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In the Supreme Court of the United States.

OCTOBER TERM 1919.

MARK EISNER, COLLECTOR OF INTERNAL revenue, plaintiff in error,
v.
MYRTLE H. MACOMBER, DEFENDANT in error.
} No. 318.

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

SUPPLEMENTAL BRIEF FOR THE PLAINTIFF IN ERROR.

This case having been remanded to the docket for reargument, it may be helpful, in a supplemental brief, to restate as concisely as possible the contentions of the Government in view of what was said at the hearing and to reply specifically to some of the arguments advanced on behalf of the defendant in error.

THE CASE.

Briefly stated, the case is this:

During the year 1916, the defendant in error, being the owner of 2,200 shares of the stock of the Standard Oil Company of California, received, as a stock dividend, 1,100 shares of the stock of that company, of which 198 and a fraction shares represented earnings which had accrued to the company subsequent to March 1, 1913 She was required to include the *par value* of these 198 shares in her taxable income for 1916, though the *market value* was much greater. Having paid the tax, she sued to recover it and has succeeded in the District Court.

STATUTE INVOLVED.

The case arises under the revenue act of 1916, 39 Stat. ch. 643, pp. 756, et seq.

Section 1 (a) imposes an income tax of 2 per cent, called the *normal tax*, on net incomes received in the preceding calendar year from all sources by *individuals.*

Section 10 imposes an annual tax of 2 per cent on net incomes received in the preceding calendar year from all sources by *corporations.*

Section 1 (b) imposes another annual tax, called the *additional tax*, on all net incomes of *individuals* in excess of $20,000. No tax corresponding to this is imposed on the income of *corporations.*

Section 2 (a) defines *net income* as including "gains, profits, and income *derived from* salaries, wages * * *, also from interest, rent, dividends" * * *, and defines dividends as—

> any distribution made or ordered to be made by a corporation, joint-stock company, association, or insurance company, *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,* joint stock company, association, or insurance company, which stock dividend shall be comsidered income, to the amount of its cash value.

Section 5 (b) provides that income from *dividends upon the stock or from the net earnings* of corporations which are themselves taxable on their net incomes, shall be *excluded* from the taxable income of individuals for the purposes of the *normal tax*. And Section 1 (b) provides that such income shall be *included* for the purposes of the *additional tax.*

Section 3 provides that for the purpose of the *additional tax*, the taxable income of an individual shall include his share of the undivided profits of a corporation if they have been permitted to accumulate beyond the reasonable needs of the business for the purpose of evading the tax.

The pertinent features of the Act are:

1. Congress has assumed the power to tax corporate gains and profits as income of either the corpotion or the stockholders, but has been careful not to impose the same tax on the same gains as the income of both.

2. A tax of 2 per cent is laid alike upon the net incomes of individuals and of corporations. But there is excluded from the taxable income of individuals all amounts received from the net earnings of corporations whose income is subject to the tax. Congress thus elected to impose this particular tax on corporate gains as income of the *corporation* rather than of the stockholders.

3. In imposing the *additional tax*, the opposite course was pursued. It is not laid on the income of *corporations* at all, but only on the income of *individuals*. And there is an express provision that the income so taxed shall include income derived from the net earnings of corporations. Congress thus elected to impose this additional tax on corporate gains as income of the *stockholders* rather than of the *corporation*.

4. In both cases, the tax is imposed on the same corporate gains. The only difference is that, in one case, the corporation pays the tax before passing the gains to the stockholders for whose benefit they have been earned, while in the other the stockholder pays the tax after he has received his share of the gains.

5. Since the tax is imposed upon income derived from dividends on capital stock or from the net earnings of corporations, and since dividends themselves are derived from net earnings, the ultimate thing taxed is *income derived from the net earnings of corporations*.

6. Such income, when derived from earnings *accruing prior to March 1, 1913*, is not subject to either the normal or the additional tax.

7. When derived from earnings accruing *since March 1, 1913*, it is not subject to the *normal tax*.

8. When so derived, it is subject to the *additional tax* and is taxed *when received*.

9. Such income is deemed to be *received* during the calendar year in which it comes to the stockholder in the form of either a *stock* or a *cash* dividend,

or in which the corporation fraudulently permits its gains and profits to accumulate beyond the reasonable needs of the business.

QUESTION INVOLVED

The *purpose* of Congress to treat stock and cash dividends alike for purposes of the additional tax is plain beyond dispute. The sole question is whether it has the *power* to tax, as a stockholder's income, corporate gains and profits when they are received by him in the shape of additional stock issued as a stock dividend.

THE CONTENTIONS.

The defendant in error contends that the tax is levied *on stock dividends per se;* that such dividends are mere readjustments of the evidence of a person's ownership and give the stockholder nothing that was not already his; that he is no richer after than before the dividend and so receives no income; and that stock dividends, for these reasons, not being income, can not be made such by congressional enactment.

The Government contends that the tax is levied on *income derived from corporate earnings;* that such income may be taxed either as the earnings accrue to the corporation or when they are *received* by the stockholder; that the act taxes it when received, but defines the word "received" so as to include not only stock dividends but, in one contingency, accrued earnings, though undistributed; that stock issued as a stock dividend is one of the forms in which corporate gains may be received, measures the extent to which such gains have made the stockholder richer, and is, in truth, the income which he has derived from capital invested in corporate stock.

The defendant in error seeks to make the test whether the mere declaration of a stock dividend makes the stockholder richer the moment after than he was the moment before.

