pose to do this has been expressed in unmistakable language; that the tax now in question is clearly within the terms of the law; and that the judgment of the district court denying the Government's right to collect it should be reversed.

Respectfully,

WILLIAM L. FRIERSON,
Assistant Attorney General.

SEPTEMBER, 1919.

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No. 318

IN THE

Supreme Court of the United States

OCTOBER TERM, A. D. 1919.

MARK EISNER, COLLECTOR, ETC.,
Plaintiff-in-Error,

against

MYRTLE H. MACOMBER,
Defendant-in-Error.

IN ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF NEW YORK.

Motion for Leave to File a Brief and Argument, and Brief of Argument of George W. Wickersham and Charles Robinson Smith as *Amici Curiae* in Support of Judgment Below.

GEORGE W. WICKERSHAM,
CHARLES ROBINSON SMITH,
as Amici Curiae.

The Dispatch Printery & Bindery Corporation
New York

SUBJECT INDEX.

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IN THE

Supreme Court of the United States,

OCTOBER TERM, A. D. 1919.

No. 318.

MARK EISNER, COLLECTOR OF UNITED STATES INTERNAL REVENUE FOR THE THIRD DISTRICT OF THE STATE OF NEW YORK,
PLAINTIFF-IN-ERROR,

AGAINST

MYRTLE H. MACOMBER,
DEFENDANT-IN-ERROR.

IN ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF NEW YORK.

Motion for Leave to File a Brief and Argument, and Brief of Argument of George W. Wickersham and Charles Robinson Smith as Amici Curiae in Support of Judgment Below.

Motion.

Now come George W. Wickersham and Charles Robinson Smith, attorneys and counsellors of this Court, and represent that there is involved in the above mentioned case a question of whether or not, under the Sixteenth Amendment of the Constitution of the United States, Congress is empowered to impose an income tax upon stock dividends of a corporation issued with respect of profits of such corporation accumulated since March 1st, 1913, upon the issue of such stock dividends and before sale thereof by the stockholder;

That this is a question which vitally affects the interests of a number of their clients who would be adversely affected by a decision affirming the position taken by the Government in this case.

Therefore, they pray leave to file a brief and argument as *amici curiae* in support of the affirmance of the judgment of the Court below; such brief and argument being as follows:

Statement.

The facts are set forth in the statement of the case in the Brief and Argument for defendant-in-error, submitted by the Honorable CHARLES E. HUGHES and GEORGE WELWOOD MURRAY.

BRIEF OF ARGUMENT.

The Government seeks to distinguish this case from the decision in *Towne* v. *Eisner*, 245 U. S., 418, upon the ground that the stock dividends there under consideration were issued with respect of profits of the corporation earned and accumulated prior to March 1, 1913, whereas here the tax was levied upon an amount of the stock dividend equal at par value to the aggregate accrued profits of the corporation earned since March 1, 1913. The argument is, that all earnings of a corporation constitute income belonging to or held in trust for its stockholders, and are subject to the constitutional power to tax incomes, which may be exercised as Congress shall elect, by imposing the tax wholly or in part upon the corporation, or wholly or in part upon the stockholders.

This argument brushes aside the separate corporate entity, treats corporate enterprise as a mere partnership, and thus establishes the plenary authority of the taxing power over the aggregate corporate gains, irrespective of whether or not the stockholders actually may have received or enjoyed any share in them. It is claimed that this position is supported by the decision of this Court in *Collector* v. *Hubbard*, 12 Wall., 1.

The Act of Congress of 1916 (39 Stat., 756, Sec. 2a), in imposing an annual tax upon the net income of a taxable person derived, *i. a.*, from dividends, provides that the term "dividends", as used in the act,

> "shall be held to mean any distribution made or ordered to be made by a corporation * * * out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether in cash or in stock of the corporation * * *, which stock dividend shall be considered income, to the amount of its cash value."

To bring a dividend within this definition, it must appear

(1) that the corporation has made or ordered a *distribution* out of its earnings or profits accrued since March 1, 1913;

(2) that such *distribution* is made payable to its stockholders, including the person taxed;

(3) that such *distribution* is payable in cash or in stock which has a cash value.

But a stock dividend, pure and simple, such as that made by the Standard Oil Company of California in the instant case, is not a *distribution* of anything. It is a mere *readjustment* of the evidences of the shareholders' interest in the corporation. The issue of certificates for shares under these circumstances is not *payment* of any earnings or profits. The provisions of the statute are not applicable to such an issue.

The Government concedes the facts, but disputes the conclusion. The Assistant Attorney General in his supplemental brief (at p. 15) says:

> "The government is under no delusions as to the nature of a stock dividend, or as to what it accomplishes. It serves to readjust the evidence of ownership by which the stockholder previously held his share of both capital and undivided profits. * * * The Government readily agrees that there has been a mere change in form of that which already belonged to the stockholder and that what was not income before is not income after a stock dividend."

It is sought to avoid the effect of this concession by the argument; that the income of *the corporation* is also the income of the stockholder; that the issue of a stock dividend distributes that income to the stockholder and that the government, which could tax the income as it accrues either against the corporation or the stockholder, acts within its powers and exercises them with fairness and restraint, when it only imposes the tax at the moment when the stockholder receives a separate stock certificate representing what the government is pleased to call "his invested profits or gains."

We challenge the soundness of this position. It is contrary alike to economic fact and well settled principles of law. We deny that it finds some support in *Collector* v. *Hubbard,* 12 Wall., 1, but even if it did, we should deem it immaterial. Since the income tax cases of 1894 (*Pollock* v. *Trust Co.,* 157 U. S., 429; 158 U. S., 601), the authority of that case is restricted to direct taxation of property. Considered in its effect upon income, it is overruled by well settled lines of decision.

Moreover, if the Government is correct in its interpretation of the statute, and Congress did attempt to tax the stockholder as the recipient of an amount of income equal to the cash value of the stock issued, even though the same be issued to represent an amount of corporate gain received and accumulated by it in previous years, upon which the corporation itself paid, or is liable to pay the tax imposed upon it, carrying the balance to the credit of surplus account, adding it to its capital, and investing it in its business; then, we submit, Congress has exceeded the constitutional limit of its powers, and in effect has imposed a direct tax upon capital, without apportionment, which may not be justified by calling the capital income, which it is not.

POINTS OF OUR ARGUMENT.

1. The principle laid down by this Court in two well-considered cases (Gibbons v. Mahon, 136 U. S., 549, and Towne v. Eisner, 245 U. S., 418), that stock dividends represent capital and do not constitute income is based on sound economic reasoning.

2. Although the Hubbard case (Collector v. Hubbard, 12 Wallace, 1) is plainly distinguishable from the case at bar, it is nevertheless inconsistent both with other and later rulings of this Court and with sound economics. It tends to block the way to a

consistent, harmonious and logical system of income taxation and it should be expressly overruled.

(a) The Hubbard case as upholding a tax on property or the income from property except by apportionment under Art. I, §2 of the Constitution has been overruled by the Pollock case.

(b) The Hubbard case, insofar as it assumes an equivalency between the property and the income of the corporation and the shares of stock in the names of the stockholders for taxation purposes, has been implicitly overruled by a long series of authorities in this Court.

(c) The suggestion that this Court has in other cases cited Collector v. Hubbard or its principle with approval except upon altogether minor points is erroneous.

3. The stock dividend is in reality not a dividend at all. It is a mere certified expression of an undivided surplus and its capitalization.

Whatsoever gain there may be in either case to the stockholder is a capital gain.

Capital gains (being mere increases in valuation) are not income until realized.

The gains that come with stock dividends when stock is sold are realized capital gains—the same in nature and similarly taxable as those gains that are made with any stock that is sold at an advance. Inasmuch as undivided corporate earnings cannot be taxed as income against the stockholder, so the stock certificates issued with respect of such earnings may not be so taxed until the gain be realized by the stockholder through sale of his stock.

FIRST POINT.

The principle laid down by this Court in two well-considered cases (*Gibbons v. Mahon* and *Towne v. Eisner*), that stock dividends represent capital and do not constitute income is based on sound economic reasoning.

The question involved here is one of definition—the meaning of the word "income" as used in the Sixteenth Amendment. It is absolutely necessary to define the meaning of that word and its limitations, if the restrictions of the Constitution on the power of taxation are to be respected.

The original provisions of the Constitution as limited by the *Pollock* case and enlarged by the Sixteenth Amendment have now given to Congress definite, broad powers of taxation with definite limitations thereon. It is settled that taxes on land or personal property are direct taxes and cannot be levied except by apportionment. On the other hand, income from whatever source derived, even income from land and personal property, may be taxed by the Federal Government without apportionment.

In applying these powers, it becomes necessary, therefore, to distinguish what is Capital and what is Income. If a stock dividend is taxable under the Revenue Act in question, it must be not because stock dividends are expressly mentioned in this Revenue Act as they are in fact mentioned, but because the term "stock dividends" is really covered by the term "income" in the Sixteenth Amendment—because, in short, stock dividends may be properly defined as income.

Just as a stream cannot rise higher than its source, so the Revenue Act could not include as taxable any items that were not already included in that single word *"Income"* as employed in the Sixteenth Amendment.

Nobody doubts that cash dividends in general are included in this word income. If stock dividends are included, it must be because stock dividends are income. If stock dividends are not dividends, then they certainly are not income. But this Court has twice decided that stock dividends are intrinsically not dividends at all. In *Towne* v. *Eisner,* the Revenue Act of 1913 used language as broad as that of the Sixteenth Amendment. The language of the Sixteenth Amendment is: "Income from whatever source derived." The language of the Act of 1913 is: **"The entire net income arising or accruing from all sources** in preceding calendar year," and yet this Court held that stock dividends were not income within that Act.

