SUPPLEMENTAL BRIEF

aving
ig has
he will

s was
tion to
ership

Court

ror.

Office Supreme Court, U. S.
FILED
OCT 13 1919
JAMES D. MAHER,
CLERK.

No. 818.

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.

SUPPLEMENTAL BRIEF FOR DEFENDANT-IN-ERROR.

ON REARGUMENT.

CHARLES E. HUGHES,
GEORGE WELWOOD MURRAY,
Counsel for Defendant-in-Error.

SUBJECT INDEX

TABLE OF CASES

ADDITIONAL AUTHORITIES.

STATUTES CITED.

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.

SUPPLEMENTAL BRIEF FOR DEFENDANT-IN-ERROR ON REARGUMENT.

In this supplemental brief, we shall address ourselves directly to the position taken by the Government on this re-argument.

The pith of the Government's contention.

The pith of the Government's contention is that the Act of 1916 did not tax 'stock dividends' *per se* (Government's Supplemental Brief, p. 21), but that the tax is to be supported as one laid, in substance, upon the stockholder's interest in corporate earnings as constituting income to the stockholder although the earnings are undivided, and that the so-called 'stock dividend' is "a mere change in form of that which already belonged to the stockholder" (*id* pp. 15, 34, 35). The Government concedes that "what was not income before is not income after a stock dividend" (*id* p. 15); insists that the 'stock dividend' is merely a "new dress" in which the stockholder's previous interest appears (*id.* p. 16); and then states its position succinctly as follows:

> "The Government claims the right to tax gains when wearing a new dress only when they were taxable in their old dress."

The Government's supplemental brief breathes the conviction that unless the tax in question can be sustained on this theory, which is reiterated throughout the argument, it cannot be sustained at all. The Government frankly jettisons the argument that "*from the very nature of a stock dividend*, its declaration *per se* confers such advantages upon the stockholder as to make the new stock a legitimate item of income without regard to when the earnings thus converted into stock may have accrued" (*id.* p. 29.)

The Government recites its argument as urged in the *Towne* case[1] only to abandon it. (*id.* pp. 29-32). It is recognized that the 'stock dividend' cannot be considered to be income because of any advantages inhering in the 'stock dividend' itself (see *infra*, p. 48). The Government states that the controversy in the *Towne* case was 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" (*id.* pp. 30, 31). It was that question which the Government says was decided (*id.* p. 31). And, the Government adds that "as applied to a case in which the right to tax depends upon the *mere declaration of the dividend*", the Government finds no fault with the statement as quoted in the *Towne* case from *Gibbons* v. *Mahon*, 136 U. S. 549, 559, as follows (Govt's. Supp. Brief, pp. 31, 32).

> "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 representing the same proportional in-

[1] *Towne* v. *Eisner*, 245 U. S. 418

terest that the original shares represented before the issue of new ones."

The Government then concedes that as a statement of "the actual effects and results of the act of declaring a stock dividend, this is undoubtedly accurate" (*id.* p. 32). The Government, as it seems to us, could do no less, for it has been distinctly held by this Court that cash dividends, or dividends of property *in specie* declared after March 1, 1913, although out of profits accumulated prior to that date were taxable income (*Lynch* v. *Hornby* 247 U. S. 339; *Peabody* v. *Eisner*, 247 U. S. 347), and there seems to be no escape from the conclusion that if a 'stock dividend' constituted income *per se*, the fact that the profits capitalized in the *Towne* case had accrued before March 1, 1913, would not have constituted a sound distinction. Being well aware of this, and conceding the undoubted accuracy of the statement above quoted as "to the actual effects and results of the declaration of a stock dividend" the Government reaches the conclusion under the *Towne* case "that, in the absence of the fact that profits being distributed are themselves taxable and the time of their taxation has been postponed until the moment of their capitalization, a stock dividend is not income" (*id.* p. 32).

The importance of this is obvious. We no longer need to address ourselves to the arguments based on alleged advantages or new rights inhering in the additional shares constituting the 'stock dividend.' That position the Government sees to be wholly untenable.