The Government says the true test is whether his previous investment has made him richer to the extent of the profits distributed by means of a stock dividend.

ACT OF 1913 AS APPLICABLE TO CORPORATE EARNINGS.

After the adoption of the Sixteenth Amendment abolishing all distinctions between incomes as to the manner in which they were taxable, the work of Congress in formulating the policy of the Government with respect to income taxes began with the act of 1913 (38 Stat. ch. 16, pp. 114, 166). That act provided for a normal and also an additional tax to be imposed annually on net incomes of individuals "arising or accruing" from all sources during the preceding calendar year. For the purpose of the normal tax, net income was not to include "the amount received as dividends upon stock or from the net earnings of any corporation * * *" which is itself taxable upon its net income. But, for the purpose of the additional tax, there was to be included income from all sources, "corporate or otherwise."

The provisions for taxing income arising or accruing from corporate sources were, (1) to require a

stockholder to report, as a part of his income, all "dividends," and (2) to tax, as income of stockholders, profits permitted by a corporation to accumulate beyond the reasonable needs of the business.

There was no effort to define dividends.

CHANGES MADE BY ACT OF 1916.

In framing the act of 1916, Congress must be assumed to have had in contemplation the act of 1913 and the controversies that had arisen under it. In so far as the two acts differ, it must be assumed that the purpose was to correct mistakes made through the use of language which was inapt to express what was really intended, or to make changes which experience had shown to be desirable. Important changes were made. The expression, "income accruing or arising" was discarded and the more definite expression, "income received" employed. But the most significant change was accomplished by adding a proviso to the effect that the term "dividends" shall be held to mean any distribution which a corporation makes or orders to be made—

> 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, . . .

It is thus made plain that whatever is received by way of a dividend of whatever kind, including stock dividends, is to be taxed, but only when the dividend is declared out of earnings accrued since March 1, 1913.

The net result is that the act by no means assumes the want of power to treat as stockholder's income corporate earnings either as they accrue to the corporation or when they are received by the stockholder. Nor has Congress refrained from exercising that power. On the contrary, the act is based on it. It is exercised by imposing the tax, according as circumstances seemed to require, on corporate earnings at every stage through which they ever pass from their accrual to their arrival in the pocket of a stockholder, as follows:

1. They are taxed while still undistributed and in the hands of the corporation if they have been permitted to accumulate beyond the needs of the business.

2. In the absence of such fraudulent accumulation, they are taxed only when they are distributed by means of either a cash or a stock dividend.

In either case, the tax is on the stockholder's share in corporate earnings. No purpose to entirely exempt such share is expressed or implied. It is exempt only so long as it remains a part of such undivided profits as are reasonably necessary to the business. The moment it assumes any one of the forms named—fraudulently accumulated profits, cash dividend, or stock dividend—it is to be taxed.

THE FACTS.

On March 1, 1913, the Standard Oil Company of California, had a paid up capital of $49,686,656.00, represented by 496,866 and a fraction shares, and

undivided profits of $20,353,068.34, making the actual value of each share of stock, in round numbers $141.00.

On January 1st, 1916, it had the same paid up capital, $20,353,068.34 of profits earned *before* March 1, 1913, and $24,499,194.68 earned after that date, and the value of each share of stock was approximately $190.00. It decided, in the language of the act of Congress, to *distribute* $24,843,327.74 of its accumulated earnings or, in the language of counsel for defendant in error, to *readjust* the evidence by which the stockholders held their interests in the corporate assets. Accordingly it declared a 50 per cent stock dividend and issued 248,433 and a fraction new shares of stock which it distributed among its stockholders.

To accomplish this, it capitalized all the profits which had been earned prior to March 1, 1913, and $4,490,259.40 which had been earned later, leaving $20,008,935.28 of the latter earnings undistributed. Since there were then outstanding 745,299 shares of stock, the value of each share was about $127.00. Approximately 18 per cent of the profits capitalized, distributed, or readjusted had thus accrued since March 1, 1913. The stockholders, as a whole, had their original 496,866 shares, 203,530 shares representing the earnings up to March 1, 1913, and 44,903 shares representing earnings after that date.

The defendant in error owned 2,200 shares of the original stock which had an actual value, on March 1, 1913, of $310,200 which, by reason of subsequent earnings had, on January 1, 1916, been increased to

$418,000. After the dividend, she had the original 2,200 shares to which had been added 902 shares, making 3,102 shares of the total par value of $310,200; the exact value of her investment on March 1, 1913. In addition, she had 198 shares of the par value of $19,800 which was her share of that portion of the earnings accruing after March 1, 1913, which the company had distributed or readjusted.

The actual value of both her original and her new shares was more than par because the company still had undivided profits in excess of $20,000,000.00. But what was actually capitalized or distributed in the form of capital was an amount equal to the par value of the new shares. Hence the tax in question was assessed only on defendant in error's share of the gains accruing after March 1, 1913, which were distributed by means of a stock dividend, or on the par value of 198 shares.

BRIEF.

The fundamental and controlling fact is that defendant in error is richer than she was on March 1, 1913, to the extent of 198 shares of Standard Oil stock which actually and in truth constitute a gain which she has derived from capital.

On March 1, 1913, defendant in error owned 2,200 shares of stock of the par value of $220,000 which, on account of undivided profits, were, in fact, worth $310,200. In 1916 she received her share of these undivided profits in the form of 902 shares of new stock. She then had 3,102 shares of stock representing exactly the value of her investment as it stood on March 1, 1913, and the earnings accruing after

that date remained undivided. Enough of the latter earnings were then converted into stock to give her an additional 198 shares. These 198 shares are hers solely because, after March 1, 1913, the corporation caused her capital to earn $19,800. And it is only this amount which she has been required to treat as taxable income.

