Cornell Law Review

Volume 23
Issue 1 *December 1937* | Article 4

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Recommended Citation
Randolph E. Paul, *Federal Corporate Surplus Tax* , 23 Cornell L. Rev. 72 (1937)
Available at: http://scholarship.law.cornell.edu/clr/vol23/iss1/4

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THE FEDERAL CORPORATE SURPLUS TAX

RANDOLPH E. PAUL*

I

CORRELATION OF DIVIDENDS PAID CREDIT AND TAXABILITY OF DISTRIBUTIONS[1]

Nothing could better illustrate the "substantial difference"[1a] between corporation and stockholder than the shifting of the center of gravity in connection with the taxability of corporate distributions accomplished by the undistributed profits surtax. The question used to be: "Will the distribution be taxable *to stockholders?*" The stockholder has been forced from the center of the stage. Interest in the tender feelings of stockholders has noticeably diminished in the face of competing sensibility. The new question is: "Will the distribution furnish a dividends paid credit *to the corporation?*" The general plan of the Federal Corporate Surplus Act is to make one question of these two questions, and to give a credit only for a distribution which is taxable. The result is transfer of concern about the taxable status of stockholders to anxiety as to the possibility of a dividends paid credit to the corporation. Since credits for the purpose of this new tax are limited, the question is of great importance to corporations.

Several statutory provisions govern the computation of the dividends paid credit under the 1936 corporate undistributed profits surtax. The Act provides (Sec. 27 (h)):

> "If any part of a distribution (including stock dividends and stock rights) is not a taxable dividend in the hands of such of the shareholders as are subject to taxation under this title for the period in which the distribution is made, no dividends paid credit shall be allowed with respect to such part."

It is also provided in the Act (Sec. 27 (e)):

> "In case of a stock dividend or stock right which is a taxable dividend in the hands of shareholders under section 115 (f), the dividends paid credit with respect thereto shall be the fair market value of the stock or the stock right at the time of the payment."

One must look beyond the four corners of the dividends paid credit section of the statute to gather together the relevant statutory provisions in connection

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*The writer is indebted to Mr. Robert Eichholz of the New York Bar for valuable assistance in the preparation of this article.

[1]No attempt is made in this article to discuss the undistributed profits surtax in its possible effects on corporate financing. For a review of this subject see Thorpe and George, *An Appraisal of the Undistributed Profits Tax*, DUN'S REVIEW (Sept. 1937).

[1a]Eisner v. Macomber, 252 U. S. 189, 214 (1920).

with the question of the extent to which stock dividends may constitute a dividends paid credit.[2] The cross-reference to Section 115 (f) is to a new provision in the 1936 Act, as follows:

> "(1) General Rule.—A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution.
>
> "(2) Election of Shareholders as to Medium of Payment.—Whenever a distribution by a corporation is, at the election of any of the shareholders (whether exercised before or after the declaration thereof), payable either (A) in its stock or in rights to acquire its stock, of a class which if distributed without election would be exempt from tax under paragraph (1), or (B) in money or any other property (including its stock or in rights to acquire its stock, of a class which if distributed without election would not be exempt from tax under paragraph (1), then the distribution shall constitute a taxable dividend in the hands of all shareholders, regardless of the medium in which paid."

Tests as to the Taxability of Stock Dividends[2a]

Since the statute gives a dividends paid credit only with respect to *taxable* stock dividends, it is first necessary to determine the extent to which such dividends are taxable. The last few years have witnessed a revival of mental activity on the subject of stock dividends. The status of taxable dividends was supposed to have been settled in 1920 by the famous *Macomber* decision.[3] This decision was accepted broadly as a complete condemnation of any attempt to tax stock dividends of all kinds. This acceptance extended to a statutory enactment of the decision in the 1921 Act.[4] The statutory exemption was continued in subsequent acts, including the 1934 Act.[5] For many years no one did any thinking on the subject of the status of stock dividends, and it was generally assumed: (1) that all stock dividends were constitutionally exempt from tax, and (2) that the statutory exemption applied indiscriminately to all such dividends.[6]

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[2]The Treasury interpretation, Reg. 94, Art. 27 (h)-1, is as follows:

"No dividends paid credit shall be allowed with respect to any part of the distribution by a corporation to its shareholders which is . . .

(c) a distribution in stock of the corporation or rights to acquire its stock which does not constitute income to its shareholders within the meaning of the sixteenth amendment to the Constitution (see section 115 (f) and articles 115-3 and 115-4)."

[2a]This term is used in the sense of dividends paid in stock of the distributing corporation, not as including corporate distributions in stock other than that of the distributing corporation.

