

1937

TAXATION - INCOME TAXATION OF STOCK DIVIDENDS

Donald H. Larmee
University of Michigan Law School

Follow this and additional works at: <https://repository.law.umich.edu/mlr>



Part of the [Securities Law Commons](#), and the [Tax Law Commons](#)

Recommended Citation

Donald H. Larmee, *TAXATION - INCOME TAXATION OF STOCK DIVIDENDS*, 35 MICH. L. REV. 692 (1937).
Available at: <https://repository.law.umich.edu/mlr/vol35/iss4/26>

This Regular Feature is brought to you for free and open access by the Michigan Law Review at University of Michigan Law School Scholarship Repository. It has been accepted for inclusion in Michigan Law Review by an authorized editor of University of Michigan Law School Scholarship Repository. For more information, please contact mlaw.repository@umich.edu.

TAXATION — INCOME TAXATION OF STOCK DIVIDENDS — The petitioner purchased cumulative non-voting preferred stock in a corporation. In subsequent years the company elected to pay, and the petitioner received, dividends in common voting stock. Later the company redeemed its preferred stock. In computing the profit made by the petitioner at the time of redemption, the commissioner allocated to the common stock a proportionate share of the original cost of the preferred stock. He thereupon taxed as income the difference between the redemption figure and the allocated portion of the cost.¹ The stockholder protested, claiming that the stock dividends should be treated as income in the years in which received, though not taxable under statutes in effect at that time. In reversing the decision of the circuit court of appeals, which had upheld the commissioner's action,² the Supreme Court *held* that the dividends paid a preferred stockholder in common stock were income and may not be treated as return of capital. The Court carefully distinguished between stock dividends which confer no different rights than the existing stock, and stock dividends which give the stockholder an interest different from his former holdings. The latter type of dividend is taxable as income under the Sixteenth Amendment. The minority dissented on the grounds that the method followed by the treasury regulations had been long in practice and had been supported by the Court in a prior decision.³ *Koshland v. Helvering*, 298 U. S. 441, 56 S. Ct. 767 (1936).

The Revenue Act of 1916 provided that a stock dividend should be considered income to the amount of its cash value.⁴ This act was passed to remedy the results of *Towne v. Eisner*,⁵ which had held that a dividend paid to common stockholders in the form of common stock was not income within the

¹This was the method prescribed by Treas. Reg. 74, arts. 58, 628 and 600, regarding Revenue Act of 1928, 45 Stat. L. 822 (1928). Also Treas. Reg. 69, arts. 1547 and 1548, regarding Revenue Act of 1926, 44 Stat. L. 11 (1926).

²The history of the principal case typified the unsettled state of the law on this subject. The commissioner's ruling was overruled by the Board of Tax Appeals, which in turn was reversed by the circuit court of appeals, (C. C. A. 9th, 1936) 81 F. (2d) 641. The decision of the circuit court of appeals was in conflict with a decision by the Circuit Court of Appeals for the Sixth Circuit. *Commissioner v. Tillotson Mfg. Co.*, (C. C. A. 6th, 1935) 76 F. (2d) 189.

³*Miles v. Safe Deposit & Trust Co.*, 259 U. S. 247, 42 S. Ct. 483 (1922), where the existing stockholders were given the right to subscribe for new shares, shares so subscribed were said not to be income.

⁴39 Stat. L. 757 (1916).

⁵245 U. S. 418, 38 S. Ct. 158 (1918).

meaning of the Revenue Act of 1913.⁶ In the leading case of *Eisner v. Macomber*,⁷ it was decided that a dividend in common stock paid to the then common stockholders was not income within the meaning of the Sixteenth Amendment, and therefore the provision of the Revenue Act of 1916 was unconstitutional. Subsequently, successive statutes and treasury regulations have followed a broad interpretation of the *Macomber* case⁸ and have provided that all stock dividends shall be non-taxable,⁹ but shall be treated as returns of capital, the original cost to be allocated to both original and dividend shares of stock. The decision in the *Macomber* case was widely criticized at the time.¹⁰ The failure to tax stock dividends as income has led not only to postponement of the accrual of tax from the time when the dividend is paid until the time when the stock is sold, but it has created an inequality of taxation between stockholders of companies who had received cash dividends and stockholders of companies who had received stock dividends although the actual value received might have been the same. The decision in the principal case, following the prophecy of many who had criticized the *Macomber* case, limits the result of that case to its facts. Under the decision, for a stock dividend to be taxable as income, it must either have resulted in the severance of assets from the corporation, or created an alteration of the preexisting proportionate interest of the stockholders.¹¹ Since a true stock dividend¹² does not involve a severance of assets from the corporation, it becomes of great importance to know when the preexisting proportionate interests have been changed. It has been argued that every stock dividend changes the preexisting rights of the stockholders because after any stock dividend is declared the stockholder has a right that the directors be more restricted in their use of the portion of the surplus that has been capitalized.¹³ While this would be an avenue whereby all stock dividends would be taxable as income, it is doubtful if it would be followed, because it would lead to a direct reversal of the *Macomber* case. However, it does appear that the distribution of any one class of stock to stockholders of a different class will be termed taxable dividends.¹⁴

Donald H. Larmee

⁶ 38 Stat. L. 167 (1913).

⁷ 252 U. S. 189, 40 S. Ct. 189 (1920).

⁸ The majority opinion in the *Macomber* case does not specifically differentiate between different types of stock dividends. The treasury interpretation is therefore "broad" only in the light of the principal case.

⁹ *Supra*, note 1.

¹⁰ Seligman, "Implications and Effects of the Stock Dividend Decision," 21 COL. L. REV. 313 (1921). For collection of discussions on this case, see Powell, "Income from Corporate Dividends," 35 HARV. L. REV. 363 at 377, note 32 (1921).

¹¹ *Commissioner v. Tillotson Mfg. Co.*, (C. C. A. 6th, 1935) 76 F. (2d) 189.

¹² I. e., a stock dividend paid in stock of the company declaring the dividend.

¹³ See Seligman, "Implications and Effects of the Stock Dividend Decision," 21 COL. L. REV. 313 at 326 (1921).

¹⁴ In the case of *James H. Torrens*, 31 B. T. A. 787 (1934), a converse of the situation presented in the principal case was present. It was held that a dividend paid to common stockholders in the form of preferred stock, other preferred stock being outstanding, was taxable. For a discussion of this case, see 1 PAUL and MERTONS, LAW OF INCOME TAXATION, § 884 (Supp. 1936).