A. Dec. 9444-F (C.C.H. Memo.), June 27, 1936; H. C. Gowran, 32 B.T.A. 820 (1935); Jas. H. Torrens, 31 B.T.A. 787 (1934); Daisy M. Ward, 29 B.T.A. 1251 (1933).

[22] See, for example, Magill, Taxable Income 47 (1936); Hendricks, The Surtax on Undistributed Profits of Corporations, 46 Yale L.J. 19, 40 (1936); Peper, Corporate Policy under the Surtax on Undistributed Profits, 22 Wash. U. L. Q. 1, 14 (1936); Schulman, Undistributed Profits Tax Avoidance after the Koshland Case, 14 Tax Mag. 703, 704 (1936); 50 Harv. L. Rev. 332, 334-5 (1936); 85 U. of Pa. L. Rev. 83, 103-04 (1936).

tax and of upholding the *status quo* as established by treasury and board rulings. We should also have to take account of the fact that the decision in *Eisner v. Macomber* has been severely criticized, and that if the necessity should arise the Court might either overrule that decision or modify its original meaning by means of an inconsistent decision distinguishable only "on the facts" of the case presented. The purpose here, however, is to present an analysis based on the assumption that the *Eisner* case still represents the law.

An analysis of the concept of income as developed in the federal taxation cases seems to indicate not only that the preferred-on-common dividend lacks some of the important characteristics of "income" but also that it has some of the characteristics of mere capital increase, which has heretofore been distinguished from income.[23] It seems to be accepted in all discussions of income that income involves a realization of gain.[24] Partly in reliance on this common understanding and partly in reliance on statutes and decided cases, we may adopt a scale of types of gains running from what seems the most clearly realized to what seems the most clearly unrealized. Accordingly we may list the realized gains as follows: (a) cash received outright, as for services rendered; (b) cash representing the excess of selling price over cost of property sold; (c) new property other than cash, but readily salable for cash, received outright and apart from any property previously owned; (d) new property, valuable but not readily marketable, received outright and apart from any property previously owned; (e) the excess of market value of new property, received in exchange for property previously owned, over the cost of the original property.[25] Beyond these are what have been considered unrealized gains: (f) simple increments in the market value of property presently owned; (g) simple increments in the valuation of property not readily marketable; (h) potential or contingent gains, such as the expectancy of gains in the future.

The previously recognized realized gains on corporate stock holdings include only: (1) cash dividends; (2) stock of another corporation received as a dividend; (3) dividends received in stock of the issuing corporation, but representing a new and separate interest in the corporation, without changing the rights represented by the former interest; (4) excess value of new stock of a different company received in exchange for stock previously held. Thus it has been held that cash dividends, whether entirely out of earnings or partially in

[23] Eisner v. Macomber, 252 U.S. 189, 207 (1920).

[24] Income is a gain derived from capital or labor or both combined; it is not a gain accruing to capital; it is not growth or increment of value in the investment; it is gain proceeding from the property, severed from the capital; it is gain coming in, being derived, *i.e.*, drawn or received by the recipient for his separate use. Eisner v. Macomber, 252 U.S. 189, 207 (1920). See note 14 *supra* for a statement of the nature of a stockholder's capital. See, generally, Rottschaefer, The Concept of Income in Federal Taxation, 13 Minn. L. Rev. 637 (1929).

[25] See 48 Stat. 703 (1934); 49 Stat. 1678, 1682 (1936); 26 U.S.C.A. §§ 111(b), 112(a), 113(a) (1936).

liquidation,[26] and even though accompanied by an offer of stock of the corporation for an amount equal to the amount of the cash dividend,[27] are taxable income. Stock of another company received as a dividend is income, whether the stock was held as an investment by the company paying the dividend,[28] or was received by the company in payment for a transfer of part of the assets to a new corporation organized for the purpose of carrying on part of the original business;[29] provided the other company is essentially a different corporation from the one paying the dividend.[30] A stockholder who receives as a dividend

[26] Kentucky Tob. Co. v. Lucas, 5 F. (2d) 723 (D. C. Ky. 1925); Langstaff v. Lucas, 9 F. (2d) 691 (D. C. Ky. 1925), aff'd 13 F. (2d) 1022 (C.C.A. 6th 1926), *cert.* denied, 273 U.S. 721 (1926).

