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Comment

INCOME TAX: TAXABILITY OF STOCK DIVIDENDS

When are stock dividends taxable as income? Adhering to the decision in *Eisner v. Macomber*,¹ Congress expressly exempted all stock dividends from taxation during the fifteen year period preceding the Revenue Act of 1936.² Under the Act of 1936³ and subsequent acts to date, stock dividends are taxable to the extent that they constitute income "within the meaning of the Sixteenth Amendment to the Constitution".⁴

In the current year (1943) the Supreme Court of the United States has twice considered particular phases of the taxability of

¹ (1920) 252 U.S. 189 (a 5 to 4 decision).

² The revenue acts from 1921 to 1934 provided that "A stock dividend shall not be subject to tax. . . ." 42 STAT. (1921) 228 §201(d); 43 STAT. (1924) 255 §201(f); 44 STAT. (1926) 11 §201(f); 45 STAT. (1928) 822 §115(f); 47 STAT. (1932) 204 §115(f); 48 STAT. (1934) 712 §115(f).

³ 49 STAT. (1936) 1648. The reason for the change in the Revenue Act of 1936 is attributed to the case of *Koshland v. Helvering* (1936) 298 U.S. 441, where the law was plunged into confusion by the decision that *certain* stock dividends constitute income under the Sixteenth Amendment.

⁴ Section 115(f) (1) of the Revenue Act of 1936, which remains unchanged to date, reads: "A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income within the meaning of the Sixteenth Amendment to the Constitution." 49 STAT. (1936) 1688.

This same provision is found in the California revenue laws. Corporation Income Tax Act, Cal. Stats. 1937, p. 2184, amended Cal. Stats. 1939, p. 2902; Cal. Stats. 1941, p. 2210. Personal Income Tax Act, Cal. Stats. 1935, p. 1090, amended: Cal. Stats. 1937, p. 1831; Cal. Stats. 1939, p. 2528; Cal. Stats. 1941, p. 3042.

stock dividends, a question which has given rise to much controversy and litigation in recent years and remains involved in many artificial distinctions.⁵

I

STOCK DIVIDENDS UNDER PRESENT LAW

Before considering the constitutional issue left undecided by the recent attack on *Eisner v. Macomber*, a brief survey of the existing law will assist in understanding the general scope of the problem.

A—TAXABLE DIVIDENDS

The following stock dividends are taxable as income:

(1) *Elective dividends*. When the shareholder is given an option to take his dividend in cash (property) or in shares of the corporation, such a stock dividend is taxable even though the shares would not ordinarily be regarded as taxable income.⁶ The reason would seem to be that since all the shareholders may not exercise their option to take shares, those who do will receive an increased proportionate interest in the corporation. Indulging in fiction it might also be argued that those who take shares are considered to have received a cash distribution and to have elected to reinvest in the new shares.

(2) *Change of Interest Stock Dividend*. When a stock dividend is declared out of net earnings of the corporation, in order to be taxable as income "there must be a change brought about by the issue of shares as a dividend whereby the proportional interest of the stockholder after the distribution was essentially different from his former interest".⁷ This is the test set forth by the Supreme Court in the recent case of *Helvering v. Sprouse*⁸ where it was decided that a stock dividend in non-voting common shares to holders of voting common shares was not taxable income. In *Strassburger v. Commissioner*,⁹ decided at the same time, it was held that a stock dividend in non-voting preferred stock to the owner of the entire common stock of the corporation was not taxable income. The conflicting views arising from the earlier case of *Koshland v. Helvering*¹⁰ are now resolved.¹¹

⁵ Recent discussions on taxability of stock dividends: James, *The Present Status of Stock Dividends Under the Sixteenth Amendment* (1939) 6 U. OF CHI. L. REV. 215; Mertens, *Recent Income Tax Trends in Stock Dividend Cases* (1942) 27 CORN. L. Q. 449; Notes: (1942) 30 CALIF. L. REV. 344; (1942) 55 HARV. L. REV. 683; (1943) 143 A. L. R. 230; (1941) 130 A. L. R. 408; (1936) 105 A. L. R. 761.

⁶ 52 STAT. (1938) 497 §115(f). 1 MERTENS, FEDERAL INCOME TAXATION (1942) §9.110.

⁷ *Helvering v. Sprouse*, *Strassburger v. Commissioner* (April, 1943) 63 Sup. Ct. 791, 87 L. Ed. Adv. Ops. 732, 734.

