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Income Tax--Non-Taxable Stock Dividends

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INCOME TAX. NON-TAXABLE STOCK DIVIDENDS.—In a recent decision the United States Court of Appeals[1] reversed the Tax Court[2] and ruled that a preferred stock dividend on common stock, where only the latter had previously been outstanding, did not become taxable as a cash dividend even though, as a result of prior negotiation, the preferred stock was sold two days later.

The petitioners, together with one other person, were the sole stockholders of the Metal Moulding Corporation. In the latter part of 1945 Chamberlin (who together with his wife owned 83.8 per cent of the stock) and the corporation's attorney started negotiations with an investment firm as to the possibility of selling a preferred stock issue similar to the one subsequently issued as a dividend. The reasons for the dividend were twofold. (1) the corporation had accumulated such a large surplus that it feared the application of the penalty surtax provided for by the Internal Revenue Code for unreasonable accumulation of earnings,[3] and (2) Chamberlin, as majority stockholder, was unwilling to have the corporation declare a large cash dividend since his own income was already subject to a high surtax rate. It was thought that such a dividend to the stockholders and a subsequent sale would enable the stockholders to obtain the corporation's earnings in the form of capital gains rather than as taxable dividends. The Lincoln National Life Insurance Company was contacted and after a detailed investigation approved the proposed issue and agreed to purchase one-half thereof (4000 shares at $100 par) A second insurance company agreed to purchase the other half of the issue. Several provisions of the preferred stock were included to satisfy the requirements of the insurance companies. The stock contained the following provisions among others: The stock was 4½ per cent cumulative subject to mandatory retirement at par plus specified premiums and accrued dividends in the amounts of 2000 shares May 1, 1948, and 1000 shares on each succeeding May 1st until fully retired May 1, 1954. The stock was also subject to redemption in whole or in part on any quarterly dividend date plus specified premiums and accrued dividends. Though no formal agreement of purchase was entered, it was not until both insurance companies had signified their willingness to buy that the directors voted the dividend. Two days later, a "Purchase Agreement" between the stockholders and the insurance companies was signed and the stocks delivered. In reporting their 1946 tax returns the stockholders listed the proceeds as capital gain from the sale of capital assets.[4]

In the Tax Court, the taxpayer relied mainly on the proportionate interest rule of *Strassburger* v *Commissioner*[5] and section 115(f) (1) of the Internal Revenue Code[6] for his contention that the stock dividend was not income within the 16th Amendment. The Tax Court held the stock taxable as income saying that: " not form but the real substance of the transaction is controlling."[7] The Tax Court felt that the reasons

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[1]Chamberlin v. Commissioner of Internal Revenue, 207 F.2d 462 (6 Cir. 1953), *cert. denied*, —— U.S. —— (1954) The case consolidates the proceedings of the following petitioners: Grace A. Chamberlin; John H. Toner; Benjamin James Carl; Guy V Schrock; Robert Pierce and Josephine H. B. Pierce, Husband and Wife. These parties presented an agreement to the Court of Appeals that the decision in this case would be the decision in the five related cases, with a separate judgment entered in each of the six cases.

[2]18 T.C. 164 (1952)

[3]INT. REV. CODE § 102.

[4]*Id.* § 117.

[5]318 U.S. 604 (1943)

[6]Internal Revenue Code Sec. 115(f) (1) provides: "A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution."

[7]*Supra* note 2 at 177.

for the transfer of funds from surplus to the capital account was neither for investment nor for use in the business but rather to reduce its large surplus to a point where the penalty surtax would not be imposed. Further the court said that: " . . . the most important purpose . . . was to enable the common stockholders to derive cash in hand . . . from their capital investment"[8] and since the will of the stockholders was in reality the will of the corporation the purpose was not a bona fide one. Thus while as a matter of form a dividend falls within the *Strassburger* case and the proportional interest rule the substance of the transaction must have a valid business purpose in order to escape taxation as ordinary income.