The outstanding fact upon which the Government rests its right to the tax in question cannot be gainsaid. *It is that, to the extent of $19,800, defendant in error is richer than she was on March 1, 1913, and this increase in wealth is actually and in truth a gain which she has derived from capital.* And since the income which Congress may tax consists of "the gain derived from capital, from labor, or from both combined", this is the fundamental and controlling fact in the case. (*Stratton's Independence* v. *Howbert*, 231 U. S. 399, 415; *Doyle* v. *Mitchell*, 247 U. S. 183, 185.)

Defendant in error's gains, received in the form of additional shares of stock, were properly taxed as income unless Congress either is without the power or has not expressed the purpose to tax this particular species of gains.

Since there is no denying the fact that defendant in error has derived, from her capital, gains which she has received in the form of additional shares of stock, and since, in general, all gains derived from capital are taxable as income, it follows that she was properly taxed, unless it can be said that Congress either has not the *power* to tax such gains in this form or has not expressed a *purpose* to do so.

The ultimate object of corporate business is gain to the stockholders. This gain always and necessarily first appears in the shape of undivided profits which are held in trust for the stockholders. When, later, dividends are declared, the cash or stock received by a stockholder is the same gain converted into a concrete form for the convenient payment, transfer, or definite assignment to him of his share of the previously undivided profits.

The relation of a stockholder to the corporation and to its assets is well understood. The money invested in corporate stock becomes, it is true, the property of the corporation, and the investor ceases to own or control it, save as he may exert an influence over corporate management. Instead of being the owner of so much money, he becomes the *legal* owner of a corresponding amount of corporate stock and thereby the *equitable* owner of an aliquot part of the net wealth of the corporation. The business, however, is the business of the stockholders, though, through the machinery of corporate organization, conducted for them by trustees. Its ultimate object is gain to the stockholders. The invested capital of the stockholder is none the less his because held in trust for him by the corporation. And when, from the use of his capital so held, profits accrue, they are his in the same sense. (*Lynch* v. *Turrish*, 247 U. S. 221, 228; *Collector* v. *Hubbard*, 12 Wall. 1.)

A stockholder can derive gain from his investment only through the earning of profits by the corporation. And it is equally impossible for the corporation to earn net profits without conferring a benefit, a gain, upon him. Whatever technical and legal distinctions may be attempted, as language is ordinarily understood, a stockholder *gains* whenever earnings or profits accrue to a corporation. This gain is precisely the same in whatever form his aliquot part of earnings and profits reaches him or is held for him. It necessarily is either held for him or reaches him in one of three forms:

1. It may be held for him by the corporation as undivided profits, when it will manifest itself in the increased value of his stock.
2. It may be paid to him in money or property as a dividend.
3. It may be transferred or assigned to him in stock issued as a dividend.

Undivided profits are the form which a stockholder's gains derived from corporate earnings first assume. There can be no dividends until there have first been undivided profits. Dividends are merely the form which the corporation causes these gains or undivided profits to assume to facilitate their convenient transfer to those for whom they have been earned. Defendant in error agrees that such gains, when paid in cash or property, are taxable income, says there is a "serious question" as to whether they can be treated as stockholder's income while undivided, and thinks there is some magic in stock dividends which entirely removes them from the realm of the taxing power.

The power to tax such gains, when distributed in cash, being admitted, the only inquiry is as to the power to tax these same gains while held in trust for the stockholder as undivided profits or when transferred or assigned to him in the form of additional stock.

The power of Congress to tax, as stockholder's income, shares of undivided corporate profits has long been a closed question in this court.

The brief for defendant in error does little more than suggest a *doubt* as to the power to tax, as stockholder's income, shares of undivided corporate profits. And this court has apparently never entertained the slightest doubt on that subject. It held years ago that the power did exist, and, both before and after the Pollock case, has consistently recognized the soundness of that holding. (*The Collector* v. *Hubbard*, 12 Wall., 1, 17; *Bailey* v. *Railroad*, 22 Wall., 604, 635, 636; *Southern Pacific Co.* v. *Lowe*, 247 U. S., 330, 336; *Lynch* v. *Turrish*, 247 U. S., 221, 228; *Lynch* v. *Hornby*, 247 U. S., 339, 343.)

This question of power is discussed in the original brief for the Government at pages 8–14, and further discussion is not now deemed necessary.

Clearly, it must be regarded as settled that a stockholder's share in the undivided earnings and profits of a corporation is within the power of Congress to tax as a part of his income.

Equally with cash dividends, and in every essential sense, stock received as a dividend is merely one of the concrete forms in which a stockholder receives gains previously held in trust for him as undivided profits, and is income within the taxing power.

The right to tax gains derived from a corporate investment when distributed by a cash dividend being admitted, and the right to tax shares in them while held by the corporation as undivided profits having been settled by this court, there can be, it is submitted, no sound reason for saying that stock dividends, the only other form which it is possible for such gains to assume, are excluded from the same taxing power.

