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1974

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1974 Wis. L. Rev. 142-175

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TAXING STOCK DIVIDENDS AND ECONOMIC THEORY

STEPHEN B. COHEN*

Since 1936, the Internal Revenue Code has treated elective stock dividends on common stock, which are taxed on receipt as shareholder ordinary income gain, differently from pro rata stock dividends on common, which are received tax-free.¹ This difference in treatment was reenacted in Section 305 of the 1954 Code;² and while the Tax Reform Act of 1969 changed many details of stock dividend taxation,³ the basic distinction between elective and pro rata stock dividends was, if anything, reinforced.⁴ The major pur-

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1. Section 115(f) of the Revenue Act of 1936, Pub. L. No. 740, ch. 690, § 115(f), 49 Stat. 1688. Section 115(f) was reenacted without change in the Internal Revenue Act of 1939, ch. 2, 53 Stat. 47. Unless indicated otherwise, all section references are to INT. REV. CODE OF 1954, as amended [hereinafter cited as CODE].

2. Section 305(a) states the general rule that "gross income does not include the amount of any distribution of the stock of a corporation made by such corporation to its shareholders with respect to its stock." Section 305(b) (1) [which from 1954 to 1969 was section 305(b) (2)] states an exception for a dividend payable at the shareholder's election, in stock or other property. Distributions of stock falling within the section 305(b) exception are taxed under section 301 which imposes a shareholder ordinary income tax to the extent of corporate earnings and profits.

3. Act of Dec. 30, 1969, Pub. L. No. 91-172, 83 Stat. 487. See S. REP. No. 91-552, 91st Cong., 1st Sess. 151 (1969); H.R. REP. No. 91-413 (Part I), 91st Cong., 1st Sess. 112 (1969); *Hearings on the Subject of Tax Reform Before the House Comm. on Ways and Means*, 91st Cong. 1st Sess., pt. 14, at 5193 (1969); *Hearings on H.R. 13270 Before the Senate Comm. on Finance*, 91st Cong., 1st Sess., pt. 1, at 62 (1969).

The 1969 Tax Reform Act provided additional exceptions to the general rule of Section 305(a). See note 2 *supra*. Technical explanations can be found in B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ch. 7, ¶¶ 7.62, 7.63 (abr. student ed. 1971) [hereinafter cited as BITTKER & EUSTICE]; Andrews & Wilson, *Stock Dividend Taxation Under the Tax Reform Act of 1969: Expansion of an Ominous Past*, 13 ARIZ. L. REV. 751 (1971); Bashian, *Stock Dividends and Section 305: Realization and the Constitution*, 1971 DUKE L.J. 1105; Committee on Corporate Taxation, N.Y.S. Bar Association Tax Section, *Comments on Proposed Regulations Under Section 305 of the Internal Revenue Code of 1954, as Amended by Section 421 of the Tax Reform Act of 1969*, 49 TAXES 460 (1971); Metzger, *The "New" Section 305*, 27 TAX L. REV. 93 (1971); Rustigan, *Stock Distributions—Section 305*, 49 TAXES 787 (1971); Tierney, *Proposed Regs. Under Section 305 Amplify Treasury's Tough Posture on Stock Dividends*, 35 J. TAXATION 86 (1971); Tierney, *Proposed Regs. Under 305(c) May Create Unexpected Taxable Stock Dividends*, 35 J. TAXATION 184 (1971).

4. BITTKER & EUSTICE, note 3 *supra*.

pose of the 1969 amendments to Section 305 was to impose a shareholder ordinary income tax on transactions with the same substance, but lacking the formal indicia, of the receipt of elective stock dividends on common stock.⁵ Therefore, a reexamination of the rationale for current distinctions between taxable and nontaxable stock dividends is particularly appropriate.

The rationale for attributing different tax consequences to the receipt of elective and pro rata stock dividends emerged from the basic tax distinction between corporate earnings distributed to shareholders and corporate earnings retained for reinvestment. In general, distributed earnings are taxed at the ordinary income rate applicable to the individual shareholder upon distribution.⁶ Retained earnings, with minor exceptions,⁷ are never directly attributed or imputed to individual shareholders but are taxed as gain to shareholders on the sale of stock to the extent that the sales price reflects earnings retained.⁸ Like all gain on the sale of stock, retained earnings receive (i) preferential capital gain treat-

5. See Levin, *Corporate Adjustments*, in A PRACTITIONER'S GUIDE TO THE TAX REFORM ACT OF 1969, at 29 (1970) (Practising Law Institute); Levin, *Principal Effects of the Tax Reform Act of 1969 On Corporations*, 52 *CHI. B. RECORD* 25, 35-39 (1970).

6. CODE §§ 301, 316. Exceptions to this general rule are provided for certain distributions that involve a significant termination of shareholder interest under sections 302 and 331. Section 302(a) grants capital gain sale treatment to distributions in redemption of stock that substantially reduce a stockholder's proportionate interest in the corporation under the standards of section 302(b). Because its main purpose is to facilitate major shifts in the control of closely-held businesses, it has been argued that section 302(a) should not apply to distributions by publicly-held corporations in redemption of common shares. See Bacon, *Share Redemptions by Publicly Held Companies: A New Look at Dividend Equivalence*, 26 *TAX. L. REV.* 283 (1971); Chirelstein, *Optional Redemptions and Optional Dividends: Taxing the Repurchase of Common Shares*, 78 *YALE L.J.* 739 (1969). When earnings previously retained are distributed in partial or complete liquidation, they generally receive capital gain treatment under section 331(a). However, the shareholder may elect a section 333 liquidation which produces ordinary income tax treatment of distributed earnings, and there is nonrecognition of gain on the liquidation of a subsidiary corporation into a parent under section 332.

In addition, section 303(a) grants capital gain sale treatment to distributions in redemption of stock from an estate to pay death taxes and funeral and administration expenses.

See generally BRTTKER & EUSTICE, chs. 7, 9, 11.

7. Domestic shareholders of foreign personal holding companies and certain other foreign corporations are taxed on their proportionate share of undistributed corporate income. See CODE §§ 551, 951. In addition, shareholders of a close corporation may elect to be taxed as a partnership. CODE § 1373.

8. There is abundant empirical evidence that market prices adjust to reflect retained earnings with a high degree of efficiency. See Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 *J. FIN.* 383 (1970). The sales price negotiated for close corporation stock typically reflects the value of all corporate assets, including assets acquired by reinvestment of earnings.

ment;⁹ (ii) tax deferral until disposition of the stock, which may not occur until many years after the earnings are generated;¹⁰ and (iii) complete tax forgiveness, if the shareholder holds the stock until his death, so that any gain attributable to retention is absorbed by a stepped-up basis.¹¹ Consequently, individual investors obtain a significant tax advantage when corporate earnings are retained for reinvestment.

Taxation of *any* stock dividend as shareholder ordinary income gain constitutes a departure from the basic tax distinction between distributed and retained earnings. Whereas a dividend in cash reduces earnings available for reinvestment, a dividend in stock does not.¹² A stock dividend, to the contrary, is commonly issued to reflect the amount by which retained earnings increase the value of shareholder equity. In the absence of a stock dividend, this equity increase is reflected in appreciation in the value of shares originally held. The taxation of *any* stock dividend, therefore, should be identified as a shareholder ordinary income tax on undistributed and retained corporate profits, inconsistent with the general proposition that retained earnings are taxed only as capital gain when stock is sold. It is essentially for this reason that pro rata stock dividends on common have been granted tax-free treatment since 1920.¹³

The tax treatment of elective stock dividends, in contrast, does depart from the basic tax distinction between retained and distributed earnings. Even though they reflect equity appreciation in the corporation, elective stock dividends have been treated as a distribution of cash. This tax treatment has been traditionally justified in terms of the constructive receipt doctrine.¹⁴ Since the stock dividend is elective, the shareholder who receives stock could, had he desired, have received a cash distribution instead. He is therefore treated as constructively receiving a distribution of cash because it was in his power to obtain a cash distribution in lieu of stock.

The constructive receipt doctrine, however, draws untenable lines between taxable and nontaxable events when applied to stock

9. CODE § 1221.

10. *Id.* §§ 1001-02.

11. *Id.* § 1014(a).

12. Compare this conclusion with the Senate Report on the 1954 Code recommending that most stock dividends be received tax-free: "As long as a shareholder's interest remains in corporate solution, there is no appropriate occasion for the imposition of a tax. Accordingly, the general rule is that no tax is imposed upon the distribution of . . . stock dividends . . ." SEN. REP. No. 1622, 83rd Cong., 2d Sess. 44 (1954).

13. See *Eisner v. Macomber*, 252 U.S. 189 (1920).

14. *Hearings on the Revenue Act of 1936 Before the House Comm. on Ways and Means*, 74th Cong., 2d Sess., at 593. See also *Lester Lumber Co.*, 14 T.C. 255 (1950); S. REP. No. 91-552, 91st Cong., 1st Sess. 150 (1969); Metzger, *The "New" Section 305*, 27 TAX L. REV. 93, 102 (1971).

dividend taxation. This becomes evident once the opportunity to elect a dividend in stock or in cash is identified as providing a choice between two different rates of cash payout. In the case of publicly-traded stock, for example, compare the recipient of an elective stock dividend with an investor who holds low payout stock. Clearly, the recipient of the elective stock dividend could have received a higher rate of cash payout by electing a cash dividend instead of a stock dividend; but, just as clearly, the investor holding low payout stock could have also obtained a higher rate of cash payout. The market in publicly-traded stock offers a wide range of cash payout rates,¹⁵ and the investor holding low payout stock could have easily acquired stock with a higher cash payout rate. Since both investors could have received a higher cash payout, logically they should be treated in a similar manner. The only difference between these two investors lies in the cost of changing the cash payout rate on their investment portfolios. Where an elective stock dividend is offered, the investor can change his election, and therefore his cash payout rate, tax free; whereas, in the absence of elective stock dividends, the investor can change his cash payout rate only by switching stocks and incurring a possible capital gains tax and brokerage fees. This difference, however, does not justify taxing the receipt of elective stock dividends at shareholder ordinary income rates. It merely suggests that a change of cash payout rate accomplished by a *change* in election should be treated as a taxable sale. This would entail imposing a capital gains tax on the appreciation in the stock on which an election is offered whenever an investor changes his election from a cash dividend to a stock dividend or a stock dividend to a cash dividend.¹⁶

15. A survey of the dividend policies of the "Fortune 500" for 1967 produced the following results:

Most of the companies in Fortune's 500 list followed a "middle course" in their dividend policy; last year 340 of them paid out between 31 and 70 percent of their earnings per common share in cash dividends

The thirty-nine companies that do not pay cash dividends include some that don't believe in them . . . and some that can't afford them At the other end of the spectrum are companies whose dividends exceeded earnings, either because the earnings were depressed . . . or non-existent In between these two extremes are a few companies that pay only nominal dividends—say, 5 to 10 percent of earnings [T]here were twenty-six [companies] that . . . paid a combination of cash and stock, and ten paying stock alone.

Similar distribution charts for the various "fifty" lists in this issue would show the merchandisers spread out in a pattern similar to that of the 500; the transportation companies leaning toward lower payouts, with thirty of them below 50 percent; the banks overwhelmingly bunched in the middle; and the utilities just as overwhelmingly bunched somewhat above the middle (thirty-one paid out between 56 and 70 percent of earnings).

Loomis, *A Case for Dropping Dividends*, 77 FORTUNE, June 15, 1968, at 184.

