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# TAXATION-STOCK DIVIDENDS AS INCOME

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TAXATION—STOCK DIVIDENDS AS INCOME—X corporation had two classes of stock outstanding. The Class *A* stock was a preferred stock entitled to cumulative dividends and a liquidation preference. The Class *B* stock was a non-voting stock, entitled to an annual $2 dividend after payment of the dividend on the preferred. Both classes were entitled to participate equally (on a pro rata basis) in any dividends in excess of the two mentioned above. The corporation declared a stock dividend, entitling each Class *A* holder to one-half share of Class *A* stock for each share presently held, and each Class *B* holder to one-half share of Class *B* stock for each share presently held. Petitioner held both Class *A* and Class *B* shares. Held, the dividend constituted income as to both the Class *A* and Class *B* shares received.[1] If the issuance of a stock dividend affects a change in the

[1] There were two dissenting opinions. One argued that only the holders of the Class *A* stock had received income. The other argued that all stockholders had received income except those having the same proportion of both the Class *A* and the Class *B* stock outstanding.

proprietary interests of the holders of the stock of the other class, then the dividend is income. *Weigand v. Commissioner,* 14 T.C. 136 (1950.)

The "change of proprietary interest" test adopted by the majority of the court seems to be in accord with the latest decisions of the Supreme Court. *Eisner v. Macomber*[2] is the leading case on the question of tax liability in connection with stock dividends. In that case the Supreme Court held that a stock dividend on common stock, where that was the only class of stock outstanding, was not constitutionally taxable under the Sixteenth Amendment. The Court indicated that this was only a distribution of further evidences of ownership, and that the taxpayer received income only when some of the assets of the corporation were segregated for his benefit.[3] In the middle 1920's the Supreme Court began to qualify this physical separation test.[4] These decisions held that if the taxpayer received a proportionately different interest in the corporation by reason of the dividend, then he had received income, and it was then not necessary to find a segregation of assets before tax consequences would attach. In its four most recent cases on this question the Court has rested its decision solely on the change in proprietary interest test.[5] However, it is not clear exactly what is encompassed by the term "change of proprietary interest." The Supreme Court has decided that income results in the following cases: (a) where there is a distribution of common stock to holders of preferred stock, both classes being then outstanding;[6] (b) where there is a distribution of preferred stock to holders of common stock under the same circumstances.[7] On the other hand, the Court has held that the following situations do not give rise to income; (a) the facts of *Eisner v. Macomber;*[8] (b) when preferred stock is distributed to the sole holder of common stock, there being no outstanding preferred at that time;[9]

[2] 252 U.S. 189, 40 S.Ct. 189 (1920). Immediately after this decision the I.R.C. was amended to exempt all stock dividends from tax liability, §201(d), Revenue Act of 1921. That was the situation until 1936. The Revenue Act of that year included the provision which is presently §115(f) of the I.R.C., which provides: "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." The Supreme Court held that Congress did not, by this section, intend to reverse Eisner v. Macomber. Helvering v. Griffiths, 318 U.S. 371, 63 S.Ct. 636 (1943).

[3] 1 MERTENS, FEDERAL INCOME TAXATION §9.107 (1942).

[4] In the so-called "reorganization cases"; Peabody v. Eisner, 247 U.S. 347, 38 S.Ct. 546 (1918); United States v. Phellis, 257 U.S. 156, 42 S.Ct. 63 (1921); Marr v. United States, 268 U.S. 536, 45 S.Ct. 575 (1925).

[5] Koshland v. Helvering, 298 U.S. 441, 56 S.Ct. 767 (1936); Helvering v. Gowran, 302 U.S. 238, 58 S.Ct. 154 (1937); Helvering v. Griffiths, supra note 2; Helvering v. Sprouse (which is combined with Strassburger v. Commissioner), 318 U.S. 604, 63 S.Ct. 791 (1943). The following discuss these cases: 1 MERTENS, FEDERAL INCOME TAXATION §9.107 (1942); Lincoln, "Stock Dividends and Stock Rights," 27 TAXES 109 (1949); Lowndes, "Taxation of Stock Dividends and Stock Rights," 96 UNIV. PA. L. REV. 147 (1947).

[6] Koshland v. Helvering, supra note 5.

[7] Helvering v. Gowran, supra note 5.

[8] Helvering v. Griffiths, supra note 5.

[9] Strassburger v. Commissioner, supra note 5.

(c) when non-voting common is distributed to both the holders of voting and non-voting common.[10] The principal case holds that there is income whenever the stock dividend causes a shift in relative interests. There would seem to be no question that the court properly decided the case in regard to the holders of the Class *A* stock. Their relative equity in the earnings of the corporation has clearly increased, to the detriment of the Class *B* holders. However it is more difficult to justify taxing the distribution to the Class *B* holders. The majority finds liability on the theory that the greater number of shares entitled to the $2 dividend make it less likely that there will be further dividends in which the Class *A* is entitled to a pro rata share. Therefore the court reasons that the dividend to the Class *B* holders adversely affects the interests of the Class *A* holders. In this manner the "change in proprietary interest" test is satisfied. That would be true if there had been a stock dividend only on the Class *B* shares, but the effect of the stock dividend on both classes works to the detriment of the Class *B* holders. Under the entire distribution, their equity in the earnings of the corporation has been reduced. As a matter of policy it would not seem reasonable to sustain the deficiency assessment where the taxpayer is in a poorer situation than had the dividend never been declared[11]

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[10] Helvering v. Sprouse, supra note 5.

[11] One difficulty with this policy argument is that there would be tax liability (for both Class *A* and Class *B* holders) were these separate dividends, and if we proceed from the premise that people in like economic circumstances should be taxed alike, it should make little difference whether this is treated as one or separate dividends.