1. 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. His share of profits are invested for him in the stock of the company. The profits are segregated from his former capital and he has a separate certificate representing his invested profits or gains. It is, of course, conceded that this transaction does not, of itself, make the stockholder richer than he was before. 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. But this contention of defendant in error proves too much and destroys her case. Her share of undivided profits which has,

by undergoing a mere change of form, become 198 shares of stock, was itself *income* within the power of Congress to tax. Unless its *change of form* destroyed its previous character it was still income. It is defendant in error and not the Government who must rely upon the change of form for success in this case. The Government claims the right to tax gains when wearing a new dress only when they were taxable in their old dress. The defendant in error's contention can not succeed unless the new dress destroys the power to tax which existed before it was put on.

2. Any thing of value, when it represents an actual gain, is income and nothing is income which does not represent a gain. Indeed there is no concrete thing which is always and for all purposes *capital* or always *income*. There is nothing of value which can not be either capital or income according as it does or does not represent or measure a gain. Money is capital and property is invested capital. Money or property when received as a gain is income. Immediately upon its receipt it becomes the capital of him who receives it. What defendant in error actually received was 198 shares of valuable stock. It became, of course, a part of her capital. But the question is, did she derive this addition to her capital from capital previously invested?

3. Defendant in error has undeniably derived gains from her investment in corporate stocks. She has received these gains in the shape of 198 shares of valuable stock. These shares have the same value

they would have had if purchased in the market. If another corporation should purchase them and distribute them among its own stockholders, they would be income of those receiving them. (*Peabody* v. *Eisner*, 247 U. S. 347.) The principle is precisely the same when the corporation invests its earnings in shares of its own stock and distributes these among its stockholders.

4. The *mere* receipt of money or property does not stamp it as income. Whether it is income or not can not be determined without an inquiry into the source from which it has been derived. It may be received as a mere conversion of property from one form to another, and, so far from being a gain of any kind, may involve an actual loss. In other words, what is accomplished by such receipt may be the realization of gains previously accrued, or it may be a return of capital. In any case, when money or property reaches him who receives it, it is immediately a part of his capital. But whether this part of his capital is taxable income depends entirely upon whether it has come to him as the measure of the earnings of his capital or his labor. The question is always, how did he get it?

5. There is no magic in the word *dividend* which makes it, or the money or stock issued under it, any more than money or property acquired in other ways, always and for all purposes, "in its nature," either income or a return of capital. If *money* is paid as the result of a dividend or the distribution of corporate assets it may or may not

be income. If the dividend has been resorted to for the purpose of distributing assets, including no profits, upon the winding up of the corporation, or for the purpose of returning to stockholders a portion of their capital upon an authorized reduction of the capital, the money received by stockholders is not income. (*Lynch* v. *Tarrish*, 247 U. S. 221.) But where the purpose and effect is to distribute or assign to stockholders earnings or profits, that which is received by stockholders, whether in money or its equivalent in property, such as stocks of other corporations, is income. (*Lynch* v. *Hornby*, 247 U. S. 339; *Peabody* v. *Eisner*, 247 U. S. 347.) When money received as dividends, therefore, is income, it is not because it is money nor yet because it is paid as a dividend, but solely because it has come to the stockholder as the earnings of his capital, because it serves to transfer or assign to him his share of corporate earnings, and not merely to return some part of his capital.

6. So far as what they serve to transfer or assign to stockholders is concerned, there are but two points of difference between cash dividends and stock dividends.

By a *cash* dividend, a corporation transfers to a stockholder his share of corporate earnings in money, while, in the case of a *stock* dividend, it first invests the earnings in its business and then issues to each stockholder new shares of stock of the same par value as his share of the earnings or, to use other words, invests each stockholder's share of the

earnings in its own stock at par and delivers to him the stock so purchased. In either case, he simply gets, in a concrete form, the actual gains he has derived from his invested capital.

The other point of difference is that a *cash* dividend may serve either to distribute profits or return capital. A *stock* dividend, on the other hand, never contemplates a *reduction* in capital but, on the contrary, necessarily implies an *increase* in capital to be represented by the new shares. It can never, therefore, serve to return capital but that which, in the form of new stock, it assigns to each stockholder is always a share of corporate earnings or gains. In other words, a *cash* dividend may or may not distribute gains, but a *stock* dividend can not, under any circumstances, distribute, assign, or transfer anything else. A *cash* dividend distributes sometimes gains and sometimes capital. A bona fide *stock* dividend always distributes gains.

If the constitutional power exists to tax corporate earnings when they are passed to the stockholder by means of a *cash* dividend, no reason is perceived why the same power does not exist to tax the same earnings when they are passed to him, in an equally concrete form, by means of a *stock* dividend.

Stock issued as a dividend is property in every sense that any other thing of value is property. It is property which has been received by a stockholder. The same test that would be applicable to any other species of property received must be applied. To illustrate, Mrs. Macomber has 198 shares of Standard

Oil Company stock which she received as her property, in 1916. From this statement it does not appear whether they constituted a part of her income for that year. If she had bought them in the market, they would clearly have *not* been income. She would merely have converted her cash capital into invested capital, and there would have been no gain. If she had received them as compensation for personal services or in payment of the rental of property, just as clearly they *would be* income, because they would represent the gain derived from her labor or her capital. If she had received them in repayment of a loan previously made which, with accumulated interest, was equal to their value, they would be income only to the extent of the interest so paid. So far as they were received in payment of principal they would be a mere return of capital. So far as they paid interest they would represent a gain derived from capital. All that Mrs. Macomber, in fact, did to acquire these shares was to invest a part of her capital in the stock of the corporation and thereby to turn over to the corporation that much of her money to use for her benefit. She still has her original stock and it is possessed of a value no less than when she acquired it. But she also has 198 new shares. For these she has paid nothing. To acquire them *she* has not labored but *her capital* has. They are hers because the corporation has caused her money to earn $19,800. If the dividend had been paid in cash, she would have had her original stock, undiminished in value, plus $19,800. That sum

would clearly be her gain. As it is, she has her original stock, undiminished in value, plus 198 shares of stock worth $19,800. The same sum still unerringly measures her gain.