16. Certain corporate multi-class capital structures are treated as creat-

The constructive receipt rationale also draws questionable lines in the case of closely-held stock. It is difficult, for example, to distinguish the opportunity to choose stock or cash afforded by an elective stock dividend from the power of any controlling shareholder to cause distribution or retention of corporate earnings. Only in the case of the elective stock dividend is the shareholder currently taxed. Yet, consistent application of the constructive receipt doctrine would require taxation as ordinary income gain in both instances since the controlling shareholder or group of shareholders, like shareholders offered an elective stock dividend, have the power to obtain a cash distribution.¹⁷ Rigorous application of

ing constructive elective stock dividends under the 1969 amendments to section 305. For example, if a corporation issues two classes of common stock, one class paying dividends in cash, the other paying dividends in stock, the stock dividend is taxed on receipt as ordinary income gain under section 305(b)(2). Another possibility is the creation of preferred stock that is not entitled to cash dividends but is convertible into common stock at a conversion ratio that increases whenever cash dividends are paid on common. Under section 305(c) the increase in conversion ratio is treated as equivalent to the receipt of an elective stock dividend on common, taxable at ordinary income rates.

In the capital structures described above, the investor *changes* his election by exchanging one class of common stock for the other or converting preferred shares into common. Under current law, both changes can be accomplished taxfree. See CODE §§ 1036, 368(a)(1)(E). This article argues that elective stock dividends should be received tax free and that a change in election should be treated as a taxable sale of stock. In the case of multi-class capital structures, this would entail repealing sections 305(b)(2) and (c) so that constructive elective stock dividends are received tax free and sections 1036 and 368(a)(1)(E) insofar as they permit tax-free exchanges that, in effect, cause a change in election altering an investor's cash payout rate.

17. It is possible to design a transaction with the same effect as a close-corporation elective stock dividend, but with significantly lower tax cost. To illustrate, suppose Z Corporation has assets of \$110, an earnings and profits account of \$10, and two shareholders A and B, each owning 50 shares or 50% of the stock. Z Corporation offers its shareholders a choice between a cash dividend of 10 cents per share or a stock dividend of one-tenth share of common stock, per share. A elects the cash and receives \$5, and B elects the stock and receives 5 additional shares. After payment of the dividends, but before taxes are imposed: (1) the corporation has \$105 in assets; (2) A now owns 50 shares out of 105 or 47.6% of the stock; and (3) B now owns 55 shares out of 105 or 52.4% of the corporation. If elective stock dividends are taxed, there is \$10 of taxable ordinary income.

The same result could be achieved by a pro rata cash dividend of 5 cents per share or \$2.50 to each stockholder, followed by the sale of 2.4 shares from A to B for \$2.50. After the dividend *cum* sale, but before taxes are imposed: (1) the corporation has \$105 in assets remaining; (2) A now owns 47.6 shares out of 100 or 47.6% of the stock; (3) B now owns 52.4 shares out of 100 or 52.4% of the stock; and (4) A still ends up with \$5 in cash. Notice that immediately after the cash dividend, value per share equals assets of \$105 divided by 100 shares or \$1.05 per share. Thus, the price of the shares sold to A equals 2.4 times \$1.05 or \$2.50. If this second form is respected, there is \$5 of taxable ordinary income and a maximum of \$2.50 taxable capital gain or, at the most, the equiva-

the constructive receipt doctrine would therefore render practically meaningless the preferential treatment currently afforded retained earnings.

The difference in the effect of elective and pro rata stock dividends on shareholder ownership interests has also been used to justify taxing elective stock dividends on common stock. Unlike pro rata stock dividends, elective stock dividends typically cause shifts in shareholders' proportionate ownership interests in the corporation. Such shifts in ownership have long been thought necessary to constitutionally permit taxation of stock dividends, and the so-called "proportionate interest" test has been the focus of most of the recent literature on stock dividend taxation.¹⁸

Aside from the constitutional issue, which is almost certainly irrelevant,¹⁹ it is difficult to perceive why a shift in proportionate

lent of \$6.25 in taxable ordinary income. Unless this dividend *cum* sale transaction is recast, taxation of close corporation elective stock dividends will obviously be futile.

18. See Andrews & Wilson, *Stock Dividend Taxation Under the Tax Reform Act of 1969: Expansion of an Ominous Past*, 13 ARIZ. L. REV. 751 (1971); Bashian, *Stock Dividends and Section 305: Realization and the Constitution*, 1971 DUKE L.J. 1105; Del Cotto & Wolf, *The Proportionate Interest Test of Section 305 and the Supreme Court*, 27 TAX L. REV. 49 (1971); Metzger, *The "New" Section 305*, 27 TAX L. REV. 93 (1971). Although some commentators have argued that the proportionate interest test should be abandoned, they have failed to suggest an alternative framework for analysis. See Lowndes, *The Taxation of Stock Dividends and Stock Rights*, 96 U. PA. L. REV. 146 (1948); Metzger, *supra*, at 142.

19. The attention paid to the proportionate interest test grew out of concern with whether a particular stock dividend produced realization, so that it was constitutional to tax it as income under the sixteenth amendment. The realization issue first arose in *Eisner v. Macomber*, 252 U.S. 189 (1920). The narrow question before the *Macomber* Court was whether Congress could impose an income tax on the pro rata distribution of a common stock dividend on common stock. The Court decided that realization must occur in order for an income tax to be imposed under the sixteenth amendment. By this, the Court meant that the mere accrual of gain, i.e., a mere increase in net worth, is not, by itself, sufficient to permit taxation. Some "separation or transformation" of the gain from what was held prior to its accrual must occur. Although the Court left unclear what kind of separation or transformation is necessary for a realization, it held that the stock dividend before it was without real substance, a mere paper transaction that did not rise to the level of a realization. The discussion of realization in *Macomber* inspired extensive comment. See E. SELIGMAN, *STUDIES IN PUBLIC FINANCE* (1925); H. SIMONS, *PERSONAL INCOME TAXATION* 197-98 (1938); Powell, *Stock Dividends, Direct Taxes and the Sixteenth Amendment*, 20 COLUM. L. REV. 536 (1920); Seligman, *Implications and Effects of the Stock Dividend Decision*, 21 COLUM. L. REV. 313 (1921).

Believing the *Macomber* rule applied to all stock dividends, Congress provided in the 1921 Revenue Act that all stock dividends "shall not be subject to tax." In 1936, the Supreme Court held that it was constitutional to tax a common stock dividend on preferred stock. *Koshland v. Helvering*, 298 U.S. 441 (1936). Congress responded by providing in the 1936 Revenue Act that stock dividends were to be taxed whenever the sixteenth amendment permitted. Later decisions formulated the rule

interests should cause a stock dividend to be taxed as if it were a cash dividend. In a large publicly-held corporation, changes in

that stock dividends produced realization and thus were constitutionally taxable whenever they changed the shareholder's proportionate interest in the corporation. *Helvering v. Sprouse*, 318 U.S. 604 (1943). For lower court attempts to apply the proportionate interest test, see *Tourtelot v. Commissioner*, 189 F.2d 167 (7th Cir. 1951), *cert. denied*, 343 U.S. 901 (1952); *Wiegand v. Commissioner*, 194 F.2d 479 (3d Cir. 1952); *Pizitz v. Patterson*, 183 F. Supp. 901 (N.D. Ala. 1960); *Messer v. Commissioner*, 20 T.C. 253 (1953).

The common justification for requiring realization is that in a money economy the separation or transformation of gain usually involves the receipt of cash, permitting easy measurement of the gain and providing the taxpayer with liquid assets to satisfy his tax liability. See Slawson, *Taxing as Ordinary Income the Appreciation of Publicly Held Stock*, 76 YALE L.J. 623, 625 (1967). Realization, however, is not always defined to include these two factors; in some instances, taxation may occur on separation or transformation notwithstanding the absence of either ease of appraisal or liquidity, or both. For example, the exchange of one item of property for another, or barter, without an intervening cash step will produce realization, as will payment in kind for services rendered. See CODE § 1001(e); Treas. Reg. § 1.61-2(d) (1973). Viewed in this light, the realization concept appears to signify a judicial conclusion that taxation in some instances is inappropriate, rather than a reason for that result. See Lowndes, *supra* note 18, at 155. See also H. SIMONS, *supra*; J. SNEED, *THE CONFIGURATIONS OF GROSS INCOME* 71 (1967); Lowndes, *Current Conceptions of Taxable Income*, 25 OHIO ST. L.J. 151 (1964).

Although the Supreme Court has never overruled the *Macomber* realization requirements, the concept has not been rigorously applied. See, e.g., *Helvering v. Horst*, 311 U.S. 112 (1940); *Helvering v. Bruun*, 309 U.S. 461 (1940). Since the *Macomber* decision in 1920, the Supreme Court has found an absence of realization in only one case, *Weiss v. Stearn*, 265 U.S. 242 (1924), and the Treasury and the Internal Revenue Service have been allowed wide discretion to define when realization has occurred. It is difficult, therefore, to believe that the realization requirement would today pose a serious obstacle to the taxation of any stock dividend.

Once a tax on stock dividends is viewed as a shareholder tax on undistributed corporate profits, the lack of a realization obstacle to taxing any stock dividend is apparent. In the case of closely-held corporations, such a tax would no more violate a realization requirement than the rule that all partnership profits be taxed annually to the partners, whether distributed to them or reinvested in the business. See CODE § 702(a). The *Macomber* Court distinguished the partnership case by implication on the ground that each partner has the legal right to compel distribution of his share of the earnings while the stockholder normally does not. *Eisner v. Macomber*, 252 U.S. 189, 214 (1920). Nonlegal constraints, however, often make this legal power irrelevant. Bittker, *Comprehensive Tax Base*, 83 HARV. L. REV. 925, 977 (1967). See also Lowndes, *Taxing the Income of the Close Corporation*, 18 LAW & CONTEMP. PROB., 558, 580-83 (1953). Moreover, in some circumstances, a shareholder, like a partner, may be able to compel payment of a dividend. See V. BRUDNEY & M. CHIRELSTEIN, *CORPORATE FINANCE* 407-12, 442-46 (1972). Thus, the *Macomber* Court's justification for the differential tax treatment accorded close corporations and partnerships is unpersuasive.

The realization requirement also appears to be without justification in the case of publicly-owned corporations. In the public corporation, accumulated earnings are reflected in the appreciation in the market value of stock. This increase in value can be analogized to the growing value

proportionate interests are virtually always trivial because of the large number of shareholders. In a close corporation, an elective stock dividend is more likely to cause a substantial shift in proportionate ownership interests. But should that be the desired result, the investors would almost certainly adopt a Section 302(b) redemption form to achieve it instead of an elective stock dividend.²⁰ Due to the congressional policy favoring substantial shifts in ownership of closely-held businesses, a qualifying Section 302(b) redemption will not, under current law, produce any tax consequences for the nonredeeming shareholders.²¹ Viewed in this manner, the proportionate interest test, like the constructive receipt rationale, does not provide a sound basis for triggering ordinary income taxation of stock dividends.

Given the basic tax distinction between distributed and retained earnings, the crucial variable in corporate-shareholder taxation is the allocation of corporate earnings between distribution and retention. With the exception of stock dividends, the Internal Revenue Code generally respects the allocation chosen. If stock dividends had no effect on this allocation, there would be little reason for treating them differently from other equity appreciation in

of a savings account as interest accrues on the initial deposit. (This analogy is borrowed from *Slawson, supra*, at 625). The savings interest is available in liquid form to the owner whenever he desires it; thus, it is realized in the year it accrues, even if not withdrawn. See Thomas Watson, 12 P-H TAX CT. REP. & MEM. DEC. 1141 (1943). Similarly, appreciation in publicly-traded stock is easily measured and can be made available in liquid form by a sale of the stock. In fact, it is not much harder to order a broker to sell stock than it is to withdraw interest from a savings account. For all these reasons, the realization requirement should be and probably is irrelevant to stock dividend taxation. See also *Helvering v. Griffiths*, 318 U.S. 371, 421 (Douglas, J., dissenting); J. SNEED, *supra*, at 71; Bittker, *Charitable Gifts of Income and the Internal Revenue Code: Another View*, 65 HARV. L. REV. 1375, 1380 (1952).