⁸ *Ibid.*

⁹ *Ibid.*

¹⁰ *Supra* note 3.

¹¹ For a note on the controversy which was resolved by the recent decision in *Helvering v. Sprouse*, *supra* note 7, see Note, (1942) 30 CALIF. L. REV. 344.

In stating the rule, it would seem the Court means that the proportional interest of the stockholder must be *increased* by the distribution, since the fact that it is "essentially different" from his former interest would not constitute income if his interest was worth the same or less than before.¹²

In the following situations there is a change (increase) in the proportional interest of the shareholder, rendering the stock dividend taxable:

(a) Where preferred shares are distributed to holders of common shares and there are other preferred shares outstanding.¹³

(b) Where common shares are distributed to preferred shareholders and there are common shares or another class outstanding.¹⁴

(c) Where preferred shares are distributed to preferred shareholders and there are common shares outstanding.¹⁵ In these situations the increase in the proportionate interest of the taxpayer on receipt of the stock dividend arises through his acquisition of valuable voting rights or liquidation and dividend preferences which he did not have previously.

(3) *Stock Rights*. Any right to subscribe for or purchase shares which permits the shareholder to acquire shares from the corporation at a price under their fair market value may be taxable as income.¹⁶ Such rights are considered analogous to stock dividends¹⁷ and are taxable only insofar as the shares acquired without full value would constitute a taxable stock dividend. Under the latest decision of the circuit court of appeals,¹⁸ taxable stock rights are subject to tax (1) at the *time* the option to buy is exercised and shares actually acquired, and (2) to the *extent* of the spread between the option price and the market value of the shares at the time the option was issued or at the time it is exercised, whichever is lower.¹⁹ Thus if a common share-

¹² However, the effect caused by a change of interest stock dividend is similar to that of a "reclassification" of shares arising from an amendment of the articles of incorporation increasing the participating rights of one or more classes at the expense of other classes.

¹³ *Helvering v. Gowran* (1937) 302 U.S. 238, noted in (1938) 51 HARV. L. REV. 702.

¹⁴ *Koshland v. Helvering*, *supra* note 3, noted in (1937) 25 CALIF. L. REV. 499.

¹⁵ *Helms Bakeries* (1942) 46 B.T.A. 308. (Although this decision by the Tax Court preceded the recent case of *Helvering v. Sprouse*, *supra* note 7, it would seem to be within the principle announced therein.)

¹⁶ Section 115(f) (1) of the Revenue Act of 1936, *supra* note 4, and subsequent acts to date, states, "A distribution . . . in stock or in rights to acquire stock. . . ." MACILL, *TAXABLE INCOME* (1936) 49.

¹⁷ *Palmer v. Commissioner* (1937) 302 U.S. 63; *Choate v. Commissioner* (C. C. A. 2d, 1942) 129 F. (2d) 684.

¹⁸ *Choate v. Commissioner*, *ibid.* This case reversed the decisions in *Arthur O. Choate* (1941) 45 B.T.A. 574 and *sub silentio* *Helen Whitney Gibson* (1941) 44 B.T.A. 950.

¹⁹ The Commissioner in the *Choate* case, *supra* note 17, maintained that (1) the amount of the dividend is measured by the fair market value of the rights at the time

holder receives in 1940 a right to buy one share of preferred stock at ten dollars and the market value of the share is twenty dollars, he receives no taxable income. But if he exercises the right in 1945 and the market value of the preferred share is fifteen dollars, he receives taxable income in 1945 to the extent of five dollars (the amount of the spread between the option price and the market value in 1945, since it is lower than the 1940 market value).

B—NON-TAXABLE DIVIDENDS

The following classes of stock dividends are not taxable:

(1) *Ordinary stock dividends.* A distribution of common shares to holders of the same class of shares is not taxable as income. In *Eisner v. Macomber*, decided in 1920, this type of stock dividend was held not to constitute income under the Sixteenth Amendment. In *Helvering v. Griffiths*,²⁰ decided in 1943, this type of stock dividend was held to be non-taxable under the present Revenue Act. The Court, on this ground, refused to reconsider *Eisner v. Macomber*. In both cases the dividends were declared out of net earnings of the corporation.²¹

(2) *Stock Rights.* Rights to acquire shares are not taxable if the shares to be acquired by exercise of the rights would be a non-taxable stock dividend.²² Thus, a distribution of rights to buy common shares to holders of common stock is not taxable income to the shareholder.