8. If an actual taxable gain accrues, it continues to be no less a gain although it may assume a new form or wear a new dress. And it is submitted, with the greatest confidence, that Congress has the clear *power* to treat as income of a stockholder, stock received by way of dividends.

The act of 1916 taxes gains derived from capital invested in corporate stocks, that is, shares of corporate gains or profits. It does not tax dividends per se but merely uses them to indicate the form in which such gains shall be taxed and to mark the time when the tax shall be collected. And, in the case of stock dividends, it uses the stock issued to measure the amount of the gains.

Assuming the *power* of Congress to tax shares of corporate earnings in any of the three forms in which such shares may reach or be held for the stockholder, the next inquiry is whether the tax imposed has been imposed on shares of corporate earnings or upon something else. An examination of the act of 1916 leaves no room for doubt that the subject of taxation which Congress had in mind was *gains derived from investments in corporate earnings accruing after March 1, 1913.*

1. A corporation and its stockholders are separate legal entities. The relation between them is analogous to that of trustee and *cestui que trust* or principal and agent. The corporation is the trustee or agent

of the stockholder to manage and control his capital for the purpose of gain. The power to deal with the corporation as a legal entity and to tax its earnings, as its income, is, of course, undoubted. And if this should be done the power to tax, as stockholder's income, these same profits, when distributed, would still exist. And if Congress had meant to treat dividends as a distinct source of income rather than as a mere change of form of gains already accrued to the stockholder, there would have been no reason why both taxes should not have been imposed. On the other hand, if Congress, looking beyond mere forms and technicalities, regarded all corporate earnings, whether divided or not, as taxable gains of the stockholder, the natural thing to do was to tax these gains either in the hands of the stockholder or in the hands of his trustee or agent, but not in the hands of both. And this is exactly what was done.

A normal tax of 2 per cent was levied on incomes of *individuals* and a like tax upon incomes of *corporations*. But dividends received by individuals from corporations which had paid the tax were excluded from their taxable income. The stockholder received his gains after his trustee had paid the tax and hence was not required to pay it again. This was a simple plan by which the Government collected from a single source and in a single sum the taxes of all the stockholders on their gains. But for the purposes of the additional tax the plan would not work without injustice. That tax was intended to reach large and not small incomes. Congress thought it should not

be imposed on incomes of less than $20,000 and it was not the intention that such incomes should bear the additional burden, as they would be compelled to do if the tax should be laid on the income of stockholders in the hands of their trustee, the corporation. On the other hand, some stockholders enjoy incomes very much in excess of $20,000. The tax they were required to pay ranged from 1 per cent to 13 per cent according to the amount of income. It would, therefore, be impossible to fix a rate of taxation on the income of corporations without taxing one class of incomes which it was not desired to tax and taxing other classes more heavily than was thought proper, or else relieving still another class of a large part of the burden it was intended they should bear. Congress, therefore, did not impose the additional tax on *corporations* at all, but since the stockholder's trustee paid no tax on his earnings, the individual was required to include in his income all gains from corporate investments.

Congress, by thus taxing corporate earnings only once but taxing them as income of either the corporation or the stockholders, as convenience dictated, has in the clearest manner evinced the purpose to treat, as the actual and ultimate subject of taxation, *corporate gains regardless of the form they may assume.*

2. The same purpose runs through the entire act. The tax is levied upon net income derived from "all sources" which, as has been seen, includes shares of corporate profits, divided or undivided. And, in defining net income, for the purpose of the additional

tax, it is provided that income derived from "dividends on capital stock or from the net earnings of corporations" shall not be included. But dividends themselves are derived from and made possible by earnings. The clear implication is that all gains derived from the *net earnings of a corporation shall be taxed*.

3. The purpose to impose the additional tax on all corporate earnings, except such as the reasonable needs of the business require to be kept undivided, is manifest. They are taxed not only when distributed but equally when permitted to accumulate beyond the needs of the business.

4. The act does not say that *dividends* shall be included as income but only that "gains, profits, and income" *derived from dividends* shall be so included. In like manner, "gains, profits, and income" *derived from salaries, wages, interest, and rent* are included. It is the *gains* which are taxed. What is received by way of salaries or wages is income because, through the payment of wages or salaries, it is a gain derived from labor. What is received by way of interest or rent is income because, through the payment of interest or rent, a gain derived from capital has been realized. Money or stock received by way of dividends is income because, through the declaration of dividends, gains derived from capital are received in concrete form.

To say that this is a tax on stock dividends *per se* would seem to be a play upon words. It is a tax on shares of corporate gains, and stock dividends are

used only to indicate one of the forms in which such gains shall be taxed, to mark the time when the tax shall be collected, and to measure the taxable value.

The tax is not laid annually on a stockholder's share of corporate earnings as they accrue. This species of gains is taxed when distributed by means of a cash or stock dividend, and then the tax for a single year is laid on all such gains so distributed, provided they have accrued since March 1, 1913. The taxable period for corporate earnings, therefore, begins with March 1, 1913, and ends with the declaration of a dividend.