[3]252 U. S. 189 (1920); TD 3052, CB-3, p. 38. Old tax practitioners will remember the original doubts as to how far the Supreme Court meant to go in this decision. The doubt revolved about the Supreme Court's use of the expression *"bona fide,"* and also specifically touched the question of the status of distributions paid in preferred stock.

[4]Sec. 201 (d) of this Act provided: "A stock dividend shall not be subject to tax."

[5]1934 Act, § 115(f); see also 1932, 1928 Acts, § 115(f); 1926, 1924 Acts, § 201(f).

[6]As pointed out in James H. Torrens, 31 B.T.A. 787 (1934), no question was

So far as the record shows, thinking processes revived for the first time in 1933 when the government first contended that a dividend upon cumulative non-voting *preferred* stock payable in *common* voting shares was not a tax-free stock dividend.[7] In the meantime the Board in a memorandum opinion in the well-known *Koshland* case had held somewhat obliquely that a common stock dividend paid to preferred shareholders was a taxable distribution. The 9th Circuit Court of Appeals reversed this decision.[8] The Supreme Court reversed the Circuit Court of Appeals, thus agreeing with the position of the Board in its memorandum opinion.[9] Congress, still mystified, was nevertheless prompt to take advantage of the *Koshland* decision and immediately in the 1936 Act passed the above-quoted provision, declaring a legislative purpose to tax such stock dividends *as might be constitutionally taxable.* The only clear part of this equivocal provision was the purpose to do everything Congress could do.

We have, therefore, as a result, a situation in which, with certain exceptions, we are ignorant as to what Congress meant in the exemption granted broadly to stock dividends by all revenue acts, beginning with the 1921 and ending with the 1934 Act, and also as to what stock dividends may be taxed if the exemption was not all-inclusive. Beginning with the 1936 Act, we know what Congress meant to do, but we do not know what part of its purpose was accomplished. We feel sure that common stock distributions paid to common stockholders are exempt, and that common stock distributions paid to preferred stockholders and preferred stock distributions to common *stockholders* are probably taxable. It is important to note that our lack of knowledge affects not only the treatment to be accorded to stockholders, but also the determination of the dividends paid credit of the distributing corporation.[10]

The starting point for any discussion of this subject is *Eisner v. Macomber.* It was therein held that a dividend in common stock paid to common stockholders was not constitutionally subject to tax.[11] The decision stated two tests for determining taxability of corporate distributions:

(1) whether the stockholders' pre-existing proportionate capital interest in the corporation has been altered; and

raised as to the exempt status of the stock dividends involved in numerous cases. See *infra* note 20.

[7]Tillotson Mfg. Co., 27 B. T. A. 913 (1933), *aff'd* 76 F. (2d) 189 (C. C. A. 6th 1935).

[8]81 F. (2d) 641 (C. C. A. 9th 1936).

[9]298 U. S. 441 (1936). See qualifications in Note 21.

[10]Corporations will also desire to secure a credit for earnings which by contract cannot be distributed as cash dividends, but which may be capitalized by distribution of stock. See Reg. 94, Art. 26-2(b), which excludes such contractual limitations from the credit provided by Sec. 26(c).

[11]In Gibbons v. Mahon, 136 U. S. 549 (1890), it was held that as between *cestui* and trustee a stock dividend is capital and not income. It was pointed out that a stock dividend neither takes from nor adds to corporate wealth, and that it does not involve any segregation or depletion of corporate assets.

(2) whether anything has been severed from that capital interest upon which a tax could be imposed.

Subsequent cases, involving distributions of stock in another corporation[12] and corporate reorganizations,[13] established what may be regarded as a third test applicable in certain instances, namely, whether the stockholders have received anything substantially different from what they previously had. This is merely a different way of stating the second test, but subsequent stock dividend cases have used the terminology of differences in the character of property, rather than that of severance.[14]

Common Stock Dividends Paid to Preferred Shareholders

At the other extreme from common stock dividends paid to common shareholders lie common stock dividends paid to preferred shareholders. In *Koshland v. Helvering*[15] it was held that such a distribution was income and not a return of capital, so that upon a subsequent disposition of the preferred shares, no part of their original cost was to be apportioned[16] to the common shares.[17] Obviously, the relative equities of common and preferred stockholders are altered in such a case. Inasmuch as the profits distributed still remain subject to the corporation's control and at risk in its business, at least some incidents of severance are missing, but the distributees have received something very different from what they had before. In the words of Mr. Justice Roberts:[18]

> "On the other hand, where a stock dividend gives the stockholder an interest different from that which his former stock holdings represented he receives income. The latter type of dividend is taxable as income under the Sixteenth Amendment."

Furthermore, by his acquisition of common stock, the preferred shareholder gets a participating capital interest in future profits.[19] In this respect the proportion and severance rules overlap.