[27] This was admitted in Eisner v. Macomber and has not since been questioned; but exceptions are made where the "cash dividend" could not in reality be used by the stockholder for anything but the stock purchase, Dietz v. United States, 6 F. Supp. 944 (W. Va. 1933); or where the "cash dividend" is issued with the understanding that most of the stockholders will take stock and they do take stock. Zellerbach v. Commissioner, 2 B.T.A. 1076 (1925).

[28] Peabody v. Eisner, 247 U.S. 347 (1918).

[29] In Rockefeller v. United States, 257 U.S. 176 (1921), a corporation had an undivided surplus greater than the value of certain of its properties. It transferred these properties to a new corporation organized in the same state to carry on part of the business, and received in exchange the capital stock of the new corporation. This stock was later distributed to the stockholders of the original corporation. *Held*, the new stock represented separate evidence of the former interest of the stockholder in the undivided surplus of the corporation and was taxable as income. (Here the dividend operated in the same manner as a cash dividend. The assets of the corporation were less after the distribution of the stock; the stockholders retained their proportionate interest in the corporation; but the market value of their holdings in the corporation was less, and in its place they had stock of a new corporation which could be sold without destroying their former interest in the original corporation.)

In United States v. Phellis, 257 U.S. 156 (1921), a corporation transferred all of its assets to a new corporation organized in another state, receiving in exchange (1) common stock of the new corporation equal to the par value of the common stock of the old, which it held as an asset against its outstanding common stock, and (2) common stock of the new corporation equal to twice the par value of the old common outstanding, which it distributed to its common stockholders as dividends. *Held*, the new stock represented a separation of the stockholder's interest in the accumulated earnings, distinct from his original capital interest represented by the old common stock, and was taxable as income. The market value of the entire holdings of the stockholder was the same before and after the transaction; but the market value had previously represented in the aggregate both the original capital interest and the interest in accumulated earnings, whereas the transaction separated these interests and made each distinguishable from the other.

[30] In Weiss v. Stearn, 265 U.S. 242 (1924), the transaction as interpreted by the Court was as follows: The original stockholders sold half their interest ($2,500,000 par value) to an incoming stockholder for $7,500,000. The corporation was reorganized in the same state, with the same assets, liabilities, and essentially the same charter; so that actually the "new" corporation was substantially identical with the old. The old stockholders turned in their $2,500,000 par value stock of the old corporation and received in return $25,000,000 par value of the stock of the new corporation. *Held*, the stock distribution was substantially the distribution of a stock dividend, non-taxable; since after that transaction the old stockholder had exactly the same proportionate interest in substantially the same corporation as before the exchange. He was, of course, taxable on any profit he made from the sale of half his shares.

shares of stock which represent a new interest in the same corporation, separate and distinct from the former interest, receives new property of value, independent of property previously owned, which constitutes taxable income.[31] Where stock formerly held is exchanged for stock of another corporation, the increased value of the new stock over the original purchase price of the old is income, whether the transaction was a simple trade of stock between parties,[32] or the new corporation was a result of the reorganization of the old corporation[33]—provided the "new" corporation is not substantially identical with the old.[34]

Stock dividends and exchanges of a form different from those already enumerated have previously been held to constitute unrealized gains, so far as the cases have come to the Supreme Court for decision. The inference to be drawn from these cases is that income requires the receipt of something new, *separate from the original capital interest.* Thus a stock dividend which represents partly the original capital interest and partly a new interest in accumulated but undivided surplus does not constitute income. In *Eisner v. Macomber* it was contended that the new common stock certificates received by a common stockholder measured the extent to which gains accumulated by the corporation had enriched the stockholder. However, it was answered by the Court that such enrichment would depend upon whether the stockholder had owned his stock during the entire period within which the gains represented by the dividend

[31] Koshland v. Helvering, 298 U.S. 441 (1936); Commissioner v. Tillotson, 76 F. (2d) 189 (C.C.A. 6th 1935); A. M. Clark v. Commissioner, Dec. 9439-H (C.C.H. Memo), May 23, 1936.