Commenting on a statement in the Government's brief that stock dividends are income whenever they, in fact, represent an actual gain to the stockholder during the *taxable period*, counsel have said:

> The Government seems to think that because the sixteenth amendment went into effect March 1, 1913, or shortly before that, any succeeding period of years is "the taxable period".

It is then asserted that both the act of 1913 and that of 1916 have their distinct and separate taxable periods, each calendar year being such a period. From this it is argued that whatever remains of undivided profits at the end of each year becomes capital and can not be treated as income accruing or received in any succeeding year.

This argument wholly misconceives the meaning both of the Government's contention and of the acts of Congress. If Congress had levied an annual tax on the stockholder's share of corporate profits *accruing during each year*, then, of course, no one would say that any part of the profits accruing during a particular year could be carried forward and treated as income of a succeeding year. But that is not this case. An annual tax is imposed on *net incomes received.* But this tax is not permitted to attach *annually* to undivided corporate profits. On the contrary, although *accruing,* Congress refrains from taxing them until *distributed,* or, in other words, treats no part of them as *received,* within the meaning of the act, until there has been a distribution. The result is that, instead of an *annual tax on accruing profits,* we have a *single tax on accumulated profits* levied when they are distributed. As a tax could not have been levied, without apportionment, on such accruing profits prior to March 1, 1913, Congress evidently felt that profits accrued before that date ought not, even if they could, be taxed directly or indirectly when afterwards distributed. It, therefore, limited the tax to dividends declared out of earnings accruing subsequent to that date. The result is that the taxable period for such gains as are received in the form of dividends begins with March 1, 1913, and ends with the receipt by the stockholder of the dividend.

The substance of the act of 1916 is that no corporate earnings are taxed as distributed gains which might not have been taxed as undivided profits when they accrued, and all such earnings which might have been taxed as undivided profits are taxed when distributed.

It is, of course, conceded that prior to the effective date of the sixteenth amendment, about March 1, 1913, a stockholder's share of undivided earnings

of a corporation could not be taxed without apportionment among the States. And it is likewise conceded that such earnings as had accrued before that date could not, as undivided profits, afterwards be taxed as stockholder's income.

The act of 1913 taxed income derived from "dividends" but did not define dividends or make their taxability depend upon the time when the earnings accrued. Under that act it was held that taxable dividends were only such as served to *distribute profits* as distinguished from merely *returning* capital, but that the nature of dividends which did distribute profits in money or property was such that they could be treated as distinct items of income without regard to whether the earnings accrued before or after March 1, 1913. It was also decided that the nature of stock dividends was not such that they could, of themselves, be treated as a distinct item of income, and hence that they could not be taxed when declared out of earnings accruing before March 1, 1913. What this court has not had occasion to decide is whether, under the act of 1913, stock dividends, though not themselves distinct items of income, were nevertheless taxable when they served to distribute earnings which accrued after March 1, 1913, and which were, therefore, themselves within the taxing power of Congress.

The act of 1916 puts a different aspect on the question. It defines dividends as including both cash and stock dividends but only when they are declared out of earnings which have accrued since March 1,

2. An assurance that a declaration of dividends would in the future specifically take account of this surplus and be declared upon it.

3. A muniment of title which enables the stockholder to deal easily with his interest in the surplus by a mere assignment of his new stock. (245 U. S. 422-423.)

These were the specific grounds upon which the right to treat stock dividends as income was rested, for, after enumerating them, the Solicitor General said:

> These advantages constitute "income" to the stockholder because they flow to him from his property rights (i. e., "capital") in the corporation, and are capable of easy, accurate monetary appraisement. (Id.)

And further pressing the argument:

> It can not be said that the corporation lost nothing or that the stockholder gained nothing. The former lost its plenary control over the surplus; instead of being indebted to "surplus," with a consequent free use of such funds, it became indebted to "capital," with a limited use of the funds. The latter gained direct right against the corporation instead of an indirect interest in the "surplus." (Id.)

The controversy was thus narrowed to the single question, whether there was anything in the nature of a stock dividend which, without more, made it income, that is whether the mere declaration of a stock dividend conferred such advantages upon the stockholder as to render the dividend an item of

taxable income. Obviously, the court so understood, for, in the opinion, it was to this question alone that Mr. Justice Holmes addressed himself. Viewed in this light, nothing that was said militates against the Government's contention in the present case. It was said that:

> We can not doubt that the dividend was capital as well for the purposes of the Income-Tax Law as for distribution between tenant for life and remainderman. What was said by this court upon the latter question is equally true for the former. (245 U. S. 426.)

It will be observed that it was not said that *no stock* dividend can be income, but only that "the" dividend (that is, the one before the court which distributed profits accruing before January 1, 1913) was capital as well for purposes of taxation as for distribution between life tenant and remainderman. As applied to a case in which the right to tax depends upon the *mere declaration of the dividend* and not upon any facts standing behind that act, no fault can be found with this or with the statement quoted from *Gibbons* v. *Mahon*, 136 U. S. 549, 559:

> 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 * * * 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

Under that act, the Government comes with this case and asks that a stock dividend declared out of earnings accrued since March 1, 1913, be included as a part of the taxable income of the stockholder receiving it, and in support of its claim says:

> 1. The law does not tax dividends of any kind because they are dividends, but only because they are, in convenient concrete form, gains which have, in fact accrued to the stockholder from capital and mark the time or stage at which Congress has enacted shares of corporate profits shall be taxable.
> 2. The purpose to lay the tax directly upon shares of corporate profits is obvious from the fact that, in different contingencies, it is to attach to every form in which it is possible for such profits to inure to the benefit of the stockholder, namely, undivided profits, ordinary or cash dividends, and stock dividends.
> 3. The tax on shares of corporate profits is levied upon condition that one of three things shall happen to them, namely, that (*a*) they shall be permitted to accumulate to evade the tax, (*b*) they shall be distributed by means of a cash dividend, or (*c*) they shall be transferred or assigned to stockholders by means of a stock dividend.