20. For example, suppose X Corp. has assets of \$200, an earnings and profits account of \$100, and 2 shareholders, A and B, each of whom owns 20 shares or 50% of the outstanding common stock. Value per common share is then 200/40 or \$5/share. If X Corp. redeems 10 shares from B for \$50, the result will be capital gain for B under section 302(b)(2) and no tax consequences to A under *Holsey v. Commissioner*, 258 F.2d 865 (3d Cir. 1958), *acquiesced*, Rev. Rul. 58-614, 1958-2 CUM. BULL. 920. After the redemption transaction is completed, A will own 20 shares or 2/3 of the outstanding stock; B will own 10 shares or 1/3 of the outstanding stock; and B will have received \$50 in assets, before taxes, from X Corp.

The same result could have been achieved by offering each shareholder a dividend payable in 20 shares of stock or \$50 in cash. If A elects stock and B elects cash, then both are treated under sections 305(b)(1) and 301 as receiving an ordinary income dividend. Notice that after the transaction is completed A will own 40 shares or 2/3 of the outstanding stock; B will own 20 shares or 1/3 of the outstanding stock; and B will have received \$50 in assets, before taxes, from X Corp.

21. *Holsey v. Commissioner*, 258 F.2d 865 (3d Cir. 1958), *acquiesced*, Rev. Rul. 58-614, 1958-2 CUM. BULL. 920. See Chirelstein, *supra* note 6, at 750.

stock that involves no actual payout of corporate assets and simply reflects earnings retained. This observation suggests that the central question in stock dividend taxation should not be whether a shareholder has constructively received a corporate distribution or whether there has been a shift in shareholder proprietary interest in the corporation. Rather, the central issue should be how, if at all, do stock dividends, if received tax-free, affect the allocation of corporate earnings between distribution and retention.

This article uses recent work in economics to examine the effect of stock dividends on the allocation of corporate earnings between distribution and retention in a hypothetical world that provides tax-free treatment for all stock dividends, both pro rata and elective. The discussion assumes throughout that corporate stock is easily marketable, and, consequently, the analysis is relevant only to the problems of publicly-traded stock. However, where appropriate, the footnotes develop modifications that would be required to extend the analysis to nonmarketable closely-held stock.²² The analysis will indicate that (1) stock dividends, if received tax free, may, to some undetermined extent, increase the proportion of corporate earnings retained for reinvestment and that (2) taxing stock dividends to avoid this outcome creates inequitable differences among both taxpayers and corporations. The article will first review the relevant work in the economics of dividends and analyze the effect of stock dividends on investor portfolio selection. The article will then discuss the role of stock dividends in corporate dividend policy. The conclusion will suggest more equitable methods of reducing the preferential treatment afforded retained earnings.

I. THE ECONOMIC THEORY OF DIVIDENDS

A. *The Irrelevance of Dividends Proposition*

We begin by assuming a world in which: 1) there are no taxes or transaction costs; 2) a dollar of retained earnings always increases common stock values by at least one dollar; and 3) shareholders always behave in a rational manner. Under these conditions, investors will be indifferent to the allocation of corporate earnings between distribution and retention; simply stated, dividends are irrelevant.²³ If earnings are distributed instead of retained, corporate investment can be financed through the sale of

22. See note 17 *supra* and notes 45, 49, 50, and 75 *infra*.

23. The source of the irrelevance of dividends proposition is Miller & Modigliani, *Dividend Policy, Growth and the Valuation of Shares*, 34 J. BUS. 411 (1961). For nontechnical explanations see W. BAUMOL, *THE STOCK MARKET AND ECONOMIC EFFICIENCY* 53-59, 72-79 (1965); R. BREALEY, *SECURITY PRICES IN A COMPETITIVE MARKET* 6-8 (1971); A. ROBICHEK & S. MYERS, *OPTIMAL FINANCING DECISIONS* 51-66 (1965). A more mathematical exposition (but not as technical as the original Miller and Modigliani article) can be found in S. DOBROVOLSKY, *THE ECONOMICS OF CORPORATE FINANCE* 70-94 (1971).

additional stock. Shareholder wealth remains constant whether corporate investment is financed through retaining earnings and skipping dividends or distributing earnings and selling more stock. When earnings are retained, the current cash dividend is less, but the shareholder's interest is not diluted by the sale of additional stock.²⁴ It can be demonstrated that the value lost through a lower current dividend exactly offsets the value gained by avoiding dilution of shareholder equity.²⁵ Moreover, shareholder pref-

24. When earnings are distributed, the current dividend is larger, but the shareholder's interest in the corporation is diluted by the sale of more stock. The value gained through a larger current dividend exactly offsets the value lost in dilution of shareholder equity. See note 25 *infra*.

25. To illustrate the "irrelevance of dividends" thesis, assume X Corp. has outstanding 100,000 shares of common stock; that it earns \$1,000,000 annually, or \$10 per share, all of which it normally pays out in dividends; and that its stock normally sells at \$100, reflecting a 10% capitalization rate. Assume further that management has identified a new investment opportunity, involving the same degree of risk as present operations, that will require an immediate outlay of \$1,000,000 and is expected to generate earnings of \$200,000 annually in perpetuity. If the investment is made, X Corp's annual earnings are expected to increase to \$1,200,000. As the company has no further investment plans, all earnings from the expanded operation will be distributed as dividends. Assume that X Corp. can finance the expansion in either of the two following ways:

i) *Retained Earnings*. X Corp. could distribute no dividends to its shareholders this year and use its current earnings of \$1,000,000 to finance the new investment. In that event, the expected dividends for all future years will be \$1,200,000 or \$12 per share. Capitalizing these future dividends at a 10% rate, the present value of a share of X Corp. will be \$120.

ii) *New Stock Issue*. X Corp. could pay a dividend of \$1,000,000 to its shareholders and finance the new investment by selling \$1,000,000 of additional common stock. Present shareholders of X Corp. would receive a current cash dividend of \$10 per share. Their wealth would consist of the \$10 dividend plus the value of the X stock after the proposed stock issue and the new investment. The value of X stock, in turn, will depend on the number of additional shares that must be sold in order to raise \$1,000,000. If n = the number of shares to be sold and P = price per share, then $n \times P = \$1,000,000$. We know that the issue price of the new X shares will be ten times the expected dividend per share (given the capitalization rate of 10%). Hence: $P = 10 \times \$1,200,000/100,000 + n$. The expected dividends still rise to \$1,200,000 to reflect the new investment, but the number of shares outstanding is increased by n to reflect the new stock issue.

When these equations are solved for n and P (by substituting the right-hand side of the second equation into the first), it turns out that $n = 9090.9$ and $P = \$110$. Thus, X Corp. can finance the new investment by selling 9090.9 shares for \$110 per share. Future dividends will be \$1,200,000/109,090.9 or \$11 per share. At the 10% capitalization rate, the value of X stock will be \$110 per share. Accordingly, for each X share they now own, present shareholders will have a \$10 cash dividend plus \$110 in share value, or total wealth of \$120 per share, just as in i) above.

Since the total wealth figure is the same for both financing techniques, shareholders should logically be indifferent to the company's dividend policy and will be just as happy whether the company finances the new investment with retained earnings or a new stock issue. This example is borrowed from V. BRUDNEY & M. CHIRELSTEIN, *CORPORATE FINANCE* 427-29 (1972).

erences for cash versus reinvestment do not affect the irrelevance of dividends proposition. An investor who desires more cash than is distributed can sell some stock to make up the shortfall, while an investor desiring a higher level of reinvestment can use excess cash distributions to acquire more stock. However, in the real world, departures from the assumed conditions distort this pattern.

B. Taxes and Transaction Costs

Once taxes and transaction costs are introduced, there exists a powerful incentive for the individual (as opposed to the corporate or tax-exempt)²⁶ investor to select a portfolio of securities with a low rate of cash payout. For the shareholder who desires reinvestment of earnings, retention by the corporation provides reinvestment at no immediate tax cost. On the other hand, if earnings were distributed, they would be taxed to the shareholder as ordinary income before reinvestment. In addition, the individual shareholder would have to incur brokerage fees to acquire additional stock.²⁷ The shareholder who desires cash for consumption can substitute the sale of a portion of his shares for the receipt of a cash dividend. Cash received from the sale will be taxed only in part, due to the immediate recovery of the basis of the shares sold, and then only at preferential capital gains rates; whereas a cash dividend would be taxed in full and as ordinary income. In theory, brokerage fees, which must be paid on the sale of stock, could outweigh the tax advantage of selling stock over receiving cash dividends. But, in practice, brokerage fees will virtually always be insignificant compared to the tax advantage,²⁸ given the current structure of both tax rates and brokerage fees.²⁹

26. Corporate shareholders are likely to prefer cash dividends, taxable under the intercorporate deduction at an effective rate of about 7.2%, to equity appreciation, taxable at a capital gains rate of 30%. Section 243 of the Code allows a corporation to deduct 85% of dividends received from domestic corporations. Corporate income above \$25,000 is taxed at a rate of 48%. See CODE § 11. Therefore, the effective rate on corporate income derived from dividends is about 15% times 48% or about 7.2%.

For tax exempt institutions there is obviously no tax advantage to a low cash payout rate because by definition they pay no taxes.

27. If, however, the corporation offers an automatic dividend reinvestment plan, brokerage fees will be de minimis. See note 30 *infra* and accompanying text.

28. In contrast, tax exempt institutions gain no tax advantage whatsoever to offset the transaction costs of selling stock and will therefore prefer cash dividends to retained earnings to satisfy cash needs.

29. The following example demonstrates that the tax advantage of substituting periodic sales for cash dividends will virtually always exceed the brokerage fees for individual investors. Assume, for example, that an investor desires to obtain a cash flow of \$1000 annually from his investment portfolio. The after-tax proceeds of \$1000 in cash dividends equal \$1000(1-t) where t is the individual ordinary income tax rate of the investor. The after-tax proceeds from \$1000 received from the sale of stock equals \$1000-(1000-b).5t where b is the basis of the shares sold and .5t is

Therefore, regardless of shareholder preferences for reinvestment or consumption, there is a significant tax incentive for individuals to prefer low payout stock over high payout stock.

Despite this tax incentive, many individuals select portfolios with a high rate of cash payout. Probably the most dramatic evidence of this fact is the large number of investors who participate in "automatic dividend reinvestment plans."³⁰ Under such a plan, the investor directs the corporation to deposit his cash dividends with a designated bank. The bank then uses the dividends to purchase additional stock in bulk on the market and forwards the stock to participating investors. The purported advantage of the plan is that it provides a collective buying arrangement with substantially lower brokerage costs than those incurred upon individual reinvestment of cash dividends. However, the plan's participants must still pay ordinary income tax on cash dividends deposited for them with the bank. Participation therefore appears irrational since an investor could just as easily obtain automatic reinvestment of earnings at zero brokerage costs and an enormous tax saving simply by holding low payout stock.

This kind of behavior might be comprehensible if high payout stock sold in the market at a discount relative to low payout stock

the capital gains tax rate of the investor. For the purposes of this example, assume that the basis is zero so that the after-tax proceeds are simply $\$1000-500t$. This will understate the after-tax proceeds of selling stock and therefore bias the results in favor of cash dividends. The tax advantage of selling shares is the difference between the after-tax proceeds of the sale and the after-tax proceeds of cash dividends or $\$1000(1-t) - 500t$.

The brokerage costs of selling stock are $1000f$ where f is the commission as a percentage of the dollar amount sold. Then selling shares to obtain cash is preferable to cash dividends provided that $1000f$ is less than $500t$, or f is less than $t/2$. This equation can be interpreted to mean that the tax rate applicable to cash dividends must be more than twice the percentage brokerage commission in order for periodic sales to be preferable to cash dividends. Since brokerage fees, even on relatively expensive odd-lot transactions, rarely exceed 5%, periodic sales are preferable as long as cash dividends are taxed at a rate exceeding 10%—a condition which will virtually always be satisfied. Cf. Miller & Modigliani, *Some Estimates of the Cost of Capital to the Electric Utility Industry, 1954-57*, 56 AM. ECON. REV. 333, 346 (1966).