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[12]U. S. v. Phellis, 257 U. S. 156 (1921); Rockefeller v. U. S., 257 U. S. 176 (1921).

[13]Cullinan v. Walker, 262 U S. 134 (1923); Weiss v. Stearn, 265 U. S. 242 (1924); Marr v. U. S., 268 U. S. 536 (1925).

[14]Other verbal variants of the tests set out in the text are (1) whether the shareholder has a value after capitalization of surplus different from the previously existing value; (2) whether there was anything more than a book adjustment involving transfer of profits from surplus account to capital stock liability; (3) whether corporate profits no longer remain the legal property of the corporation; (4) whether the profits no longer remain at risk in the corporate business. See Michaels v. McLaughlin, 20 F. (2d) 959 (D. C. N. D. Cal. 1927). However, these tests seem to be largely descriptions of results rather than explanations of reasons.

[15]298 U. S. 441 (1936).

[16]Cf. Reg. 94, Arts. 115-7, 111-1, 113(a) (12)-1; Reg. 86, Arts. 115-8 , 111-1, 113(a) (12)-1; Regs. 77, 74, Arts. 628, 600; Regs. 69, 65, Arts. 1548, 1599; Reg. 62, Art. 1548.

[17]The same conclusion had previously been reached in Com'r. v. Tillotson Mfg. Co., 76 F. (2d) 189 (C.C.A. 6th 1935).

[18]At p. 446

[19]See dissenting opinions in James H. Torrens, 31 B. T. A. 787 (1934), and H. C.

Other Types of Stock Dividends

Between the opposite poles of the *Koshland* and *Macomber* cases lie numerous other types of stock dividends, the taxable status of which has not been settled. Where there are no preferred shares already outstanding, a distribution of preferred stock to common stockholders does not alter their proportional interests and gives them nothing that they did not have before the distribution. Such dividends have been repeatedly treated as non-taxable distributions.[20]

There is considerably more doubt concerning such a distribution where preferred shares are already outstanding. The inconclusive nature of the decisions is heightened by the fact that prior to the 1936 Act, the exemption of stock dividends from taxation may have made the problem *statutory* rather than *constitutional*.[21] In *James H. Torrens*[22] and *H. C. Gowran*[23] a majority of the Board, evidently considering that Congress had intended to exempt from tax only those dividends which fell within the rule of *Eisner v. Macomber,* ruled on the question on constitutional grounds. It declared that its previously announced rule,[24] that a common stock dividend to preferred stockholders was taxable because of the substantially different character of the shares received on distribution, should be applied to the converse factual situation of a distribution of preferred stock to common stockholders. There were vigorous and exhaustive dissents in both cases. On the question of statutory interpretation the dissenting members said that if the exemption was intended only to cover the *Macomber* situation, it was mere surplusage. The minority did not consider the *Tillotson* case applicable, because: (1) in that case preferred stock dividends were in arrears, so that there was, in a sense, a liquidation of a debt rather than a voluntary distribution; and (2) common stockholders have a capital interest in the corporate surplus, so that preferred stock given in payment thereof represents capital, or a mere evidence of a share in the surplus to the extent of the dividend.

Gowran, 32 B.T.A. 820 (1935), *rev'd* 87 F. (2d) 125 (C.C.A. 7th 1936), wherein it is pointed out that preferred stockholders have only an income interest in the corporate surplus, so that common stock given in payment of that income interest constitutes income.

[20]Com'r v. Brown, 69 F. (2d) 602 (C.C.A. 7th 1934); Frances Elliott Clark, 28 B.T.A. 1225 (1933); T. Pierre Champion, 27 B.T.A. 1312 (1933); Louis Rorimer, 27 B.T.A. 871 (1933); Robert R. Meyer, 27 B.T.A. 44 (1932); Alfred A. Laun, 26 B.T.A. 764 (1932); IT 2493, CB VIII-2, p. 133. In most of these cases the point seems to have been more or less assumed. Similarly, a distribution of new non-voting B common to holders of voting A common has been held non-taxable in Chapman v. U. S., 63 Ct. Cls. 106 (1927).

[21]The opinion in the Koshland case expressly avoids passing upon the question of statutory construction—whether Congress had imposed tax as distinguished from having the right to do so.

[22]31 B.T.A. 787 (1934).

[23]32 B.T.A. 820 (1935), *rev'd* 87 F. (2d) 125 (C.C.A. 7th 1936); see also Annie M. Pfeiffer, Mem. Op. June 7, 1936, *rev'd* 88 F. (2d) 3 (C.C.A 2d 1937).

[24]Tillotson Mfg. Co., 27 B.T.A 913 (1933), *aff'd* 76 F. (2d) 189 (C.C.A. 6th 1935).