In this respect the Court is supported by sound economic reasoning. A consideration of the distinction between Capital and Income will show that this is so; and **as the subject matter of the Sixteenth Amendment was an economic question, it must be assumed in default of plain language to the contrary, that the people in so fundamental a law as a constitutional amendment employed terms in treating it that would be conformable to sound economic principles.**

In a sense, **all capital excepting bare land** was in its origin income. What we now know and recognize as capital was originally wages or salary or profits or rents or interest or return or remuneration of some sort for effort or for the use of previous capital. The whole economic situation is in a state

of flux—a state of change, not a fixed state but a state of becoming, and thus income is continually becoming capital. For purposes of this definition, it is important to fix the time when this occurs, or at least its boundaries, because income that has once become capital can no longer be taxed as income under the Sixteenth Amendment unless we break down all the limitations of the Constitution —all distinction between income and capital—all distinction between income taxes and capital or direct taxes.

There is often no ear-mark to show what items of property or money are income and what capital. A man's wages, his salary, his interest or cash dividends, may be thus ear-marked at the time of their receipt; but in industry, the gross returns indiscriminately include the return or repayment of the capital invested in manufacturing the goods as well as the profits thereon, and in such case a mere adding up of receipts does not show the income of the industry. The greater part of those receipts is capital return. Hence it becomes necessary to keep elaborate accounts and at fixed periods determine that part of the receipts which is the return or restoration of the capital invested in materials and wages, etc., in producing the goods and that part, if any, left over for profits or income. But in either or any case, these returns thus constituting income unless consumed quickly become capital.

What was the income of one year becomes the capital of the next. An income tax, therefore, in order to be a real tax on income must as nearly as possible catch that income whilst it is income or as soon thereafter as the amount of income for the given period can be determined. It is obvious that no one year's income can be known until after the end of that year and in industry it takes days, weeks and sometimes months after the end of the year to compute what has been that year's income. For this reason, much of the year's income thus open to taxation may have become changed into fixed forms of capital before the tax can even be computed or levied; but that is a difficulty inherent in the income tax, and this difficulty only emphasizes the need in a true income tax, of levying the tax as promptly as possible and before the income to be taxed can have been too largely changed in character.

Time is thus an important element in distinguishing capital from income.

With a tax law known in advance, there will be no difficulty in reserving from the ebb and flow of the year's income enough to pay each year's taxes as they may be computed shortly thereafter.

These considerations lead to the conclusion that the income of any one year should be taxed only once and not at two different times—and especially not in two successive years or tax periods.

To illustrate with a concrete case: We will suppose that a given corporation has paid in 1916 its taxes on all its 1915 income including its surplus for that year. This surplus has become invested in extensions and has then become fixed capital. The corporation gives its stockholders certified proof of this fact by distributing additional shares covering exactly the beneficial interests they had before—no more and no less, certifying however to them the fact that the business has been extended and that some of the Company's income has been made capital. This stock dividend is distributed in 1916 because the earnings of 1915 permitted this capitalization of income, but the earnings are 1915 earnings. Now, mark the result. If the stockholder is taxed on this stock dividend, he is in effect made to pay in 1917 as if on 1916 income what was in reality 1915 earnings. And yet, if there be any distinction whatsover between Income and Capital, it is obvious that what was earned as income in 1915 cannot be considered the income of 1916. By that time it has clearly become capital. In this particular case, we have a confirmation that it has become capital, because the fact is so certified to us by this stock dividend which is a way of saying that the company had not the cash to pay a dividend and needed to capitalize these residual profits to extend its business. This certification that income has become capital is certainly not income in itself—no new income. The stockholder is intrinsically no richer the instant after than the instant before the dividend, and the corporation is no poorer, as the Supreme Court several times has said.

So that the Government's contention amounts to this: That this income earned by the corporation in 1915 and subjected to an income tax as soon thereafter as possible in 1916, may still in 1917 be made to pay another income tax as 1916 income just because in that later year it is certified to the stockholder not as income but as capital.

Our analysis thus discloses two conclusive reasons why stock dividends are not income. First: that already emphasized by this Court, that they are like undivided profits—the stockholder is no *richer* than before merely by reason of the stock dividend; and secondly, that at the time when the stock dividends were received, they had ceased to be earnings of the taxable year, having already become capital.

The very fact that Congress in this Revenue Act found it necessary expressly to specify stock dividends proves that they would not be included in the broad term *"Dividends"; if* they are not included in the term *Dividends,* they certainly are not included in the Sixteenth Amendment, for if stock dividends are income, it must be because they are dividends.

This analysis is in accord with the views and the reasoning of scientific economists.

"Income and capital are therefore two aspects of wealth. In the one case we measure wealth as a flow of services or a stream of satisfactions; in the other case, as a stock of services or a fund of satisfactions. * * * The original conception of income is therefore pleasure or benefit income" ("Principles of Economics," Seligman, 7th Ed., p. 16).

With this ultimate psychological analysis we have, however, little to do in any scheme of taxation which concerns money or money's worth; and so Prof. Seligman adds: "In modern times value has come to be estimated in terms of money and income is accordingly used in general to denote the inflow or revenue in money—the money income as opposed to the pleasure or benefit income." And again, "Capital is capitalized income" (*Id.,* p. 17).

The distinction between income and the accumulation of postponed and deferred income that we call capital is the fundamental distinction in economic life.

"The business man's income means money income" ("The Nature of Capital and Income" by Prof. Irving Fisher, p. 103).

"Income as contrasted with capital denotes that amount of wealth which flows in during a definite period and which is *at the disposal of the owner for purposes of consumption, so that in consuming it, his capital remains unimpaired"* (Seligman, Income Tax, p. 19).

(See Prof. Seligman's masterly analysis in an article entitled "Are Stocks Dividends Income?" reprinted from the September, 1919, number of the American Economic Review and accompanying main brief in this case.)

No one would be disposed to dispute, but on the contrary all would accept this Court's definition of income as "the gain derived from capital, from labor, or from both combined". But when the Government undertakes to apply this definition to anything of value in whatever form, however inchoate, unrealized and unseparated, which represents a gain derived from capital, labor, or both, to paper gains in fact, the Government is contradicted both by the previous rulings of this Court and by sound economic reasoning.

If gains in general and paper gains may properly be considered income, then this would hold true of mere appreciation in value of real estate or of personal property that is not sold—a gain that is not realized. But this sort of appreciation or gain in capital value can never constitute income within the Sixteenth Amendment. See *Gray* v. *Darlington,* 15 Wallace, 63; the last sentence in *Lynch* v. *Turrish,* 247 U. S., 221, at p. 231; *Baldwin Locomotive Works* v. *McCoach,* 221 Federal, 59, and *Towne* v. *Eisner* (*supra*).

And if a stockholder holds stock in a corporation which has made large earnings that have not been divided, and on which the corporation has paid its income tax, such stockholder has indeed made an unrealized, an inchoate, capital gain and his stock has probably advanced in market price. This increment is perhaps property which might be taxed as such. But can this unrealized gain in his capital be considered income and taxable as income within the Sixteenth Amendment by any amount of legislation? Certainly not if the distinction is to be preserved between the corporation as one person and the stockholders as distinct persons; nor if the distinction is to be preserved between a gain which is realized and which produces the money to pay an income tax and one which is unrealized and produces no money.

It cannot be doubted that the sort of gain referred to by this Court as constituting income was a realized gain—not the gain of mere appreciation in value.

This appears from an examination of what this Court referred to in the two cases in which it defined the word.

In *Stratton's Independence* v. *Howlett* (231 U. S., 399, 415), the gains thus defined were the profits of a mining company from the mining and sale of coal.

In *Doyle* v. *Mitchell* (247 U. S., 183, 185), the gains in question were the profits from the cutting and sale of timber.

There was evidently nothing inchoate about gains such as those. They were gains that had been realized and "cashed in" and of course they were taxable as income.

This distinction between realized and unrealized gains is of capital importance in the income tax. Unrealized gains are technically inchoate gains and inchoate gains are not income. This does not mean that a gain in capital may not become income. Capital increment becomes income when realized—that is, when cashed; until then, barring a few exceptions alluded to below, it is inchoate. Realized capital increment is income in its widest sense. Unrealized capital increment is not income but simply an appreciation of capital—no flow of income whatever.

The distinction was well marked by this Court in *Lynch* v. *Hornby* (247 U. S., 339), where it spoke of "accumulated earnings as coming to fruition," and of a "*realization in possession of an inchoate and contingent interest that the stockholder had in a surplus of corporate assets previously existing*" (p. 344).

The same thought is expressed by Mr. Justice Holmes in Towne v. Eisner where he says: "If the sum, [that is, the same amount as the stock dividend] had been carried from surplus to capital account without a corresponding issue of stock certificates, which there was nothing in the nature of things to prevent, we do not suppose that any one would contend that the plaintiff had received an accession to his income." 245 U.S., at p. 426.

When we speak of realization, we usually mean a realization in cash. But this is not always so. A lessor of a farm who receives his rent in produce; the farmer who gathers his harvests and holds them unsold beyond the taxable year; the manufacturing company which makes unusually large sales on credit, which sales are not cashed during the taxable year: all these are cases where realized profits and income are clearly made during the taxable year although they be not cashed in.

But all these, like dividends in kind, are new gains separable from the capital which produced them and they are realized in the possession of, and are under the control of, the recipient—and they can be realized in cash by him without in any way affecting his rights in these respective sources of his income.

The Union Pacific stockholder who received B. &

O. shares as a dividend received a new gain separable from his Union Pacific shares—a gain realized in the concrete form of income producing property and realizable in cash by sale thereof without affecting his investment rights in the Union Pacific (*Peabody* v. *Eisner,* 247 U. S., 347).

But if the Union Pacific had given him a stock dividend instead of this dividend in kind, he would have realized no new gain—he would have had nothing intrinsically new to cash that he did not have before—and if he had sold the new stock he would have parted not with a thing separated from the Union Pacific Company but with a percentage of his former interest in that company itself.

A most important point is the separation of the increment from the capital.

This separation is necessary in order to constitute income. The increment as separated is income. The increment of capital unseparated is capital—whether it be a corporate surplus or a gain in value. From the shareholder's point of view an increase in the surplus of the corporation is precisely like an appreciation in value of real estate or other property holdings—no more, no less.

In another aspect, this separation of income from capital means giving to the stockholder personally control of something he did not have before. Give him a dividend in cash or in tons of coal or in stocks of other companies than his own and he controls something new—may do with it what he please without affecting his interest in his company. Give him a stock dividend and he neither owns nor controls anything new whatsoever, in an intrinsic sense. And let him but sell his stock dividend and he loses control *pro tanto* of that which he had before. He diminishes his beneficial interest in, and percentage of control of his company.