In a unanimous decision the Court of Appeals reversed the Tax Court saying that the tax effect of the distribution can only be determined at the time of issue of the dividend and not by any later events, and since the pre-existing interests of the shareholders were not changed, as a matter of form the dividend was not taxable. It dismissed the business purpose and substance doctrines on the ground that a dividend legally created and distributed " . . . does not change from a non-taxable dividend into a taxable one because of the purpose of its issuance or on account of the good or bad judgment of the directors in declaring it."[9] In so holding it followed closely the proportional interest doctrine on which it felt the Supreme Court cases were based. The court further said that the redemption features of the dividend were well within the principles of sound corporation economics and financing and that the right to avoid or decrease taxes by means permitted by law is a well settled principle provided the steps taken are not merely sham or formalities.

The recent history of stock dividend cases is based on the proportional interest rule. In *Towne* v. *Eisner*,[10] the Supreme Court, in holding that a dividend of common stock on common stock was not taxable, said that the proportional interest of each stockholder had not changed, and " . . . his old and new certificates together are worth only what the old ones were worth before."[11] By the Revenue Act of 1916,[12] stock dividends were specifically made taxable but in *Eisner* v. *Macomber*[13] the Supreme Court held that under the 16th Amendment income did not include dividends which did not change the proportional interests of the stockholders. The court indicated that such a tax would be a direct tax on property and hence would require apportionment under Article 1 of the United States Constitution.[14] Thus the court seemed to rely chiefly on the rationale that income had not been severed from capital or realized by such a distribution. The Tax Court pointed out, however, that the substance in the principal case was that the surplus was so intermingled with plant and inventory as to make distribution in cash impractical.

Though the *Macomber* case dealt with a dividend of common on common, the case seems to have caused broader exemptions. The Revenue Act of 1921 stated that "A stock dividend shall not be subject to tax . . . "[15] and subsequent re-enactments up to the Revenue Act of 1934 construed the case as covering all dividends paid in stock of the distributing corporation. During this period numerous reorganization

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[8] *Id.* at 178.

[9] *Supra* note 1 at 469.

[10] 245 U.S. 418 (1918).

[11] *Id.* at 426.

[12] 39 STAT. 756, c. 464 (1916).

[13] 252 U.S. 189 (1920).

[14] U. S. CONST. Art. 1, § 2, cl. 3 and § 9, cl. 4.

[15] Sec. 201(d) Revenue Act of 1921.

cases came before the Supreme Court[16] which repeatedly pointed out the distinction of cases where the stockholder had a different proportionate interest after the dividend and the type of dividend involved in *Eisner* v *Macomber* In 1936 the Supreme Court in *Koshland* v *Helvering*[17] unanimously held that a dividend of common stock on preferred stock constituted income within the 16th Amendment since it changed the proportionate interests of the stockholders. The same was held in *Helvering* v. *Gowran,*[18] where the dividend was in preferred stock on common stock where both types were outstanding, the Court holding that the proportional interests of the stockholders had been changed. The Tax Court tried to liken the present case to the above two cases on the ground that no actual cash disbursement had been made. disregarding the change in interest test.

The Revenue Act of 1936 said that a stock dividend.

> " shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution."[19]

This provision came before the Supreme Court in *Helvering* v *Griffiths*[20] in which the government asked the Court to reconsider and overrule the *Macomber* case (to which this case was almost identical, common on common with only common stock outstanding) In an exhaustive analysis of the legislative history and intent of the 1936 Revenue Act the Court with three dissents, held that Congress intended to incorporate the *Eisner* v *Macomber* rule. The Court said.

> "We are unable to find that Congress intended to tax the dividends in question and without Congressional authority we are powerless to do so. That being the case we cannot reach the reconsideration of *Eisner* v. *Macomber* on the basis of present legislation and Regulation."[21]

However, the overtones of the *Griffiths* case leave the distinct impression that should Congress wish to tax all stock dividends the Court would find it constitutional. Certainly the Court would prefer congressional legislation to judicial legislation, and perhaps the latest note in this respect is supplied by the Court of Appeals in its concluding statement in the *Chamberlin* case:

> "If the profit from a transaction like the one here involved is to be taxed at the same rate as ordinary income, it should be done by appropriate legislation, not court decision."[22]