Furthermore, the minority argued that the majority opinion was incorrect in basing its conclusion on the answer to the question whether preferred stock was outstanding at the time of the distribution[25] for the reason that the interest of other preferred stockholders was not altered, but remained limited to a prescribed dividend in any case.

When the same question reached the Second Circuit in *Pfeiffer v. Comm'r*,[26] that court held the dividend non-taxable without considering the constitutional question. It reasoned that the *statutory* exemption covered *all* stock dividends. In reviewing the *Gowran* case,[27] the Seventh Circuit reached the same conclusion, but added that, on the authority of *Koshland v. Helvering*, the dividend was constitutionally taxable, since it distributed "property rights of variant character" from those which the stockholders previously owned. Inasmuch as the Supreme Court has granted certiorari[28] in these two cases, some progress toward the solution of these questions may be hoped for in the present term.[28a]

No cases have yet arisen involving preferred shares distributed to preferred shareholders.[29] Elements of severability are not many. It may, however, be considered that such a distribution is a taxable dividend under the proportion rule, because future earnings would thereafter be subject to a greater preference in favor of preferred stockholders[30] as between such stockholders and common stockholders.[31]

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[25] This distinction has been preserved by the Board. See August Horrmann, 34 B. T. A. 1178 (1936).

[26] 88 F. (2d) 3 (C. C. A. 2d 1937).

[27] Gowran v. Com'r, 87 F. (2d) 125 (C. C. A. 7th 1936).

[28] 57 Sup. Ct. 924, 925 (1937).

[28a] On December 6, 1937, the Supreme Court announced its decisions in the Gowran and Pfeiffer cases, holding that the stock dividends involved did not constitute taxable income under laws in force when paid. The opinion places the decision on statutory construction—*Ed.*]

The feasibility of using common stock distributions to preferred stockholders to secure a credit is minimized where the preferred stock calls for a cash dividend. In such cases the assent of the distributees will be necessary, especially in the case of cumulative preferred stock the dividends on which are in arrears. See Thorpe and George, *An Appraisal of the Undistributed Profits Tax,* DUN'S REVIEW, p. 9, in (Sept. 1937).

[29] In L. Elmer Wood, 29 B. T. A. 735 (1934), preferred stockholders were given the option of receiving cash or additional preferred shares. In holding this to be a cash dividend, the Board regarded only the optional feature involved.

[30] But as to this argument, see dissenting opinions in the Gowran and Torrens cases, in which it is contended that the limited interest of new preferred stockholders in the corporate surplus does not materially affect the equities of other stockholders.

[31] Other types of dividends may be mentioned in passing. In Doerschuk v. U. S., 274 Fed. 739 (D. C. E. D. N. Y. 1921), debenture bonds distributed to common stockholders were held to be income. The contention that a debenture bond was like preferred stock was dismissed without comment. In T. I. Hare Powel, 27 B. T. A. 55 (1932), a distribution of rights to convertible bonds was held non-taxable. Remarking that the decision in Miles v. Safe Deposit Co., 259 U. S. 247 (1922), rests on the fact that stock rights are evidence of a preemptive right inherent in stock ownership, and that this preemptive right extends to convertible bonds, the Treasury is in accord; GCM 13275, CB XIII-2, p. 121.

Treasury Shares

The proper treatment to be accorded distributions of treasury shares raises a separate statutory problem. Section 27 (c) of the 1936 Act provides for a dividends paid credit in respect of dividends in kind "including stock of the corporation if held by the corporation as an investment". The regulations state:[32]

> "Unless shown to the contrary, shares of capital stock once issued but thereafter acquired by the corporation in any manner whatsoever, but not retired, shall be deemed to be held by the corporation as an investment."

This provision is certainly of doubtful constitutionality[33] as applied to treasury common shares distributed to common stockholders.[34] Any distinction between a distribution of *authorized* and a distribution of *treasury* shares would have slim foundation in reality, and would be at most little more than a formula for overruling the decision in *Eisner v. Macomber.*

The theory of the statute is apparently that treasury shares are an asset[35] of the corporation, a distribution of which would fall within the rule of *Peabody v. Eisner.*[36] A review of the authorities[37] as to whether treasury stock is to be carried as an asset or a liability would be both futile and inconclusive. As pointed out by Judge Learned Hand,[38] it is really neither the one nor the other. In Judge Hand's own words,

> "To carry the shares as a liability, and as an asset at cost, is certainly a fiction, however admirable. They are not a liability, and on dissolution could not be so treated, because the obligor and obligee are one. They are not a present asset, because, as they stand, the defendant cannot collect upon them. What in fact they are is an opportunity to acquire new assets for the corporate treasury by creating new obligations. In order to indicate this potentiality, it may be the best accounting to carry them as an asset at cost, providing, of course, all other assets are so carried."

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[32]Reg. 94, Art. 27(c)-1.