There is an additional factor that should influence all investors (individual, corporate, and tax-exempt) to prefer retained earnings over the issuance of new securities to finance profitable expansion. There are no special transaction costs incurred by internal financing with retained earnings. On the other hand, external financing through the sale of new securities requires special registration and underwriting costs. If external financing is sought, these extra costs will reduce corporate assets and therefore shareholder wealth. Additional advantages of internal financing are described by W. BAUMOL, *supra* note 23, at 75.

30. See N.Y. Times, Nov. 26, 1970, at 65, col. 2. Among corporations offering such plans are AT&T, Dow, Gamble Stores, Stewart Warner, and Allegheny Power. Brokerage commissions under these plans work out to as little as 0.07%.

sufficient to compensate for the tax disadvantages.³¹ A considerable amount of empirical work has been performed to test this hypothesis, but thus far every study has failed to produce any significant evidence that high payout shares sell at a discount. Most studies, in fact, have indicated that, instead of selling at a discount, high payout stock may actually command a premium in the market relative to low payout stock.³² It is important therefore to explain why high payout stock sells at no discount in the market despite its significant tax disadvantage. There are at least two hypotheses that may explain this phenomenon.³³

C. *The Inefficiency Hypothesis*

In the real world it is inaccurate to assume, as was done above, that a dollar of retained earnings always increases common stock

31. By analogy, the interest on corporate bonds suffers from a tax disadvantage relative to interest on tax-free municipal bonds. However, corporate bonds sell at a discount relative to municipals, sufficient to compensate for the tax disadvantage for individuals in lower tax brackets. See B. BITTKER & L. STONE, *FEDERAL INCOME, ESTATE AND GIFT TAXATION* 176-78 (4th ed. 1972).

32. There is considerable debate over the extent to which high payout stock commands a premium in the market. Conventional wisdom among security analysts has given cash dividends up to four times the weight of retained earnings in valuing common stock. See B. GRAHAM, D. DODD & S. COTLE, *SECURITY ANALYSIS* 515-18 (4th ed. 1963). Empirical studies support the proposition that the market values distributions somewhat more highly than retentions, although the results do not uphold the view that distributions are valued four times higher than retentions. R. BREALEY, *SECURITY PRICES IN A COMPETITIVE MARKET* 16 (1971). One study of 69 electric companies for the years 1958 to 1962 found that retained earnings were weighted less than half as much as dividends by the market in valuing stock. Brigham & Gordon, *Leverage, Dividend Policy, and the Cost of Capital*, 23 J. FIN. 85 (1968). This study, however, was subject to several important biases that might have exaggerated any market preference for cash dividends. See R. BREALEY, *supra*, at 15. A second study found that the market weighted distributions only 5.3% more than retentions in 1961 and 7.1% more in 1962. Diamond, *Earnings Distribution and the Evaluation of Shares: Some Recent Evidence*, 2 J. FIN. & QUANT. ANAL. 14 (1967). A third study of 300 stocks between 1946 and 1963 can be interpreted as revealing only a slight positive correlation between market value and the proportion of earnings that a company distributed. Arditto, *Risk and Return on Equity*, 22 J. FIN. 19 (1967). Other empirical work is reviewed in R. BREALEY, *supra*, at 11-21.

33. This article discusses the inefficiency hypothesis and the irrationality hypothesis. Two other explanations have been offered to explain the non-existence of a market discount for high payout stock; however, due to their inherent limits, they deserve only brief mention.

First, it has been suggested that market uncertainty can explain investor preference for a high cash payout stock.

With perfect markets, the investor always could sell part of his holdings or re-invest the dividends to satisfy his desire for consumption However, with uncertainty, stock prices fluctuate. Certain investors may regard as unsatisfactory the alternative of selling a portion of their stock for income at fluctuating prices. As a result they may have a definite preference for current dividends.

J. VAN HORNE, *FINANCIAL MANAGEMENT AND POLICY* 251 (2d ed. 1971)

values by at least one dollar. Rather, the crucial factor is how the market evaluates the profit potential of a project in which retained earnings are reinvested. If the projects chosen are inefficient relative to investments of comparable risk available in the market, then the increase in stock values will be less than one dollar for each dollar of earnings retained. For example, suppose management decides to retain earnings to finance a project that is expected to return 6 percent and that the market return on stock investments of comparable risk is 10 percent. Then the market will capitalize the 6 percent return at 10 percent, so that each dollar retained will increase stock values by only 60 cents.³⁴

[hereinafter cited as VAN HORNE]. Other economists, however, have rejected this explanation. See R. BREALEY, *supra* note 23, at 6; J. LORIE & M. HAMILTON, *THE STOCK MARKET: THEORIES AND EVIDENCE* 121 (1973); Miller & Modigliani, note 23 *supra*. Moreover, even if accepted, this uncertainty hypothesis cannot explain why individuals acquire high payout stock even though they intend to invest cash dividends in additional stock.

Second, the existence of outstanding rights to acquire common stock (whether in the form of executive stock options, convertible securities, or simple warrants) may create an incentive for distribution of earnings. If earnings are retained, the resulting increase in share values must include a discount for the possible future dilution of shareholder equity on the exercise of rights to acquire stock. But if earnings are distributed, only current stockholders have a right to share in them since the holders of rights are entitled to cash dividends only if and when their rights are exercised. In theory, therefore, the value gained by avoiding future dilution might offset the tax disadvantage when earnings are distributed. In practice, however, it is doubtful whether value gained by avoiding dilution is significant enough to have this effect. See W. BAUMOL, *supra* note 23, at 83-90.

34. It is important to note that management cannot finance an inefficient project through new equity capital, i.e., by selling additional stock. The capital market requires a certain level of future prospects from a firm that applies to it for funds. If the market evaluates a proposed project as inefficient relative to investments of comparable risk available in the market, it will not supply the funds. In contrast, management can avoid the direct discipline of the market by financing projects with retained earnings. Because of the separation of ownership and control in the large corporation, the capital market is generally unable to exercise direct influence over the use of retained earnings. The market's usual reaction to the use of retained earnings to finance an inefficient project is in the value it ascribes to the stock in question. This discussion, however, does not imply that the market will necessarily react unfavorably whenever earnings are retained to finance a project that the market would have refused to support with new equity capital. See text accompanying notes 33-35 *infra*.

One explanation offered for the possible inefficient use of retained earnings is the so-called "sales maximization hypothesis." This hypothesis supposes that executive salaries are "far more closely correlated with the scale of operations in the firm than its profitability." See W. BAUMOL, *BUSINESS BEHAVIOR, VALUE, AND GROWTH* 46 (1959). Therefore, corporate management will often decide to expand operations with retained earnings in order to maximize sales and thereby increase executive salaries, despite the possible inefficiency of expansion. O. WILLIAMSON, *THE ECONOMICS OF DISCRETIONARY BEHAVIOR* 79-84 (1964); Buchanan, *Theory and Practice in Dividend Distributions*, 53 Q.J. ECON. 81 (1938).

In a world without taxes and transaction costs, shareholders will always prefer the distribution of earnings over their retention to finance an inefficient project that increases stock values by less than one dollar for each dollar invested. Once taxes and transaction costs are introduced, however, investors will only sometimes prefer distribution over retention of earnings to finance a relatively inefficient project that causes stock values to rise less than one dollar for each dollar invested.³⁵ Whether any given investor will, in fact, prefer distribution is a complex question and depends on a number of factors, the most important of which are the shareholder's tax bracket and his preference for reinvestment or consumption of earnings.

To illustrate this, suppose corporate management proposes to retain earnings to finance a project that will increase stock values by only 60 cents for each dollar retained. First consider the shareholder who prefers reinvestment of earnings. One dollar distributed, net of shareholder ordinary income taxes and brokerage fees equals $(1-t)(1-c)$ where t is the investor's marginal tax bracket and c is the percentage brokerage commission. One dollar retained increases share values by 60 cents, which may be taxed at capital gains rates in the future when the investor disposes of his stock. Therefore, one dollar retained, net of future capital gains tax, produces $.60(1-.5t)/(1+i)^n$ where n is the number of years between the generation of earnings and the disposition of stock, i is an interest rate to reflect the value of deferral, and $.5t$ is the investor's capital gains tax rate. In any given year, retention will increase shareholder wealth more than distribution if $.60(1-.5t)/(1+i)^n > (1-t)(1-c)$. A simple approximation of this inequality can be obtained by assuming that the investor participates in an automatic dividend reinvestment plan, so that brokerage fees are de minimis and that he plans to hold the stock until his death so that all gain due to retentions escapes taxation. Then retention will increase shareholder wealth more than distribution if $.60 > (1-t)$, or $t > .40$. This result indicates that retention is preferable for the shareholder who desires reinvestment if his marginal tax bracket exceeds 40 percent. In that case, the pretax value of retained earnings is less than the pretax value of cash distributions because of the relative inefficiency of the project financed by the retained earnings. However, the tax advantage of retention more than offsets the value lost due to the inefficiency of reinvestment.

For the investor who desires cash for consumption, the calculations are equally complex. One dollar distributed, net of shareholder ordinary income taxes, equals $(1-t)$. The proceeds of selling stock, net of brokerage fees and capital gains taxes, are $.60[(1-c)-(1-b).5t]$ where c is the percentage brokerage commission and b is

35. See H. BIERMAN & S. SMIDT, *THE CAPITAL BUDGETING DECISION* 153-55 (1966).

the ratio of the basis to the market value of shares sold. Retentions are preferable for the investor who desires cash if $.60[(1-c)-(1-b).5t] > (1-t)$. To simplify, assume brokerage fees are de minimis because the investor participates in a collective selling plan and that the basis is one half the value of shares sold. Retentions are then preferable if $.60(1-.25t) > (1-t)$, or $t > .47$. This result indicates that retention is preferable for the investor who desires cash if his marginal tax bracket exceeds 47 percent.

This illustration assumes that the rate of return on retained earnings was 6 percent, or $3/5$ of the market return of 10 percent for investments of comparable risk. Under this condition, retention will be preferred by investors who desire reinvestment and whose tax bracket exceeds 40 percent and by investors who prefer cash and whose tax bracket exceeds 53 percent. If retained earnings were put to more inefficient uses, then the investor's tax bracket would have to be even higher for the tax advantage of retention to offset the loss in value caused by the inefficiency of reinvestment. For example, if each dollar retained increased stock values by only 40 cents, then retention will be preferred by shareholders who desire reinvestment only if their tax bracket exceeds 60 percent and by those who want cash only if their tax bracket exceeds 67 percent.

The inefficiency of reinvestment hypothesis may therefore explain why high payout stock does not sell at a discount despite its tax disadvantage. Empirical testing of the hypothesis, however, has produced highly ambiguous results. One recent study found an average rate of return on retained earnings of 3.0 to 4.6 percent, compared with 14.5 to 20.8 percent on new equity.³⁶ These results confirm the inefficiency hypothesis as an explanation of why high payout stock fails to sell at a discount in the market. Given the wide differential in rates of return, the tax advantage of a low payout rate will be offset by the value lost due to the inefficiency of reinvestment. The validity of these statistical results, however, has been the subject of considerable debate. A recalculation of the identical data, under different assumptions, found almost no differential between the return on retained earnings and the return on new equity capital.³⁷ The absence of any differential is, of course,

36. Baumol, Heim, Malkiel & Quandt, *Earnings Retention, New Capital and The Growth of the Firm*, 52 REV. ECON. & STAT. 345 (1970) [hereinafter cited as BHMQ]. The study compared the average rate of return on retained earnings with the average rate of return on new equity for 900 industrial corporations from 1946 to 1970.