(3) Any stock dividend which does not increase the proportionate interest of the shareholder or give him any new rights which may be of value is non-taxable. In the following situations stock dividends are not taxable:

(a) Where common shares are distributed to holders of common, regardless of other classes outstanding at the time of the dividend.²³

(b) Where preferred shares are distributed to holders of common and only common stock is outstanding at the time of the dividend.²⁴

(c) Where non-voting common shares are distributed to holders of voting common, regardless of other classes outstanding at the time of the dividend.²⁵

they became income; (2) stock rights were income when received; (3) stock rights were income whether they were dividends or not.

²⁰ (March, 1943) 63 Sup. Ct. 636, 87 L. Ed. Adv. Ops. 597.

²¹ The attempt to justify the taxability of ordinary stock dividends rests on the theory that by disregarding the separate legal entity of the corporation, the accumulated earnings of the corporation represent unrealized income to the shareholder. However, where a stock dividend is issued on the basis of a capitalization of paid-in surplus or reduction surplus, and not on the basis of a capitalization of net earnings, the distribution is entirely a "return" of invested capital and would not be taxable income. *Lich v. United States Rubber Co.* (1941) 39 Fed. Supp. 675, 683. See Note (1941) 25 MINN. L. REV. 744, 762, n. 86.

²² *Choate v. Commissioner*, *supra* note 17.

²³ *Helvering v. Griffiths*, *supra* note 20; *Eisner v. Macomber*, *supra* note 1.

²⁴ *Strassburger v. Commissioner*, *supra* note 7.

²⁵ *Helvering v. Sprouse*, *supra* note 7.

(4) *Distribution of Treasury Shares.* Where treasury shares are distributed gratuitously to existing shareholders the law remains somewhat undecided. Although recent Treasury Regulations have considered such a dividend taxable income when the shares were "held as an investment" by the corporation,²⁶ an important decision by the Board of Tax Appeals (now Tax Court) presents a contrary view.²⁷ Such a reissue of shares is in no sense a stock dividend since there is no capitalization of surplus. It might, however, cause a change of proportionate interest as between different classes of shareholders. Treasury shares are not assets; they merely represent a withdrawal of assets by the corporation at some previous time, and their status is indistinguishable from unissued shares.²⁸ It is gross error to regard treasury shares as an accumulation of profits, assets, or an investment by the corporation. The validity of the Treasury Regulations, therefore, seems highly questionable on principle as well as on authority.²⁹

C—COST-BASIS

If a stock dividend is taxable when received, the cost-basis of the shares for the purposes of taxing profits on a resale at a later time is the market value of the shares on receipt.³⁰ Thus a taxpayer who receives a taxable dividend share in 1940 which has a market value of ten dollars and later sells the same share in 1945 for fifteen dollars must pay an income tax on ten dollars (the market value on receipt) in 1940 and on the five dollar gain in 1945.

If a stock dividend is non-taxable when received, it reduces the cost-basis of all the shares held by the shareholder. The cost is to be ascertained by allocating the original cost between the original shares and the shares received as dividends.³¹

To know what is or is not subject to tax at any one time is an intensely practical matter which requires continual reference to statutory changes and current decisions of the courts. However, to know what is or is not within the power of Congress to tax as income is a fundamental question of constitutional law, much less dynamic and practical.

²⁶ U. S. Treas. Reg. 103 §19.27(d)-1 provides "... the term 'property' [dividend] includes shares of capital stock of a corporation making the dividend distribution if such shares of stock are *held by it as an investment*." (Italics added.)

²⁷ David Bruckheimer (1942) 46 B.T.A. 234 (a distribution of treasury common shares to holders of common stock was not income to the shareholder).

²⁸ See 1 MERTENS, *op. cit. supra* note 6, §9.117; Hills, *Federal Taxation v. Corporation Law* (1937) 12 WIS. L. REV. 280, 299.

²⁹ David Bruckheimer, *supra* note 27.

³⁰ Duke, *Federal Taxation of Stock Dividends When Received, and Their Cost Basis when Sold* (1937) 15 TAX MAG. 593, 596; 3 MERTENS, *op. cit. supra* note 6, §§21.145-21.155.

³¹ *Ibid.*

II

RECONSIDERATION OF *EISNER V. MACOMBER*

Under the present Revenue Act, an ordinary stock dividend is not taxable income.³² Whether Congress by changing the Act may tax such dividends under the Sixteenth Amendment presents a constitutional question "of the first magnitude"³³ in which the government has shown its interest.