Not so with a real dividend, be it cash or tons of coal or securities in another company. Let him part with these and his interest in his company, the source of this dividend, remains entirely unaffected.

As Prof. Seligman says: "Income is that wealth which flows in during a definite period and *which is at the disposal of the owner for purposes of consumption*" (Seligman, Income Tax, p. 19). The gain must be some new thing at the disposal of the owner or it is not income. To illustrate: after a 25 per cent stock dividend on 100 shares of stock, the stockholder has nothing more and nothing intrinsically different to dispose of than before. In either case by selling one-fifth of his holdings he would part with precisely the same interest in the company and its surplus—lose precisely the same degree of control. And in either case, if he holds his stock he holds the same interest, the same undivided earnings, the same control.

Almost all these points of distinction between gains in general and real income are set forth in that one short sentence cited from *Lynch* v. *Hornby* (*supra*). An undivided corporate surplus as regards the stockholder has not yet "come to fruition"; is not yet "realized"; is not "in possession" as regards him. It is on the contrary "inchoate," and it is "contingent"—because its "coming to fruition," being "realized," or coming into his possession, depends on other wills than his—so that he may never receive it. And as a mattter of fact in most cases never will—for in most cases the surplus will have been capitalized—and the stock dividend is but the formal authentication of that fact.

An undivided corporate surplus, therefore, which the corporation has set aside for extensions and virtually capitalized, lacks the very essense of income from the stockholder's point of view. It is as little income and as much capital as is the increase in value of one's unsold real estate.

It is believed that no country in the world has ever attempted to tax a shareholder because of an increase in the surplus of a corporation (if exception be made of Chap. 173 of the Laws of 1864, which since the *Pollock* case to be discussed later, would now be deemed unconstitutional—see below).

Whenever a corporation has made substantial earnings, three courses are open to it: It may either declare a cash dividend, or it may merely increase its surplus, or it may distribute a so-called stock dividend.

In the case of the cash dividend, the new increment is a realized gain, separated from the company's assets, and is income. In the case of the increase in surplus, the unrealized gain is not income and no money is furnished to pay an income tax unless some of the stock is sold. In the case of the stock dividend, the new increment is not a realized gain and it is not income and, as in the preceding case, no income is produced to pay an income tax unless some of the stock is sold. "The stock dividend is like an increased surplus—it is not like a cash dividend. In fact, a stock dividend is not a dividend at all in the sense in which a cash dividend is a dividend. The entire confusion really arises from a misnomer." (Seligman's article, *supra*, p. 534).

In the case of the cash dividend, the corporation in the first instance had made its profits on which it is liable to an income tax, and it has taken a part of those profits from its own assets and given them to the stockholder as a realized gain to him on which he too is liable to an income tax.

On the other hand, the case of the undivided surplus and the case of the so-called stock dividend are intrinsically similar, in that what was a gain to the corporation on which it has paid an income tax has become capital; and whether it stands as a surplus or stands as officially capitalized by stock certificates, in neither case is it a realized gain to the stockholder. Nor in either case has the corporation parted with anything.

But, where a dividend is made in kind—that is in property or in shares or securities of another corporation, the company does part with some of its own assets and give its stockholders dominion over them. These assets are not invested as capital in the Company's business; they constitute a real gain to the stockholder over what he had before. And if he sell the items received in order to pay his income tax, he does not part with any interest in or control over his corporation, as he would do if he sold his stock dividend shares. Real dividends transfer to stockholders property which previously belonged to the corporation. Stock dividends do not do this. The situation both of the Company and of the stockholders is intrinsically the same just after, as just before, a stock dividend.

On the former hearing of this case, the Government argued in effect that a stock dividend is similar to a dividend in the stock of another corporation —although this Court had distinctly said the contrary in *Peabody* v. *Eisner*, 247 U. S., 347. "It hardly is necessary to say that this case is not ruled by our decision in *Towne* v. *Eisner*, since the dividend of B. & O. shares was not a stock dividend but a distribution *in specie* of a portion of the assets of the Union Pacific, and is to be governed for all present purposes by the same rule applicable to the distribution of a like value in money" (p. 349).

Of course, the stock dividend like the dividend in kind would affect or reduce the previous book value of outstanding shares of stock; but it would *reduce them by dilution*. The dividend in kind *reduces them by subtraction*. And the stock dividend would not reduce the corporation's assets and it would not increase the stockholder's assets—as would the dividend in kind or in another company's stock or in cash. The stock dividend takes nothing from the company and consequently gives nothing to the stockholder that he did not have before. Not so the dividend in cash or in the stock of another corporation. The corporation here parts with some of its assets. The stockholder becomes *pro tanto* sole owner of these. He has a new power of disposition and a control that he did not have before.

The dividend in kind in the stock of another company if sold involves no parting with assets essential to the original company or still belonging to it, and above all it involves no sacrifice of or change in voting control—no change whatever in the stockholder's investment in the business or in his percentage of future dividends and earnings.

The time may come, however, when the stockholder will realize on his inchoate gains. He may sell his stock. In fact, he is almost certain to do so at some time or another; and when this happens, the increased value imparted to his total holdings, whether through the surplus or the stock dividend, will show itself in the enhanced price received, and he will have to pay a tax on the profit. But at that time he will be cashing in his profit and will be perfectly able to pay the tax out of that particular income instead, perhaps, of being forced to sell capital or borrow money in order to pay a so-called income tax which would not be a tax on income.

A very interesting discussion of this subject from

the economic point of view has been published in Vol. III of the Bulletin of the National Tax Association, April-June, 1918. At page 161 is an article on *"The Economic Nature of the Stock Dividend"* by Prof. Fred. Rogers Fairchild, Professor of Political Economy at Yale University: at page 237, a reply thereto by Henry H. Bond, State Income Tax Deputy, at Boston, Mass., in an article entitled "A Practical Aspect of the Stock Dividend Question"; and on page 240 another article by Prof. Fairchild entitled "The Stock Dividend—a Rejoinder."

Below are some quotations from Prof. Fairchild's articles:

> **"It is unfortunate that the term 'dividend' was ever used in this sense. The 'stock dividend' is really not a dividend at all, but merely a bookkeeping change in the liability of the corporation to its stockholders. Were it not for this unfortunate use of terms, the common notion that a stock dividend is income, like a cash dividend, would probably never have occurred to anyone."**

Again:

> "The inclination to regard a stock dividend as income may sometimes be traced back to the notion that an increase in the value of capital is income. This fundamental error has been the cause of much confusion. Let us see exactly what is the relation between capital and income. Capital is a fund or stock of wealth in existence at a given time. Income is the flow of services or benefits of capital during a period of time. * * * Income must not be confused with growth of the capital."

* * * * * * * *

> **"The Supreme Court, in deciding that a stock dividend is not income, was therefore following sound economic principle."**

* * * "it is worthy of note that some of the most serious errors in our tax legislation have been due to confusion as to the true nature of capital and income and their relation to each other. The clear-cut decision of the Supreme Court as to the stock dividend was greatly needed."

At page 242:

> **"Whether the dividend is paid in cash, in stocks of other companies, in tons of coal, or anything else, so long as something is taken from the corporation's assets and given to the stockholders, the latter have received income from the corporation. The pro rata distribution of new shares of the corporation's own stock does not do this. * * *"**
>
> "The whole difference between the cash dividend and the other cases (those referred to by Mr. Bond) is that in the first the value of the shareholder's capital represented by the stock has been reduced and income has been received, whereas in the two other cases there has been no such reduction of capital and no income."

Mr. Bond's article at page 237 is scarcely occupied with a real analysis of the subject or the intrinsic merits of the question, but rather with citing examples of well known companies that have declared stock dividends where the shares subsequently rose greatly in value, and deducing from these particular facts the general conclusion that the total market values of the stockholder's holdings invariably rise on the declaration of a stock dividend, and that therefore the stock dividend constitutes income.

But it is a fallacious argument in support of the taxation of stock dividends that the total value of a stockholder's unsold holdings is often raised thereby in market value.

Shares also rise when a company's report shows that it has recently made large surplus earnings. Are these too income to the stockholders even though not distributed?

Mr. Bond admits that they are not, for he says: "It (*income*) is not received by a stockholder when merely added to corporate surplus." If this be correct, and we submit that it is, this shows that the market value of unsold shares has nothing to do with the case,—any more than a rise in the market value of one's real estate or of a herd of cattle.

And cases are numerous where shares of stock decline in value on the declaration of a stock dividend—so that the aggregate market value may be less than before. Is such a stock dividend nevertheless income also, although it represent a capital loss?

The truth is that the only bearing of market value is as and when the stockholder elects to sell a part of his stock. Then it is that market value determines whether his stock dividend represents a realized gain and therefore income or a realized loss. To make this fallacy clearer, let us consider the converse of a stock dividend.

Suppose a company has sustained losses impairing its capital 50 per cent. and that it reduces its capital stock accordingly—stockholders now being compelled to give up 50 per cent. of their old stock. Is this a loss that may be deducted from their other income? Manifestly not, because it is not a realized loss. They continue to retain their same proportionate interests in the company. The company may recoup that loss later. They are at liberty to sell their stock and realize their loss at once and deduct it. But so long as they hold their stock, such a loss is but an inchoate loss, a potential loss, an unrealized loss, an unseparated loss, and one that in fact ultimately may never turn out to be a real loss at all.

This antithesis between a plus stock dividend and a minus stock dividend makes it clear that corporate gains and corporate losses even though they be represented by an increase or decrease of capital stock and even though they be accompanied by changes in market value are not income gains or income losses of the shareholder.

In sound economics this is so, and in law this is so too, if we are to uphold the rule upon which all our vast system of corporate enterprise is founded —that rule, or legal fiction, which regards the corporation as an entity distinct from its shareholders.