37. Friend & Husic, *Efficiency of Corporate Investment* 55 REV. ECON. & STAT. 122 (1973). The recalculations were performed under two different sets of statistical assumptions. The first recalculation produced an average return of 8.1% on returned earnings versus 14.0% on external equity. The second recalculation produced an average return of 9.8% to 11.2% on retained earnings and 11.7% to 12.3% on external equity. The authors of the BHMQ study replied to this critique in Baumol, Heim, Mal-

inconsistent with and tends to disprove the inefficiency of investment hypothesis. In view of these conflicting results, it is uncertain whether the inefficiency hypothesis provides an adequate explanation of market behavior.

D. The Irrationality Hypothesis

A second possible explanation of why high payout stock does not sell at a discount despite the tax disadvantage is irrational investor behavior.³⁸ Investors, for example, may be prejudiced against the invasion of "capital" to fulfill consumption needs.³⁹ Appreciation in stock values, even due to retained earnings, may be perceived as "not-to-be-invaded-capital," while cash distributions are viewed as "spendable income." This perceptual confusion, however, cannot account for the fact that many investors acquire high payout stock even though they intend to reinvest cash distributions in additional stock of the distributing corporation. To some extent these investors may simply be ignorant of the tax angle.⁴⁰ But one financial writer has found that even ignorance is not an adequate explanation.

[D]ividend income received means capital gains opportun-

kiel & Quandt, *Efficiency of Corporate Investment: A Reply*, 55 REV. ECON. & STAT. 128 (1973). See also W. BAUMOL, *THE STOCK MARKET AND ECONOMIC EFFICIENCY* 76-79 (1965); Whittington, *The Profitability of Retained Earnings*, 54 REV. ECON. & STAT. 152 (1972).

The BHMQ statistics are consistent with other evidence that corporate management often reinvests earnings without regard for the efficiency of their use. After interviewing top officials of 20 major companies in several different industries, one author observed,

The net conclusion is that the common practice of these 20 companies with respect to quantitative guides to investment decisions suggested a cost-free concept of retained earnings for the so-called mandatory investments in maintaining traditional product lines and a rough internal opportunity cost standard for "voluntary" investment opportunities.

G. DONALDSON, *CORPORATE DEBT CAPACITY* 62 (1961). But see Mendelson, *Payout Policy and Resource Allocation*, 116 U. PA. L. REV. 377 (1968).

38. Miller & Modigliani, *supra* note 23, at 435; Miller & Modigliani, *Some Estimates of the Cost of Capital to the Electric Utility Industry*, 1954-57, 56 AM. ECON. REV. 333, 346 (1966).

39. Cf. Mark Twain's statement that "Spending one's capital is feeding a dog on its own tail." H. PROCHNOW & H. PROCHNOW, JR., *A TREASURY OF HUMOROUS QUOTATIONS* 48 (1969). See also R. BREALEY, *supra* note 23, at 7; VAN HORNE, *supra* note 33, at 178-94.

40. One study, conducted by interviewing individuals about their investment goals, concluded that, except in very high income classes, only a minority of individuals profess to have taken taxes into account in formulating their investment policies. See J. BUTTERS, L. THOMPSON, & L. BOL-LINGER, *EFFECTS OF TAXATION INVESTMENTS BY INDIVIDUALS* 33 (1953). More recent empirical work, however, shows a significant negative correlation between stock payout rate and shareholder tax bracket. See Elton & Gruber, *Marginal Stockholder Tax Rates and the Clientele Effect*, 52 REV. ECON. & STAT. 68 (1970). This correlation suggests that investors are, to some extent, influenced by the tax disadvantage of high payout stock.

ities foregone. Most stock holders will admit the logic of this case, and will declare themselves unequivocally on the side of capital gains—in general. . . . Yet it is a peculiar fact of life that many stockholders who acknowledge that dividends generally eat into capital gains will vigorously resist any attempt by their own companies to cut their dividends; in other words, they will not concede that what is good for them generally is good for them specifically.⁴¹

This observation suggests that some investors, whether they desire to consume or reinvest earnings, attach a special irrational or subjective significance to a high cash payout per se that is felt to outweigh the tax disadvantage. The hypothesis of an irrational preference for a high cash payout therefore offers an alternative to the inefficiency of reinvestment hypothesis as an explanation of why high payout stock sells at no discount in the market despite its significant tax disadvantage.⁴²

E. Conclusions

In a world that assumes the nonexistence of taxes and transac-

41. Loomis, *A Case For Dropping Dividends*, 77 *FORTUNE*, June 15, 1968, at 183. The market usually reacts unfavorably to any decrease in corporation payout rates, despite the tax disadvantage of high payout stocks. This unfavorable reaction, though, may not necessarily be evidence of systematic market preference for a high cash payout. It is commonly believed that corporate dividend policy is used to convey information. Lower dividends, therefore, may be interpreted by the market as signaling management's belief that future prospects have deteriorated. See VAN HORNE, *supra* note 33, at 250. See also E. SOLOMON, *THE THEORY OF FINANCIAL MANAGEMENT* 142 (1963). However, one recent study of 310 firms from 1945 to 1968 concluded that "the information content of dividends can only be trivial," and therefore cannot explain management reluctance to reduce dividends. Watts, *The Information Content of Dividends*, 46 *J. Bus.* 191, 211 (1973).

42. It has been suggested that the irrational preference for a high payout rate may actually reflect rational strategy.

"[I]f an ordinarily rational investor had good reason to believe that other investors would not behave rationally, then it might well be rational for him to adopt a strategy he would otherwise have rejected as irrational."

Once such defensive "irrationality" is recognized as a possibility, no investor can be expected to have confidence that others will refrain from it. . . . Each, on rational grounds, will be motivated to behave in an "irrational" manner because he knows that others will, for the same reason, have rational grounds to do so as well.

. . . [I]t seems to be a standard view that shares of low payout companies will sell at a discount To the extent that this is the general expectation of security purchasers, even though they consider it a manifestation of irrationality, they will have no option but to behave in a manner that makes the prediction come true. We would then expect that perfectly rational investors would have no choice but to place a subjective valuation lower than they would have otherwise on the companies that retain a relatively large percentage of their earnings, and that this reasoning would provide its own justification—the stocks of these companies would sell at a discount as compared with issues paying more generous dividends.

W. BAUMOL, *supra* note 23, at 56-57.

tion costs, efficient investment, and rational investor behavior, investors will be indifferent to the allocation of corporate earnings between distribution and retention. The real world, however, differs materially from this theoretical construct. Taxes and transaction costs, inefficient reinvestment, and possible irrational preferences cause shareholders to be anything but indifferent to the allocation of corporate earnings. Since these factors do not influence all shareholders in the same way, investors prefer a wide range of cash payout rates.

II. THE EFFECT OF STOCK DIVIDENDS ON INVESTOR SELECTION OF PAYOUT RATES

This section uses economic theory to analyze the probable consequences of allowing tax-free receipt of pro rata and elective stock dividends on common stock. Under current law, pro rata stock dividends are received tax free, and elective stock dividends on common stock are taxed on receipt as shareholder ordinary income gain.⁴³ While a significant number of public corporations do issue pro rata stock dividends, elective stock dividends are virtually never issued because of this high tax cost.⁴⁴ Therefore, a crucial part of the analysis will consist of examining the probable uses of elective stock dividends if their receipt were permitted tax free. Since investor demand for retention or distribution of corporate earnings may, to some undetermined extent, be influenced by irrational investor behavior, the analysis will proceed in two parts. The effect of tax-free stock dividends on investor cash payout preferences in a world of rational behavior will be considered first. The analysis will then be modified to consider tax-free stock dividends in a world of irrational investor behavior.

A. Under the Assumption of Rational Investor Behavior

1. PRO RATA STOCK DIVIDENDS ON COMMON STOCK

Pro rata stock dividends on common stock are issued to reflect an increase in stock values due to retained earnings.⁴⁵ If stock

43. CODE § 305(b)(1).

44. See Loomis, *supra* note 15, at 184.

45. Usually stock dividends on common are paid in common stock, but on occasion close corporations may distribute stock dividends in preferred on common. Under the proportionate interest test, the taxability of this type of stock dividend turned on whether there was preferred stock outstanding before the distribution. See note 19 *supra*. If there was not, the stock dividend was viewed as tax free because the nature of the shareholder's interest in value, voting, dividends, and liquidation was unchanged. *Helvering v. Sprouse*, 318 U.S. 604 (1943). On the other hand, if preferred stock was outstanding and if it was not held in the same proportion as common stock, then the preferred stock dividend altered the common stockholder's proportionate interest in earnings and assets. This was considered sufficient to produce the constitutionally required realiza-

dividends are not issued, this increase in value is reflected by appreciation in the value of shares originally held. Accordingly, a pro rata common stock dividend on common shares should cause no change in either the total value or proportionate share of each stockholder's interest.⁴⁶ The distribution merely provides each in-

tion. *Helvering v. Gowran*, 302 U.S. 238 (1937). Under the 1954 Code all preferred stock dividends paid pro rata on common stock are received tax free under section 305 (a).

Preferred stock dividends on common have sometimes been issued to bail out corporate earnings and profits at preferential capital gains rates. See, e.g., *Chamberlain v. Commissioner*, 207 F.2d 462 (6th Cir. 1953), *cert. denied*, 347 U.S. 918 (1954). If the preferred stock is callable, it may be sold to a third party who resells it to the issuing corporation. This scheme attempts to disguise a cash dividend as a stock dividend followed by a sale allowing the investor preferential capital gain treatment. Since the stock dividend is a disguised cash distribution, rather than a symbol of cash retained, its taxation should be distinguished from taxation of undistributed and reinvested earnings. Although a pro rata dividend of preferred stock on common may, at present, be received tax free under section 305 (a), section 306 now imposes an ordinary income tax on most sales of preferred stock dividends in order to thwart this scheme. See *BITTKER & EUSTICE, supra* note 3, ch. 10.

Because close corporation stock is not readily marketable, it will be the unusual case where a shareholder is able to find an outside party willing to purchase preferred stock for a bona fide investment (as opposed to the bail-out where the third party is a conduit and not a genuine investor). This rarity, therefore, probably justifies imposing an ordinary income tax on the sale of all preferred stock dividends on common on the ground that they are almost certainly being used to disguise a cash distribution. Section 306 imposes a shareholder ordinary income tax on all such sales with the exception of dispositions that produce a substantial termination of the investor's interest.

In the unusual case where a sale to a bona fide investor is contemplated, the sale of a preferred stock dividend enables the shareholder to obtain cash at capital gains rates by transferring part of his interest without a dilution of rights to residual values and control that would accompany a sale of part of his common stock. If the investor had no preferred stock to sell, he might be unwilling to dilute his residual and voting rights to obtain cash at capital gains rates and so would be more likely to prefer a cash distribution by the corporation. This reasoning may justify taxing all sales of close corporation preferred stock received as a dividend on common, whether bona fide or not.

It should be asked at this point how a bona fide sale of preferred stock received as a dividend on common differs from preferred stock issued to common stockholders on initial incorporation. The sale of the latter stock does not result in ordinary income taxation under section 306. This differential tax treatment may be explained by the fact that preferred stock outstanding from the time of incorporation is likely to have received annual cash dividends taxable at ordinary income rates. On the other hand, where only common stock is outstanding from initial incorporation, it is less likely that any significant cash distributions on stock will have been made and more likely that a preferred stock dividend is a device to bail out corporate earnings at capital gains rates.

46. The pro rata common stock dividend on common stock is considered the classic example of the nontaxable stock dividend under the realization test because the shareholder's interest is changed only nominally, being exactly the same as it was before, except for the absolute number

vestor with a larger absolute number of shares and additional pieces of paper. Therefore, if investors behave in a rational manner, pro rata stock dividends on common stock should not affect investor preferences for cash payout.