The Government's present contention then is, not that the 'stock dividend' is taxable as constituting income in itself but as the form or garb of a previous interest in the undivided corporate profits of the corporation which the Government contends was taxable as constituting income to the stockholder.

We may quote again from the Government's supplemental brief with respect to the nature of a 'stock dividend.' The Government does not wish to be considered as being under any delusion as to the matter. The Government says (*id.* p. 15).

> "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."

And, while a good deal is said in the Government's supplemental brief as to "distribution", it is finally conceded that "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." (*id.* p. 42). Of course, the true import of this concession is not obscured by its form. Obviously, it not only "*may be*" but it *is* more accurate to speak of a 'stock dividend' as readjusting the evidence of ownership, that is, of the proportional interest in all the shares of stock represented, rather than as a distribution of undivided profits.

Contending that the stockholder's interest in the undivided profits of the corporation constitutes income to the stockholder, the Government insists that Congress has used 'stock dividends' to measure the amount of the stockholder's gains and to indicate the form in which such gains shall be taxed (*id* p. 21). The Government says that, through the 'stock dividend,' the interest in the undivided corporate earnings has merely undergone a "change of form"; that what was income before remained income and that the Government claims the right to tax "gains" in the "new dress" *only* when they were taxable "in their old dress" (*id.* p. 16).

This thought runs through the argument and appears in the final statement of the Government's brief as to the decision in the *Towne* case: " 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" (*id.* p. 35).

We have reviewed these emphatic statements of the Government's position, not only because they point very clearly the fallacies in the argument formerly urged by the Government in the endeavor to maintain that 'stock dividends' from their very nature constituted income, but also because they put in a strong light, as we view it, the lack of any valid basis for the tax assailed.

We answer

(1) The tax in question is not laid with respect to the taxpayer's interest in undivided corporate profits

as constituting income to the taxpayer, or upon the 'stock dividend' as the form or dress in which a previous gain or income to the taxpayer appears. The tax is laid upon the 'stock dividend' as constituting income in itself.

(2) Undivided corporate profits do not constitute income to the stockholder.

(3) 'Stock dividends' do not constitute income.

(4) The tax in question is an income tax and cannot be sustained as anything else. The 'stock dividend' is treated as a part of the taxable income and, as such, it is subjected to a graduated surtax according to the taxpayer's total net income from all sources.

FIRST. The tax in question is not laid with respect to the taxpayer's interest in undivided corporate profits as constituting income to the taxpayer, or upon the 'stock dividend' as the form or dress in which a previous gain or income to the taxpayer appears. The tax is laid upon the 'stock dividend' as constituting income in itself.

The Government's argument proceeds, as we think, upon a profound misconception of the statute. The tax on 'stock dividends' is a surtax. It is a graduated tax on the net income of individuals. The Act in question[1] (Section 2) provides that the "net income" shall include gains, profits, and income derived from salaries,

[1] Act of September 8, 1916, Part I, Sec. 2 (a); 39 Stat. 756.

wages * *dividends" etc. It provides that the term "dividends" shall include any "distribution" made by a corporation "out of its earnings or profits accrued since March first, nineteen hundred and thirteen, whether in cash or in stock of the corporation "*which stock dividend shall be considered income,* to the amount of its cash value." (Italics ours).

Thus, while the Act refers to a "distribution" out of corporate earnings accrued since March 1, 1913, it is the "stock dividend" that is to be "considered income." Of course, Congress cannot make that income which concededly is not income, by saying that it shall be "considered" to be income. And if 'stock dividends' are not in themselves income, as it is apparent they are not, and as the Government is constrained to concede, 'stock dividends' in themselves cannot be "considered income".

The argument which the Government now advances in its endeavor to sustain the tax loses sight of a vital point. It goes without saying that the taxpayer can only be taxed upon *his* income. Congress by virtue of the power to lay taxes on income has no power to tax one man for the income of another. The argument for the Government by overlooking this fact involves a fundamental fallacy. The Act does not condition the liability of the taxpayer to pay the tax on 'stock dividends' by reference to any previous enjoyment by the taxpayer of any gain through the undivided earnings of the corporation which may have been capitalized.