We may freely admit that as a general rule the stock of a well-managed company that pays so-called extra dividends in stock besides its cash dividends will sell at higher prices than a stock which earns the same amount but accumulates the difference as a surplus. If there were no advantage in the declaration of stock dividends, it is reasonable to suppose that these would not be declared. But these advantages, whatever they are, are not income; and as was so well put by Mr. Justice HOLMES in *Towne* v. *Eisner,* "If the plaintiff gained any small advantage by the change, it certainly was not an advantage of $417,450, the sum upon which he was taxed." 245 U. S., at p. 426. (This having been the amount of the so-called stock dividend.)

One of these advantages is that stock dividends afford a convenient way of increasing the cash dividends in a gradual way as the annual earnings may be increased by the earning power of the undivided earnings that are capitalized. A company that each year pays 6 per cent. in cash dividends

and 5 per cent in stock, in reality increases its cash dividends 3/10 of 1 per cent. each year over the year before. It would be difficult to express this regular increase of rate on an unchanged capital stock without having resort to an ever increasing complication of fractions in the dividend rate.

It is surely also an advantage to stockholders to have the fact of the capitalization of earnings officially authenticated by a stock dividend. It does point to the prosperity of their company. Annual stock dividends indicate progressively increasing earning power.

There may be other incidental advantages. The sentiment of having more counters is potent with many persons.

But certainly no one of these advantages nor all of them together constitute income—nor do they make income of that which would not have been income without them.

In any case the advantage of declaring a stock dividend over leaving the same amount in undivided surplus is certainly not equal to the amount of the stock dividend. In fact, these advantages are all speculative or doubtful. In some cases a stock dividend causes a fall in the total market value of the stock holdings. The market's attitude towards stock dividends is always a matter of doubt, and can never be predicted. Sometimes stock dividends are declared where the stock is selling below par, and being badly received by the market, the shares decline still further, although earnings may have fully justified the capitalization of the year's surplus into a stock dividend.

In conservatively managed companies, on the other hand, which pay regular cash dividends and earn a surplus, it cannot be denied that in the long run the payment either regularly or occasionally of stock dividends through a capitalization of earned surplus into shares of stock that are expected themselves to go in the future and pay similar dividends will add considerably to the favor with which such a company is regarded and to the market value of its shares.

In some companies not so conservatively managed such a stock dividend policy would be regarded as unsound finance, and cause a fall in price.

This shows how utterly fallacious it is to regard an increase in market value as income in and of itself, unless it is realized by a sale of stock. It is neither income itself, nor in any slightest degree proof that an unrealized stock dividend is income. If the stocks of well managed companies that pay stock dividends should sell proportionately higher than those of others, in what way does this increase in market value constitute income? Only in one way and that is where the stockholder shall elect to sell. He will then get a higher price, and at that time, the United States Revenue will get a larger income tax because of the fact that the stock-dividend-paying stock will have sold higher proportionately than the stocks of those companies which merely accumulate the same amount in surplus. **The truth is that the United States Revenue will in the long run and over a period of years gain more revenue by a policy of exempting stock dividends than by taxing them.**

But these considerations as raised by Mr. Bond are all incidental and have nothing to do with the main and the intrinsic question which in its two-fold aspect is this:

(1) In sound economics can an undivided surplus of a corporation be regarded as income of the stockholder; and (2) can that same surplus, merely because capitalized by stock dividends, be deemed income although the stockholder receives nothing intrinsic that he did not have before?

Undoubtedly, these undivided surpluses and these so-called stock dividends do increase the stockholder's capital values. They are gains in a sense, but they are inchoate gains, unrealized gains; they take nothing from the corporation and they only become income when realized through sale. Unlike a dividend in cash or tons of coal, or stocks of other companies, he gets no new thing separated from his company of which he may dispose as he pleases without in any way affecting his interest in his company.

> "While a stock dividend would increase the number of his shares, it proportionately diminishes the value of each of his shares, leaving the aggregate value as it was before."
>
> *Staats* v. *Biograph Co.,* 236 Federal, 454, 457.

Market value then has nothing to do with the case. The whole basis of the claim that a stock dividend is income is that the corporation has made earnings and has capitalized them by this new stock. The basis for the claim is the earnings of the corporation and not the market value of the stock. Now, the earnings of the corporation and the real capital of the corporation are precisely the same whether a stock dividend is declared or whether it is not declared. This fallacy of talking about market values obscures this fundamental fact. The earnings certainly exert an influence on market value. The declaration of a stock dividend may or may not exert an influence on market value but market value has no bearing on the income of the teenth Amendment cannot now be construed as embracing stock dividends in its use of the word *"Income"* without enlarging it so as to embrace matters not specifically pointed out—without in fact altering the definition of the word laid down by the highest judicial authority and without violating rules of sound economic reasoning as well.

Its use in the sense in which it had been judicially construed should be presumed.

> *Latimer* v. *U. S.,* 223 U. S., 501, 504.

> "It is a well settled rule of construction that language used in a statute which has a settled and well-known meaning sanctioned by judicial decision is presumed to be used in that sense by the legislative body."

And see

> *Kepner* v. *U. S.,* 195 U. S., 100, 124;
> *The Abottsford,* 98 U. S., 440.

SECOND POINT.

Although the *Hubbard* case is plainly distinguishable from the case at bar, it is nevertheless inconsistent both with other and later rulings of this Court and with sound economics. It tends to block the way to a consistent, harmonious and logical system of income taxation and it should be expressly overruled.

The case was decided upwards of fifty years ago, when the income tax had been but little studied either in its economic or in its constitutional aspects.

It turned principally on questions of procedure. The grave constitutional questions involved which were subsequently to demand the most earnest consideration of this Court in the *Pollock* case were scarcely referred to. The *Pollock* case, the Sixteenth Constitutional Amendment and subsequent cases, have since then settled the underlying principles involved.

As the Attorney General substantially rests his case on *Collector* v. *Hubbard,* it will be worth while to analyze this case with some particularity, so as to show how inapplicable it is to present conceptions of taxation—whether economic or constitutional.

Collector v. *Hubbard* (12 Wall., 1) arose under the income tax provisions of Chapter 173, Laws of 1864.

As applied to corporations the scheme of the Act was to provide a 5 per cent. tax on all corporate earnings.

Section 122 provided for a 5 per cent. tax on the amount of interest, dividends or profits of railroad, canal and turnpike companies.

Section 120, a similar tax upon the earnings of banks, trust companies and insurance companies.

Section 117 put all other companies, including manufacturing companies, in a class by themselves and sought to accomplish the same result by the indirect method of taxing the stockholders instead of the corporation. That section provided that the gains and profits of a corporation should be included in estimating the annual gains, profits and income of any person entitled to the same, whether divided or otherwise. In other words, each stockholder in these last named companies, for reasons that do not appear, was required to report as part of his income his *pro rata* of the earnings, divided or undivided, of any corporation in which he held stock and to pay the 5 per cent. tax thereon, while the corporations themselves of this class were not taxed at all.

Whatever may be thought of making stockholders pay taxes on undivided corporate profits never received and perhaps never to be received by them —the object of the Act at least was to levy a uniform tax on the earnings of all corporations alike for each taxable year. Only the method of assessing or levying the tax varied with the two classes of corporations. This was recognized by the then Attorney General in his argument of that case, wherein he said: "In all cases the entire annual gains and profits of every corporation, divided or undivided, seem to be within the aim and province of the statute as objects of taxation."

This was no case of double taxation. Only one tax was to be levied on any one year's corporate earnings, but that was levied not on the corporation but on its shareholders.

Nor was it a case of taxing the earnings for a year subsequent to the year when earned and at a time when they had really become capital. Least of all was it a case of first exacting an income tax from the corporation in one year and then treating those same earnings though undivided as the income of the stockholder in the next succeeding year.

The corporate earnings of manufacturing companies as such were deemed by the Statute, whether rightly or wrongly, to be the taxable interest of the stockholders but only for the year when earned by the Company.

Whilst it is believed and will be argued later on that any such enactment as Section 117 would now

be unconstitutional—it is important to stress these facts because they establish essential differences between the *Hubbard* case and the contentions of the Government here.

Another important fact is that the constitutionality of making stockholders pay an income tax on income never received by them seems to have received little or no consideration in that case.

Only in the last few short paragraphs of the Court's opinion were the merits considered—that is, the right of Congress to levy such a tax on corporate earnings against the stockholder and after scant consideration it seems to have been thought that the stockholder's interest in the earnings was taxable as a property interest.

(a) The Hubbard case as upholding a tax on property or on the income from property except by apportionment under Article I, §2 of the Constitution has been overruled by the Pollock case.

This the Attorney General virtually admits, but he argues that the tax would have been invalid under the *Pollock* decision, not because the views announced in the *Hubbard* case were unsound, but because the Hubbard tax was a direct tax on property and not apportioned among the states, and he argues in effect that the Sixteenth Amendment, which does not authorize a direct tax at all, but merely relieves from the rule of apportionment taxes on the income of property from whatever source derived, would again today reauthorize a tax like that in the *Hubbard* case.

But the tax involved in the *Hubbard* case actually was a direct tax on property and would be so considered at this day. The Sixteenth Amendment has no application to such a tax. The very views expressed by the Court and which the Government quotes in its support show that it considered the stockholder's interest in the corporation and its earnings as a property interest. This is what the Court said:

> "* * * undivided profits are the property of the shareholder * * *"
>
> "undivided profits invested in real estate, etc. * * * are investments in which the shareholders are interested."
>
> "Annual gains and profits, whether divided or not, are property and therefore are taxable."

If the shareholder has any interest in these corporate gains and profits before they are divided as dividends, it is a property interest and a tax upon it against the shareholder would be a direct tax now as much as ever. The Sixteenth Amendment does not touch it. For these corporate profits are not income of the shareholder. They are as the Court says, property. As such they may be taxed but the tax being a direct tax would now, since the *Pollock* case, have to be apportioned.

These remarks of the Court that these undivided corporate gains are property of the shareholder may not be easily reconciled with what it elsewhere says to the effect that "it is as competent for Congress to tax annual gains and profits before they are divided among the holders of the stock as afterwards."

If it be meant by that, that Congress has power to tax total corporate gains and profits against the corporation, there can be no doubt of it. But if it be meant thereby that Congress may levy against the stockholder a tax on the undivided gains and profits of the corporation, then with due respect, the statement is not sound law. The stockholder's

interest in these undivided gains is property, as the Court so well said; it is included in his ownership of stock in the corporation and a tax on them would be in effect a tax on his stock, a direct tax and not an income tax.