A few weeks after the *Griffiths* case, in two cases decided together, *Strassburger* v *Commissioner* (involving a preferred dividend on common where only common was previously outstanding), and *Helvering* v. *Sprouse*[23] (involving a non-voting common dividend on voting and non-voting common), the Supreme Court held, again with three dissents, that the *Griffiths* case controlled on grounds of no proportionate change of interest and on the same basis they distinguished the *Koshland* case where the proportionate interests were changed. Though the court noted that the dividend had not been sold or redeemed, the stipulated facts in the *Strassburger* case show that

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[16]United States v. Phillis, 257 U.S. 156 (1921), Rockefeller v. United States, 257 U.S. 176 (1921), Cullinan v. Walker, 262 U.S. 134 (1923), Weiss v. Stearn, 265 U.S. 242 (1924), Marr v. United States, 268 U.S. 536 (1925)

[17]298 U.S. 441 (1936)

[18]302 U.S. 238 (1937).

[19]Sec. 115(f) (1) Revenue Act of 1936, now INT. REV. CODE § 115(f) (1)

[20] 318 U.S. 604 (1943)

[21]*Id.* at 404.

[22]*Supra* note 1 at 472.

[23]318 U.S. 604 (1943)

the sole stockholder gave the stock dividend to his wife five days after he received it, later reacquiring it on her death.

It is interesting to observe that in both the *Griffiths* case and the *Strassburger* case three judges dissented; Justices Douglas, Black and Murphy in the former and Justices Reed, Frankfurter and Jackson in the latter. It would seem that the dissenters in the *Griffiths* case submitted rather quickly to stare decisis. Had the *Strassburger* case preceded the *Griffiths* case those six judges apparently would have held the dividend taxable although for different reasons.[24]

There seems to be no logical justification for the loophole that exists at the present time as to taxation of preferred stock dividends. Certainly in the present case the Supreme Court could have granted certiorari without embarrassing itself as to former decisions. The Court has made successful use of the so-called "business-purpose" doctrine in blocking obvious attempts at avoidance of dividend tax through literal compliance with the code.[25] The distinction between taxable and non-taxable dividends in a case stretched so far as the principal case is an open invitation for tax avoidance by small corporations where in reality, as the Tax Court pointed out, the wish of the stockholders becomes the action of the corporation.

The business purpose doctrine and the form and substance doctrine are both part of the common law of taxation and principally involve the same issues. The Tax Court seems to have made the mistake of changing the definition of the word "substance" in an effort to distinguish all the previous cases cited above. Perhaps its best attack would have been to assume the correctness of the previous decisions and place a greater reliance on cases such as *Bazley* v. *Commissioner*[26] and *Gregory* v. *Commissioner*.[27] The Supreme Court implies in the *Bazley* opinion that while the case dealt with reorganization its decision stems from basic concepts of the realization of earnings and not alone from reorganization statutes. The Court said:

> "It was not the purpose of the reorganization provision to exempt . . . what as a practical matter is realized gain. Normally a distribution by a corporation, whatever form it takes, . . furnishes the proper occasion for the determination and taxation of gain."[28]

However, the Court of Appeals has left itself open to even greater criticism. While precedent is on its side for the proportional interest rule it has made mockery of the business purpose and form and substance doctrines. It looked only to the substance of the preferred stock itself and failed to recognize that there was no logical bona fide business purpose—that substance must relate to the entire transaction. Certainly the issuance of preferred stock should as a matter of substance have greater purpose than the evasion of surtaxes by both the corporation and its stockholders. Yet the court unequivocably states that the case was:

> ". . a series of legal transactions no one of which is fictitious *or so lacking in substance* as to be anything *different from what it purports to be*."[29] (Emphasis added.)

The court also said that the issue here is whether the dividend is taxable as income from a cash dividend or as income resulting from a long term capital gain and therefore, it is not the usual case of complete tax avoidance. The court seems rather short sighted, for while perhaps not the usual case it is seemingly a more successful type of evasion.

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[24] DeWind, *Preferred Stock "Bail-Outs" and the Income Tax*, 62 HARV. L. REV. 1126 (1949).
[25] Gregory v. Helvering, 293 U.S. 465 (1935); Bazley v. Commissioner, 331 U.S. 737 (1947).
[26] 331 U.S. 737 (1947).
[27] 293 U.S. 465 (1935).
[28] *Supra* note 26 at 740.
[29] *Supra* note 1 at 471.