[32] For example, A buys a share of X stock for $100. Later, when the market value is $300, A exchanges this with B for a share of Y stock also worth $300. A is taxable on a gain of $200. See 26 U.S.C.A. §§ 111(b), 112(a), 113(a) (1936).

[33] In Cullinan v. Walker, 262 U.S. 134 (1923), a corporation, through trustees, transferred all its properties to two new corporations, receiving back all the stock and bonds of the new corporations. The trustees retained the bonds and exchanged all the stock for all the stock of a new holding company organized in another state; then distributed all the stock and bonds in their hands to the original stockholders. The stockholder bought his original 26% interest in the old corporation for $26,000; and after the exchange held 26% of the stocks and bonds of the new corporations, worth nearly $1,600,000. *Held*, the difference between the value of the new and the cost of the old was income. The stock of the holding company was an interest in an essentially different company from the original; the holding company could have sold its entire interest in the original enterprise without affecting the rights of its stockholders.

In Marr v. United States, 268 U.S. 536 (1925), a New Jersey corporation having outstanding $15,000,000 par value of 7% voting preferred stock and $15,000,000 par value of common stock transferred its assets and liabilities to a new Delaware corporation capitalized at $20,000,000 of 6% non-voting preferred and $75,000,000 of common. The preferred of the new corporation was exchanged at 1⅓ shares for 1, and the common at 5 shares for 1. *Held*, the new corporation was not substantially identical with the old, but had different powers and incidents. The difference between the cost of the old and the market value of the new shares constituted income; since the transaction represented an exchange of properties and not a retention of the same proportionate interest in the same corporation.

[34] Where the new corporation is substantially identical with the old, there is not an exchange of one set of properties for a different set. Weiss v. Stearn, 265 U.S. 242 (1924); Marr v. United States, 268 U.S. 536, 542 (1925).

were accumulating; and further that enrichment through increase in the value of the capital investment is not income in any proper sense of the word.[35] In *Towne v. Eisner*, a similar contention had been answered by the statement that if the common stockholder gained any advantage by such a transaction, it was not the market value of the certificates received.[36] Not every new right or interest represented in a stock dividend can make the stock dividend income. Thus in the case of a common stock dividend on common stock, the payment of the dividend is a recognition of the fact that past earnings of the corporation have enriched the shareholder; that the enhanced market value of his shares has been the reflection of a substantial addition to the corporate assets, rather than a mere rise occasioned by extrinsic circumstances. That this is in a real sense a gain to the stockholder is indicated by the fact that in the case of partnerships the individual partners are taxable on their respective shares of the annual earnings, even though those earnings are permanently reinvested in the business. Nevertheless, while the stock dividend is a recognition of a gain, the new certificate received does not represent a gain *separated* from the stockholder's original capital interest. It does represent an increase in the extent of his financial interest; but it also represents part of the rights in the corporation which were formerly represented by his original shares. The old and new shares *taken together* now represent the legal interest in the corporate entity which was formerly represented by the old shares alone. In this respect the common-on-common dividend is essentially different from the common-on-preferred; for the latter now represents the addition to the shareholder's financial interest, formerly represented by the accrued dividend, in the form of shares which carry a new legal interest in the corporate entity entirely apart from the former interest. It seems, therefore, that any dividend which does not adequately separate the new interest acquired from the previous capital interest owned should not be held to be income to the shareholder unless the *Eisner* case is to a corresponding extent modified.

Preferred stock received as a dividend on common, where both types are already outstanding, lacks several of the attributes of a realized gain and retains several attributes held in *Towne v. Eisner*, *Eisner v. Macomber*, and subsequent cases to characterize capital increase rather than realized gain. Thus, except in the case of exchanges of stock, all gains previously held to constitute income have been in a form which is severable from the original interest without impairing the proportionate interest of the shareholder in the assets, earnings, and control of the original corporation.[37] In the case of an exchange, there is an entirely new interest which does not conflict with the old because no old interest is retained. On the other hand, all non-severable interests have

[35] 252 U.S. 189, 214.