[33]It is suggested by the writer in (1937) 50 HARV. L. REV. 332, 339, that the dividends paid credit might in this instance be considered to be independent of the taxability of the distribution, in the same manner that distributions in liquidation chargeable to earnings or profits confer a credit under § 27(f), although not taxable as a dividend to the stockholder under § 115(c). The author of this note adds, however, that in view of the avowed purpose of the Act to increase taxable income in the hands of shareholders, § 27(h) should be considered as covering all cases but those specifically excepted.

[34]Dividends in treasury shares had been held non-taxable, prior to the 1936 Act, by both the Board and the Bureau. See James Kay, 28 B. T. A. 331 (1933); IT 2449, CB VIII-1, p. 101.

[35]Gain or loss may be realized upon the sale of treasury stock; see Reg. 94, Art. 22(a)-16.

[36]247 U. S. 347 (1918); see (1936) 36 COL. L. REV. 1321, 1328.

[37]MONTGOMERY, AUDITING THEORY AND PRACTICE (4th ed. 1927) pp. 244-247; KESTER, ACCOUNTING THEORY AND PRACTICE (3rd ed. 1925) vol. II, pp. 181, 409-410.

[38]In Borg *et al* v. International Silver Co., 11 F. (2d) 147, 150 (C. C. A. 2d 1925).

But it would seem that by distribution to stockholders as a dividend treasury shares lose this potentiality which gave them their character as an asset. In the hands of distributees treasury stock does not change relative equities, nor does it constitute a different kind of property from what was held before. While it may be arguable that there has been a severance from the corporate assets, it has been pointed out that the courts are interpreting the severance requirement as necessitating merely a distribution of a different kind of property from that on which the dividend was declared.

II

Preference Problems in Their Relation to Elective Distributions

The 1936 Act has added to the perplexity of one who would determine how certain types of corporate distributions should be treated by hoth corporation and stockholder. The corporation is, of course, interested in obtaining a dividends paid credit. Section 115 (f)(2) will provide food for thought for many a corporate executive. This section provides that a certain type of distribution, which may for convenience be called an optional dividend,[39] shall be considered to be taxable, the effect from the corporation's standpoint being that the distribution will furnish the basis for a dividends paid credit. Doubts are bound to arise as to the availability of any credit at all, because of the provisions of Section 27 (g) which reads as follows:

> "No dividends paid credit shall be allowed with respect to any distribution unless the distribution is pro rata, equal in amount, and with no preference to any share of stock as compared with other shares of the same class."

In most instances of dividends paid or payable in more than one medium it will be impossible, as well as undesirable, to arrange that each distributee receive the exact same cash value per share. Is Section 27 (g) to be interpreted literally, and if not, where is the line to be drawn?[40]

Before engaging in a more detailed discussion of this question, it is necessary to note that Section 115 (f)(2) may be to some extent limited by Section 115 (f)(1).[41] There are numerous cases[42] passing upon the taxability of dividends paid or payable partly in stock and partly in cash,[43] but their full relevance to the present problems is doubtful. It must be repeated that

[39]In some cases this term may not be precisely accurate, but it is sufficiently descriptive of these dividends to serve for purposes of this discussion.

[40]For a discussion in another connection of drawing lines in tax cases, see Paul, Studies in Federal Taxation (1937) pp. 100-104.

[41]All parts of a statute are to be read together. Hellmich v. Hellman, 276 U. S. 233 (1928); U. S. v. Troy, 293 U. S. 58 (1934); Helvering v. Morgan's Inc., 293 U. S. 121 (1934).

[42]See Paul and Mertens, Law of Federal Income Taxation (1934) §§ 8.74-8.83 and cases therein cited.

[43]The cases which discuss "form" and "substance" in connection with stock dividends

from 1921 through 1935 the courts had only to decide whether a given distribution, in the hands of a given distributee, was "in substance" a stock dividend, and if a stock dividend, whether it was of a type exempted from taxation by the Revenue Act. This is primarily a question of statutory construction. Since the 1936 Act the courts must decide whether a given distribution is a stock dividend which may be taxed. This is a question of constitutional power to tax.

The most important cases wherein the dividend was held non-taxable have involved an agreement in advance by a controlling majority *with the corporation*,[44] that they would take stock irrespective of what the minority would receive.[45] The theory is that the stockholder receiving stock never had a legal claim against the corporation for anything but stock.[46] The requirement that a distributee must have no possible claim against the corporation for cash,[47] in order to render the dividend non-taxable to him, is a good working rule and one to which the courts and the Board have turned more and more as a way out of difficulty.

