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## PRESENT TAXABLE STATUS OF STOCK DIVIDENDS IN FEDERAL TAX LAW†

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The Constitution of the United States conferred upon Congress a general power to tax. That power was expressly made subject to certain limitations and conditions. Thus, taxes on exports were specifically prohibited,<sup>1</sup> and subsequent judicial construction prevented the imposition of taxes that would unduly impede the exercise by the states of their governmental functions.<sup>2</sup> The principal conditions imposed were that direct taxes must be apportioned among the states on the basis of their respective populations,<sup>3</sup> and that indirect taxes had to be uniform throughout the United States.<sup>4</sup> The sole reason for the constitutional classification of federal taxes into direct and indirect was that their levy was to be subject to these two diverse rules. It is unnecessary for present purposes to review the decisions of the Supreme Court of the United States searching for a test of a direct tax. There does not exist even now a logically adequate judicial definition thereof, nor even a comprehensive enumeration of the taxes includible in that constitutional category of taxes. It is sufficient for present purposes that the Supreme Court decided in the Pollock Cases<sup>5</sup> that an income tax on the income from property sources was a direct tax. That decision made any kind of federal income tax a practical, though not a legal, impossibility. The decision was directly responsible for the proposal and ultimate ratification of the 16th Amendment to the Constitution of the United States.

The 16th Amendment conferred upon Congress the power "to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration." The influence of the decision in the Pollock Cases is self-evident. Its minimum purpose and effect was to relieve taxes upon income from property sources from the apportionment requirement applicable to direct taxes. Rent, interest, and ordinary dividends, were the principal types of such income. It had been decided long before the Pollock Cases that a tax on income from non-

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<sup>1</sup> U. S. Const. Art. I, §9.

<sup>2</sup> See Rottschaefer, *CONSTITUTIONAL LAW* (1939), pp. 96-110.

<sup>3</sup> U. S. Const. Art. I, §2, §9.

<sup>4</sup> U. S. Const. Art. I, §8, Clause 1.

<sup>5</sup> *Pollock v. Farmers' Loan & Trust Co.*, 157 U. S. 429, 15 Sup. Ct. 673, 39 L. ed. 759 (1895); 158 *id.* at 601, 15 *id.* at 912, 39 *id.* at 1108 (1895).

property sources was an indirect tax.<sup>6</sup> The ratification of the 16th Amendment thus made it constitutionally possible for Congress to levy a general income tax that would not flaunt current theories of justice in the field of taxation. There is nothing in its language that would normally suggest that it was intended to change the constitutional character of an income tax on income from property sources from a direct tax into an indirect tax or excise. This transmutation was, however, effected by the Supreme Court in *Brushaber v. Union Pacific R. Co.*<sup>7</sup> The reasoning by which this result was reached is quite turgid, and contains some rather uncomplimentary implications for the majority of the Supreme Court in the Pollock Cases. It is, however, the only reasonable inference from that reasoning. The result is that all federal income taxes laid after the adoption of the 16th Amendment are indirect taxes or excises. That Amendment did not, however, transfer to the constitutional category of excises any taxes theretofore includible in the class of direct taxes other than those direct taxes that can properly be described as taxes on income. A capital levy, for example, could be held an excise by reasoning based on the 16th Amendment only if the Supreme Court were prepared to hold that it was a tax on income. This does not mean, however, that it could not redefine the terms "direct tax" and "excise" so as to exclude a capital levy from the former and include it in the latter class. Any tax imposed by Congress which does not conform to the apportionment requirement applicable to direct taxes will, of course, be invalid if held to be a direct tax. If, however, the tax results from the inclusion of certain receipts in income in connection with an income tax, a successful attack can be made on it on the score that it violates that apportionment requirement only by establishing (a) that the receipt did not constitute income, and (b) that the tax on its receipt is a direct tax. That is, it does not follow from the fact that the receipt does not constitute income within the meaning of the 16th Amendment that the tax thereon is direct. That it is such may require argument directly concerned with the constitutional meaning of "direct tax." This consideration is of some consequence in connection with the issue to which this article is devoted. Proof that stock dividends of the type involved in *Eisner v. Macomber*<sup>8</sup> are not income within the meaning of the 16th Amendment is not logically the equivalent of proof that the tax thereon in connection with an income tax, or some other tax designed to tax that same increment of wealth, are direct taxes. However, the principal constitutional issue usually debated in connection with attempts to subject such dividends

<sup>6</sup> *Springer v. United States*, 102 U. S. 586, 26 L. ed. 253 (1881).

<sup>7</sup> 240 U. S. 1, 36 Sup. Ct. 236, 60 L. ed. 493, L. R. A. 1917D 414 (1916).

<sup>8</sup> 252 U. S. 189, 40 Sup. Ct. 189, 64 L. ed. 521 (1920).

to a federal income tax has been whether they constitute income within the meaning of that amendment. The subsequent discussion will take this into account, so far as it considers the constitutional aspects of the subject.

#### STATUS UNDER THE INTERNAL REVENUE CODE

The status of stock dividends in the federal income tax system has once more become an issue because of several important decisions rendered by the Supreme Court during its last term.<sup>9</sup> The character of those issues can be set forth best by a descriptive account of these decisions. The first, and from many aspects the most important, is that of *Helvering v. Griffiths*.<sup>10</sup> The taxpayer was the owner of common stock of A Co. During his taxable year 1939 he received a dividend thereon payable in common of precisely the same kind as that with respect to which the dividend was paid. That was the only class of A Co. stock outstanding at the time when the dividend was declared and paid. The amount transferred by A Co. from surplus to capital stock in connection with the declaration and payment of the stock dividend was less than its earned surplus accumulated since February 28, 1913. The payment of the dividend would, therefore, have been taxable if a stock dividend of this character satisfied both the constitutional and statutory tests of taxable income. The Commissioner of Internal Revenue assessed an additional tax based on including in the taxpayer's 1939 income an amount equal to the fair market value of the dividend shares at the time of their receipt. The taxpayer appealed to the Board of Tax Appeals which sustained his position that he had realized no income by the receipt of the dividend. It in turn was sustained by the Circuit Court of Appeals for the Second Circuit.<sup>11</sup> It is the Supreme Court's decision in this case, and the prevailing and dissenting opinions therein, that constitute the new point of departure for any consideration of the present status of stock dividends in the federal income tax system.