He may not have any such gain at all. He may have bought the stock the day before the 'stock dividend' was declared. What he paid for the stock would be his capital investment. That investment covered the full value of the stock as he bought it and thus embraced the value of the assets of the corporation including all corporate surplus and undivided profits. The 'stock dividend,' as the Government says, "does not, of itself, make the stockholder richer than he was before." The Government admits that "what was not income before is not income after a stock dividend." Manifestly, then, the taxpayer has no income by virtue of the 'stock dividend' or by virtue of any corporate profits made before his purchase of the stock, as the interest in the surplus accumulated prior to his purchase is embraced in his capital investment on that purchase. The one who sells the stock to him, of course, is taxed on the profits realized by him through the sale. That is, the gain which the seller realized by the sale of the stock, including whatever enhancement of the value of the stock was due to undivided corporate profits made by the corporation before the sale, is taxed to the seller. The purchaser never had this gain, but still, when he (the purchaser) gets the 'stock dividend', although it is a "mere adjustment" of the evidence of his capital investment, he is compelled by the Act to pay the tax on the 'stock dividend' as "income". Not, as the Government concedes, because it is income, but as the Government contends because it is a "new dress" or garb or form of the interest in undivided corporate profits.

But this interest in undivided profits was no gain to the taxpayer whatever, but was embraced in the price paid for the stock and that gain is taxable to the seller of the stock, so far as he realized it through the sale, and is taxable to any preceding vendors to the extent that they realized a gain, through the increased value of the stock, on their respective sales.

In this particular case, the 'stock dividend' was declared on January 16, 1916. The capitalized surplus amounted to about $25,000,000. Of this upwards of $20,000,000 was surplus accumulated before March 1, 1913. About $4,500,000 was surplus earned by the corporation later and before January 1, 1916. It appears that Mrs. Macomber owned her stock before January 1, 1916, but the Act of 1916 did not tax her for that reason. It taxed her on the 'stock dividend' declared in 1916 because of that 'stock dividend' precisely and to the same extent as it would have taxed her on the same 'stock dividend' if she had bought her stock after January 1, 1916. *The Act taxed all those who got the added number of shares through the 'stock dividend' regardless of the question whether they had owned the stock when the capitalized profits were made by the corporation, that is, regardless of the question whether they previously had any gain whatever on the value of their holdings through the making of corporate profits during the period of their ownership.* The tax on 'stock dividends' as "income" hits every one who gets so-called 'stock dividends' although he may not in any way have had any increment of value whatever. He is, concededly, not enriched by the 'stock dividend' itself.

None of the capitalized profits may have been made while he was a stockholder. So far as his predecessors realized gains on selling the stock by reason of the accumulation of profits during their ownership, they have been taxed on that realized gain and when the stockholder in question sells he will of course be taxable on any gain he may realize through his sale.

It is therefore a fundamental misconception, which vitiates the argument of the Government, to say that the tax is laid on the gains accrued through the ownership of an interest in the undivided profits, which gain is simply taxed in its "new dress" or "changed form." This is to lose sight altogether of the actual tax and the situation of the taxpayer.

It is of the essence of an income tax that the taxpayer cannot escape. Income is essentially a thing personal to the taxpayer. It is, we think, a most extraordinary perversion to say that what is *not income to the taxpayer* can still be taxed as such, on the theory that there is a "change of form" in the income of *some one else* or a "new dress" for the income of some one else.

Congress has attempted to tax 'stock dividends' as income. The statute assumed in the Government's argument does not exist. No condition has been made that the taxpayer shall have had any previous gain through enhancement of the value of his investment by reason of the making of corporate profits. It makes no difference whether or not he has had any such gain, or whether any enhancement that may have taken place is the gain of another who has sold the stock and thus actually realizing a gain is taxable thereon.