[36] 245 U.S. 418, 426 (1918).

[37] See the discussion of the Rockefeller and Phellis cases in note 29 *supra*; also the Koshland case, discussed at p. 314 *supra*, and note 10.

been held not to constitute income.[38] This distinction is reasonable in the light of what is commonly regarded as a realized gain: for something new, of value and independent of other interests, is almost as clearly realized as if it were cash; whereas a new interest which is inseparably bound up with an old cannot be fully realized by conversion into cash without disturbing the previous interest. Yet where preferred stock is received as a dividend on common, the new and the old certificates taken together represent the old interest plus the chance of sharing with the preferred stockholders in dividends and assets *if* in the future the earnings are reduced or assets are depleted.[39] The new interest not only appears to be contingent, but the new stock received is not severable from the old without leaving the stockholder's rights subordinate to additional preferences in dividends and in share of the assets on liquidation.[40] Further, in the previous cases the new interest or the newly severed interest has been substantially equivalent in extent to the market value of the new shares received, the value at which the income was fixed; and where the new interest was not substantially equivalent in extent to the value of the unit sought to be taxed, it has been held that taxation was improper.[41] This distinction again seems founded on a clear notion of what constitutes a realized gain. However, since common stock subject to additional preferences is not ordinarily worth its previous value, the effect of a preferred-on-common dividend—even though it may increase the total value of the holdings—should be to depress the value of the common shares; so that the market value of the new preferred will ordinarily be greater than the amount that can be attributed to the new interests acquired. The value is due partly to the *preference* and partly to the transfer of surplus formerly available for common dividends to the account of the new preferred, at the expense of the common stock.

While it seems clear from the preceding examination that the preferred-on-common dividend does not fall within the reasons stated in the *Koshland* case for holding a stock dividend to be income, nevertheless a number of commentators have suggested that the slightest change in the stockholder's interest in the corporation is sufficient to take the dividend out of the class controlled by the

[38] *Cf.* note 24 *supra.*

[39] If the earnings become less than sufficient to pay the common stockholders an amount equal to the preferred dividends, there will be some advantage in holding preferred stock and sharing the available dividends with the preferred holders; and similarly, if on dissolution the amount left for the common stockholders is less than the share paid to preferred holders, there will be advantage in holding some preferred.

[40] It was said by Mr. Justice Brandeis in Marr. v. United States, 268 U.S. 536, 541 (1925), that common stock subject to the prior claims of $20,000,000 of 6% preferred is substantially different from common stock subject to the prior claims of $15,000,000 of 7% preferred. The same argument applies here. An interest is not strictly "severable" if the result of its severance is to leave the original interest less than before.

[41] Towne v. Eisner, 245 U.S. 418, 426 (1918). See p. 319 *supra.*

Eisner case and to bring it within the exceptions developed in later cases.[42] The source of this opinion seems to be a quite evidently erroneous interpretation of the cases involving exchange of shares on reorganization. The difference between *Weiss v. Stearn* on the one hand, and *Cullinan v. Walker* and *Marr v. United States* on the other is that in the one case the reorganized corporation was held to be substantially identical with the old; so that no real change of corporate identity took place, and hence the old stock was not in effect exchanged for stock of another corporation: whereas in the other two cases relatively slight changes in the corporate entity were held to make the reorganized corporation essentially different from the old; so that there was in effect an exchange of shares of one corporation for shares of another. The question in these cases was not whether a change in the stockholder's interest made his new stock income, but whether a sufficient change had taken place in the old corporation to make the transaction by which old stock was exchanged for new an exchange of a set of property interests in one corporation for a set in an essentially different corporation. The results to the stockholders followed from a change of corporate identity, and not from a slight alteration of their interests in the same corporation. The conclusion seems irresistible, therefore, not only that authority is lacking for the opinion that a preferred-on-common dividend is taxable, but also that the principles stated in well-established decisions tend to uphold the contrary opinion.