The facts of the Griffiths Case were on all fours with those of *Eisner v. Macomber*.<sup>12</sup> The Commissioner was thus making a direct attack upon that case. He undoubtedly based his hopes of having that landmark overruled in no small part upon a change in the personnel of the Supreme Court during the last decade. The majority of the Court has at least postponed the time when its members will have to take their

<sup>9</sup> *Helvering v. Griffiths*, 318 U. S. 371, 63 Sup. Ct. 636, 87 L. ed. — (1943); *Helvering v. Sprouse*, 318 U. S. 604, 63 Sup. Ct. 791, 87 L. ed. — (1943); *Strassburger v. Com'r of Int. Revenue*, 318 U. S. 604, 63 Sup. Ct. 791, 87 L. ed. — (1943).

<sup>10</sup> This case will hereinafter be referred to as the Griffiths Case; *Helvering v. Sprouse* hereinafter be referred to as the Sprouse Case; and *Strassburger v. Com'r of Int. Revenue* will be hereinafter referred to as the Strassburger Case.

<sup>11</sup> 129 F. (2d) 321 (C. C. A. 9th, 1927).

<sup>12</sup> 252 U. S. 189, 40 Sup. Ct. 189, 64 L. ed. 521 (1920).

stand for or against the Macomber Case by holding that the stock dividends in question were excludible from gross income as a matter of statutory construction. *Eisner v. Macomber* was decided in 1920. The Revenue Act of 1921, enacted the following year, expressly excluded all stock dividends from taxable income.<sup>13</sup> This provision was repeated in every subsequent Revenue Act until that of 1936. It was then changed to read that "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."<sup>14</sup> The shift to this narrower exclusion of stock dividends from the class of taxable dividends was due to the Supreme Court's decision in the *Koshland Case*.<sup>15</sup> It had held therein that a dividend on the preferred stock of a corporation paid in its own common stock constituted income within the 16th Amendment, and that no part of the basis of such preferred could be validly allocated to the common stock received as a stock dividend thereon. In the year following that in which the *Koshland Case* was decided, the Court followed the logical implications of its position therein by sustaining the Treasury in treating the gain basis of stock dividends that could constitutionally be treated as income as zero.<sup>16</sup> The Treasury's first interpretation of Section 115(f)(1) of the Revenue Act of 1936 clearly recognized that a stock dividend of the *Eisner v. Macomber* type had not been rendered taxable,<sup>17</sup> and it construed the same provision of the Revenue Act of 1938 and of the Internal Revenue Code in the same manner.<sup>18</sup> This construction was in force when the dividends in the *Griffiths Case* were paid. In fact it remained in force until late in 1940.<sup>19</sup> All these facts (except that mentioned in the sentence immediately preceding), coupled with an interpretation of expressions of members of Congress, played an important role in leading the Court's majority to conclude that Congress intended Section 115(f)(1) to include in taxable stock dividends only those which were income within the meaning of the 16th Amendment as that had been judicially construed up to the time of the enactment of said Section in the Revenue Act of 1936. It is not nec-

<sup>13</sup> Rev. Act of 1921, §201(d).

<sup>14</sup> Rev. Act of 1936, §115(f)(1). The same provision appeared in all subsequent Revenue Acts and was carried into the Internal Revenue Code, 115 (f) (1), U. S. C. A. Title 26, §115(f) (1).

<sup>15</sup> *Koshland v. Helvering*, 298 U. S. 441, 56 Sup. Ct. 767, 80 L. ed. 1268 (1936), hereinafter referred to as the *Koshland Case*.

<sup>16</sup> *Helvering v. Gowran*, 302 U. S. 238, 58 Sup. Ct. 154, 82 L. ed. 224 (1937), hereinafter referred to as the *Gowran Case*.

<sup>17</sup> Reg. 94, Art. 115-7.

<sup>18</sup> Reg. 101, Art. 115-7; Reg. 103, Art. 19. 115-7.

<sup>19</sup> Treasury Decision 5020, which amended Reg. 103, Art. 19.115-7, dated November 15, 1940. The corresponding Articles of Regulations 101 and 94 were amended by Treasury Decision 5110, dated January 19, 1942.

essary for present purposes to evaluate this part of the majority's argument. It is, however, only fair to state that the force of the Treasury's responses to Section 115(f)(1) as an argument in favor of the majority's position depends on the reasons that induced the Treasury to treat that Section as not having made stock dividends of the *Eisner v. Macomber* type taxable. The language of the Regulations cited in the majority opinion is perfectly consistent with the position that the Treasury still considered *Eisner v. Macomber* as a valid interpretation of the 16th Amendment. Its Regulations, therefore, reflect its views on the meaning of that Amendment rather than its views as to the intention of Congress. The minority's position on the meaning of Section 115(f)(1) is supported by it by better reasoning than that urged by the majority to sustain its position on this point. It is not improbable that the fact that the Treasury was giving a retrospective operation to its change of Regulations in the instant case was the dominant factor in shaping the majority's decision. If the injustice of such a retrospective application were to be avoided, it was necessary to make the decisive issue that of the meaning of Section 115(f)(1). If the 16th Amendment permitted treating stock dividends of the *Eisner v. Macomber* type as income, and if Section 115(f)(1) was intended to allow the taxation of all stock dividends that constitute income within that Amendment, then the reversal of the Treasury's original Regulation construing that Section would be required by the Constitution itself. In that event the Treasury would have no power to limit the change to subsequently paid stock dividends, since that would involve the assertion of a power to ignore the Constitution. Courts sometimes protect persons against the logical consequences of an overruling decision, but administrators have no such power. It appears that the Treasury used doubtful strategy in selecting its test case.