In *Helvering v. Griffiths*,³⁴ the Supreme Court decided that a stock dividend in common shares issued out of net earnings of the corporation to holders of common shares was not taxable under Section 115(f)(1) of the Revenue Act of 1939.³⁵ The taxpayer owned common shares of the Standard Oil Company of New Jersey on which she received two dividends of the identical kind of stock during the year 1939 whose market value on receipt totaled \$109.01. This amount was not included as income in the taxpayer's return for the year. The majority of the Court was of the opinion that the constitutional question decided in *Eisner v. Macomber* was not presented for reconsideration since a proper construction of Section 115(f)(1) (which makes stock dividends taxable) does not evince an intention by Congress "to do what *Eisner v. Macomber* held it could not [do]".³⁶

The dissenting opinion delivered by Mr. Justice Douglas, in which Justices Black and Murphy joined, construed Section 115(f)(1) of the Revenue Act as an expression of intention by Congress to tax stock dividends to the full extent permitted under the Sixteenth Amendment, thereby challenging the decision of the *Eisner* case. It was then argued by Mr. Justice Douglas that "*Eisner v. Macomber* should be overruled."³⁷

In reconsidering the doctrine of *Eisner v. Macomber*, one is confronted with fundamental principles of constitutional and corporation law.

As to the constitutional issue of what is "income" under the Sixteenth Amendment, it is customary as a starting point to state the concept expressed in the *Eisner* case, "the gain derived from capital, from labor, or from both combined; provided it be understood to include profit gained through sale or conversion of capital assets."³⁸ This definition commands much respect and has been accepted as the true meaning of income as used in the Sixteenth Amendment. How-

³² *Helvering v. Griffiths*, *supra* note 20.

³³ *Ibid.* at 648, 87 L. Ed. Adv. Ops. at 610.

³⁴ *Supra* note 20.

³⁵ (1939) I. R. C. §§1, 9, 47. For the text of §115(f)(1) see note 4, *supra*.

³⁶ *Helvering v. Griffiths*, *supra* note 20, at 648, 87 L. Ed. Adv. Ops. at 610.

³⁷ *Ibid.* at 656, 87 L. Ed. Adv. Ops. at 619.

³⁸ *Eisner v. Macomber*, *supra* note 1, at 207.

ever, there have been many departures from this concept in the development of income taxation until today it is generally recognized that there is no settled meaning to the term "income" as used in the Constitution.³⁹ Despite the so-called indefiniteness surrounding the present "changing concept,"⁴⁰ it is axiomatic that capital may not be taxed as income, and it is still essentially a question of what *gain* can be taxed and when it can be taxed. Today, in the light of the cases, one may advance as the true definition of constitutional income two general views:

(1) The *liberal view* which may be stated as that part of the *Eisner* definition preceding the proviso, that is, "gain derived from capital, labor, or both combined". This view would not recognize the conventional legal distinction between realized and unrealized economic gain which in recent years has become quite artificial,⁴¹ but would hold any increment in value taxable whether severed or not. Under such a definition of income, Congress would have power to tax all economic gain whenever it accrued, and whether there has been a sufficient realization of that gain by the taxpayer to justify the imposition of an income tax would be a practical question of policy to be determined by Congress and not a question of power to be determined by the Court. However, at this stage in the development of the law, such a view seems to find more support from economic theorists than from the courts and legal writers.⁴²

(2) The *strict view* which follows from a more realistic interpretation of the cases considers constitutional income to be *realized income* as defined in the *Eisner* case, but qualified by many indefinite exceptions to the older meaning of realization.⁴³ In other words realized income under the *Eisner* doctrine was the actual receipt of economic gain, that is, "gain through sale or conversion of capital assets". Today it is "settled that the realization of gain need not be in cash derived from sale of an asset",⁴⁴ but may occur when there is a constructive receipt of economic gain. While it may be true that realization under this view

³⁹ MAGILL, *op. cit. supra* note 16, at 392; Note (1932) 45 HARV. L. REV. 1072.

⁴⁰ 1 MERTENS, *op. cit. supra* note 6, §5.03.

⁴¹ *Helvering v. Brunn* (1940) 309 U. S. 461; *Helvering v. Horst* (1940) 311 U. S. 112; see 1 MERTENS, *loc. cit. supra* note 40.