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are, as might be expected, in considerable confusion, and it is impossible to formulate any satisfactory rule. For example, the same distribution has been held a stock dividend in one court as to one shareholder, and a cash dividend in another tribunal as to a different shareholder. See Deitz v. U. S., 6 F. Supp. 944 (D.C.S.D. W. Va. 1933), and Margaret B. Payne, 19 B. T. A. 1305 (1930).

See opinion of Judge Learned Hand in Com'r v. Sansome, 60 F. (2d) 931 (C. C. A. 2d 1932), *cert. denied* 287 U. S. 667 (1932), in which he speaks of "such vague alternatives as 'form' and 'substance,' anodynes for the pains of reasoning."

The cases cited suggest the not inconceivable situation under the 1936 Act in which one court will hold a distribution taxable to stockholders and another court will deny the corporation a credit for the same distribution because *not* taxable to stockholders. This kind of conflict could, of course, favor taxpayers as well as the Treasury; it would be perfectly possible for the corporation to obtain a credit and for the stockholders to remain untaxed.

[44]Where some or all stockholders merely agree *inter sese* to take stock, and the corporate resolution calls for payment in cash, the dividend has been held not to be a stock dividend. The corporation had created an account payable which it was legally bound to satisfy in cash or its equivalent. See W. J. Hunt, 5 B. T. A. 356 (1926); Eugene E. Paul, 2 B. T. A. 150 (1925).

[45]U. S. v. Mellon, 281 Fed. 645 (C. C. A. 3d 1922); U. S. v. Davison, 9 F. (2d) 1022 (C. C. A. 3d 1926); Jackson v. Com'r, 51 F. (2d) 650 (C. C. A. 3d 1931); Irving v. U. S., 44 F. (2d) 246 (Ct. Cl. 1930); W. Q. Wright, 10 B. T. A. 806 (1928); George T. Smith, 21 B. T. A. 782 (1930).

[46]Considerable weight is attached in these cases to the fact that the corporation's cash position did not warrant distribution of cash to all stockholders. While this circumstance is a factor to be considered in border-line cases, it never seems to have been controlling. If the corporation has sufficient surplus it may properly borrow to make payment. See Eugene E. Paul, 2 B. T. A. 150 (1925); see also FLETCHER, CYCLOPEDIA CORPORATIONS (1932) Vol. 11, § 5342.

[47]There may, of course, be situations involving constructive receipt, as where dividends are applied to the payment of an uncalled portion of the subscription price. Unless the resolution does not provide explicitly that the dividend is to be so used, or unless stockholders have given notes for the balance due which are cancelled upon declaration of the dividend, the dividend has usually been held non-taxable. Teehan v. U. S., 25 F. (2d) 884 (D. C. D. Mass. 1928); Michaels v. McLaughlin, 20 F. (2d) 959 (D. C. N. D. Cal. 1927); J. F. Carlston, 22 B. T. A. 217 (1931); J. E. Brading, 17 B. T. A. 436 (1929); Charles Watson Hull, 13 B. T. A. 299 (1928); W. Q. Wright, 10 B. T. A. 806 (1928); IT 2455, CB VIII-1, p. 218; see PAUL AND MERTENS, LAW OF FEDERAL INCOME TAXATION (1934) §§ 8.80, 8.81.

It may be argued that the type of distribution involving a prior agreement by large interests to take stock does not fall within Section 115 (f)(2) because, as to the majority shareholders, there is no real election. This is doubtless true,[48] but leaves in the air the situation with respect to the amounts paid to minority stockholders. Unquestionably, the distribution is taxable in their hands, either because they received cash, or because they could elect to do so. But if they receive cash, a credit may be disallowed under Section 27 (g) because of a difference between the amount of cash per share and the value of stock per share distributed.

Distributions conferring a real option have more frequently been held taxable to all recipients. This is certainly true in the case of a cash dividend declaration[49] accompanied by a provision that stockholders may elect to take stock.[50] Even if all distributees elect to take stock, the form of the resolution gives rise to a debtor-creditor relationship between corporation and stockholders,[51] with the result that the stock is distributed in satisfaction of an account payable and therefore constitutes taxable income.[52]

Where the dividend is declared payable in stock with an option to the stockholder to take cash, no such debtor-creditor relationship arises until the stockholder notifies the corporation of his election to receive cash. Accordingly, the Treasury has previously ruled that those who take stock are in receipt of a non-taxable dividend,[53] since there is merely a transfer of surplus to capital account. However, the Commissioner's regulations now provide[54] that an optional dividend is taxable irrespective of the form of the resolution. Inasmuch as the question has now become one of constitutional power, this ruling may well be valid if some stockholders take *cash* and some take *stock*.

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[48]The Treasury interpretation, Reg. 94, Art. 115-8, includes within Sec. 115(f) all optional distributions "whether the election is exercised or exercisable before or after the declaration of the distribution." However, where it appears that no cash dividend at all would have been declared without a prior agreement by large stockholders to take stock, such stockholders cannot properly be said to have had any option.