The consequences and implications of the decision in the *Griffiths* Case are of considerable importance. It was a 5 to 3 decision, since Mr. Justice Rutledge did not participate in the consideration or decision of the case. If the Court continues to maintain the position of its majority that stock dividends of the *Eisner v. Macomber* type are non-taxable as a matter of statutory construction, regardless of the constitutionality of taxing them, it will require an amendment to the Internal Revenue Code before the Court can even pass on the present constitutional status of that decision. An amendment expressly including all stock dividends in gross income would be the simplest method for according the Court this opportunity. In the meantime opinions will differ as to what the Court would have held on that issue had the majority accepted the minority's interpretation of Section 115(f)(1). But the *Griffiths* Case raised another important issue. A stock dividend

is presently excludible from gross income if it does not constitute income within the 16th Amendment as construed up to the time of the enactment of Section 115(f)(1) of the Revenue Act of 1936. The extent of that exclusion thus depends upon the judicial construction of that Amendment as of a given date so far as that construction involved the status of stock dividends. There would be no reasonable basis for resorting to decisions not involving that matter in attempting to define the precise scope of the decision in the Griffiths Case. The question then becomes one as to the extent to which stock dividends had been held to be not income within the 16th Amendment up to the critical date.

It would have been an easy matter to have limited the scope of the decision to excluding from income a dividend on common stock payable in common of the same type in a case in which no other class of common was outstanding at the time of the declaration and payment of the stock dividend. It would also have been reasonable to limit its scope to the payment of a dividend on common payable in common of the same type even though other classes of stock were outstanding at the time of the declaration and payment of the stock dividend. Both of these views as to the scope of the Griffiths Case would be justified by developments between the decision of *Eisner v. Macomber* and the date of the enactment of Section 115(f)(1). This has not been what the Supreme Court has done. The reason therefor, and for the doubts as to the precise effects of the Griffiths Case, is to be found in the difficulties of determining the exact basis for the decision in *Eisner v. Macomber*. The Court had held therein that there could be no income within the 16th Amendment unless the transaction claimed to involve the receipt of income included an element called "realization." It thus became essential to develop some test or tests by which the presence or absence of that element could be detected in transactions involving the acquisition of wealth by a person.<sup>20</sup> The Court's first thorough going consideration of the problem was that found in the prevailing opinion in the case last mentioned. The tests evolved were inevitably affected by the specific form in which the problem was presented in the case before the Court. That is, their selection was determined largely by the character of the legal relation between the corporation and its shareholders. The Court was merely following ordinary usage in the business and financial community in treating the shares as representing capital in the hands of the shareholder, and in adopting the view that such capital was wholly distinct from the corporate assets. It was

<sup>20</sup> For a criticism of the judicial theory of realization as a condition to the existence of income, see Irving Fisher, *CONSTRUCTIVE INCOME TAXATION* (1942), pp. 139-141.

quite correct in holding that a stock dividend of the *Eisner v. Macomber* type did not sever anything from the corporate assets nor give the shareholder anything for his separate use that he did not already possess. These were the facts that gave force to the analogy employed by it in describing capital as the tree and income as the fruit. It was, therefore, held that two things at least were constitutionally required before a corporate distribution to its shareholders could be treated as income, and that these were (a) severance of assets from the corporate assets and (b) the receipt of the severed assets by the shareholder for his separate use. This is in reality but a single test stated in terms of the effect of the distribution upon both the corporation and the shareholder. The majority opinion does support its conclusion in part by the fact that the stock dividend in question did not alter the pre-existing proportionate interest of any shareholder in the corporation. However important the Court may have considered this factor in this case, it became exceedingly important in two cases decided on the authority of the *Griffiths Case* shortly after the decision therein.<sup>21</sup>

The course of decisions subsequent to *Eisner v. Macomber* developed the concept of realization in connection with corporate distributions to shareholders in ways that can be made consistent with the reasoning of *Eisner v. Macomber* only by giving meanings to "severance from corporate assets" and "receipt by the shareholder for his separate use" that lie outside the ordinary sense of those expressions. A short time after that decision it was held that a dividend paid in the paying corporation's own bonds constituted a taxable dividend to the shareholders.<sup>22</sup> It is doubtful that common usage would look upon the mere assumption of an obligation to pay the amount of the bonds at some future date as involving the immediate separation of anything from the corporate assets. It is, of course, true that such a financial operation would at once reduce the corporate net worth by the amount of the future payments agreed to be made. It would be equally doubtful that common usage would consider those who had received the bonds as having had distributed to them any part of the corporate assets. From their point of view they had received a promise that the corporation would at some future time transfer to them a part of its assets. However, the market would recognize those bonds as a separate form of property having a value of their own. But that could be said with equal truth of common shares received as a dividend on common stock of the same class. The real difference between such a stock dividend and a dividend paid by a corporation in its own bonds is that in the former case the shareholder's relations to the corporate assets have

<sup>21</sup> The reference is to the *Sprouse* and the *Strassburger Cases*. See footnote 9.

<sup>22</sup> *Doerschuk v. United States*, 274 Fed. 739 (D. C. N. Y., 1921).



remained unchanged, whereas in the latter case his relations to the corporate assets have been transformed from those of an ultimate owner to those of an immediate creditor. A further difference is that a stock dividend, regardless of its type, capitalizes surplus without affecting the corporation's net asset position, while a dividend paid in the corporation's own bonds does not capitalize any part of the surplus and reduces the corporate net assets. Income was held to have been realized because the shareholder had received for his own separate use something which "did not invest the holder with merely a different form of holding stock." That is, the acquisition of a claim against, or of an interest in, corporate assets different from that evidenced by the shares on which the dividend had been paid constituted realization. The same test of realization was applied in the Reorganization Cases.<sup>23</sup> It was, of course, assumed in all the cases thus far discussed that the corporate action affected its own earned surplus, that is, what had once been income to it.

I have thus far ignored the significance of the Court's reliance in *Eisner v. Macomber* upon the fact that the stock dividend involved therein did not alter the pre-existing proportionate interest of any shareholder. Did this mean that a corporate distribution could involve no realization if it did not alter the pre-existing proportionate interest of the shareholder? That is undoubtedly what was intended. At any rate the Court itself appears to have so interpreted it. In *Koshland v. Helvering*<sup>24</sup> it stated that *Eisner v. Macomber* had decided that a dividend in common on common was not income, and that it had been "said" therein "that such a dividend was not income because by its payment no severance of corporate assets was accomplished and the pre-existing proportionate interests of the stockholders remained unaltered." It also referred to the fact that it had, shortly after the enactment of the Revenue Act of 1921 (which expressly excluded all stock dividends from income) pointed out "the distinction between a stock dividend which worked no change in the corporate entity, the same interest in the same corporation being represented after the distribution by more shares of precisely the same character, and such a dividend where there had either been changes in the corporate identity or a change in the nature of the shares issued as dividends whereby the proportional interest of the stockholder after the distribution was essentially different from his

<sup>23</sup> *United States v. Phellis*, 257 U. S. 156, 42 Sup. Ct. 63, 66 L. ed. 180 (1921); *Rockefeller v. United States*, 257 U. S. 176, 42 Sup. Ct. 68, 66 L. ed. 186 (1921); *Cullinan v. Walker*, 262 U. S. 134, 43 Sup. Ct. 495, 67 L. ed. 906 (1923); *Marr v. United States*, 268 U. S. 536, 45 Sup. Ct. 575, 69 L. ed. 1079 (1925); *Weiss v. Stearn*, 265 U. S. 242, 44 Sup. Ct. 490, 69 L. ed. 1001 (1924). For a discussion of these cases, see Rottschaefer, *The Concept of Income in Federal Taxation* (1928) 13 MINN. L. REV. 637.