⁴² Under this view of income the entire holdings of an individual at any particular time would consist of either capital or income; there would be no such hybrid concepts as "accretions to capital" or "capital gains". If A, worth \$100 in 1942, is worth \$150 in 1943, he has \$50 that is "income" which Congress could tax. However, once this view is adopted the Court will have a dual function in passing on the constitutionality of an income tax. It must not only ascertain whether there has been an economic gain to the taxpayer but also whether the measure of that income is accurate; else the Sixteenth Amendment is reduced to absurdity and a tax on capital sustained.

⁴³ Magill, *Realization of Income Through Corporate Distributions* (1936) 36 COL. L. REV. 519; 1 MERTENS, *op. cit. supra* note 6, ch. 5.

⁴⁴ *Helvering v. Brunn*, *supra* note 41, at 469.

is a *sine qua non* of taxable income and unrealized increment in value is not taxable, the modern doctrine of constructive realization gradually narrows that area of economic gain which may be denominated unrealized income. Recourse must be had to the Court to know in each particular case at what time it is proper to say that constructive realization takes place. It may occur when the taxpayer obtains the "fruition of the economic gain which has already accrued to him."⁴⁵ Under this concept which seems to prevail today, in order to impose a valid income tax there must be (1) economic gain and (2) some occurrence which will justify the conclusion by the Court that the gain has been realized.

With a general understanding of the possible constitutional meanings of income under the Sixteenth Amendment, the next inquiry is principally a matter of corporation law—the nature and effect of stock dividends in relation to the income of the shareholder. Stock dividends may be discussed in terms of the following general classes.

A—STOCK SPLIT-UP

One type of stock issue is where there is a mere split-up of units or subdivision of existing shares without any increase of legal capital on the part of the corporation. Such a split-up produces no change in the surplus, shareholders' claims to net earnings, proportionate interest, or relative rights in the corporation. This is "cutting the melon" into more pieces without any increment in the size of the cut. Obviously, there is no economic gain in substance or in form to the shareholder whether the corporation be regarded as a separate legal entity or not. Under the present law a stock split-up is not taxable income.⁴⁶ Under either the *liberal* or *strict* view of the meaning of income as used in the Sixteenth Amendment there could be no income to the shareholder and a tax on such an increase in share units would clearly be a tax on capital investment.

B—ORDINARY STOCK DIVIDENDS

Another type is the ordinary stock dividend, involved in both the *Eisner* and *Griffiths* cases, where the dividend is declared out of net earnings of the corporation in common shares to holders of common. As in all stock dividends the corporation parts with no assets. The shareholder's proportionate interest in the assets of the corporation is not changed and his relative rights remain the same as before the so-called dividend.⁴⁷ The basis of the new issue is a transfer on the corporation books of a certain amount of surplus to legal capital

⁴⁵ *Helvering v. Horst*, *supra* note 41, at 115.

⁴⁶ *Bass v. Commissioner* (C. C. A. 1st, 1942) 129 F. (2d) 300.

⁴⁷ *BALLANTINE, CORPORATIONS* (1927) 516-18.

(stated capital).⁴⁸ What the shareholder receives is simply new evidence of the same interest which he held in the *assets* and *earnings* of the corporation before the dividend. Clearly the shareholder does not obtain any actual realized economic gain by a capitalization of surplus. It might be argued that *Eisner v. Macomber* stopped at this point since its major premise was that only income actually realized is taxable under the Sixteenth Amendment. But even under the modern interpretation of income, how can it be said that an increase of share units in the same interest amounts to a constructive realization of economic gain to the shareholder or amounts to any gain at all? The only essential difference from a stock split-up is that the corporation in making an ordinary stock distribution transfers an amount of surplus to capital.⁴⁹ This, however, may be done without a stock dividend by order of the directors under modern laws,⁵⁰ and there is no constructive or actual increase in the shareholder's equity thereby. Thus, there is no economic gain by virtue of the new shares which could be realized either actually or constructively by the shareholder. Even the dissenting justices in the *Griffiths* case would concede this to be true.⁵¹

At this point it is submitted that the dissent in the *Griffiths* case fails to establish the proposition it attempts to prove, namely, that "*Eisner v. Macomber* should be overruled". The *Eisner* case decided that an ordinary stock dividend in common shares to holders of common was not income within the Sixteenth Amendment to the Constitution. In his dissent Mr. Justice Douglas concedes the fact, as he must, that a "stock dividend normally will not increase the wealth of the stockholder."⁵² An ordinary stock dividend makes no change in the net worth of the shareholder.