[49]See Eisner v. Macomber, 252 U. S. 189, 215 (1920): "It is said that there is no difference in principle between a simple stock dividend and a case where stockholders use money received as cash dividends to purchase additional stock contemporaneously issued by the corporation. But an actual cash dividend, with a real option to the stockholder either to keep the money for his own or to reinvest it in new shares, would be as far removed as possible from a true stock dividend, such as the one we have under consideration . . ."

[50]L. Elmer Wood, 29 B. T. A. 735 (1934); Joseph Paper, 29 B. T. A. 523 (1933); TD 3052, CB-3, p. 38.

[51]U. S. v. Guinzburg, 278 Fed. 363 (C. C. A. 2d 1921).

[52]Bacon-McMillan Veneer Co., 20 B.T.A. 556 (1930); Callanan Road Improvement Co., 12 B. T. A. 1109 (1928).

[53]GCM 6709, CB VIII-2, p. 132. See also IT 2538, CB IX-1, p. 144, wherein a cash dividend was declared payable in stock to those who had *previously* notified the corporation of their election to take it. It was ruled that the shares distributed were not taxable, since the rights of shareholders to receive stock had become fixed prior to the declaration of the dividend. The debt of the corporation was reduced *pro tanto*.

[54]Reg. 94, Art. 115-8; ". . . the entire distribution is a taxable dividend regardless of— . . .

(3) whether the declaration of the dividend provides that payment will be made in one medium unless the shareholder specifically requests payment in the other."

In this situation proportionate equities will have been substantially changed. But where all take stock and the dividend resolution does not create a debtor-creditor relationship, it would still seem that the distribution is not constitutionally subject to tax in the hands of its recipients.

The application of Section 27 (g) in the case of an optional dividend paid to some stockholders in one medium and to other stockholders in another medium puts corporate taxpayers in a quandary.[55] The Commissioner has interpreted this section very strictly, as follows:

> "Before a corporation may be entitled to any dividends paid credit with respect to a distribution, regardless of the medium in which the distribution is made, every shareholder of the class of stock with respect to which the distribution is made must be treated the same as every other shareholder of that class. The limitation imposed by the Act is unqualified and the existence of a preference is sufficient to prohibit allowance of the dividends paid credit regardless of the fact (1) that such preference is authorized by all the shareholders of the corporation, or (2) that the part of the distribution received by the shareholder benefited by the preference is taxable to him as a dividend. A corporation will not be entitled to a dividends paid credit with respect to any distribution upon a class of stock if there is distributed to any shareholder of such class (in proportion to the number of shares held by him) more or less than his pro rata part of the distribution as compared with the distribution made to any other shareholder of the same class. The disallowance of the dividends paid credit, where any preference or inequality in fact exists, extends to the entire amount of the distribution and not merely to a part of such distribution."

The examples given do little to illuminate the present problem. Indeed, it is difficult to discover the real purpose underlying this section. The purpose of the undistributed profits surtax is to subject profits to higher surtaxes, either in the hands of large stockholders who would not otherwise have withdrawn earnings from the corporate business, or in the hands of the corporation itself.[56] The aggregate effect of Sections 27 (e) and (h) and Section 115 (f) is that a distribution taxable to stockholders is not taxed to the corporation, and vice versa. Inasmuch as it is impossible that any "earnings or profits" will escape both corporate and individual surtaxes, Section 27 (g) seems to be surplusage. It is well settled that preferential distributions may constitute dividends taxable to the recipients,[57] and in cases where they are so taxable Section 27 (g) imposes, in effect, a double surtax by allowing the

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[55]Reg. 94, Art. 27(g)-1.

[56]See the President's Message to Congress: "The accumulation of surplus in corporations controlled by taxpayers with large incomes is encouraged by the present freedom of undistributed corporate income from surtaxes. Since stockholders are the beneficial owners of both distributed and undistributed corporate income, the aim, as a matter of fundamental equity, should be to seek equality of tax burden on all corporate income whether distributed or withheld from the beneficial owners." H. Rep. No. 2475, to accompany H. Rep. 12395, 74th Cong., 2nd Sess., p. 2; Sen. Rep. No. 2156, to accompany H. Rep. 12395, 74th Cong., 2nd Sess., p. 2.

[57]Paul and Mertens, Law of Federal Income Taxation (1934) § 8.12

corporation no credit. Of course, this provision will prevent the spreading of dividend payments among shareholders in the lower brackets.[58] That is, a large shareholder will not be able to have his share of corporate earnings retained in the business untaxed to him while the corporation at the same time materially reduces its surtax liability by cash distributions to numerous small stockholders. But the sweeping interpretation promulgated by the Treasury seems unwarranted in its possible application to optional distributions.