<sup>24</sup> 298 U. S. 441, 56 Sup. Ct. 767, 80 L. ed. 1268 (1936).

former interest." The reference is to the opinions rendered in the Reorganization Cases. The opinions therein certainly justified the view that realization was present where a shareholder received dividend shares that gave him a different interest in the corporate assets than he had had before. That factor, however, had reference rather to the test of severance of corporate assets for the separate use of the shareholder than to that of a change in the pre-existing proportionate interest of the shareholders. The language in the above quotation which refers to a dividend where there had been "a change in the nature of the shares issued as dividends whereby the proportional interest of the stockholder after the distribution was essentially different from his former interest" suggests that the differences between the dividend shares and the shares with respect to which they were paid must include such differences as result in a change in the shareholder's pre-existing proportionate interest in the corporation. However, the Court asserted further along in that same opinion that "where a stock dividend gives the stockholder an interest different from that which his former stock holdings represented he receives income." If the "different interest" there referred means one that includes a change in the shareholder's pre-existing proportionate interest in the corporate net assets, then there is no inconsistency between the various statements in the opinion as to the requisites for the existence of a constitutionally taxable stock dividend. If, however, the Court intended to assert that a stock dividend was constitutionally taxable in every case where the dividend stock conferred upon its recipient any interest in the corporate net assets, or in the control of corporate affairs, that was different from that which he had by virtue of his ownership of the stock with respect to which the dividend had been paid, then there would be an inconsistency between its statements in the opinion as to the requisites for the existence of a constitutionally taxable stock dividend, since a stock dividend meeting this test would not necessarily meet the test of a change in the shareholder's pre-existing proportionate interest in the corporate net assets. In the case now being discussed (the Koshland Case) the shareholder owned preferred stock and received dividends thereon in the corporation's own common stock. The payment of such a dividend did not reduce the corporate assets by any amount whatever. It did, however, give the shareholder an interest in the corporate net assets different from that represented by his preferred stock, and altered his pre-existing proportionate interest in the corporation. In so far as it altered his proportionate interest therein, it also changed adversely the proportionate interest therein of all those who owned common stock at the time the preferred was paid its stock dividend. The Court, in holding such stock dividend to constitute

income, must have held that the transaction "accomplished" a severance of corporate assets. Since no corporate assets actually were severed from corporate ownership, the concept "severance from corporate assets" must denote something that can occur even when corporate assets are not diminished by the transaction. That something is a readjustment of claims in the net assets by giving some former claimants thereto a new type of claim therein or new rights of control over corporate assets and affairs. It probably cannot be held to denote also the changes in pre-existing proportionate interests in the corporation of the shareholders receiving the dividend, nor in the pre-existing proportionate interests therein of the other classes of shareholders, which usually, but not always, characterizes the payment of stock dividends in shares of one class on shares of another class. If "severance from corporate assets" be construed to include that type of change, then it would not merit consideration as a second and distinct test of the existence of income realization in the various stock dividend cases. It would, therefore, be a justified interpretation of the decision in the *Koshland Case* that a stock dividend may be constitutionally treated as income if (a) it accomplishes a severance of corporate assets in the sense that the payment of the dividend confers upon the recipient an interest in the corporate net assets different from that represented by his stock on which such dividend was paid, and (b) it alters such shareholder's pre-existing proportionate interest in the corporate net assets. It is also arguable that the reasoning in the opinion in that case justifies the same proposition as to the requisites for a constitutionally taxable stock dividend, but it would constitute unwarranted dogmatism to assert that such reasoning is consistent only with that view.

The courts have developed their theories as to what stock dividends are constitutionally taxable by reasoning derived from *Eisner v. Macomber*. That case definitely decided that a stock dividend that meets a certain test is in the class of stock dividends that are not income within the 16th Amendment. If that were all that it had decided, it would furnish no basis for concluding what stock dividends were not in that class. The general resort to the *Eisner v. Macomber* theory of non-taxable stock dividends in the cases holding certain stock dividends constitutionally taxable proves that the courts have interpreted that case as having decided more than the proposition set forth above. If it be deemed to have decided that the whole class of stock dividends constitutionally non-taxable is exhausted by those that meet the test imposed by *Eisner v. Macomber*, then those that are constitutionally taxable can be determined by the approach actually adopted by the courts. The fact that they have used that approach supports the view

that all stock dividends are constitutionally taxable except those includible within the principles of *Eisner v. Macomber*. That that case and the *Koshland Case* failed to make completely clear the factors necessary to render a stock dividend constitutionally non-taxable appears from developments subsequent to the case last mentioned. The principle question was whether a stock dividend could be constitutionally taxed if it did not alter the pre-existing proportionate interest of shareholders in the corporation. The matter was finally settled by two decisions rendered by the Supreme Court a short time after its decision in the *Griffiths Case*. These were *Helvering v. Sprouse* and *Strassburger v. Commissioner of Internal Revenue*.<sup>25</sup>