2. ELECTIVE STOCK DIVIDENDS ON COMMON STOCK

A tax-free elective stock dividend, like a pro rata stock dividend, will not affect investor preferences for high versus low cash payout. Yet if tax-free treatment were permitted, elective stock dividends might become important as a method by which a corporation may offer shareholders a choice of two or more cash payout rates on its common stock. Unless elective stock dividends are issued, a corporation must offer all its common shareholders the *same* cash payout rate.⁴⁷ To illustrate, assume that a corporation allows each shareholder to vary the allocation of earnings per share between distribution and retention. It is almost inevitable that some shareholders will elect less cash and more retention per share than others. Those who elect more retention per share should end up with a larger proportionate interest in the corporation than those who take more cash.⁴⁸ This, in turn, will require the distribution of additional stock to shareholders electing retention to reflect their proportionately greater interests. In contrast, when a corporation pays the same cash dividend per share of common, there is no change in any shareholder's proportionate interest that would require the distribution of additional stock. Elective stock dividends thus enable a corporation to offer its common shareholders a choice of cash payout rates.⁴⁹

of shares and pieces of paper. See note 19 *supra*. Under present law, such stock dividends are received tax free. See CODE § 305(a).

47. However, on rare occasions, a controlling interest may waive its right to receive cash dividends without receiving a stock dividend in lieu of cash. See Rev. Proc. 67-14, 1967-1 CUM. BULL. 591; B. GRAHAM, D. DODD & S. COTLE, SECURITY ANALYSIS 495-96 (4th ed. 1963).

48. Compare this analysis with the language of section 305(b)(2), providing that a stock dividend is taxable when it results in "(A) the receipt of property by some shareholders, and (B) an increase in the proportionate interests of other shareholders in the assets or earnings and profits of the corporation."

49. The taxation of the receipt of elective stock dividends as shareholder ordinary income gain deters their use by closely-held corporations. Therefore, taxing elective stock dividends, in effect, is the functional equivalent of a requirement that a close corporation maintain only one rate of cash payout on its common stock. However, this requirement will not generally affect the ability of close corporation investors to obtain a low rate of cash payout. If the close corporation common is owned by one person, the requirement is irrelevant since the corporation can vary the one payout rate to suit his preferences. Where there is more than one common stockholder, the one cash payout rate will reflect a compromise among the owners. If a controlling block of shareholders favors low cash dividends and the compromise reflects this preference, then the requirement of one cash payout rate does not affect the ability of investors to obtain a low rate

The ability to choose between two different cash payout rates on a single corporation's common stock makes it substantially cheaper for an investor to alter the cash payout rate on his stock portfolio.⁵⁰ When no election is available, an investor can alter the payout rate only by changing the stocks in his portfolio. The sale and purchase transactions require payment of a capital gains tax and brokerage fees. The election, on the other hand, avoids the capital gains tax and brokerage fee barriers to portfolio adjustment and allows an investor to alter the payout rate at no cost simply by changing his election.

The elimination of barriers to portfolio adjustment is important for two reasons. First, without barriers to adjustment, investors will alter their cash payout rates with greater frequency. Empirical studies have demonstrated a negative correlation between

of cash payout. It is only when a controlling block of investors favors a high rate of cash payout that the compromise rate will limit the ability of minority shareholders to obtain a low rate of cash payout. The taxation of elective stock dividends is therefore an ineffective and arbitrary method of regulating shareholder demand for the preferential treatment accorded retained earnings in the close corporation.

50. In addition, an election permitting a choice of stock dividend in either common or preferred may be used to transfer residual interests from retiring to active participants in a close corporation. Assume, for example, that father and son each are employed by and own 50% of the common stock of X Corporation. The father plans to retire and wishes to obtain a source of cash income to replace his salary, while the son will remain active in the business and have sufficient cash income provided by his salary. To satisfy both, X Corporation might issue a dividend of preferred stock to the father and of common stock to the son. The corporation will then pay the father regular cash dividends on his preferred while maintaining a low cash dividend rate on the common. This transaction does not involve a disguised cash distribution since the father is simply switching a part of his investment from a residual equity to a preferred interest.

In the absence of stock dividends, X Corporation must pay all common shares the same cash dividend reflecting a compromise between the preferences of father and son. Under this condition, cash dividends on all common shares will rise on the father's retirement due to his increased preference for cash. The election to be paid a stock dividend in preferred on common avoids this result by allowing the father to transform his common stock into cash-dividend-paying preferred. This may cause lower cash dividends to be paid to both father and son than in the absence of the election.

Until 1969 preferred stock dividends on common used to transfer residual interests were received tax free in order to facilitate major shifts in the control of closely-held businesses. See Marjorie N. Dean, 10 T.C. 19 (1948). Since the 1969 Tax Reform Act, however, the picture is less clear. Section 305(b)(3) now provides for ordinary income taxation of distributions that result in "the receipt of preferred stock by some common shareholders, and (B) the receipt of common stock by other common shareholders." Although section 305(b)(3) literally applies to our father-son hypothetical, there is evidence that Congress intended to suspend its application when stock dividends are used to shift residual interests from retiring to active investors. See 115 CONG. REC. 37902 (1969) (remarks of Senator Russell Long in response to a question by Senator Aiken).

the payout rate chosen and an investor's tax bracket.⁵¹ This means that the desire to obtain a lower payout rate is correlated with a higher tax bracket and, conversely, that a desire to maintain a higher payout rate is correlated with a lower tax bracket. Therefore, the lowering of barriers to adjustment will tend to increase the concentration of low payout stock among high bracket investors and high payout stock among low bracket investors. This, in turn, will cause a decrease in the aggregate rate at which all cash dividends are taxed. Second, the existence of a costless election also influences the effective tax rate on retained earnings. Because an adjustment in a portfolio's cash payout rate can be accomplished without selling stock, the time interval between the generation of earnings and the disposition of stock will tend to increase. As this interval grows, taxation is deferred with a corresponding decline in the effective rate at which retained earnings are taxed.

3. TAXING STOCK DIVIDENDS: THE IMPACT ON INVESTORS

The preceding discussion indicates that in a world in which investors behave rationally and stock dividends on common stock are *not* taxed, elective stock dividends may affect shareholder taxation in two ways. First, they may decrease the aggregate tax rate on cash dividends by lowering the barriers to portfolio adjust-

51. A recent study by Elton & Gruber, *Marginal Stockholder Tax Rates and the Clientele Effect*, 52 REV. ECON. & STAT. 68 (1970) hypothesized that the lower a firm's cash payout rate, the smaller the percentage of total return that a stockholder expects to receive in the form of dividends and the larger the percentage he expects to receive in the form of capital gains. Thus, the high payout firm should attract stockholders in relatively lower tax brackets than the low payout firms. To test this hypothesis, data was collected on the behavior of stock prices on ex-dividend dates for all stock on the New York Stock Exchange that paid dividends during the period April 1, 1966 to March 31, 1967. Ex-dividend behavior permitted indirect study of the correlation between payout rate and tax bracket since [a] stockholder selling stock before a stock goes ex-dividend loses the right to the already declared dividend. If he sells the stock on the ex-dividend day he retains the dividend but should expect to sell it at a lower price (because of this dividend retention). In a rational market the fall in price on the ex-dividend day should reflect the value of dividends vis-à-vis capital gains to the marginal stockholders. . . . [Thus] one can infer marginal stockholder tax brackets from observing the ex-dividend behavior of common stocks.

Id. at 69. The results showed a significant negative correlation between payout rate and tax bracket. Earlier studies had produced inconclusive results. See J. BRITAIN, *CORPORATE DIVIDEND POLICY* 45 (1966). See also T. ATKINSON, *THE PATTERN OF FINANCIAL ASSET OWNERSHIP* (1956); J. BUTTERS, L. THOMPSON, & L. BOLLINGER, *EFFECTS OF TAXATION INVESTMENTS BY INDIVIDUALS* (1953); E. COX, *TRENDS IN THE DISTRIBUTION OF STOCK OWNERSHIP* (1963); D. HOLLAND, *DIVIDENDS UNDER THE INCOME TAX* 38-39 (1962); Crum, *Analysis of Stock Ownership*, 31 HARV. BUS. REV. 36 (1953); Shoup, *Taxation of Dividends*, in 3 HOUSE COMM. ON WAYS AND MEANS, 86TH CONG., 1ST SESS., *TAX REVISION COMPENDIUM* 1537-38 (Comm. Print 1959).

ment, thereby increasing the concentration of cash dividends among lower income investors. Second, tax-free elective stock dividends may also reduce the effective tax rate on retained earnings by tending to postpone the disposition of stock. Taxation of elective stock dividends on receipt, as under present law, prevents any loss in revenue resulting from either of these rate reductions. Because of this high tax cost under present law, elective stock dividends are virtually never issued. Therefore, stock portfolios can only be adjusted through market transactions that require payment of a possible capital gains tax and brokerage fees.

It is obviously not necessary, however, to tax elective stock dividends at ordinary income rates in order to use the capital gains tax as a barrier to adjustment and to maintain the effective tax rate on retained earnings. Both goals could be achieved by the less drastic means of allowing tax-free receipt of elective stock dividends and treating the shareholder who changes his election as if he had sold the stock and imposing a capital gains tax on that occasion. If this proposal were enacted, the only remaining difference between elective stock dividends and market transactions as methods of portfolio adjustment would then be that the investor would incur brokerage fees if adjustment occurs through market sales and purchases. When contrasted with this proposal, the extra effect of the current scheme of taxing stock dividends is to maintain brokerage fees as a barrier to portfolio adjustment.

From the standpoint of revenue, it probably makes little difference whether a change in election is treated as a sale of stock or whether elective stock dividends are taxed, which is to say whether brokerage fees are eliminated or maintained as a barrier to adjustment. It is true that without brokerage fees, adjustment will tend to occur with greater frequency, causing a decrease in the aggregate tax rate on cash dividends. But adjustment would still require payment of a capital gains tax, and greater frequency of adjustment would mean an offsetting increase in the effective rate of tax on stock gains.

From the standpoint of equity, however, it does matter whether brokerage fees are eliminated or maintained as a barrier to adjustment. Since brokerage fees are a decreasing percentage of the dollar amount traded, they burden smaller investors more than larger investors.⁵² Therefore, since taxing elective stock dividends as ordinary income gain maintains brokerage fees as a barrier to portfolio adjustment, it is an inequitable method of taxation when compared with treating a change in election as a sale of stock.

52. The commission charges set by the New York and American Stock Exchanges for "odd lot" transactions are a decreasing function of the dollar amount involved; therefore, transaction costs per dollar invested will be larger for smaller amounts. STANDARD & POOR, STOCK GUIDE 225 (1973).

B. Under the Assumption of Irrational Investor Behavior

1. PRO RATA STOCK DIVIDENDS ON COMMON STOCK

If investors behaved in a rational manner, pro rata stock dividends on common stock would not influence investor preferences for high versus low cash payout stock. In the real world, however, a significant number of corporations do issue pro rata stock dividends on common to attempt to influence investor preferences for cash payout.⁵³ Corporate management apparently believes that stock dividends will increase the attractiveness of a low rate of cash payout.⁵⁴ Some investors, for example, may be reluctant to fulfill consumption needs by selling stock because they view such action as an "invasion of capital." They may perceive stock dividends as "spendable income" and therefore be less reluctant to sell them to obtain cash, whereas appreciation in shares originally held may still be perceived as "not-to-be-invaded capital."⁵⁵ Moreover, whether they prefer to consume or reinvest earnings, shareholders may attach a subjective or nonrational importance to dividends in stock similar to that attached to dividends in cash. In other words, a payout consisting of a dividend in stock may satisfy their irrational preference for stock offering a high payout.

