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Federal Taxation: Taxability of Stock Dividends

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FEDERAL TAXATION: TAXABILITY OF STOCK DIVIDENDS

Tourtelot v. Commissioner, 189 F.2d 167 (7th Cir. 1951)
Wiegand v. Commissioner, 4 P-H 1951 FED. TAX SERV. ¶72,484 (3d Cir. 1951)

Stockholders of a corporation with two classes of stock outstanding, common and preferred, received a fifty percent stock dividend on each class. Ten stockholders held all the stock; three held the same percent in each class, and the other seven different amounts – some with all their holdings in one class or the other and some with disproportionate amounts in the two classes. The Tax Court held all to be taxable on the dividends received,[1] but the Court of Appeals for the Seventh Circuit said that one of the stockholders who held the same percent of stock in each class did not receive a taxable dividend. The Court of Appeals for the Third Circuit, however, said that the dividends to the remaining nine stockholders were taxable, this decision applying to the two remaining stockholders who held the same percent of stock in each class. The consequence of the conflict is an order for reargument.

> "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."[2]

Under this provision, courts have thus far applied the basic rule that a dividend of stock is taxable or not depending on whether the shareholder has the same interest before and after the dividend.[3] When a corporation has only one class of stock outstanding, as common, and a dividend of common stock is made on that common, such a stock dividend does not constitute income for taxation,[4] since the stockholders have the same interest after as before the dividend.

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[1]Edwin L. Wiegand, 14 T.C. 136 (1950).

[2]52 STAT. 496 (1938), 26 U.S.C. §115 (f) (1) (1946).

[3]Helvering v. Sprouse, 318 U.S. 604 (1943); Helvering v. Pfeiffer, 302 U.S. 247 (1937); Koshland v. Helvering, 298 U.S. 441 (1936).

[4]Helvering v. Griffiths, 318 U.S. 371 (1943).

The points of view of the courts in the instant cases account for the apparently conflicting results. The decisions by the Tax Court and by the Court of Appeals for the Third Circuit indicate that those courts considered the stock dividend as a whole, whereas the Court of Appeals for the Seventh Circuit considered the effect of the stock dividend on the individual stockholder. Since the dividends of common stock carried advantages and the dividends of preferred stock resulted in disadvantages, those shareholders who had only one class or disproportionate amounts of each class held stock representing a different interest after the dividend from the interest held prior to the dividend.

The Court of Appeals for the Seventh Circuit, having before it only one stockholder, held that since he had the same percent in each class he did not have a different interest after the dividend; consequently, the dividend as to him was not taxable as income. Whether "the whole body of stockholders taken as a single class is to be considered, or whether the individual situation of each taxpayer is what governs" was a point presented in the first case by the dissent of Judge Opper,[5] who strongly contended that the individual situation of each taxpayer should control.

The rule of *United States v. Phellis*[6] is that it would be erroneous to test the question as to whether an individual stockholder derived income by regarding alone the general effect upon the aggregate body of stockholders. Contrasted to that position is the majority opinion in the *Wiegand* Tax Court decision to the effect that[7]

> "The determination of whether a given stock dividend does, or does not, constitute taxable income must rest on some other basis than the mere fact that the recipient fortuitously did or did not hold stock of another class on which the distributing corporation also paid a stock dividend."

If the shareholders are treated individually and if the ones with the same percent of stock in each class are held not to have received a taxable dividend, the result in an extreme case might be that *A*, with 25% of the stock in each class, would not have a taxable divi-

[5]Edwin L. Wiegand, 14 T.C. 136, 153 (1950).
[6]257 U.S. 156 (1921).
[7]Edwin L. Wiegand, 14 T.C. 136, 150 (1950).