The facts in the *Sprouse Case* were as follows. The corporation paying the stock dividend had outstanding at the time of its payment two classes of common stock. The only difference between them was that the one class had, and the other did not have, the right to vote. The taxpayer owned only voting common stock. During 1936 the corporation paid a dividend on all its stock, in non-voting common stock, the taxpayer thus receiving a dividend on his voting common in non-voting common. The Board of Tax Appeals sustained the Commissioner of Internal Revenue in including the value of such dividend in the taxpayer's 1936 gross income.<sup>26</sup> It did so because the stock received differed in character from that on which it had been paid. The Circuit Court of Appeals to which the taxpayer carried the case reversed the Board's decision.<sup>27</sup> Its reason was that a stock dividend which does not produce a change in the pre-existing proportionate interest of the shareholders does not constitute income within the 16th Amendment. Since the distribution involved in the case effected no change therein, the inclusion of the value of the dividend in the taxpayer's income was held to violate the 16th Amendment. Its decision was affirmed by the Supreme Court which held the case to be "ruled" by the *Griffiths Case* and not by the *Koshland Case*. It follows that the dividend in the *Sprouse Case* did not come within the meaning of income as used in the 16th Amendment as construed up to the time of the enactment of Section 115(f)(1) of the Revenue Act of 1936. The Court's reason for its position is found in that part of the majority's opinion in which it explains why the *Koshland Case* was inapplicable. It denied that that case had decided that a stock dividend could be constitutionally taxed in every instance in which the stock received as a dividend differed in any respect from that with respect to which it had been paid. It asserted that "On the contrary the decision was that,

<sup>25</sup> These two cases were decided together; for citation see footnote 9.

<sup>26</sup> (1940) 42 B. T. A. 484, where it appears *sub. nom.* *John M. Keister v. Com'r of Int. Revenue*.

<sup>27</sup> *Sprouse v. Com'r of Int. Revenue*, 122 F. (2d) 973 (C. C. A. 9th, 1941).

to render the dividend taxable as income, there must be a change brought about by the issue of the shares as a dividend whereby the proportional interest of the stockholder after the distribution was essentially different from his former interest." It may, accordingly, be taken as definitely settled that no stock dividend constitutes income within the 16th Amendment as construed at the critical date unless it effects an essential change in the pre-existing proportionate interests of the shareholders in the corporation. It is not sufficient that the character of the interest represented by the dividend stock is different from that represented by the stock on which the dividend stock was paid. That alone will not make the dividend constitutionally taxable. But nothing in the decision expressly or impliedly holds that a stock dividend could be taxable unless such difference too were present. It merely holds that it alone is not a basis for treating the dividend as income within the 16th Amendment.

The Strassburger Case was decided on the same reasoning. It is necessary merely to state its facts. The taxpayer was the sole owner of all of a corporation's outstanding stock which consisted of common stock only. It paid a dividend in its newly authorized preferred. The lower court held the dividend taxable on the basis of the Koshland Case which it construed as holding that a stock dividend was income within the 16th Amendment if the dividend stock gave the recipient a different interest in the corporate assets than that represented by the stock on which the dividend was paid.<sup>28</sup> Its decision was reversed by the Supreme Court. The only reason not adduced by it in the Sprouse Case was that the distribution of the stock dividend brought about no change in the sole stockholder's interest in the corporation since he owned it all both before and after the receipt of the stock dividend.

A question naturally raised by the Sprouse and Strassburger Cases is whether they have altered in any respect the tests developed in *Eisner v. Macomber* for determining what stock dividends are constitutionally tax-free. It has already been pointed out that that case, as subsequently construed and applied by the Supreme Court, not only decided that every stock dividend which accomplished no severance of corporate assets and left the pre-existing proportionate interests of the shareholders unchanged was a member of the class of constitutionally non-taxable stock dividends, but also decided that a stock dividend that did not meet those tests was not a member of that class. Furthermore, no decision of the Supreme Court has held that inclusion in that class requires compliance with any other test, or that compliance with any other tests alone will admit any stock dividend to that class. It may, therefore, be properly asserted that, up to the decision of the Sprouse

<sup>28</sup> *Strassburger v. Com'r of Int. Revenue*, 124 F. (2d) 315 (C. C. A. 2nd, 1941).

and Strassburger Cases, the class "constitutionally tax-free stock dividends" was identical with the class "stock dividends which accomplished no severance of corporate assets and which made no change in the pre-existing proportionate interests of the shareholders in the corporation." The Sprouse and Strassburger Cases in their reasoning certainly stress the absence of change in the pre-existing proportionate interest of the shareholders as the factor that required the conclusion that the stock dividends therein involved did not constitute income under the 16th Amendment as that had been construed up to the time of the enactment of Section 115(f)(1) of the Revenue Act of 1936. The question is whether those decisions, and the Supreme Court's reasoning in support thereof, justify an inference that the absence of such change alone is sufficient to bring a stock dividend within the class of those constitutionally tax-free. If the answer thereto be in the affirmative, the requirement that in order to be constitutionally tax-free a stock dividend must not accomplish a severance of corporate assets will have been eliminated. Accordingly, if the distribution of the stock dividend in either of those cases effected the result theretofore denoted by the concept "severance of corporate assets," the decision therein will require the inference that that test need no longer be met to entitle a stock dividend to be held constitutionally tax-free. The wholly artificial nature of that concept has already been pointed out. As a matter of fact no stock dividend involves any actual separation of assets from the corporate assets, nor anything that could be described as an acquisition of corporate assets by the shareholder receiving the stock dividend. The concept, as applied by the courts, denoted only that the interest in the corporation represented by the dividend stock was essentially different from that represented by the stock on which the stock dividend had been paid.<sup>29</sup> The stock dividend in the Strassburger Case clearly accomplished a "severance of corporate assets" in the only sense in which that concept had any meaning as an independent test of the taxable character of a stock dividend under the 16th Amendment. It is fairly arguable that the dividend in the Sprouse Case did not effect a severance of corporate assets in even this sense of the concept since the difference between the two classes of stock therein might well be considered not essential. The Strassburger Case, however, held constitutionally tax-free a stock dividend that accomplished a severance of corporate assets, and did so solely because it did not accomplish a change in the pre-existing proportionate interests of the shareholder in the corporation. Hence it demands the conclusion that the sole remaining test of whether a stock dividend is

<sup>29</sup> See *Helvering v. Gowran*, 302 U. S. 238, 58 Sup. Ct. 154, 82 L. ed. 224 (1937) and the Reorganization Cases cited in footnote 23.

tax-free under the 16th Amendment, within its meaning as of the critical date, is the effect of its distribution upon the shareholders' pre-existing proportionate interest in the corporation. If its distribution effects a change therein, it constitutes income within the 16th Amendment as of the critical date; if it effects no such change, it does not constitute income within that Amendment as of that date.