The theory on which the Douglas dissent rests, while it may possibly be sound in part, merely requires overruling the dictum of *Eisner v. Macomber* that only realized income actually received is taxable under the Sixteenth Amendment. This in no way involves the specific question whether a stock dividend itself is income. As the assets of the corporation increase over a period of time, so does the amount of the shareholder's proportional interest therein. The shareholder receives an unrealized increment of value through the undistributed profits and unrealized gains of the corporation which make

⁴⁸ Katz, *Accounting Problems in Corporate Distributions* (1941) 89 U. OF PA. L. REV. 764, 774.

⁴⁹ Hills, *Model Corporation Act* (1935) 48 HARV. L. REV. 1334, n. 59.

⁵⁰ Hills, *ibid.* at 1363; BALLANTINE & STERLING, *CALIFORNIA CORPORATION LAWS* (1938) 222; CALIF. CIV. CODE §348c.

⁵¹ "The declaration of a stock dividend normally will not increase the wealth of the stockholder." *Helvering v. Griffiths*, *supra* note 20, at 657, 87 L. Ed. Adv. Ops. 620.

⁵² *Ibid.*

his share contract intrinsically worth more. Thus, while a stock dividend is not income in any sense to the shareholder, it might be accepted according to Mr. Justice Douglas as "an occasion for recognizing that accrual of wealth"⁵³ which Congress would have power to tax as income under a liberal interpretation of the Sixteenth Amendment. However, Congress could only constitutionally tax the shareholder when he received the stock dividend to the extent of the economic gain he already had when the dividend was declared, which amount obviously would not be measured by the market value of the stock dividend. It is only the income of the corporation and not that of the shareholder which may be properly measured by the net earnings of the corporation from which the stock distribution is made. The dissent in the *Griffiths* case concedes that the market value of the stock dividend is a "crude" measure of this increase in the value of the shareholder's interest in the corporation over the period of time up to the declaration of the dividend.⁵⁴ However, it would seem that to impose a tax on such an inaccurate measure of economic gain would be to tax as income an amount that is a part of the shareholder's capital investment as well as a part of his unrealized income from that investment, thereby allowing to a certain extent a direct tax on invested capital as a valid income tax. The actual amount of the shareholder's economic gain, if any, which supposedly becomes constructively realized on receipt of the stock dividend and thus within the power of Congress to tax as income is extremely difficult to determine. However, the difficulty of computation should not justify an arbitrary method which actually allows an income tax on invested capital. There are two theories under which the economic gain of a shareholder over a particular period could be fairly accurately determined. Under the *dissolution theory* the income would be the difference between the shareholder's original investment at the time of purchase and the present value of his entire interest computed on the basis of an imaginary dissolution of the corporation. Under the *market value theory* the income would be the difference between original investment and the market value of the entire interest of the shareholder. It is clear therefore that an ordinary stock dividend is not income itself; and while it might be considered as an occasion for taxing whatever unrealized income has accrued to the shareholder over a particular period, it does not constitute a proper measure of that increase in net worth. At this point it seems proper to suggest as a practical argument in reference to the Douglas theory of taxing the unrealized income of the shareholder on receipt of a stock divi-

⁵³ *Ibid.*⁵⁴ *Ibid.*

dend, that under Section 115(f)(1) of the Revenue Act there is no justification for spelling out an intention of Congress that a stock dividend was to be a signal for recognizing the unrealized accrual of wealth of the shareholder and that such unrealized income was intended to be made taxable.

Another fundamental aspect of corporation law which the dissenting opinions in both the *Eisner* and *Griffiths* cases seem unwilling to respect is the separate entity of the corporation.⁵⁵ In general, for tax purposes as well as in other phases of the law, the corporation and the shareholder are not to be regarded as the same person unless it is necessary to prevent an abuse of the corporate privilege.⁵⁶ This sound rule was followed in the *Eisner* case where the majority opinion made a clear and comprehensive analysis of the corporate entity. The separate capacity of the corporation is no fiction; it is an important statutory privilege which is fully recognized in collecting the corporate income tax. Even the layman is aware that, unlike a partnership, a loss sustained by the corporation is not necessarily a loss to the shareholder and likewise a gain to the corporation is not regarded as a gain to the shareholder. The net earnings of the corporation represent the economic gain of the corporate concern and not the economic gain of the individual shareholders. The shareholder has merely the interest in the corporation which he derives from his share contract. If the corporation retains its gains, the only economic gain which a shareholder may have is the possible increment in the market value of his shares which does not depend directly on whether or not the corporation has accumulated net earnings. Thus in determining the taxable income of the shareholder one should not confuse the income of two taxable persons. A shareholder can have constructive realization only of his own economic gain in the value of his shares and not in the gain of the corporate net worth.