In view of the constant buying and selling of shares in a host of corporations, it is plain that for every taxpayer who has owned his shares of stock while undivided profits are being accumulated, there are other taxpayers who have not owned their shares during such period but who have paid the full value of the shares (based on all elements of value, corporate surplus included) and to whom the full value of their shares, as it stood before the declaration of the 'stock dividend,' was in no possible aspect anything but a capital investment.

The Government says that had Mrs. Macomber bought the 198 shares, which as a part of the 'stock dividend' it is sought to tax as income, that "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" (Govt's Supp. Brief, p. 20). But the same would have been true had she bought her holding of 2200 shares in January, 1916, before the declaration of the 'stock dividend.' She would then have paid in the market the full value of the shares embracing all their proportionate interest in the aggregate corporate assets including the undivided surplus. When on the increase of stock through the 'stock dividend' she got 1100 additional shares she simply had in 3300 shares the same value that she had previously in 2200 shares, her proportionate interest being unchanged. This transaction, concedes the Government, would have "made her no

richer". That which "was not income before is not income after a stock dividend." Under this Act, however, she would have been taxed just the same.

The Act makes no distinction with respect to the time of acquisition. It does not attempt to tax on the condition that the taxpayer has had an increment of value through the undivided profits of the corporation that are capitalized, but it manifestly attempts to tax 'stock dividends' as such, as constituting income regardless of any such previous increment to the taxpayer's interest. No administration of this tax law could possibly be had under the law which would attempt any such distinction. It is the '*stock dividend*' which the Act says shall be *considered income*.

We refer below to the case of *Collector* v. *Hubbard*, 12 Wall. 1, but it may now be observed that under the Act of 1864, there under consideration, the tax was laid on the stockholder's interest in undivided corporate profits as an incident to his interest as a shareholder. But under that statute it was necessary to find as a fact, and the Trial Court in the *Hubbard* case (the case came up from the Supreme Court of Connecticut) did find as a fact, that "at the time of the assessment, which was made in the year 1865, and during the year 1864 which was covered by the assessment" the plaintiff owned the stock in the corporations on account of whose profits during the year 1864 he was taxed (*Hubbard* v. *Brainard*, 35 Conn. 563, 565). The *Hubbard* case affords no basis for the contention that the tax there in question could be laid, when it was not based on the fact that the taxpayer owned the stock when the profits were accumulated and that the increment in value was added to the stock in his ownership. It gives no ground for the argument that a tax may be laid, as the present tax is laid, solely upon the fact that the taxpayer owns the stock at the time of the 'stock dividend,' that is, upon the mere receipt of the added shares constituting the 'stock dividend' without change in his proportionate interest. The two taxes are widely different. In the one case a person is taxed on the theory (which we consider *infra*, pp. 26 ff) that during the taxable period, by virtue of his ownership of the shares and by virtue of the undivided profits made by the corporation, the value of his stock interest has been increased. In the other, he is taxed because on a certain date he is the owner of a certain amount of capital, regardless of the question whether he has been enriched at all, and simply because of a readjustment in the evidence of his investment. The latter is certainly a direct tax upon property by virtue of ownership, unless the dividend in itself constitutes income which it is now conceded it does not. There was in the *Hubbard* case no taxation of 'stock dividends.' Whatever the bearing of that case upon the taxation of stockholders with respect to undivided corporate profits as constituting income to the stockholders, it has no application to this case, where the tax is not laid with respect to any such increment to the taxpayer.

We repeat:—In the vast number of cases where the shares have been sold after the accumulation of profits

which are subsequently capitalized on the issue of the stock dividend, the tax in question against the buyer whose capital investment represented the full value of the shares (based on all elements of value including the undivided profits) cannot be sustained on the theory that the 'stock dividend' which the buyer receives is income to him because of any gain to him through the accumulation of profits during the ownership of another. When the added shares constituting the 'stock dividend' are issued, he has the same capital investment,—the same proportionate interest of the same value. The tax in question is obviously nothing but a tax on his capital investment. *The statute authorizes no distinction between such purchasers and any other stockholders who get 'stock dividends.' All who get 'stock dividends' are on the same footing under the law. As to all there is the same criterion of taxability. It is the "stock dividend" that is to be "considered income."* The statute treats the mere declaration of the 'stock dividend' and the receipt of the new certificates as constituting income, as if this transaction had made the taxpayer richer than before when, in fact, as the Government admits, it had not.