It is difficult to evaluate the belief that stock dividends have these effects since it has received virtually no empirical testing. If the proposition were generally true, corporations would be expected to issue stock dividends to reflect any and all earnings retained for reinvestment. Since most corporations do not issue regular stock dividends, the proposition may be unsupported conjecture. The fact remains, however, that a significant number of corporations do issue pro rata stock dividends on common on a regular basis.⁵⁶ Furthermore, since a large corporation's expenses in issuing stock dividends can amount to several hundred thousand dollars,⁵⁷ it is unlikely that stock dividends would be issued without the expectation that investors will be affected in some way.⁵⁸ Therefore, at least in some circumstances, stock dividends are ex-

53. See note 15 *supra*.

54. E. DONALDSON & J. PFAHL, *CORPORATE FINANCE* 619 (2d ed. 1963). "[S]hareholders expect to receive dividends when there are earnings. In the event the company has used or needs the money in the business, it can retain the money and still pay a stock dividend. In this way the shareholder is pacified." *Id.* See also H. GUTHMANN & H. DOUGALL, *CORPORATE FINANCIAL POLICY* 526 (3d ed. 1955).

55. VAN HORNE, *supra* note 33, at 275; Smith, *Tax Treatment of Dividends*, in 3 HOUSE COMM. ON WAYS AND MEANS, 86TH CONG., 1ST SESS., *TAX REVISION COMPENDIUM* 1548 (Comm. Print 1959).

56. See note 15 *supra*.

57. R. BREALEY, *supra* note 23, at 62. Some financial writers have suggested that stock dividends may be used to convey information. However, a recent empirical study casts substantial doubt on this view. See Watts, note 41 *supra*.

58. See note 54 *supra*.

pected to affect shareholder preferences for high versus low cash payout. To the extent that this expectation is justified, pro rata stock dividends on common influence investors to demand portfolios with a lower average rate of cash payout than they would in their absence.

2. ELECTIVE STOCK DIVIDENDS ON COMMON STOCK

A dividend payable at the shareholder's election in cash or in stock would affect investors in three ways. First, as explained in the section assuming rational behavior, the election would lower barriers to the adjustment of portfolio cash payout rates. Second, elective stock dividends, like pro rata stock dividends, may increase the attractiveness for investors of low cash payout stock. Third, elective stock dividends permit investors to receive a low cash payout while holding stock that offers the option of receiving a high cash payout. To the extent that this arrangement satisfies the irrational preference for high cash payout stock, investors will acquire stock offering elective stock dividends and elect to receive stock as a substitute for demanding a high rate of cash payout. It is probable that tax-free elective stock dividends would be an especially attractive substitute for investors who participate in automatic dividend reinvestment plans.⁵⁹ Instead of directing the corporation to deposit cash dividends with a bank for the acquisition of additional stock, investors could direct the corporation to retain earnings for internal reinvestment and to forward a stock dividend to reflect earnings retained. However, to the extent the preference for cash payout is explained by the inefficiency hypothesis, internal reinvestment will not be an acceptable substitute for using cash dividends to acquire stock in the market.

3. TAXING STOCK DIVIDENDS UNDER THE IRRATIONALITY HYPOTHESIS: THE IMPACT ON INVESTORS

The preceding discussion indicates that under the irrationality hypothesis, stock dividends, if received tax free, may influence investors to demand portfolios with a lower average rate of cash payout. This increased demand will tend to cause an increase in the proportion of corporate earnings retained and sheltered from shareholder ordinary income taxation. Taxation of stock dividends, both pro rata and elective, therefore, might be justified as a means of limiting shareholder demand for retained earnings.

If this is the justification for taxation however, the tax falls unevenly on shareholders with different preferences. The extent to which an individual's investment earnings are sheltered from ordinary income taxation is directly related to the proportion of earnings retained. Stock dividend taxation, by its nature, does not

59. See text accompanying notes 30-31 *supra*.

focus on this proportion. Rather, taxation focuses on a device that may influence some investors to demand portfolios with a lower rate of cash payout. For example, when all stock dividends are taxed, a low cash payout rate will be less attractive to investors who attribute some subjective or irrational importance to stock dividends. But taxation will not affect investors who are satisfied with a low cash payout rate in the absence of stock dividends. Therefore unless there is some virtue to penalizing only investors with irrational preferences, taxing stock dividends seems a curious way to limit the proportion of corporate earnings retained and sheltered from shareholder ordinary income taxes.

III. STOCK DIVIDENDS AND CORPORATE DIVIDEND POLICY

Corporate management has the legal power to allocate corporate profits between distribution and retention.⁶⁰ In the absence of elective stock dividends, a given corporation can offer only one cash payout rate on its common stock.⁶¹ This payout rate should attract common stockholders with similar cash payout preferences.⁶² Moreover, once attracted, they will oppose any reduction in the corporate payout rate unless their individual preferences change.⁶³ To compensate for the lower payout rate, shareholders would have to engage in market transactions to alter the composition of their investment portfolios. Since this alteration may entail the payment of capital gains tax and brokerage fees, shareholders will oppose a payout reduction. Furthermore, manage-

60. Factors such as the depreciation allowance, cash flow, and interest rates are important determinants of a given corporation's dividend policy. For a summary of empirical studies of corporate dividend policy see R. BREALEY, *supra* note 23, at 4-33. Major studies include J. BRITAIN, *CORPORATE DIVIDEND POLICY* (1966); S. DOBROVOLSKY, *CORPORATE INCOME RETENTION, 1915-43* (1951); R. GOODE, *THE CORPORATION INCOME TAX* (1951); Lintner, *Distribution of Incomes of Corporations Among Dividends, Retained Earnings, and Taxes*, 46 AM. ECON. REV. 97 (May 1956) (Papers and Proceedings).

61. See text accompanying notes 47-49 *supra*.

62. In their seminal article on dividend theory, Modigliani and Miller predicted that a given payout rate would attract investors with similar cash payout preferences. Modigliani & Miller, *The Cost of Capital, Corporate Finances and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958). Other financial theorists have expressed agreement with this proposition. See, e.g., H. BIERMAN & S. SMIDT, *supra* note 35, at 155; Elton & Gruber, *supra* note 40, at 68.

63. Stated differently, this means that investors prefer corporations that maintain stable dividend rates. The view that corporate management should pursue a stable dividend policy has been frequently expressed in corporate finance literature. See, e.g., H. GUTHMANN & H. DOUGALL, *CORPORATE FINANCIAL POLICY* 528-29 (1955). Two empirical studies indicate that management generally takes this advice. See generally G. DONALDSON, *CORPORATE DEBT CAPACITY* (1961); Lintner, *Distribution of Incomes of Corporations Among Dividends, Retained Earnings, and Taxes*, 46 AM. ECON. REV. 97 (May 1956) (Papers and Proceedings).

ment may be reluctant to reduce cash dividends because a change in dividend rate is often viewed as conveying management's opinion of future prospects.⁶⁴ The market, for example, may view a fall in dividends as signalling a cloud on the corporate horizon and react by assigning a lower value to the corporation's stock. As the following discussion indicates, however, shareholders may be more willing to accept a lower payout rate, and a reduction in cash dividends may convey a different message, when stock dividends are issued.⁶⁵

64. See, e.g., R. BREALEY, *supra* note 23, at 20; A. ROBICHEK & S. MYERS, *supra* note 23, at 55; Thompson & Walsh, *Companies Stress Dividend Consistency*, 25 MANAGEMENT RECORD 30 (Jan. 1963). Whether this market perception is justified is difficult to test empirically because a determination of management's opinion of the future in connection with each dividend policy change must be made. For one attempt, see Darling, *A Surrogate Measure of Business Confidence and Its Relation to Stock Prices*, 10 J. FIN. 442 (1955). Moreover, one recent empirical study casts doubt on the thesis that dividends convey information. See Watts, note 41 *supra*.

65. Although this article focuses on stock dividends and common stock, some general observations concerning preferred stock and corporate dividend policy should be noted. Preferred stock is issued with dividend and liquidation rights that are limited but have priority over the residual open-ended rights of common stock. See generally B. GRAHAM, D. DODD & S. COTTLE, *SECURITY ANALYSIS* 375-83 (4th ed. 1963). Preferred stock is acquired by investors who prefer a secure but limited flow of cash dividends. Preferred stockholders, therefore, actively resist attempts to replace their dividend in cash with a dividend in stock. H. GUTHMANN & H. DOUGALL, *CORPORATE FINANCIAL POLICY* 528 (1955). However, their resistance may be tempered when stock dividends on preferred are issued to resolve a corporate deadlock that has interrupted the payment of all cash dividends on both preferred and common stock. V. BRUDNEY & M. CHIRELSTEIN, *CORPORATE FINANCE* 157-239 (1972).

Preferred stockholders receive cash dividends only when management, usually representing common stock, votes to pay them, and management cannot legally pay dividends on common until the prior dividend rights of preferred are satisfied in full. Therefore, if management desires to pay dividends on common, there is a powerful incentive to vote regular cash dividends on preferred. This incentive is diminished, however, when the corporation has been unable to pay preferred cash dividends and arrearages have accumulated on the preferred. Arrearages may be so large that their satisfaction would require all available cash for many years. Since common stock can then be paid a dividend only after many years, there is little incentive to pay anything on the preferred at all. The result is a deadlock in which management is unwilling to pay cash dividends on preferred and therefore unable to pay them on common.

This quandary can be resolved by offering the preferred stockholders additional equity interests in lieu of cash in satisfaction of their arrearage rights. If accepted, the arrearages are wiped out, and only *current* preferred cash dividends need be satisfied before paying dividends on common stock. Thus, once again there is a powerful incentive for management to vote cash dividends on preferred. Preferred shareholders will obviously find this arrangement more acceptable if stock dividends are received tax free. Unless the deadlock is broken, there is little prospect of cash dividends ever being paid by the corporation. Therefore, tax-free stock dividends, in satisfaction of large arrearages, may cause an *increase* in cash distributed and actually reduce the retention of corporate earnings.

A. *The Use of Stock Dividends to Achieve a Lower Cash Payout Rate*

Investors may be less inclined to oppose a decrease in cash payout when it is accompanied by the issuance of a pro rata or an elective stock dividend. If the assumption of irrational behavior is correct, some investors may view the stock dividend as "spendable income" comparable to cash. Moreover, while a decrease in cash dividends alone may signal gloomy prospects, the addition of a stock dividend or the opportunity to receive a stock dividend may be interpreted as conveying the message that management still regards the future as rosy.⁶⁶

The elective stock dividend offers an additional advantage. The elective stock dividend, unlike a cash dividend on common, enables a corporation to maintain two or more cash payout rates on its common stock. To illustrate the importance of this, suppose corporate management discovers an attractive investment opportunity that it wishes to finance with retained earnings by decreasing its cash payout rate. In the absence of stock dividends, this would require lowering the cash payout rate on common across the board, but a significant number of shareholders who prefer the current rate will oppose this reduction, and their opposition will often succeed. If, instead, the corporation offers shareholders the choice between receiving cash dividends at the current rate or equity appreciation in the form of stock dividends, shareholder opposition may be diminished. The election will enable the corporation to reduce its cash dividends, without encountering opposition, to the extent that some shareholders prefer the lower cash payout rate. Moreover, even if none of the corporation's current shareholders elect the lower cash payout rate, the ability to receive stock dividends in lieu of cash will make its stock attractive to an entirely new clientele with lower cash payout preferences. As these new purchasers acquire its shares and elect to receive dividends in stock, the corporation will be able to retain funds in greater volume.

Arrangements with the effect, if not the appearance, of elective stock dividends⁶⁷ may also facilitate certain corporate acquisitions.⁶⁸

Under the Tax Reform Act of 1969, all stock dividends paid on preferred are taxable at ordinary income rates. CODE § 305(b)(4). There is virtually no explanation of this provision in the congressional reports other than the statement that its purpose is to halt "an obvious tax avoidance technique."

66. VAN HORNE, *supra* note 33, at 276. See also B. GRAHAM, D. DODD & S. COTTLE, *SECURITY ANALYSIS* 499 (4th ed. 1963); H. GUTHMANN & H. DOUGALL, *CORPORATE FINANCIAL POLICY* 524 (3d ed. 1955).