On consideration it becomes apparent that the dissenting opinion in the *Griffiths* case will not stand analysis. To the extent that it proposes to treat a stock dividend itself as income to the shareholder, it rests on fantasy rather than reason. To the extent that it holds a stock dividend a proper time and measure for taxing the unrealized increment of value of the shareholder's interest, it fails to recognize that the market value of the new shares is not a valid measure of that unrealized income. To the extent that it suggests that Congress has authority under the Sixteenth Amendment to tax the economic gains of a taxpayer whenever it sees fit, it probably represents the

⁵⁵ BALLANTINE, *op. cit. supra* note 47, at 6, 19, 26.

⁵⁶ "As a general rule a corporation and its stockholders are deemed separate entities and this is true in respect of tax problems." (Italics added.) *New Colonial Co. v. Helvering* (1934) 292 U. S. 435, 442. 10 MERTENS, *op. cit. supra* note 6, §§61.04, 61.07.

law of tomorrow. However, to accomplish the latter requires only a qualification, generally recognized, of the constitutional definition of income expressed in the *Eisner* case and not the overruling of that sound decision that an ordinary stock dividend is merely new evidence of an existing interest in an investment contract and not income.

By indulgence in legal fiction one may arrive at almost any result in any phase of the law. Even an ordinary stock dividend may be reached through an income tax by a conclusive presumption that a cash dividend has been received which is immediately reinvested in the corporation. The imaginary cash dividend would be the basis for the tax and not the stock dividend. Such a fiction may be justifiable in the case of an *elective dividend*⁵⁷ where the shareholder has an election to take cash or shares; but in an ordinary stock dividend where no such election is given, the presumption seems entirely false and unfounded.

C—CHANGE OF INTEREST STOCK DIVIDEND

The change of interest stock dividend is another type which the Supreme Court has recognized and surprisingly held to constitute taxable income under the Sixteenth Amendment.⁵⁸ The only difference between this type and the ordinary stock dividend is that the shareholder acquires some additional participating rights in the corporate enterprise which he did not have previous to the dividend, just as he might receive by an amendment of the articles of incorporation reclassifying his shares. Much of the confusion in the law today may be ascribed to the failure of the courts to consider the nature, source, and value of these rights. *Koshland v. Helvering*⁵⁹ involved a dividend in common shares to holders of preferred where both classes were outstanding, and the entire common share dividend was held to be income. *Helvering v. Gowran*⁶⁰ involved a dividend in preferred shares to holders of common where both classes were outstanding, and the entire preferred share dividend was held to be income. The rights received by the shareholder in the *Koshland* case were new voting rights and the rights to participate in dividends and assets with the diluted common shares. The only rights received by the shareholder in the *Gowran* case were the dividend and liquidation rights of the preferred shares which diluted his common shares. It must be observed that the rights acquired in both cases were at the expense of the existing shareholders of the class in which the divi-

⁵⁷ The principle that a waiver of actual receipt of income renders one chargeable with constructive receipt would seem to apply. 2 MERTENS, *op. cit. supra* note 6, §10.06.

⁵⁸ *Koshland v. Helvering*, *supra* note 3; *Helvering v. Gowran*, *supra* note 13.

⁵⁹ *Supra* note 3.

⁶⁰ *Supra* note 13.

dend was declared, and not at the expense of the corporation. The validity of such dividends is highly questionable as a matter of corporation law,⁶¹ and it would seem that the injured shareholders could complain of the wrong sustained by them or at least be allowed to deduct as a loss the amount which is "income" to the favored class of shareholders. However, conceding the validity of such a dividend, the only actual income it confers is the monetary value of the additional rights acquired; and to evaluate the voting rights of a common share of stock as equal to the sale value of the whole share, or to evaluate the dividend and liquidation preferences of a preferred share as equal to the sale value of the share itself, is obviously arbitrary and incorrect. Such rights form only a small portion of the entire value of the share. In effect, the Court seems to sustain a tax which is partly on capital investment and only partly on unrealized gain in the form of new rights of uncertain value as a valid income tax under the Sixteenth Amendment. The *Koshland* and *Gowran* cases, it is submitted, cannot be sustained in full, and to rely on them in attempting to justify an income tax on an ordinary stock dividend (which confers no gain at all) is to follow the deviations of error into greater error and injustice.