This confusion of language, if we may be permitted to call it such, is all due to the views generally entertained at the time of the *Hubbard* case which arose in consequence of the *Hylton* case (*Hylton* v. *U. S.*, 3 Dallas, 171) that a tax on carriages or other personal property was an excise tax and not a property tax or a direct tax. Taxes on personal property and on incomes, both having been at that time regarded as excise taxes, there was no occasion for the Court to distinguish between them. Therefore, whether the tax of 1864 were deemed a personal property tax or a tax on profits or on income, it seemed equally to be an excise tax and within the power of Congress. In neither case did an apportionment then seem necessary.

But the *Pollock* case holds that a tax whether on property or on the income from property is a direct tax.

> The Sixteenth Amendment merely authorizes a tax on the income from property without regard to apportionment and leaves direct taxes on property, real or personal, where the *Pollock* case left them.
>
> *Brushaber* v. *Union Pacific R. R. Co.*, 240 U. S., 1.

So that the *Pollock* case, notwithstanding the Sixteenth Amendment, remains today as a barrier against the taxation of a stockholder's interest in the corporation or its undivided profits—for these are as to him property and such a tax would be a direct tax.

How can the stockholder's interest in the undivided earnings of his corporation be anything else than property? They are a gain if one please. They constitute an addition to the value of his capital. But for all the control he has over them they are no more of a gain than an appreciation in the value of his real estate. In neither case can he enjoy the gain unless he sell.

In *Southern Pacific Co.* v. *Lowe*, 247 U. S., 330, 335, this Court said, speaking of the accumulations of earnings in that case:

> "* * * we are bound to consider the accumulations that accrue to a corporation prior to January 1, 1913, as being capital and not income. *And we perceive no adequate ground for a distinction in this regard between an accumulation of surplus earnings and the increment* due to an appreciation in the value of the assets of the taxpayer."

And there surely is no distinction as regards the taxpayer at any given date, whether his capital values have increased through mere appreciation in market values as of real estate, or whether his stock has been made more valuable intrinsically by earnings that he is not allowed to receive and enjoy. Neither sort of gain constitutes income to him. This has been abundantly shown in the preceding discussion of economic doctrine. But the man in the street knows this for himself without argument. He knows that where a corporation fails to pay him dividends out of its earnings he has no income. An appreciation of capital he may have. This may even be ultimately more valuable to him than the cash dividend. But income it is not. It cannot pay butcher's or grocer's bills or taxes. And income which cannot be made to do these things is

not intrinsically income, and it seems preposterous to suppose that the Sixteenth Amendment could refer to income in any such sense. These unrealized gains are property, are capital, and nothing else.

It may be proper to tax these accretions—appreciation in value of real estate or securities, undivided surplus of corporation. But if so, they should be taxed for what they are—property interests—and the taxes would have to be apportioned. Before they can properly be taxable as income either in the economic or in the popular sense or as we believe in the constitutional sense, they must be made income by a sale of the property so that the gains may have been realized.

The title both legal and equitable in corporate property and in corporate earnings is in the corporation. This the Court admitted in the *Hubbard* case. If the title is in the corporation, then it certainly is not in the stockholder, and it is difficult to see how he can have any taxable interest either in the corporate property or its earnings. The Court there avoided this difficulty by remarking that the stockholder is an owner of shares and that one of the incidents of shares is "the right to receive all future dividends." But the right to receive future dividends, which may never be declared, is certainly not the same thing as the receipt of real dividends actually declared—and such a right certainly does not constitute income. It is an inherent right of property in the shares and it is a property attribute but it is a contingent right at best.

The notion that such an abstraction as a contingent right to receive future dividends if and when other wills than ours choose to declare them constitutes a present taxable income for us, shows how thoroughly the Court was governed in the *Hubbard* case by the authority of the *Hylton* case, that a tax on carriages and personal property generally was an excise tax and similar in that regard to the income tax—a view definitely overruled by the *Pollock* case, and which to that extent must be deemed to have been confirmed by the Sixteenth Amendment.

But *Gibbons* v. *Mahon*, 136 U. S., 549, is decisive of this question, that a stockholder's interest in corporate earnings is property, is capital.

> **"Reserved and accumulated earnings, so long as they are held and invested by the corporation, being part of its corporate property, it follows that the interest therein represented by each share is capital and not income of that share, etc., etc." (p. 558).**

So that in whatever way one looks at the *Hubbard* case, and whatever way may have been the judicial view in 1864, the subject matter there taxed was not income but property and being property the case and the grounds upon which it rested have been overruled by *Pollock* v. *Farmers' Loan & Trust Co.*, 157 U. S., 429.

(b) THE HUBBARD CASE, INSOFAR AS IT ASSUMES AN EQUIVALENCY BETWEEN THE PROPERTY AND THE INCOME OF THE CORPORATION AND THE SHARES OF STOCK IN THE NAMES OF THE STOCKHOLDERS FOR TAXATION PURPOSES, HAS BEEN IMPLICITLY OVERRULED BY A LONG SERIES OF AUTHORITIES IN THIS COURT.

The novel principles imagined in Chapter 173, Laws of 1864, for imposing the income tax of a corporation upon its stockholders and the views expressed thereon in Collector v. Hubbard as interpreted by the Attorney General here, would completely obliterate the well-established legal entity of the corporation as distinct from its stockholders and make of it for taxation purposes a partnership.

They do more, because in a partnership, partners required to pay a debt of the partnership would have recourse to the corporate fund to recoup themselves. But stockholders paying a tax under the Act of 1864 on the undivided earnings of their corporations would have no such right to compel repayment by the corporation.

The corporate entity cannot be disregarded as is urged by the Government in this case, or as the language used by Mr. Justice Clifford in the Hubbard case would seem to warrant.

> "The corporation is a person distinct from the stockholder. It is true, it is what is denominated an artificial person, and may be said to be ideal and intangible. But that it is a person in law is the first principle learned by the student in opening any book on corporations. Its stockholders are distinct and different persons. They are usually not liable for its debts, and have no right to the *enjoyment or possession* of its property during the period of its duration or until it be dissolved by some procedure known to the law." (Italics ours.)
>
> *Cook* v. *Burlington*, 59 Iowa, 251.

In an early decision of this Court, in which the opinion was written by no less a personage than Chief Justice MARSHALL, the Court permitted itself to ignore the separate legal entity of a corporation, and to treat it as a mere aggregation of its members. But subsequent consideration satisfied the Court of its error, and even the illustrious Chief Justice acknowledged the mistake made in departing from the settled principles of corporation law. The history is interesting and instructive. The case was that of *Bank of United States* v. *Deveaux*, 5 Cranch, 84. The question there was, whether or not a corporation might sue in the Federal Courts under the Judiciary Act, which extended the judicial power of the United States to controversies between citizens of different States. Was a corporation a citizen of the State of its incorporation within the meaning of this act, irrespective of the citizenship of its members? The Court decided it was not. Chief Justice MARSHALL, writing the opinion of the Court (following a previous ruling in *Strawbridge* v. *Curtis*, 3 Cranch, 267), held that

> "That invisible, intangible, and artificial being, that mere legal entity, a corporation aggregate, is certainly not a citizen; and, consequently, may not sue or be sued in the courts of the United States, unless the rights of the members, in this respect, can be exercised in their corporate name. If the corporation be considered as a mere faculty, not as a company of individuals, who in transacting their joint concerns, may use a legal name, they must be excluded from the courts of the union."

Therefore, it was held that the Court might look to the character of the individuals who composed the corporation, and if all of them were citizens of a state other than that of the opposite party to the suit, maintain the jurisdiction of the Federal Court, but not otherwise. This decision is about the only recorded example of a narrow construction by Chief Justice MARSHALL of the powers granted by the Constitution to the federal government.

In *Louisville R. R. Co.* v. *Letson* (2 How., 497), the question again was presented to the Court. Referring to the previous decisions of *Bank of United States* v. *Deveaux* (5 Cr., 84) and *Strawbridge* v. *Curtis* (3 Cr., 267), Mr. Justice WAYNE delivering the unanimous opinion of the Court said:

> "We do not deny that the language of those decisions do not justify in some degree the inferences which have been made from them, or that the effect of them has been to limit the jurisdiction of the circuit courts in practice to the cases contended for by the counsel for the plaintiff-in-error. The case of *Strawbridge* and *Curtis* was decided without argument. That of the *Bank* and *Deveaux* after argument of great ability. But never since that case has the question been presented to this Court, with the really distinguished ability of the arguments of the counsel in this, in no way surpassed by those in the former. And now we are called upon in the most imposing way to give our best judgments to the subject, yielding to decided cases everything that can be claimed for them on the score of authority, except the surrender of conscience. After mature deliberation, we feel free to say, that the cases of *Strawbridge* and *Curtis*, and that of the *Bank* and *Deveaux*, were carried too far, and that consequences and inferences have been argumentatively drawn from the reasoning employed in the latter which ought not to be followed. Indeed, it is difficult not to feel that the case of *The Bank of the United States* and *The Planters' Bank of Georgia*, 9 W., 904, is founded upon principles irreconcilable with some of those on which the cases already adverted to were founded. The case of *The Commercial Bank of Vicksburg and Slocomb*, 14 P., 60, was most reluctantly decided upon the mere authority of those cases. We do not think either of them maintainable upon the true principles of interpretation of the constitution and laws of the United States. A corporation, created by a State, to perform its functions under the authority of that State, and only suable there, though it may have members out of the State, seems to us to be a person, though an artificial one, inhabiting and belonging to that State, and therefore entitled, for the purpose of suing and being sued, to be deemed a citizen of that State. We remark,

too, that the cases of *Strawbridge* and *Curtis*, and the *Bank* and *Deveaux,* have never been satisfactory to the bar, and that they were not, especially the last, entirely satisfactory to the court that made them. They have been followed always most reluctantly and with dissatisfaction. By no one was the correctness of them more questioned than by the late Chief Justice who gave them. It is within the knowledge of several of us, that he repeatedly expressed regret that those decisions had been made, adding, whenever the subject was mentioned, that if the point of jurisdiction was an original one, the conclusion would be different. We think we may safely assert, that a majority of the members of this court have at all times partaken of the same regret, and that, whenever a case has occurred on the circuit, involving the application of the case of the *Bank* and *Deveaux,* it was yielded to, because the decision had been made, and not because it was thought to be right. We have already said that the case of *The Bank of Vicksburgh* and *Slocomb,* 14 Pet., 60, was most reluctantly given, upon mere authority. We are now called upon, upon the authority of those cases alone, to go further in this case than has yet been done. It has led to a review of the principles of all the cases. We cannot follow further, and upon our maturest deliberation we do not think that the cases relied upon for a doctrine contrary to that which this court will here announce, are sustained by a sound and comprehensive course of professional reasoning. Fortunately, a departure from them involves no change in a rule of property."