The entire structure of the Government's argument thus rests, as we view it, on an unsound foundation.

SECOND. Undivided corporate profits are not income to the stockholder.

It is of the essence of income that it should be realized. Potentiality is not enough. Book entries or opinions of increase are not income. Income necessarily

16

implies separation and realization. The increase of the forest is not income until it is cut. The increase in the value of lands due to the growth and prosperity of the community is not income until it is realized. Where investments are concerned, there is no income until there has been a separate, realized gain. When a corporation earns profits, it receives money over the amount of its expenditures. The money belongs to the corporation; the profits are the property of the corporation. If the corporation distributes its earnings in dividends, properly so-called, that is, in money, or in property *in specie*, the stockholder has realized a gain and that gain is income. The amount was the corporation's; it is now his, separated and realized. If the corporation, instead of segregating a portion of its property and transferring the ownership to the stockholders, accumulates its net earnings and invests them in plant and betterments, what gain has the stockholder? Apart from the dividends actually paid and segregated from the corporate assets he has realized nothing. His shares may have increased in value, but he has not realized the increase. He cannot realize it except by selling his shares, or some of them, or through a liquidation. If he sells the shares and in this way realizes a gain from his investment, this gain is income and he is taxable on it. Let it also be assumed for the argument's sake that if the corporation is liquidated, and the assets are distributed or are converted into money and the money distributed among the stockholders, he then realizes his share and whatever gain he thus realizes on his investment is income and he is taxable on it.

But unless he realizes a gain by selling his shares, or through liquidation, what has he by reason of the use by the corporation of its accumulated earnings in extensions of plant? He may have an enhanced value of his shares, but this is simply the enhanced value of his proportionate interest, his capital investment. It is not yet income. So far as he is concerned, it is potential but not realized. His interest is still the capital interest of a stockholder.

The enhancement in the value of his shares may never be realized. It is still involved in the enterprise. It may decrease in value. When the stockholder does sell, he may get no gain whatever. When the corporation liquidates, he may have no gain. The unrealized increment is not income and may never become income.

The Government speaks of dividends as "forms" of corporate profits (Govt's. Supp Brief, p. 13). But true dividends are not "forms". They are the realized gains to the stockholder, realized by the transfer of property into his ownership. He no longer has merely a capital interest, that is, his right to receive dividends, his right to a proportionate share of the net assets on liquidation, he not only has a capital interest, but he has separated from that and transferred into his separate ownership a sum of money which is his separate property, segregated from his share investment. Because a 'stock dividend' is not a dividend at all, but only a readjustment of the evidence of an interest already owned, it does not follow that true dividends in cash or property are "forms". This characterization cannot avail to obscure the distinction between what is a true dividend and what is not.

The enhanced value of shares through investment of corporate surplus still leaves the stockholder without income. The fact that he may sell and thus realize is not the same as realization. The value, whatever it may be prior to sale or liquidation, is still the value of his capital interest. There is no income while the investment is in this conditon, except as true dividends are received by which sums of money or specific assets are separated from the capital investment and realized as gains to the stockholder.