In the recent cases of *Helvering v. Sprouse* and *Strassburger v. Commissioner*⁶² the Supreme Court, relying on the *Griffiths* case, refused to extend the unsound doctrine of the *Koshland* case to situations where the rights acquired by a distribution of shares of a different class did not increase the proportional interest of the shareholder, although the legal capital was increased. On examination one finds that it is not *Eisner v. Macomber*, but rather *Koshland v. Helvering* and its "misbegotten progeny" that should be reconsidered.⁶³

The Court should not reduce to confusion fundamental concepts and doctrines of corporation and constitutional law in order to sustain a particular income tax. There is ample power in Congress to cope with the problem of stock dividends without "bungling" legislative assistance from the judiciary.

III

POWER AND POLICY OF CONGRESS

Under its broad taxing power,⁶⁴ Congress has authority to reach an ordinary stock dividend by a direct property tax on the shareholder,⁶⁵ or by an indirect excise tax on the corporation under the

⁶¹ Ballantine and Hills, *Corporate Capital and Restrictions* (1935) 23 CALIF. L. REV. 229, 257; Hills, *loc. cit. supra* note 49; Note (1941) 25 MINN. L. REV. 744, 767.

⁶² *Supra* note 7.

⁶³ Traylor, *A Critique of Koshland v. Helvering* (1938) 16 TAX MAG. 453.

⁶⁴ Gray, *Federal Taxing Power and the Income Tax* (1942) 26 MINN. L. REV. 421.

⁶⁵ A direct tax on the shareholder would require apportionment, of course, and it would probably be impracticable. U. S. CONST. Art. I, Sec. 2, cl. 3; Sec. 9, cl. 4.

doctrine of *Flint v. Stone Tracy Co.*⁶⁶ by taxing the privilege of doing business in a corporate form measured by the market value of all ordinary stock dividends distributed. Such an excise tax could be imposed on the corporation and its probable effect would be to discourage stock dividends, which serve no useful purpose, but tend to deceive shareholders and investors as well as inflate market prices.

It has been suggested that, "From a practical common sense point of view there is something strange in the idea that a man may indefinitely grow richer without ever being subject to an income tax."⁶⁷ However, the Supreme Court has not as yet assented to the view that all economic gain is taxable under the Sixteenth Amendment. The power of Congress seems to turn at present on a vague doctrine of constructive realization of gain. Unless the Court is willing to abandon the rapidly changing realization requirement, it will be possible, though not probable in most cases, for a man to "grow richer" without paying an income tax.

However, conceding that Congress has authority by virtue of the Sixteenth Amendment to tax the shareholder's economic gain arising from the unrealized enhancement in the value of his shares, strong considerations of policy still favor the traditional view that only gains actually realized should be taxed as income. It tends to hopeless confusion to impose income taxes on the constructive increases in the investment of a shareholder over some particular period of time. Apart from considerations of fairness to the shareholders, there is great uncertainty involved in trying to compute the amount of a "gain" which may never be received. The practical advantage of imposing such an income tax on shareholders must be questioned. While certain shareholders may have economic gain which would be taxable income, others may have an economic loss which would be deductible. If the separate entity of the corporation is disregarded and the net earnings retained by the corporation considered the basis of the tax on the shareholders, then that same value which has been realized by the corporation and subjected to a heavy corporate income tax is treated as taxable income to the shareholder. In taxing the same income a second time, it would seem that Congress should at least wait until the corporate income is actually distributed and realized by the shareholder.⁶⁸ However, such considerations among others are for Congress to appraise in formulating a legislative policy which must react favorably to the well known canon that when a tax

⁶⁶ (1911) 220 U.S. 107. The doctrine of *Flint v. Stone Tracy Co.* is discussed in Traynor, *National Bank Taxation* (1929) 17 CALIF. L. REV. 456, 457.

⁶⁷ Powell, *Income from Corporate Dividends* (1922) 35 HARV. L. REV. 363, 376.

⁶⁸ "The double taxation of corporation dividends should be stopped." MAGILL, *THE IMPACT OF FEDERAL TAXES* (1943) 19, 27, 143.