Since the power to tax shares of corporate profits, divided or undivided, can not be successfully challenged, these positions, in no way, conflict with *Towne* v. *Eisner*, are supported by reason and authority, and fully justify the tax claimed in this case. Indeed, the defendant in error now, in effect, takes the same position which the Government took and the court rejected in *Towne* v. *Eisner*. Dealing with gains which had accrued before March 1, 1913, and hence were not taxable as undivided profits, the Government endeavored unsuccessfully to maintain that there was something in the nature of a stock dividend which could convert nontaxable capital into taxable gains. Dealing now with gains which were taxable as undivided profits, defendant in error is forced to contend that there is something in the nature of stock dividends which can convert taxable gains into nontaxable capital. The Government failed because a stock dividend is a mere change of form and does not affect the taxability of that whose form it changes. The defendant in error must fail for the same reason.

When a stock dividend is declared the stockholder realizes on his gains just as substantially and in the same way as when a cash dividend is declared and, as is frequently done, he immediately uses the money received to purchase new stock issued by the company.

There can scarcely be any difference in principle between this and the case in which stockholders use the money received as cash dividends to purchase of the corporation additional stock. In the latter case, the tax is not imposed on the new stock but on the money which represents a share in corporate earnings. In the former case, the stock issued in payment of a stock dividend is not taxed as such. It merely furnishes evidence of the value of a share in corporate earnings which is taxed.

The identity, in principle, of the two cases is well illustrated by the method resorted to sometimes for accomplishing the same purposes that are accomplished by declaring stock dividends. In Missouri and some other States, and under the National Banking laws, statutory provisions are construed to prevent the issuance of stock in payment of dividends. In those States the same result is obtained by the corporation declaring and paying a cash dividend and the stockholders, having previously subscribed for the new stock, paying for it with the money received as dividends. Can it be supposed, for a moment, that the stockholder, in one State, who has received a stock dividend has, in fact, *gained* any less than a stockholder, in another State, who has received a dividend of the same amount in cash and immediately used it, pursuant to a previous agreement, to acquire additional stock?

Reply to arguments on behalf of defendant in error.

It is believed that a complete answer to the arguments advanced on behalf of defendant in error is to be found in what has already been said. But a more specific reply to some of these arguments will now be attempted.

A stock dividend, while it does not cause the corporation to part with any of its assets, does segregate the stockholder's share of profits from his capital and gives him something of value which is derived from his invested capital.

The argument of counsel seems to be based on the idea that there can be no income to the stockholder unless and until the corporation parts with some of its assets. But the question is not whether the corporation has lost anything, but whether the stockholder has gained anything? When he receives a cash dividend the money is income, not because the corporation has parted with it and not merely because he has received it but because he has received it *as the fruit of an investment* previously made. It is taxed because Congress has enacted that his share of corporate profits shall be taxed when it is segregated *in this way*. The important fact is not a segregation from the corporation of some of its assets but, if a segregation of any kind is necessary, it must be of the stockholder's *gains* from his capital. Congress has now, however, by the act of 1916, enacted that the tax shall be collected when the segregation is accomplished by means of a stock dividend. And this is a real segregation. Before a dividend, one certificate is the evidence of a stockholder's ownership of a share of capital and also a share of profits. When he receives a cash dividend the value of his certificate is reduced and the money received measures the gain which his investment has yielded. When he receives a stock dividend, the par value of his *new* certificate measures his *gains*. As the fruit or result of his investment something of value which is distinct from his original capital and distinct from the corporation's ownership of its assets has come to him. And, as applied to the present case, it may be said that there is no very substantial difference between Standard Oil stock and cash.

The fact that a stockholder is no richer immediately after than immediately before a stock dividend is wholly unimportant.

Counsel for defendant in error assert that the fundamental fact is that a stockholder is no richer after than before a dividend. The fact is admitted but its importance is denied. On a given day one owns a certificate of stock which evidences his ownership of an aliquot part of the capital stock plus the same aliquot part of undivided profits amounting to 50 per cent of the capital. The next day, by virtue of a 50 per cent stock dividend, he owns two certificates, which, however, together evidence his ownership of the very same capital and profits. Of course, no one would say that he has, in the meantime, become richer. But neither has one become richer who one day owns a share of stock which, with its accumulated profits, is worth $150, and, on the next day, by virtue of a cash dividend, owns a share of stock worth $100 and has $50 in cash.

The important fact is that, assuming that the 50 per cent profits have been earned since March 1, 1913, he has, in either case, become richer since that date through the earnings of his invested capital. Congress has seen fit to say that these earnings may accumulate free from tax until they are delivered to him either as cash or in stock. His gain comes, not from the declaration of a dividend of any kind, but from what his capital has earned. The only effect of the dividend is to fix the date upon which, under the law, his share of corporate earnings, previously accrued, becomes taxable.

What was held in Lynch v. Hornby and Towne v. Eisner does not conflict with the present contention that the tax of 1916 is laid on corporate earnings in the form of dividends and not merely on dividends per se.