This decision was followed in *Marshall* v. *B. & O. R. R. Co.,* 16 How., 314, and *Covington D. Co.* v. *Shepherd,* 20 How., 227, and the rule there adopted that a corporation is a legal entity—a person—created by the state of its incorporation, entirely

distinct from the individuals who compose its membership, was definitely and finally declared to be the law by Chief Justice TANEY in *O. & M. R. R. Co.* v. *Wheeler,* 1 Black, 286.

In *Humphreys* v. *McKissick,* 140 U. S., 304, 312, Mr. Justice FIELD said:

> "The property of a corporation is not subject to the control of individual members, whether acting separately or jointly. They can neither encumber nor transfer that property, nor authorize others to do so. The corporation—the artificial being created—holds the property, and alone can mortgage or transfer it, and the corporation acts only through its officers, subject to the conditions prescribed by law."

In *Donnell* v. *Herring-Hall-Marvin Safe Co.,* 208 U. S., 267, 273, Mr. Justice HOLMES said:

> "Philosophy may have gained by the attempts in recent years to look through the fiction to the fact and to generalize corporations, partnerships and other groups into a single conception. But to generalize is to omit, and in this instance to omit one characteristic of the complete corporation, as called into being under modern statutes, that is most important in business and law. A leading purpose of such statutes and of those who act under them is to interpose a non-conductor, through which in matters of contract it is impossible to see the men behind."

In *Southern Pacific Co.* v. *Lowe,* 247 U. S., 330 (1918), the corporate fiction was disregarded but the case is valuable for PITNEY, J.'s, caution (page 338) that:

> "The case turns upon its very peculiar facts and is distinguishable from others in which the question of the identity of a controlling stockholder with his corporation has been raised."

In this case, the Southern Pacific Co. owned all the stock in the Central Pacific Railroad; the latter railroad had earned certain surplus profits and these the Southern Pacific Co., as sole stockholder, caused to be converted into a cash dividend, and paid to itself. The surplus profits accrued before March, 1913; the dividend was declared and paid after March, 1913. The transaction was held not taxable.

In *Pullman Car Co.* v. *Missouri Pacific Railway Co.,* 115 U. S., 587 (1885), it was held that an agreement by the respondent railroad to haul Pullman cars over roads controlled by lease or ownership did not import an obligation to haul cars over roads owned by companies in which the respondent held practically all the stock. In *Peterson* v. *Chicago, Rock Island & Pacific Railroad,* 205 U. S., 364, 391 (1907), it was held that a railroad was not shown to be doing business in a certain State if it was merely shown to have been the owner of practically the entire capital stock of another railroad which operated in that particular State. See also *Stone* v. *Cleveland C. C. & St. L. Railroad,* 202 N. Y., 452 (1911).

The same principle was involved in *Continental Tyre Co.* v. *Daimler* (1915), 1 K. B., 893 (reversed by the House of Lords on a question of termination of agency by war (1916) 2 A. C. 307). The issue there was the permissibility of payments in wartime to a corporation chartered under the English Companies Act, the majority of whose stockholders were subjects of Germany. The court rejected the plea of the debtor that the substance and not the technicalities of the matter should be regarded, saying:

> "It cannot be technically an English company and substantially a German company except by the use of inaccurate and misleading language. Once it is validly constituted as an English company it is an artificial creation of the Legislature and it retains its existence for all intents and purposes. It is a living thing with a separate existence which cannot be swept aside as a technicality. It is not a mere name or mask or cloak or device to conceal the identity of persons and it is not suggested that the company was formed for any dishonest or fraudulent purpose. It is a legal body clothed with the form prescribed by the Legislature."

A like decision was rendered by the New York Supreme Court in a similar case. See *Schulz* v. *Raimes,* 100 Misc. (N. Y.), 697 (1917).

This principle especially should be adhered to on a question of taxation.

Taxes are, fundamentally, the price paid by property owners for the assurance to them by the State that they will be protected in the enjoyment of their property. *Union Refrigerator Transit Co.* v. *Kentucky,* 199 U. S., 194, 204 (1905). They should therefore not be assessed upon property which they have no right to enjoy.

The exceptional cases where the corporate entity has been disregarded but serve to prove the rule.

These cases generally are those where not to disregard the fiction, would permit the corporation or its stockholders to evade contractual obligations or commit a fraud or a crime with impunity, or, as in *Southern Pacific Co.* v. *Lowe, supra,* would permit the imposition of unjust burdens upon the corporation.

In *United States* v. *American Refrigerator Transit Co.,* 142 Fed., 247 (1905), the United States sought to restrain the paying of rebates to a shipper in violation of the Elkins Act. The defense was that the defendant was not a shipper but a freight soliciting agent. All the stock in the defendant was owned by the Pabst Brewing Co., and members of the Pabst family, and the Brewing Company made all its shipments through the defendant's agency. It was held that the corporate fiction would be disregarded and an injunction issue.

(*United States* v. *Lehigh Valley Railroad*, 200 U. S., 257 (1911); *United States* v. *Delaware, L. W. Railroad*, 238 U. S., 516, 529 (1915); *Brundred* v. *Rice*, 49 Oh. St., 540, involve a similar principle.)

In *Linn Timber Co.* v. *United States*, 236 U. S., 574 (1915), it was held that one who had notice of a defect in his title could not create a corporation and, becoming its chief stockholder, sell his land to the corporation as to a *bona fide* purchaser, with a view toward cutting off the claims which had made his title defective.

In *People* v. *North River Sugar Refining Co.*, 121 N. Y., 582 (1890), several corporations engaged in the business of refining sugar, including the defendant corporation, made through their directors an agreement whereby all the stock of all the corporations was transferred to certain trustees. The defendant then ceased to refine sugar. Upon the bringing of a writ of *quo warranto* to wind up the corporation, the contention was made that the corporation had committed no offense, and that only the stockholders and directors were guilty. The court refused to recognize the corporate fiction and, holding that there had been corporate action, refused to allow the writ to be defeated by "the assumed innocence of a convenient fiction" (p. 622).

In *First National Bank* v. *Trebein*, 59 Oh. St., 316, 52 N. E., 834 (1898), the debtor Trebein formed a corporation with his wife, daughter, son-in-law

and brother-in-law, and conveyed all his property to it. The court ordered the conveyance set aside, but denied that the property could have been sold on execution by Trebein's own creditors prior to reconveyance. The language of the court, however, on the circumstances under which the fiction may be disregarded goes beyond the rule sustained by authority.

> "But modern cases, sustained by the best text writers, confine the fiction to the purposes for which it was adopted—convenience in the transaction of business and in suing and being sued in its corporate name, and the continuance of its rights and liabilities, unaffected by changes in its corporate members; and have repudiated it in all cases where it has been insisted on as a protection to fraud or any other illegal transaction."

A better statement of the law is that of HAIGHT, D. J., in *Peckett* v. *Wood*, 234 Fed., 833, 838 (1916), quoted *infra*, p. 49.

There seems to be perfect unanimity among the authorities in cases where a person, having contracted not to engage in a certain business, proceeds to form a corporation with himself as chief stockholder and to carry on the prohibited business under the corporate name. It is proper in such cases to enforce the contract by injunction directed against the corporation: *Moore & Handley Co.* v. *Towers Hardware Co.*, 87 Ala., 206 (1880); *Beal* v. *Chase*, 31 Mich., 490; *Hall's Safe Co.* v. *Herring-Hall-Marvin Safe Co.*, 146 Fed., 37 (1906). But a strong case for preserving intact the corporate fiction though it be employed to evade a detrimental contract is *People's Pleasure Co.* v. *Rohleder*, 109 Va., 439, where a covenant not to convey to persons of African descent was held not violated by conveyance to a corporation composed exclusively of colored persons.

The case of *In re Rieger,* 157 Fed., 609, along with *In re Muncie Pulp Co.,* 139 Fed., 546 and *Hunter* v. *Baker Motor Vehicles Co.,* 225 Fed., 1006, aff'd. 238 Fed., 894, are instances of the "mere adjunct" cases where the corporate fiction is regarded with impatience. In those cases it was disregarded, not because to do so is the only way to prevent fraud, but simply to avoid circuity of action and expenditures of time—"in a case where a corporation is so organized and controlled and its affairs are so conducted as to make it merely an instrumentality or adjunct of another corporation." Per Noyes, C. J., *In re Watertown Paper Co.,* 169 Fed., 252, 256 (1909). These "mere adjunct" cases are unsound in that they turn on what is at best a question of degree; and they furnish no unequivocal criterion of responsibility. They have not been approved by this Court.

Judge Noyes, in his opinion, reaffirmed the general rule in this language:

> "Now, it is an elementary and fundamental principle of corporation law that a corporation is an entity separate and distinct from its stockholders and from other corporations with which it may be connected. The fact that the stockholders of two separately chartered corporations are identical, that one owns shares in another, and that they have mutual dealings, will not, as a general rule, merge them into one corporation, or prevent the enforcement against the insolvent estate of the one of an otherwise valid claim of the other * * *. Unless, therefore, it can be shown that some exception to the general rule of separate existence and liability applies in this case, it must follow that the claim of the Pulp Company should have been allowed."

Haight, D. J., in *Peckett* v. *Wood,* 234 Fed., 883, 838 (1916), in an opinion upon which the C. C. A. (3rd Circ.) affirmed the judgment, insists very strongly upon the recognition of the corporate entity except for the prevention of fraud, or some like consideration.