67. See the articles cited in note 3 *supra*; Levin, *Corporate Adjustments*, in *A PRACTITIONER'S GUIDE TO THE TAX REFORM ACT OF 1969*, at 29 (1970) (Practising Law Institute); and Levin, *Principal Effects of the Tax Reform Act of 1969 On Corporations*, 52 *CHI. B. RECORD* 25, 35-39 (1970).

68. See Loomis, *A Case for Dropping Dividends*, 77 *FORTUNE*, June 15,

For example, suppose X Corp. proposes to acquire Z Corp. for X common stock. If X common has a low cash payout rate, the owners of Z corp. may find the offer unattractive. To overcome their reluctance and maintain a low cash payout rate on its original common, X Corp. might offer the Z shareholders a new class of X common with a high cash dividend rate. It should be noted that this arrangement requires the distribution of regular stock dividends on the original X common to compensate for the difference in amount of cash dividends on the two classes of common stock.

B. *Taxing Stock Dividends: The Impact on Corporations*

Taxation of elective stock dividends imposes a penalty sufficient to deter their use by management in setting corporate dividend policy. In the first place, taxation creates a barrier to corporate acquisitions that depend on arrangements designed to furnish two different cash payout rates on the stock of the acquiring corporation.⁶⁹ More importantly, taxation makes it more difficult for a corporation to increase its retained earnings through a reduction of its cash payout rate. This latter difficulty illustrates the discriminatory impact of stock dividend taxation on corporate capacity to retain earnings and shelter shareholder gains from ordinary income taxation.

As noted above, the extent to which a corporation shelters earnings from shareholder ordinary income taxation is directly related to the proportion of earnings retained, but stock dividend taxation does not focus on this proportion. The taxation burden falls instead on the use of stock dividends to increase the rate of retention without regard to the actual proportion of earnings retained. For example, taxation will deter a corporation that retains a low proportion of its earnings from raising its retention rate by issuing stock dividends. In contrast, taxation will not affect companies that began with a "growth" character and have always retained a high proportion of earnings. Rather than limiting the extent to which any given corporation can be used to retain earnings to its shareholders' tax advantage, stock dividend taxation discriminates against companies that began with a "non-growth" character and later, with the possibility of profitable investment, desire to ex-

1968, at 180; Ray, *Stock Dividends: Section 305(b) and the Conglomerates*, U. So. CAL. 1969 TAX INST. 341; Metzger, *The Impact of Section 306 Upon Convertible Preferred Stock Issued in a Corporate Reorganization*, 116 U. PA. L. REV. 755 (1968).

69. See Eustice, *The Tax Reform Act of 1969: Corporations and Corporate Investors*, 25 TAX L. REV. 509, 542 (1969). Viewed in this light, the taxation of elective stock dividends might be justified as a deterrent to conglomerate mergers. The problem with this justification, however, is that the Code does not restrict taxation to elective stock dividends issued in connection with conglomerate acquisitions. In addition, even if there were such a limitation, questions about the propriety of using tax policy as a surrogate for the enforcement of the antitrust laws would remain.

pand more rapidly.⁷⁰

IV. CONCLUSION

Under present law, an elective stock dividend is treated as producing shareholder ordinary income gain while a pro rata stock dividend on common stock is accorded tax-free treatment. Since a stock dividend, whether elective or not, does not distribute assets out of corporate solution, taxing any stock dividend appears inconsistent with the basic tax distinction between retained and distributed corporate earnings. Moreover, neither the doctrine of constructive receipt nor the proportionate interest test justifies taxation of elective stock dividends as if assets were distributed from the corporation. This article has used economic theory to analyze the relationship between stock dividends and shareholder taxation in a hypothetical world that grants tax-free treatment to all stock dividends, both pro rata and elective.

On the basis of this analysis, several conclusions can be stated. First, the central problem in the economics of dividends is why high payout stock sells at no discount in the market despite its significant tax disadvantage. In the financial literature, two major hypotheses have been advanced to explain this phenomenon. One theory posits that the tax advantage of low payout stock may be offset by inefficient reinvestment of retained earnings by corporate management. Since the validity of the inefficiency hypothesis is uncertain, theorists have ventured a second hypothesis; namely, that investors have an irrational preference for high payout stock. Fortunately, an analysis of stock dividends and investor preferences can be performed without verifying either theory simply by analyzing the effect of tax-free stock dividends on investment preferences assuming first that investors behave rationally and then that they behave irrationally.

Second, the effect of tax-free stock dividends on investor demand

70. This discrimination presents especially serious consequences for the public utility industry, faced with increased needs for capital funds to meet the energy crisis and federal and state antipollution requirements. Since it is less expensive to finance expansion with retained earnings, these companies have attempted to use elective stock dividends to lower cash dividends and increase reinvestment of earnings. Since elective stock dividends are taxed, these companies are less able to reduce cash dividends and more likely to seek financing through the sale of new securities. See, e.g., B. GRAHAM, D. DODD & S. COTLE, SECURITY ANALYSIS 492, 500-01 (4th ed. 1963); Smith, *supra* note 55, at 1549. See also Lee, *The Stock Dividend*, 37 TAXES 959, 970-71 & n.71 (1959); Leist, *Efforts to Tax Stock Dividends Under Section 305 Opposed: Experts Differ*, 11 J. TAXATION 70, 71 (1959); Tax Planning & Business Management Dept., *IRS Attempts to Stop 2-Classes-of-Common-Tax-Saving Plan; Legality Questioned*, 5 J. TAXATION 178 (1956); Tax Planning & Business Management Dept., *Two Classes of Stock: One Gets Cash, One Stock Dividends; A Useful Tax Planning Tool*, 4 J. TAXATION 312 (1956).

for retention or distribution of corporate earnings depends upon whether investors are influenced by irrational preferences. If investors behave rationally, tax-free stock dividends on publicly-held common stock will not affect shareholder demand for retention or distribution of corporate earnings. If, on the other hand, investors behave irrationally, tax-free stock dividends make a low cash payout rate more attractive and tend to increase the proportion of earnings retained by the corporation.

Third, if the irrationality hypothesis is accurate taxing stock dividends might be justified as a means of limiting the sheltering of corporate earnings from shareholder ordinary income taxes. However, taxation would affect only those investors for whom stock dividends have some subjective or irrational importance. Those investors who are satisfied with a low cash payout in the absence of stock dividends would not be affected.

Fourth, whether investors behave rationally or irrationally, elective stock dividends on publicly-held common, if accorded tax-free treatment, eliminate the capital gains tax and brokerage fees as barriers to the adjustment of a portfolio's cash payout rate. This elimination of barriers may, to some undetermined extent, decrease the effective rates at which both cash distributions and retained earnings are taxed. It is possible, however, to avoid any reduction in revenue that tax-free elective stock dividends might cause by treating the shareholder who changes his election as if he sold his stock and imposing a capital gains tax on that occasion. Compared with this alternative, the present method of taxing elective stock dividends as ordinary income gain has an inequitable impact on investors because the effect of present law is to maintain brokerage fees as a barrier to portfolio adjustment and brokerage fees burden smaller investors more than larger investors.

Finally, at the corporate level, taxing stock dividends on publicly-held common deters the use of stock dividends to increase the proportion of earnings retained for reinvestment. Taxation, therefore, will not affect "growth companies" that retain a high proportion of earnings without paying stock dividends and will discriminate against companies that began with a "non-growth" character and later desire to expand more rapidly.

These conclusions indicate that taxing stock dividends has an inequitable impact on the ability of both investors and corporations to shelter retained earnings from shareholder ordinary income taxes. If there is legitimate concern about the preferential treatment afforded retained earnings, then the preference should be attacked in a comprehensive manner that affects all shareholders and all corporations. While thorough evaluation of the methods of reducing the preferential treatment of retained earnings is beyond the scope of this paper, two possibilities deserve brief mention.

An administratively convenient method of eliminating the retained earnings tax preference would be to impose a corporate-level tax on retained earnings that exceed a certain percentage of the year's profits. This proposal differs from the present accumulated earnings tax that is restricted to the retained earnings of closely-held corporations that exceed reasonable business needs.⁷¹ An across the board accumulated earnings tax would obviously affect the degree to which all shareholders and all corporations shelter retained earnings. The threat of such a tax may cause the distribution of corporate earnings with the imposition of a shareholder ordinary income tax on the amount distributed. If corporate earnings are distributed, the tax burden will be progressive, varying among shareholders as a function of individual tax rates. But if the threat fails to cause distribution, the accumulated earnings tax would be imposed at the corporate level with a proportional burden on all common stockholders of a given corporation.

A more progressive tax proposal would impose a heavier tax on retained earnings directly at the shareholder level. The current shareholder tax rate on retained earnings is a function of: the tax rate applied to appreciation in the value of stock; the time interval between the generation and taxation of retained earnings; and whether the shareholder holds the stock until his death so that a stepped-up basis is granted by section 1014(a).⁷² Instead of taxing stock dividends, the effective rate of tax on retained earnings could be increased by altering the above factors individually or in appropriate combination. Section 1014(a) could be repealed,⁷³ and the tax rate applied to stock gains could be increased.⁷⁴ Finally, in order to shorten the time interval between generation and taxation of retained earnings, stock appreciation could be taxed at regular intervals, whether the stock is sold or not, with gain measured by the public market value of the stock.⁷⁵ This second

71. See BRITKER, *supra* note 3, ch. 8.

72. See text accompanying notes 8-11 *supra*.

73. This change was unsuccessfully proposed by the Treasury in 1963. See *Hearings on H.R. 8362 Before the House Comm. on Ways and Means, 88th Cong., 1st Sess., at 47-52 (1963)*.

74. Any increase in the capital gains rate will tend to increase rigidity in capital markets. See NEW YORK STOCK EXCHANGE, TAXES—EQUITY CAPITAL—AND OUR ECONOMIC CHALLENGES 38-40 (1953). However, combining an increased capital gains tax with regular taxation of unrealized stock appreciation would eliminate this problem.

75. See Slawson, note 19 *supra*.

For the closely-held corporation, there is no public market, and non-market appraisal of stock can be extraordinarily difficult. Therefore, retained earnings in the close corporation could be allocated to individual shareholders for taxation at regular intervals.

Such a method of taxation in a publicly-held corporation with a multi-class capital structure would be extremely impractical because of the difficulty of allocating earnings to the various equity interests. If, for example, dividends on cumulative preferred stock were always paid, there would

proposal, while probably more progressive in its impact, has the disadvantage of being considerably more complex than a corporate-level tax on retentions. Both proposals, however, deserve serious consideration as alternatives to the taxation of stock dividends in order to limit the sheltering of retained earnings from shareholder ordinary income taxes.

be no question how to allocate retained earnings to common stock. But suppose that although earnings are available, preferred dividends are skipped and arrearages accumulated. Since the preferred arrearages have priority over common stock dividend and liquidation rights, it would be unfair to allocate to the common stock all earnings retained by skipping preferred dividends. On the other hand, the preferred arrearages may not be satisfied for a number of years, if at all. Therefore, it would be unfair to allocate these earnings in their entirety to the preferred stock. In theory, the proper amount to allocate to the preferred could be calculated by estimating the present value of the arrearage rights with any residual allocated to the common stock. In practice, however, such estimates would not possess a high degree of accuracy since they require specifying how far in the future and with what degree of confidence the market expects arrearage rights to be satisfied.

A similar problem exists when there are securities convertible into common stock. Unless the conversion right has no market value, it would be unfair to allocate retained earnings in their entirety to the common stock since they may be subject to future dilution. On the other hand, it would be unfair to treat the convertible securities as if they were converted for the purpose of allocating retained earnings since they may not all be converted into common stock. In theory, one might construct an allocation formula by estimating the number of securities that will be converted. In practice, however, such estimates would probably be highly inaccurate. See H. SIMONS, *supra* note 19, at 189-96.