It is said that the divergent opinions in *Lynch* v. *Hornby* and *Towne* v. *Eisner* show that the tax is laid upon dividends *per se* and refute the present contention that the tax is laid upon corporate earnings and that dividends have been selected as a convenient form in which to reach such earnings.

In both of those cases, it was true that the earnings distributed were beyond the power of Congress to tax. It may be said then that *Lynch* v. *Hornby* does hold that, under the act of 1913, *cash* dividends *per se* were taxed. This was because that act contained nothing which limited the tax to dividends declared out of *taxable* profits. But certainly nothing was said which implied a want of power in Congress to impose a tax only on all dividends of whatever kind which, in fact, serve to distribute profits which it *might have taxed while undistributed*, and this, as has been seen, is exactly what the act of 1916 does.

If not included under the term "dividend," stock dividends were excluded from taxation by the act of 1913.

It is said, in effect, that *Towne* v. *Eisner* must be regarded as determining that a stock dividend, in its very nature, can never be treated as income, for otherwise such dividends were taxed by the act of 1913 which embraced "the entire net income arising or accruing from all sources." This language was used to express the general purpose of the act. It was followed, however, by other language prescribing the manner in which different species of income were to be reported and taxed. A stockholder's share of corporate profits was not required to be reported, unless such profits had been permitted to fraudulently accumulate, until it reaches him in the form of a "dividend." The purpose to exclude from taxation corporate earnings save in one of these two forms was obvious. When, therefore, it was held that stock dividends were not "dividends" within the meaning of the act, the result was that stock issued as dividends merely represented undivided profits, which Congress refrained from taxing, held by a different title and evidenced in a different way. Manifestly, being clearly excluded from the purpose of Congress to tax, they could not have been held to be included in the general language quoted.

As to the taxability of undivided profits, the present case involves no consideration which was not equally involved in Collector v. Hubbard.

Counsel have quoted from the opinion in *Collector* v. *Hubbard* as follows:

> Annual gains and profits, whether divided or not, are property, and, therefore, are taxable.

The argument seems to be that the case turned on the fact that this interest of the stockholders was *property* rather than that it was *income*. The implication is that the court then thought that Congress

had power to levy direct taxes on *personal property* without apportionment and hence, having found that the thing taxed was personal property, did not find it necessary to pursue the inquiry further. But the tax under consideration was, in form and in fact, an income tax and the thing taxed was a share in corporate earnings. The case must, in any view, be authority for the proposition that *property*, such as a share of undivided corporate profits, might be taxed along with income by an act which purported to tax only income. One of two propositions must follow:

1. Such share of undivided profits was held to be income to stockholders as the profits accrued, or

2. Though not income, Congress, having the power to tax it as property, might, under that power, tax it along with income and by an act which purported to tax nothing but income.

The first proposition would be conclusive of the case. The second would sustain the tax as an excise tax on the privilege of receiving dividends even though it could not be sustained as an income tax.

The tax is imposed upon shares of corporate earnings, divided or undivided, and the various forms, including stock dividends, in which they shall be taxable, are specified. It is, therefore, immaterial whether such a dividend be regarded as distributing profits or only readjusting the evidence of their ownership.

An elaborate argument has been indulged to show that the tax in question is not one on *undivided profits*. This, however, is beside the question. It may be more accurate to speak of a stock dividend as readjusting the evidence of ownership of undivided profits rather than as distributing such profits. But, by specifying the various forms in which corporate earnings shall be taxable, the act clearly expresses the purpose to tax them, *divided or undivided*, according to circumstances. When a stock dividend has been declared, they have either been divided or, of necessity, they remain undivided, though held by a different title. In either event, they have assumed one of the forms in which Congress has said that they shall be taxable.

If any unfairness results from the Government's construction of the law, it is much less than would result from that urged by defendant in error.

It is stated that the Government's construction of the law imputes to Congress the intent to perpetrate a gross inequity. It may be replied that it is impossible to frame any general tax law in which inequalities can not be found. Moreover, what is called a gross inequity, when examined, does not seem so very gross. It is true that a stockholder who has stock of the par value of $1,000 which carries with it a share of undivided profits worth $100 is no richer and has gained no more than another who owns stock of the same par value but has received his profits in the shape of a stock certificate for $100. The suggestion is that it is unjust to tax one and not the other. But no corporation is compelled to declare stock dividends. It is only done when supposed to be, for some reason, an advantage to stockholders.

Otherwise, such part of the profits as it is not thought proper to distribute in cash would be left undivided. If there appears to be enough advantage to stockholders in having their profits in additional stock to justify paying the tax, the corporation may declare a stock dividend; if not, it is at liberty to keep the profits undivided. It is difficult to see any glaring injustice in this. Certainly there is no such injustice as would result from taxing cash dividends and not taxing stock dividends. In that event, one receiving $1,000 in cash would pay a tax, while one who received a stock certificate which could be immediately converted into $1,000 would go free.

The general plan seems to be a fair one. None are required to treat as income corporate earnings so long as they remain undisturbed in the hands of the corporation. Those who receive them from the corporation in cash or stock, in money or invested capital, must treat as income the value of what they receive.

By not imposing an annual tax on accruing corporate profits, Congress has not withdrawn for all time the hand that gathers taxes from such profits accruing during a particular year. It has merely stayed that hand until the happening of a named contingency—a distribution of accumulated profits.

Conclusion.

It is clear that Congress has the power to tax, against stockholders, shares of corporate profits when they take the form of stock dividends; that the purpose 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.

No. 318

FILED
OCT 13 1919
JAMES D. MAHER,

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.

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