There should be no confusion of mere accretions to capital and income. When a tax is laid on property according to value, of course, the property interest is valued with all its accretions. Thus, if a tax is laid on the property of A, which consists of shares of stock, these shares should be valued at whatever they may be worth according to the available standards of value. In thus valuing shares, the entire proportionate interest in the aggregate assets of the corporation would be valued without distinction between capital and surplus. But the fact that this property in shares may be valued at a given amount, and that this value may include the proportionate interest in undivided profits cannot be taken to import that the interest in undivided profits is income. The enhanced value of the shares is merely the enhanced value of the capital investment. The accretion has not been separated from the capital. When a property tax is laid, that entire value may be taxed as the value of the property. But the unseparated and un-

realized increment of capital cannot be treated as income and taxed as such. For example, if the Federal Government laid a direct tax by apportionment on the shares as property, the value of the shares would be taken on the basis of their proportionate interest in all the corporate assets, undivided profits of the corporation as well as capital. But in laying an income tax under the Sixteenth Amendment, it must appear that there has been income, that is, a separated, realized gain and it is not enough to point to an unseparated accretion to the capital investment, which as a part of that capital interest would appropriately be valued if a direct tax were laid upon it.

It is evident that the interest of a shareholder, by virtue of the ownership of his shares, is a *capital* interest. It is a single interest in the aggregate assets of the corporation subject to the payment of debts. The shareholders are not the owners of the property, profits or the invested accumulations of the corporation. The interest of each shareholder in the assets of the corporation is one that can only be enjoyed in possession in case there is a winding-up or liquidation. The fact that the value of the share interest may be greater at one time than another in no way changes the nature of the interest. The shareholder has the right to vote, to receive dividends, and on liquidation to receive his proportionate part of the surplus that may remain after debts are paid. He has the right to have the assets of the corporation properly employed in the corporate enterprise. He may transfer his right by sale. Except as he receives dividends he has no segregated interest in corporate surplus or undivided profits. His interest by virtue of stock ownership is always his proportionate right with respect to the aggregate assets of the corporation, subject to the payment of all liabilities, and he has no divisible interest in the profits which the corporation holds, without distribution, and invests in its plant and business. The shareholder has simply his share, his interest, in the corporate enterprise. The corporation must, of course, pay its income tax upon its profits, but there is no income to the shareholder unless he receives it. His share interest is a "capital" interest.

At this point, it may be observed that the profits earned by the corporation are its property, not the property of the shareholders. This distinction is not a form or technicality. It is a vital distinction inherent in corporate organization. The interest of the shareholder is a distinct interest. The profits of the corporation are not his profits. This distinction between the title of a corporation and the interest of its shareholders in the property of the corporation, including its earnings, has been authoritively established by two lines of decisions of this Court in cases involving the power of taxation.

In the first the Court considered the power of the states to tax shares of stock of national banks in the hands of shareholders, and it was held that although all of the capital of the national bank was invested in securities of the United States, which were tax exempt, the states were authorized, under the consent given by Congress, to tax national bank shares because of the substantial distinction between the interest of the shareholders and that of the corporation. In the leading case, *Van Allen* v. *The Assessors*, 3 Wall. 573, the Court said (p. 584):

"The tax on the shares is not a tax on the capital of the bank. The corporation is the legal owner of all the property of the bank, real and personal and within the powers conferred upon it by the charter, and for the purposes for which it was created, can deal with the corporate property as absolutely as a private individual can deal with his own * * *

"The interest of the shareholder entitles him to participate in the net profits earned by the bank in the employment of its capital, during the existence of its charter, in proportion to the number of his shares; and, upon its dissolution or termination, to his proportion of the property that may remain of the corporation after the payment of its debts. This is a distinct independent interest or property, held by the shareholder like any other property that may belong to him."

The same ruling was made in

People v. *Commissioners*, 4 Wall. 244;
Bradley v. *The People*, 4 Wall. 459;
National Bank v. *Commonwealth*, 9 Wall. 353, 358, 359;
Owensboro National Bank v. *Owensboro*, 173 U. S. 664, 680.

See also,

Evansville Bank v. *Britton*, 105 U. S. 322;
Cleveland Trust Company, v. *Lander*, 184 U. S. 111;
Home Savings Bank v. *Des Moines*, 205 U. S. 503;
Rogers v. *Hennepin County*, 240 U. S. 184.

The second line of authorities consists of decisions in controversies involving the impairment of contracts for tax exemption, in which again this Court has pointed out that the taxation of a shareholder on account of his interest in the property of the corporation is not the equivalent of a tax on the corporation's property.