> "Although, as was said in the *Watertown Paper Company* case, *supra,* in some cases, when necessary for the furtherance of justice in one way or another, corporate entity may be disregarded where the corporation is so organized and controlled and its affairs are so conducted as to make it merely an instrumentality or adjunct of another concern, yet this is an exception to the general rule and fundamental principle that a corporation is an entity, separate and distinct from its stockholders, and from other concerns with which it may be connected * * *. Except in cases where it is necessary to circumvent fraud, or in cases which proceed on the theory of estoppel, or those where it is sought to take possession of property ostensibly belonging to a corporation entirely controlled and owned by the principal debtor, for the purpose of protecting the creditors of the latter, as well as the former, it will be found that the instances are rare indeed where the general and settled rule of separate corporate identity is disregarded."

The provisions of Section 3 of the Income Tax Law of 1916, fall within the exceptions to the general rule. The section provides that:

> "For the purpose of the additional tax, the taxable income of any individual shall include the share to which he would be entitled of the gains and profits, if divided or distributed,

whether divided or distributed or not, of all corporations, joint stock companies or associations, or insurance companies, however created or organized, formed or fraudulently availed of for the purpose of preventing the imposition of such tax through the medium of permitting such gains and profits to accumulate instead of being divided or distributed; and the fact that any such company * * * is a mere holding company, or that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be *prima facie* evidence of a fraudulent purpose to escape such tax * * *."

That a fraud upon the law may not be accomplished by resorting to an otherwise legal form of organization is well settled. The anti-trust cases are illustrations of this principle—

Northern Securities Co. v. *U. S.*, 193 U. S., 197;
Standard Oil Co. v. *U. S.*, 221 U. S., 1;
U. S. v. *American Tobacco Co.*, 221 U. S., 106.

The separateness of the corporation and its shareholders has never been more emphatically expressed than in recent opinions of this Court. In *Gibbons* v. *Mahon*, 136 U. S., 549, it was said:

"**The distinction between the title of a corporation and the interest of its members or stockholders in the property of the corporation is familiar and well settled.** The ownership of that property is in the corporation, and not in the holders of shares of its stock. The interest of each stockholder consists in the right to a proportionate part of the profits whenever dividends are declared by the corporation during its existence under its charter, and to a like proportion of the property remaining, upon the termination or dissolution of the corporation, after payment of its debts.

"**Money earned by a corporation remains the property of the corporation and does not become the property of the stockholders unless and until it is distributed among them by the corporation.** The corporation may treat it and deal with it either as profits of its business, or as an addition to its capital."

In *Lynch* v. *Hornby*, 247 U. S., 339, this Court said:

"The stockholder is in the ordinary case a different entity from the corporation * * *"

In *Peabody* v. *Eisner*, 247 U. S., 347, it was said:

"In this case the plaintiff-in-error stands in the position of the ordinary stockholder, whose interests in the accumulated earnings and surplus of the company are not the same before as after the declaration of a dividend; his right being merely to have the assets devoted to the proper business of the corporation and to receive from the current earnings or accumulated surplus such dividends as the directors, in their discretion, may declare; and without right or power on his part to control that discretion."

See also a long line of cases on the taxation of bank stock, etc., cited in the main brief of defendant-in-error, wherein it is held that the shares of stockholders may be taxed although the capital of the bank be exempt, the reason being that the capital with its surplus owned by the corporation and the shares owned by the stockholders are different and distinct. Both the nature of the things owned and the ownerships are different.

These principles of law are elementary.

In the case of *Owensboro National Bank* v. *Owensboro*, 173 U. S., 664, Mr. Justice WHITE, referring to these authorities, said:

> "If the postulate upon which they necessarily rest be overthrown by saying that there is an equivalency between the taxation of the property of the Bank and the shares of stock in the names of the stockholders, it would follow that the principles upheld by the cases would disappear with the destruction of the reasons upon which they were placed."

It is because there is no such equivalency that shares may still be taxed where corporate property is exempt by law. Since this equivalency of ownership and this equivalency for taxation purposes is denied as between the shares on the one hand and the corporate property on the other, it follows that the corporate property and the earnings of the corporation cannot be imputed to the holder of the shares for taxation purposes, for this would be to admit the equivalency of the two titles for taxation purposes, which this long series of cases has denied; and *Gibbons* v. *Mahon*, *supra*, overrules the *Hubbard* case, where it says that "money earned by a corporation that is, its income, remains the property of the corporation and does not become the property of the stockholders unless and until it is distributed among them by the corporation."

These cases and the citations that follow are utterly inconsistent with the doctrine of regarding corporate earnings as the income of shareholders. They implicitly overrule the *Hubbard* case and that case should be explicitly overruled.

The net result of the decisions is accurately and

tersely summed up in Vol. 10, Cyclopedia of Law and Procedure, as follows:

> "Capital and shares are species of property distinct from one another. The capital or capital stock belongs to the corporation considered as a legal person or entity; the shares are the property of the individual shareholders."
>
> "Shares of stock are personal property."
>
> "Shareholders are not tenants in common or co-owners of the property of the corporation in any sense; but the title thereto rests in the legal entity called the corporation."
>
> "It follows that a shareholder's interest in the property of the corporation cannot be seized and sold under judicial process as can the interest of a partner or tenant in common, although his shares, considered as distinct property, can be."
>
> "The relation of trustee and 'C. Q. T.' of debtor and creditor, or of partners, does not exist between the shareholders of an incorporated company and the corporation itself." They may deal with one another as strangers.
>
> "As already stated, a joint-stock corporation is in general a trustee for its shareholders only so far as may be necessary for the protection of their several rights of property in their several shares."
>
> "Non-liability at Common Law. 1. General Rule. As already seen a corporation and its shareholders are distinct persons in law. The general rule of law, therefore, is that the shareholders of the joint-stock corporation are not liable for its debts or for its torts, except to make good the amount due to the corporation for their shares, unless made so by constitutional or statutory enactment, or unless they have assumed a larger liability by contract or by conduct."

See pp. 364, 366, 373, 374, 376, 649.)

Not being liable for the corporation's debts, why should they be liable for its taxes?

Elementary as these principles are, it is worth while to recall them in order to show how they contradict the theory that for taxation purposes the undivided earnings of a corporation are the earnings of its stockholders.

There is no element of wrong-doing here—no attempt to evade the payment of a just tax. The contention is that any corporation as a separate legal entity having earned profits should pay the income tax on them. There is no difficulty in compelling it to do so. It is admitted that to the extent that these profits may be actually distributed in dividends the stockholders should pay another tax as on income received by them. It is contended that to make stockholders pay an income tax on the undistributed earnings of a corporation not received by them (as was done in Section 117, Chapter 73, Laws 1864) would not only be a monstrous injustice in itself, but would withdraw that protection against personal liability which the stockholder depends upon in embarking his money and which is one of the principal reasons for the legal fiction of separate corporate entity and separate ownership of property.

So far from this being a case for an exception to the rule of corporate entity, it is a case involving one of the fundamental reasons for its assertion.

Now this rule and the principle of stockholders' exemption from liability are laid down as rules of law by the various states under whose laws most corporations are incorporated. Can it be possible that the Congress has been clothed with the constitutional power to set aside these rules of property for the purpose of levying an income tax not against the corporation which has earned and still holds

the income but against stockholders who do not hold it and may never receive it?

If so, then it would not be difficult to imagine an income tax of 65 per cent. or so levied against some large stockholder upon so-called income of his still held by the corporation—the payment of which could work his ruin.

And a new tax act in such case might levy a similar confiscatory tax on all stockholders alike—big and little. This would be worse than confiscation—for confiscation takes only what one has. This sort of an 1864 tax on undivided corporate earnings would compel stockholders to get money elsewhere by loan or otherwise to pay on income they had never received and perhaps never would receive.

These are but a few of the inequalities and injustices and difficulties that will be met if that principle of Chapter 173, Laws of 1864, is sustained, which permits the taxing power to tax income not where it is but where it is not—to tax the stockholder on earnings of the corporation not received by him.

If Congress may tax these undivided earnings against the stockholder when he has not received them, may it tax them again if and when he receives them as a cash dividend?

And if he pay a tax on them whilst controlled by the company, must he pay again on the profit that his stock may realize when he comes to sell it—a profit made possible by these very accumulated earnings?

Nothing can save us from these inconsistencies but an adherence to the well-established rule and beneficent fiction of the law—that the corporation is a distinct person and entity.

(c) The suggestion that this Court has in other cases cited Collector v. Hubbard or its principle with approval except upon altogether minor points is erroneous.

The case of *Bailey* v. *Railroad Company,* 22 Wallace, 604, relied upon by the Government as maintaining the same principles and justifying the taxation of stock dividends has no application here. The case involved a revenue act which taxed not the stockholders but the Railroad Corporation upon all dividends in scrip or money, declared by the Railroad Company as part of the earnings, profit, income or gains of the Company, etc. The earnings of the Railroad Company were manifestly a proper subject for income tax or excise tax. The payment of these earnings in cash dividends among the stockholders or the issuance of scrip was regarded as a fit subject of taxation against the corporation and probably would be so today; but no such question is involved here. No stock dividend was directly involved. It was remarked by this Court subsequently in *Gibbons* v. *Mahon,* that the opinion in the *Bailey* case of Mr. Justice CLIFFORD, the same judge who wrote the opinion in the *Hubbard* case, contained "some general expressions which taken by themselves might seem to ignore the settled distinction between the property of a corporation and the interests of the shareholders." But these remarks of the learned Justice were *obiter* and did not affect the decision of the case, and the learned Justice in making them was undoubtedly governed by the idea prevailing at that time that as a result of the *Hylton* case personal property and its use as well as earnings were a fit subject for an excise tax. If, however, there be anything in the *Bailey* case which seems to lend support to the *Hubbard* case, whether directly or *obiter,* it must be deemed to have been overruled with the latter case.