The next question concerns the meaning of the concept "change in the pre-existing proportionate interests of the stockholders." The principal factors with respect to which the rights of different classes of stockholders vary are (a) their rights to dividends, (b) their rights on the liquidation of the corporation, and (c) their voting rights. These are the major factors that define a shareholder's interest in the corporation. In the case of a corporation with but one class of stock outstanding, the proportionate interests of shareholders vary directly with the number of shares held by them. In the case of a corporation with two classes of stock outstanding that differ from each other only in that one class is voting stock and the other non-voting, the proportionate interest of the shareholders, regardless of the class of stock owned, in respect of their claims to dividends and to distribution on liquidation also vary directly with the number of shares held by them. This is also true, so far as voting rights are concerned, as among the shareholders owning voting stock, but not as among all the stockholders of both classes. If now a dividend in non-voting stock is paid to all shareholders, and if the dividend is the same amount for both classes, the resulting readjustment of the capital structure will not disturb the pre-existing proportionate interests of any shareholder with respect to any of the three factors. This was the situation in the *Sprouse Case* in which such a dividend was held not to be income. If in this case the equal stock dividend had been paid in voting stock, the result would be different. Assume that the corporation in question had outstanding 1000 shares of voting common and 2000 shares of non-voting common, both of equal par value. Each share, regardless of its class, is entitled to 1/3000th of each dividend distribution and to the same fraction in a liquidating distribution. If now a 10 per cent stock dividend is paid in voting common on both classes of stock, the number of voting shares will be increased to 1300, while the number of non-voting shares will remain at 2000. Each share, regardless of its class, will now be entitled to 1/3300th of each dividend and liquidating distribution. However, each owner of voting common will now own 1.1 share for each share formerly owned, and each owner of non-voting common will now own 1 share non-voting and .1 voting common for each share of non-voting common formerly held. Every stockholder will thus receive 1.1/3300ths of each dividend and liquidating distribution for each

share formerly held, regardless of its class. But  $1/3000$ th equals  $1.1/3300$ th. Hence there has been no change in the pre-existing proportionate interest of any shareholder so far as these two factors are concerned. This is not true so far as voting rights are concerned. The dividend has increased the voting stock to 1300 shares of which 200 are now owned by holders of non-voting common who acquired them by virtue of their status as holders of such non-voting common. Each share of voting stock now carries  $1/1300$ th of the voting power instead of  $1/1000$ th. Each owner of voting common now owns 1.1 share thereof with respect to each share formerly held, but that gives him only  $1.1/1300$ th of the corporate voting power instead of the  $1/1000$ th his single share formerly carried with it. And  $1.1/1300$ th is less than  $1/1000$ th. Furthermore, each holder of a share of non-voting common now has .1 share of voting common for each share of non-voting common formerly held, and has thereby acquired  $.1/1300$ th of the corporate voting power, whereas he formerly had none with respect to his ownership of a share of non-voting common. The pre-existing distribution of voting power has been altered. If that power is included in that "interest in the corporation" which may not be altered by a stock dividend if that dividend is to be constitutionally tax-free, then the dividend in question is not so tax-free. But that at once raises another problem. The pre-existing proportionate interest in the corporation, so far as the voting power of stock is a factor in its definition, has been altered with respect to both the voting and the non-voting common, to the disadvantage of the former and the advantage of the latter. Would the distribution of such a stock dividend be held taxable even in the hands of a holder of voting common? This would be most unjust, but law and justice do not always coincide.

The payment of a stock dividend on common stock in stock of the same class when no other class of stock is outstanding is non-taxable. This was decided in *Eisner v. Macomber* and reaffirmed in the *Griffiths Case*. A question may fairly be raised as to whether the decision would be the same if there were preferred stock outstanding at the time of the payment of such a dividend. The answer can be given only by considering the nature of its preferences. Assume a case in which it is preferred as to both dividends and on liquidation, the dividends are limited to a fixed rate, the amount payable on liquidation also limited to a definite amount, and it has no voting rights whatever. An increase in the number of shares of common stock is without effect upon the position of a preferred stock of this character. Such an increase would not alter the proportionate interest of the class of preferred stock in the corporate earnings or net assets or in its voting power, nor would it alter the proportionate interest of any holder of such pre-



ferred in those respects. This would be true whether the increase were due to a new issue to the public or to the distribution of a stock dividend. If due to the latter cause, it would also leave the pre-existing proportionate interests of the common stockholders unaltered in every respect. It follows that the distribution of such a stock dividend in this situation would not constitute income.

A variant of the case last considered would be one in which the outstanding preferred differed from that assumed in the preceding paragraph in one respect only. Assume it to be entitled to be paid \$5 per share before any dividends were paid on the common, and entitled to share equally with the common after that had received \$6 per share during any given year. The payment of a stock dividend on the common in common will increase the amount required to meet the \$6 per share requirement that has to be paid it before the preferred can share in further distributions during the year. It will furthermore increase the number of shares among which the additional distribution will have to be spread. Both of these changes alter the pre-existing proportionate claims to earnings and surplus as between the common shareholders as a class and the preferred shareholders as a class, and as between the shareholder of the one class and the shareholder of the other class. However, it would continue unaltered the pre-existing proportionate interests among the shareholders of each class. The question then arises whether the existence of the requisite change in the shareholders' pre-existing proportionate interest is to be tested by the results of the payment of the dividend upon the relative claims of the two classes of stock or by its effect upon the relative claims of the shareholders of each class taken as the unit. The decisions in the *Koshland* and *Gowran* Cases support the former of these positions. While they involved stock dividends on one class of stock paid in shares of another class, the change in the pre-existing proportionate interests in the corporation could not have been held to exist if the test had been applied only to the change in the relative positions *inter se* of the class of shareholders receiving the stock dividend. Hence it may be safely concluded that such a stock dividend would constitute income under the new test if that can be satisfied by such change involving but one of the factors defining a shareholder's interest in the corporation.