Of less practical importance, but no less illuminating analytically, is the dividend on participating preferred stock paid in common. The principles previously stated apply also to this type of dividend; yet some of the elements present in the case of common on non-participating preferred are also present here. In the usual type of participating preferred stock, the preferred first receives its stated share of the dividend being distributed, or of the assets on liquidation. Then the common receives a like amount per share; and afterward the two types share alike. It can be seen that, unlike the case of preferred-on-common, this transaction increases the present book value of the holdings of the preferred shareholder receiving the dividend, and also the share in dividend distributions.[43] The preferred holder has received some new interest: that of a

[42] For example, "A shareholder may be held to have realized income from a corporate distribution of stock, if its result is to change his proportionate interest in the corporation *or to confer upon him different types of rights*" (citing Marr v. United States, 268 U.S. 536 (1925)) (italics added) 50 Harv. L. Rev. 332, 334 (1936).

A distribution to common shareholders of preferred stock having the same rights as preferred already outstanding gives the shareholder something essentially different from the equity in the corporation which he already had, within the meaning of the test in the Marr case. Hendricks, The Surtax on Undistributed Profits of Corporations, 46 Yale L.J. 19, 40 (1936). See also Magill, Realization of Income through Corporate Distributions, 36 Col. L. Rev. 519, 536–37 (1936).

[43] To illustrate, suppose a corporation having outstanding 1,000 shares of participating preferred entitled to $5 per year or one share of common stock, at the option of the directors;

common shareholder, entitled to a part of all dividends and assets distributed to the common stock. Yet part of this new interest has been acquired at the expense of the interests formerly represented by the preferred stock; for the preferred must now share all distributions with a larger class of common shares. Each preferred share now represents a smaller proportionate interest in any excess distributions over and above the amount of its preference. Consequently this is a case in which the shareholder undoubtedly does receive an increased proportionate interest in the corporation; but in which the new interest is only partially distinct from the former interest. The new certificate represents partly gain secured at the expense of the common shareholders, and partly the old interest in excess distributions. It seems impossible to say, consistently with the *Eisner* case, that the new shares of common stock received by the holder of participating preferred represent a gain derived from the capital, *severed* from the original capital interest; yet it seems impractical to allow a stockholder to escape taxation on a new and valuable property interest merely because it is imperfectly dissociated from his original capital. As Mr. Justice Holmes said in his dissent in *Eisner v. Macomber*, the purpose of the Sixteenth Amendment was to get rid of nice questions of this kind.[44]

PROHIBITING REFUNDS OF UNCONSTITUTIONAL TAXES*

Under the authority of the unconstitutional Agricultural Adjustment Act,[1] the Internal Revenue Bureau collected processing taxes of approximately a billion dollars.[2] At the time the act was passed the statutory and common law provided for refunds of unconstitutionally-collected taxes regardless of whether or not the tax had been shifted to consumers,[3] and there was no general pro-

and also 10,000 shares of common stock. Suppose that in a given year the earnings are $275,-000, and that these are distributed in cash. The preferred will receive its $5 per share and $20 extra; and the common likewise will receive $25. But suppose that in 5 successive years the directors issue the preferred dividends in common stock and make no further distributions. Now the same $275,000 will be distributed, $5 per share and $13.75 extra; but the share of each preferred shareholder, holding one preferred and 5 common, will be $5 and $107.50 extra. The share of the *preferred stock* has been reduced in the ratio of 25.0 to 18.75; but the share of the *preferred shareholder* has been increased in the ratio of 112.5 to 25.0. The preferred shareholder would make a similar gain with respect to share in the assets on dissolution, or book value.

[44] 252 U.S. 189, 220 (1920).

* For related problems see Field, The Recovery of Illegal and Unconstitutional Taxes, 45 Harv. L. Rev. 501 (1932).

[1] 48 Stat. 31 (1933); 7 U.S.C.A. § 601 *et seq.* (1936), hereafter referred to as the AAA. It was held unconstitutional in United States v. Butler, 297 U.S. 1 (1936).

[2] 14 Tax Mag. 108 (1936).

[3] U.S. Rev. Stats. § 3220 (1878); 45 Stat. 996 (1928); 26 U.S.C.A. § 1670(a) (1) (1935). See notes 14 and 15 *infra*.