In *Lynch* v. *Turrish,* 247 U. S., 221, the question was whether when a corporation was liquidated *in toto* in 1914 the profits that had accumulated on the shares prior to March 1, 1913, could be deemed income or capital. The Court decided that the income had become capital. In reference to *Collector* v. *Hubbard,* it did say that it had been there held that the stockholder could have an interest taxable under the act considered (that of 1864) but it hastened to point out that his interest was *"not identical with the corporation"* and it gave no consideration whatsoever to the question whether such stockholder's interest could be considered income or capital and whether if taxed at this time it could be taxed as income without apportionment or as property with apportionment.

But the most significant fact in answer to the Government's reliance on *Collector* v. *Hubbard* is that in *Southern Pacific Co.* v. *Lowe,* 247 U. S., 330, this Court having an opportunity to rest its decision on *Collector* v. *Hubbard* declined to do so.

In that case the Southern Pacific Company owned all the capital stock of the Central Pacific R. R. Co., and was in possession of all its property and earnings under lease and it treated the whole as its own. Accumulations of earnings had been taken over by it and constituted technically a debt from the lessee. But as the lessee owned all the lessor's stock a formal dividend at any time would have *pro tanto* wiped out the debt. This dividend was not declared formally until 1914, and the Treasury Department claimed that this was taxable as for that year, although the earnings had been received before March 1, 1913, and although this declaration of dividend was nothing more than a formal ratification by the directors of what was already a *"fait accompli."*

This Court held this dividend not taxable for certain reasons set forth in its opinion. But it expressly disclaimed the idea that it was influenced by *Collector* v. *Hubbard,* and the Court said:

> "We do not rest this (decision) upon the view that for the purposes of the Act of 1913 stockholders in the ordinary case have the same interest in the accumulated earnings of the company before as after the declaration of dividends. The Act is quite different in this respect from the Income Tax of June 30, 1864, under which this Court held in *Collector* v. *Hubbard* * * * that an individual was taxable upon his proportion of the earnings of the corporation, although not declared in dividends."

The Court went on to distinguish that case from the one then at bar.

Only a term or two before *Lynch* v. *Turrish,* this Court had occasion to decide *Towne* v. *Eisner* and it there based itself on *Gibbons* v. *Mahon,* 136 U. S., 549, in which case the distinction between corporate ownership and the interest of shareholders was clearly set forth in this language:

> "The ownership of the property is in the corporation and not in the holders of shares of its stock * * *. Money earned by a corporation remains the property of the corporation and does not become the property of the stockholder unless and until it is distributed among them by the corporation."

In confirmation of this same idea, this Court in *Towne* v. *Eisner* in effect said that if the sum in

question had been carried from surplus to capital account without any stock issue "we do not suppose that anyone would contend that the plaintiff received an accession to his income"; but this is exactly what the Government pretends took place in *Collector* v. *Hubbard.*

As we read these words of the Court, they are in direct contradiction of the Government's view of the *Hubbard* case, and of the *dictum* of the Court in the case itself.

As we read them, those words quoted from Towne v. Eisner say plainly that undivided earnings passed by a corporation from surplus to capital account would not constitute income of a stockholder, and so we come back to the query—are they made income by the mere fact that their capitalization is represented by new stock certificates issued in the same proportions as the old?

THIRD POINT.

The stock dividend is in reality not a dividend at all. It is a mere certified expression of an undivided surplus and its capitalization.

Whatever gain there may be in either case to the stockholder is a capital gain.

Capital gains (being mere increases in valuation) are not income until realized.

The gains that come with stock dividends when stock is sold are realized capital gains—the same in nature and similarly taxable as those gains that are made with any stock that is sold at an advance. Inasmuch as undivided corporate earnings cannot be taxed as income against the stockholder the stock certificates issued with respect of such earnings may not be so taxed, until the gain be realized by the stockholder through sale of his stock.

The proponents for the treatment of stock dividends as income do not altogether agree upon the grounds of the faith that is in them.

Thus some courts consider that a stock dividend is like a cash dividend with an option to subscribe to an equal amount of new stock—and so by calling it a cash dividend, though no cash passes, they impute to it the quality of cash income (see *Tax Comm'r* v. *Putnam*, 227 Mass., 522, also the *Swan* case, *infra*).

The Attorney General on the other hand, basing his case on what we consider the erroneous *dictum*

of the *Hubbard* case, is obliged to concede that a stock dividend is like an undivided corporate surplus.

But he argues that because undivided corporate profits were thought fifty years ago to be taxable as against the stockholders, so may those profits now be similarly taxed when represented by new stock certificates. Or, as he puts it, the right to tax undivided profits "could not be destroyed by the issuance of stock certificates to represent these undivided profits."

Thus far we agree with him in his analysis of what the stock dividend really is. But his conclusions as to its taxability fail to follow because the *Hubbard* case (as shown *supra*) has been overruled in fact by the *Pollock* case and in principle by other rulings of this court and is contrary to sound law and sound economics generally.

And, because further, whilst it is perfectly true that ~~at~~ any instant of time a stock dividend is similar to the undivided profits which have occasioned it—it is also true that the attempt in Chapter 173, Laws 1864, was to tax corporate earnings for the actual year when earned, whilst the stock dividends here being considered present a case of taxing the undivided corporate earnings which they represent for the year after they had been earned and when they had really become capital—and when the corporation itself had already paid its income tax on these very earnings.

With the failure of the *Hubbard* case to support him, the Attorney General's argument falls to the ground.

But it remains true as he admits that a stock dividend is like an undivided corporate surplus—and since the latter is not taxable as income of the stockholder, it follows that the former cannot be.

The other and opposing view, that a stock dividend is like a cash dividend with a right to subscribe to new stock is easily disposed of on analysis.

This is the view maintained in *Swan Brewery Co., Ltd.*, v. *The King*, Law Reports (1914) A. C., 231, and in *Tax Commissioner* v. *Putnam*, 227 Mass., 522, cases both decided before the recent tax decisions of this Court and in conflict with them, and cases both occurring in jurisdictions where there was no constitutional limitation of the taxing power.

Corporations sometimes do declare a cash dividend and give also a right to subscribe to new stock.

When they do this, stockholders have three courses open to them after receipt of their cash.

1. They may keep the cash and refuse to subscribe, and this they will do in case the conditions should become unfavorable or the stock decline to par or below as frequently happens in these cases, or

2. They may keep their cash dividend and sell their rights to subscribe in case these command a premium. In which case they make a realized gain in addition to their cash dividend which is taxable as income, or

3. They may subscribe and hold the new stock and thus keep up their former percentage of stock control and of right to future dividends.

In the case of a stock dividend pure and simple, this last is the only course open to the stockholder. He is given no choice whatsoever—no power of disposal whatsoever over any new thing.

The theory we are considering ignores the difference between giving a stockholder cash with three

options—and giving him no cash and no option. Notwithstanding the *Swan* case and the *Putnam* case, the stock dividend gives the stockholder no cash and no option

Of course, in either case the stockholder may sell stock. And when he does so his profits will constitute income.

It is a figment of the imagination to assert that two things so radically different are in reality the same.

Not only is the view thus entertained in the *Swan* case and the *Putnam* case directly contradicted by *Gibbons* v. *Mahon* and *Towne* v. *Eisner*, it is also contradicted by the unifying principle which led to superficially contradictory results in *Lynch* v. *Hornby* (*supra*) and *Towne* v. *Eisner* (*supra*).

In both these cases dividends had been declared after March 1, 1913, out of corporate earnings that had been accumulated before that date, but in *Lynch* v. *Hornby* the dividend was made in cash whilst in *Towne* v. *Eisner* the so-called dividend was made in stock. This Court held that the cash dividend, though accumulated from earnings made before the Sixteenth Amendment, was income to the stockholder for the year 1914 when received by him; whilst it also held in *Towne* v. *Eisner* that the stock dividend distributed in 1914 out of earnings accumulated before the Sixteenth Amendment was not income but capital. The unifying principle which produced these opposite results was the distinction between capital and income—a cash dividend, unless in liquidation, being always income and a stock dividend being always capital. This negatives in the most direct and positive way the false analysis employed in the *Swan* case and the *Putnam* case, which would liken the stock dividend in any regard whatsoever to a cash dividend. A stock dividend, therefore, is plainly not like a cash dividend with a right of subscription to new stock.

The government's other analysis is the correct one, viz.: that undivided profits and stock dividends are intrinsically the same thing as regards the stockholder and their effect on his income.

His gain in both cases is an inchoate, contingent, unrealized, unseparated gain giving him nothing new whatsoever to control or dispose of.

His gain is a capital gain. As was said in *Gibbons* v. *Mahon* (*supra*):—" * * * accumulated surplus * * * being part of its corporate property, it follows that the interest therein represented by each share is capital and not income of that share."

His interest in the company and in all its property is absolutely unchanged in either case.

> "A stock dividend really takes nothing from the property of the corporation and adds nothing to the interests of the shareholders. Its property is not diminished and their interests are not increased. After such a dividend, as before, the corporation has the title in all the corporate property; the aggregate interests therein of all the shareholders are represented by the whole number of shares; and the proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interest that the original shares represented before the issue of the new ones."
>
> *Gibbons* v. *Mahon*, 136 U. S., 549.
>
> "If the sum had been carried from surplus to capital account without a corresponding issue of stock certificates, which there was nothing in the nature of things to prevent, we do not suppose that anyone would contend that the plaintiff had received an accession to his income. Presumably his certificate would have the same value as before. Again, if a certificate for $1,000 par were split up into ten certificates each for $100, we presume that no one would call the new certificates income. What has happened is that the plaintiff's old certificates have been split up in effect, and have diminished in value to the extent of the value of the new."
>
> *Towne* v. *Eisner*, 245 U. S., 418, 426.

And Prof. Seligman puts it the same way when he says: "The stock dividend is like an increased surplus: it is not like a cash dividend. In fact a stock dividend is not a dividend at all in the sense in which a cash dividend is a dividend. What is most important above all is he (the stockholder) is no richer than he would have been if there had been no dividend at all, but a simple distribution to surplus." (cf. Prof. Seligman's article *supra* at pp. 534 and 535 of the Review or at page 81 of the reprint herewith.)

For the foregoing reasons, it is respectfully submitted that the judgment of the District Court was correct and should be affirmed.

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Amici Curiae.