Another variant of the original case is that in which the outstanding preferred is without any voting rights whatever, is preferred as to dividends up to a fixed and limited amount, and is preferred on liquidation up to a fixed amount but entitled to share equally with the common after the latter has received a fixed amount. The payment of a dividend in common on the common in such case would increase the proportionate interest of the common stock in that part of the net assets

existing at the time of liquidation which was in excess of the amount required to meet the claims of the preferred to a fixed amount prior to any distribution to the common. The pre-existing proportionate interest therein is altered as between the two classes of stock, and also with respect to any holder of shares of each class. The change would benefit the common at the expense of the preferred. No change would occur in the relative positions of the common stockholders *inter se*. But, as heretofore pointed out, that would probably be held immaterial. Hence it is highly probable that a dividend of common stock paid on the same kind of common stock would constitute income under the facts herein assumed if the new test can be satisfied by a change involving but one of the factors defining a shareholder's interest in the corporation.

It has never yet been judicially determined whether a dividend on preferred stock paid in preferred stock of the same class constitutes income within the meaning of the 16th Amendment. The simplest case would be one in which the common stock was the only other class of stock outstanding. Assume a case in which the capital structure at the time when such a dividend is paid consists of 2000 shares of common stock and 1000 shares of preferred, the latter's preferences being limited to a \$5 per share dividend and the recovery of par on liquidation. Assume next the distribution of a 10 per cent dividend on the preferred paid in the same preferred. The result will be to increase the prior claim of the preferred in the earnings and surplus, and in the assets remaining on the liquidation of the corporation. This alters the pre-existing proportionate interest of the preferred in the corporation relative to the common shareholders. It does not alter the pre-existing proportionate interest among the preferred shareholders *inter se*. Since, however, the alteration of the preferred's proportionate interest relative to the common involves a similar alteration of the pre-existing proportionate interest of each preferred shareholder, the receipt of the dividend can be constitutionally treated as income. It will not be necessary to modify the assumed facts of the case stated in this paragraph by changing the preferences accorded the preferred stock. Such changes would affect the character of changes that such a dividend would effect in the preferred shareholder's pre-existing proportionate interest in the corporation. They would not eliminate such changes. Hence such a stock dividend as is now being considered would in all cases constitute income within the 16th Amendment.

The preceding discussion of possible cases in which the constitutional character of a stock dividend might arise has involved making certain assumptions that were not expressed. One of these was that all the outstanding stock was not owned by a single person. The

Strassburger Case held that the payment of a dividend on the common in a newly issued preferred did not constitute income where all the common was owned by one person, since he owned the entire interest in the corporation both before and after the payment of the dividend. Assume a corporation with both common and preferred stock outstanding, all of which is owned by one person. A stock dividend on the common paid in either common or preferred, and one on the preferred paid in either preferred or common, will effect no change in the sole shareholder's pre-existing proportionate interest in the corporation under the test applied in the Strassburger Case. Hence no such stock dividend can be constitutionally taxed as income. This is a most sensible position.

It was also tacitly assumed, wherever there was more than one class of stock outstanding at the time when the stock dividend was paid, that the several classes were not owned by the same persons in the same proportion. The effects of a contrary assumption must now be considered. Assume a corporation with 2400 shares of common and 1200 shares of preferred stock outstanding, and that A owns one-half of each class, B owns one-third of each class, and C owns one-sixth of each class. A 50 per cent dividend in common is now paid on the common. Its effect upon A, B, and C, as owners of common stock, is shown by the following table:

	<i>Shares owned before dividend</i>		<i>No. shares received as dividend</i>	<i>Shares owned after dividend</i>	
	<i>No.</i>	<i>Per cent</i>		<i>No.</i>	<i>Per cent</i>
A .....	1200	50	600	1800	50
B .....	800	33-1/3	400	1200	33-1/3
C .....	400	16-2/3	200	600	16-2/3

The dividend does not alter their pre-existing proportionate interest in the corporation so far as that is represented by their common stock. Their proportionate interest as represented by their preferred stock is not changed. Hence the dividend has made no change in their pre-existing proportionate interest in the corporation as represented by both the common and preferred stock. The distribution of that dividend would, therefore, not constitute income within the 16th Amendment. This is true also of a stock dividend on the preferred paid in the same preferred. It is not necessary to illustrate this by a tabular presentation. Let it now be assumed that a 25 per cent dividend is paid on the common in the preferred. The effects upon A, B, and C will be as follows:

	<i>No. common shares owned</i>	<i>Pfd. shares owned before dividend</i>		<i>Pfd. shares received as dividend</i>	<i>Pfd. shares owned after dividend</i>	
		<i>No.</i>	<i>Per cent</i>		<i>No.</i>	<i>Per cent</i>
A .....	1200	600	50	300	900	50
B .....	800	400	33-1/3	200	600	33-1/3
C .....	400	200	16-2/3	100	300	16-2/3

The dividend could have no effect upon the pre-existing proportionate interest of the shareholders so far as that was represented by the common stock. The table shows that their pre-existing proportionate interest in the corporation, so far as represented by their preferred stock, is left unchanged. Hence the dividend effected no change in their pre-existing proportionate interest in the corporation as represented by both the common and preferred stock. Its distribution would, therefore, not constitute income within the 16th Amendment. This would be true also had the dividend been paid on the preferred in common. These instances show that the important thing is not the existence of more than one class of stock at the time that the stock dividend is paid, but how the ownership of the classes is distributed. The results indicated in this paragraph will occur only if all classes of stock outstanding at the time when a stock dividend is distributed are owned by the same individuals in the same proportion. This is not likely to occur except in a family corporation. The case in which there is but one class of stock outstanding at the time of distributing a stock dividend produces exactly the same effects as those found to exist in the cases first considered in this paragraph. Hence a stock dividend on such single class paid in a newly issued stock of a different class is not constitutionally taxable.