Corporations will naturally attempt to avail themselves of optional distributions as a means of securing a credit while retaining earnings in the business.[59] To accomplish this purpose they will be inclined to make their offer of stock as attractive as possible. Of course, if there is too great a differential between the stock and cash offers, stockholders will have no real option,[60] and the distribution may be held to be a non-taxable stock dividend. Where the stockholder might reasonably elect one medium or the other, he will be taxed under Section 115 (f) and, by the literal wording of Section 27 (g), the corporation will secure no credit. Double taxation is the result.

The same may well be true even where the directors make an honest effort to arrange exact equality between cash and stock. For purposes of the dividends paid credit valuation of stock is to be "at the time of the payment".[61] If there is a fluctuation in the value of the stock between the date of declaration and the date of payment, as there may well be these days, there will no longer be exact equality. Furthermore, since directors' criteria of value are likely to differ from the Treasury's method of computation,[62] there is no guarantee that the Commissioner will regard the valuation contemplated in the corporate resolution as conclusive.[63]

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[58]See PAUL AND MERTENS, LAW OF FEDERAL INCOME TAXATION (1934) § 32A.30.

[59]In addition to the use of taxable stock dividends and optional dividends, there are tax minimizing possibilities in the use of part-paid shares, calling payments thereon coincidentally with the declaration of cash dividends. See J. E. Brading, 17 B. T. A. 436 (1929); Charles Watson Hull, 13 B. T. A. 299 (1928); Luthe Hardware Co., 6 B. T. A. 53 (1927); Theresa Zellerbach, 2 B. T. A. 1076 (1925). See also Graham, *The Undistributed Profits Tax and the Investor,* (1937) 46 YALE L. J. 6, 8. This method will not, however, be effective unless stockholders are given a real opportunity to get cash if they so desire. J. F. Carlston, 22 B. T. A. 217 (1931); W. Q. Wright, 10 B. T. A. 806 (1928).

[60]See PAUL AND MERTENS, LAW OF FEDERAL INCOME TAXATION (1934) § 32A.34, (Supp.) wherein it is pointed out that "the term 'election' certainly implies a real choice between genuine alternatives".

[61]Sec. 27(e).

[62]To the possible suggestion that both directors and the Commissioner use market quotations alone, the answer is that market quotations are a fallible index of true value when considered to the exclusion of other factors. See PAUL AND ZIMET, *Realistic Valuation for Federal Tax Purposes,* included in STUDIES IN FEDERAL TAXATION (1937).

If corporations resort to an increased use of taxable stock distributions, stockholders may frequently have to sell their stock to pay the tax. The consequent lowering of market quotations, especially where no ready market exists, might cause the corporation to secure an unduly small credit, if market prices are to be the sole guide to value.

[63]It should be borne in mind that for the purposes of the dividends paid credit the value of a "taxable stock dividend" is "the fair market value of the stock or the stock

Some of the results indicated can hardly have been intended by Congress and certainly they are undesirable. The statute, as it stands, puts corporate directors in an unfortunate dilemma. The ultimate cure is an amendment of the statute. Short of statutory amendment, it would be desirable for the Treasury Department to take the courageous position of liberally interpreting[64] Section 27 (g) by ruling that equality of opportunity is sufficient compliance with Section 27 (g), and that the Section does not require mathematical equality of distribution. Such a construction does no violence to the two-fold legislative intent of forcing corporate distributions or taxing in the corporation where no distribution is made, and would serve the purpose of saving from double taxation where none appears to have been intended. The legislative purpose would also be saved of preventing a credit where cash distributions are made to small stockholders and are withheld from larger interests[65] which are taxable at higher brackets.

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right at the time of the payment" (§ 27(e)), whereas the value of a distribution of treasury stock is "the adjusted basis of the property in the hands of the corporation at the time of the payment, or the fair market value of the property at the time of the payment, whichever is the lower" (§ 27(c)).

[64]Signs are not lacking that the Commissioner is willing to be reasonable. See Mim. 4514, CB XV-2, p. 90. The corporation had issued a 1% preferred stock dividend to holders of common stock (other preferred stock being already outstanding). Holders of very small numbers of common shares received cash. Holders of less than 100 common shares received scrip certificates conferring none of the privileges of a shareholder, and which would become void unless exchanged for a full preferred share within a reasonable time. Holders of 100 common shares received a whole share of preferred stock instead of 100 scrip certificates. It was ruled that this distribution was not so preferential as to make Art. 27 (g)-1 apply.

See also IT 3037, CB XVI-1, p. 2. "In any case in which the taxability of the distribution is debatable . . . the general policy will be to allow a tentative credit."

[65]Or where the latter receive a special non-taxable stock dividend.