The last case that merits special consideration is that in which the stock distributed as a dividend consists of treasury stock. Such stock is technically still outstanding. The simplest case is that in which the corporation has only one class of stock outstanding. Assume a corporation which has issued 11,000 shares of its common stock. It buys in 1,000 shares. Technically it still has 11,000 shares outstanding, so that each share represents a  $1/11,000$ th interest in the corporation. Actually, were the corporation to liquidate while this condition existed, the net assets would be distributed among the 10,000 shares in the hands of the public. If the 1,000 treasury shares are now distributed as a dividend, each holder of any of the 10,000 shares in the hands of the public will get .1 of a share as a dividend for each share held by him. Prior to the distribution the ownership of a single share of the stock in the hands of the public represented ownership of a  $1/11,000$ th interest in the corporation. This was, however, true in a technical sense only. After the distribution the owner of each such share will own 1.1 shares, which represent a  $1.1/11,000$ th interest in the corporation. The proportional interest of each shareholder is different from what it was before the treasury stock was distributed as dividends. The result is, however, attributable solely to accepting a legal technicality as a premise. There is no consideration of fairness that would justify including such a stock dividend in the class of those constitu-

tionally taxable. The Board of Tax Appeals (now the Tax Court) held such a dividend not to constitute income within the 16th Amendment. It rejected the Commissioner's contention that the treasury shares, being held for investment, constituted property and that the dividend was taxable on that basis.<sup>30</sup> The Treasury has finally ruled it non-taxable.<sup>31</sup> The rule would be different if the treasury stock was a preferred stock which had been distributed as a dividend on the common stock at a time when some of the same class of preferred was outstanding. The decision in the *Gowran Case*<sup>32</sup> would undoubtedly be used as the basis for treating such a stock dividend as income within the 16th Amendment. The only difference between it and the assumed case is that the preferred stock distributed to the common shareholders therein was not treasury stock.

It has already been stated that the major factors defining the interest in a corporation represented by any given share of stock are its rights to dividends, its rights on liquidation, and its voting rights. The distribution of a stock dividend which changes the pre-existing proportionate interest of shareholders with respect to all those factors is clearly taxable under the Constitution. The *Koshland Case* involved a stock dividend that effected a change in respect of all three factors. The question is whether it is sufficient, in order to make a stock dividend constitutionally taxable, that a change occur in the pre-existing proportionate interest of the shareholders so far as that change involves but one of those factors. This is an issue that has thus far received no consideration from courts or administrative bodies, at least so far as the writer is aware. The language of the Supreme Court is that, "to render the dividend taxable as income, there must be a change brought about by the issue of the shares as a dividend whereby the proportional interest of the stockholder after the distribution (is) essentially different from his former interest."<sup>33</sup> It is a fair inference therefrom that a change in a shareholder's pre-existing proportionate interest is sufficient if it involves any factor that might be considered as essential in defining that interest. It is not necessary that the change involve all factors defining it. The distribution of a stock dividend that alters pre-existing proportionate claims to dividends, or that alters pre-existing proportionate claims in the assets distributable on liquidation, certainly will be held to give the distributee a proportional interest "essentially different from his former interest." An alteration therein involving either of them would render the distribution constitutionally

<sup>30</sup> David Bruckheimer, 46 B. T. A. 234 (1942). For an earlier decision by the Board in accord with this, see James Kay, 28 B. T. A. 331 (1933).

<sup>31</sup> Treasury Decision 5290, approved August 13, 1943, which amends Reg. 103, §19.115-7.

<sup>32</sup> See footnote 29.

<sup>33</sup> See *Helvering v. Sprouse*, 318 U. S. 604, 63 Sup. Ct. 791, 87 L. ed. — (1943).

taxable. A distribution that altered only the pre-existing proportional distribution of voting power might well be held to be insufficient by itself to render the distribution taxable. The Court would have had to determine that matter if the dividend in the Sprouse Case had been in voting common. As it is, there is nothing in the decisions or opinions of the courts to help in solving it.

It may be well to make a brief summary of the discussion up to this point. The problem with which it was concerned arose because of the decision in the Griffiths Case.<sup>34</sup> The Supreme Court held therein that a stock dividend paid on the common stock in stock of the same class could not be taxed as income under the statute in force during 1939, the year in which the dividend was paid. The Commissioner of Internal Revenue had assessed a tax in reliance upon Section 115(f)(1) of the Internal Revenue Code<sup>35</sup> which provided that a distribution by a corporation to its shareholders in its own stock should "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." The Court construed this to exclude from income all stock dividends that did not constitute income within the meaning of the 16th Amendment as of the time of the enactment of the Revenue Act of 1936. That was made the critical date because that Act was the first to introduce the provision relied upon by the Commissioner in imposing the tax. The statutory rule in effect during the fifteen years prior thereto had excluded all stock dividends from income. The meaning of the 16th Amendment as of the critical date thus became the criterion for determining the scope of Section 115(f)(1). That resolved itself largely into a problem of discovering the test of non-taxability and of taxability developed by *Eisner v. Macomber* and the *Koshland*, *Gowran*, *Sprouse* and *Strassburger* Cases. The net effect of the decisions and reasoning in those cases is that Section 115(f)(1) excludes from income any stock dividend that does not change the shareholder's pre-existing proportionate interest in the corporation, and excludes from income no other type of stock dividend. Whether a stock dividend effects such a change can be ascertained only by examining the capital structure of the corporation before and after the payment of such dividend. *Eisner v. Macomber* and the *Griffiths* Case decide that the requisite change does not occur if a dividend is paid on the common stock in common stock of the same class at a time when there is no other class of stock outstanding. The *Sprouse* Case has definitely settled that the payment of a dividend in non-voting common on both the voting and non-voting common, at a

<sup>34</sup> 318 U. S. 371, 63 Sup. Ct. 636, 87 L. ed. — (1943).

<sup>35</sup> U.S.C.A. Title 26, §115(f)(1).

time when no other class of stock was outstanding, does not effect the requisite change where the only difference between the two classes of stock was that the one class only had voting power. The Strassburger Case puts into the class of non-taxable stock dividends a dividend on the common stock paid in preferred stock at a time when the common alone was outstanding where all of it is owned by a single shareholder. The decision would have been the same had there been several classes outstanding at that time if all the issued stock had been then owned by a single shareholder. The Koshland and Gowran Cases indicate two situations in which a stock dividend does produce the change requisite to treating the dividend as income. In each of them the dividend was paid in shares of one class on shares of a wholly different class at a time when shares of both classes were outstanding. These decisions are important, but there remain numerous situations to which the courts have not yet given authoritative answers. Some of these were analyzed and considered in the course of this article. In conclusion, it should be noted that, while the discussion has been constantly concerned with the meaning of the term "income" in the 16th Amendment, the conclusions relate not to the present constitutional status of stock dividends but to their constitutional status as of a prior date. The principles were developed for the purpose of determining the scope of a statutory provision whose scope the Supreme Court had defined in terms of the meaning of the word "income" in the 16th Amendment as of a given prior date. The present constitutional status of stock dividends will be dealt with in the next section of this article.

*(To be continued.)*