> *Bank of Commerce* v. *Tennessee,* 161 U. S. 134, 146;
> *Shelby County* v. *Union and Planters' Bank,* 161 U. S. 149, 153-154;
> *Wright* v. *Georgia R. R. & Banking Co.,* 216 U. S. 420, 425.

See also,

> *Farrington* v. *Tennessee,* 95 U. S. 679;
> *Sturges* v. *Carter,* 114 U. S. 511;
> *Tennessee* v. *Whitworth,* 117 U. S. 129;
> *New Orleans* v. *Houston,* 119 U. S. 265;
> *New Orleans* v. *Citizens' Bank,* 167 U. S. 371;
> *Powers* v. *Detroit & Grand Haven Ry.,* 201 U. S. 543.

When the question of the nature of the shareholder's interest in undivided profits came before this Court in *Gibbons* v. *Mahon* (136 U. S. 549) the question was carefully considered and explicitly determined. The Court pointed out the distinction between the money earned by the corporation, and the shareholder's income, and ruled expressly that the interest of the shareholder in the accumulated earnings of the corporation, as a part of his share interest, was capital and not income, so long as the earnings were held and

invested by the corporation as a part of its corporate property.

It is apparent that in *Gibbons* v. *Mahon, supra,* the former expressions in opinions of this Court had been carefully examined (136 U. S. p. 560). It was remarked that the opinion of Mr. Justice Clifford in the *Bailey* case, 22 Wall. 604, contained "some general expressions which, taken by themselves, might seem to ignore the settled distinction, (affirmed by this court in earlier and later cases above cited,) between the property of the corporation and the interests of the shareholders." Summarizing its views, the Court said in the *Gibbons* case, speaking through Mr. Justice Gray (*id.* pp. 557, 558):

> **"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. Van Allen v. Assessors, 3 Wall. 573, 584; Delaware Railroad Tax, 18 Wall. 206, 230; Tennessee v. Whitworth, 117 U. S. 129, 136; New Orleans v. Houston, 119 U. S. 265, 277.**
>
> **"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. Acting in good faith and for the best interests of all concerned, the corporation may distribute its earnings at once to the stockholders as income; or it may reserve part of the earnings of a prosperous year to make up for a possible lack of profits in future years; or it may retain portions of its earnings and allow them to accumulate, and then invest them in its own works and plant, so as to secure and increase the permanent value of its property. * * ***
>
> **"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, as between the tenant for life and the remainderman, legal or equitable, thereof."**

And, in the opinion in *Towne* v. *Eisner, supra,* referring to the 'stock dividend' there under consideration and to the views expressed in *Gibbons* v. *Mahon* this Court said;

> **"Notwithstanding the thoughtful discussion that the case received below we cannot 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."**

It is thus to be observed that the Court in the *Gibbons* case not only held that the 'stock dividend' was not income, but also distinctly ruled that the interest of the

shareholder in the accumulated earnings of the corporation, so long as they are held and invested by the corporation, is a *capital interest* and *not* income.

It is in the light of the clear authorities which we have cited that the case of *Collector* v. *Hubbard,* 12 Wall. 1, upon which it is apparent that the Government chiefly relies, should be considered.

The *Hubbard* case arose under section 117 of the Act of 1864 (13 Stat. 281, 282), which provided that "the gains and profits of all companies," other than those otherwise taxed, should "be included in estimating the annual gains, profits or income of any person entitled to the same, whether divided or otherwise."

It is manifest that the provision of the Act of 1864, was to insure the payment of the tax upon the earnings of the corporation (see *Gibbons* v. *Mahon,* 136 U. S. 549, 560). Under the Act of 1864 there were three provisions relating to taxes upon corporate earnings. Section 122 (13 Stat. 284-285) related to railroad, canal and turnpike companies and provided for a tax of five per cent upon the amount of interest, dividends or profits. After a long-standing difference of opinion [1] it was finally de-

---

[1] *Barnes* v. *The Railroads,* 17 Wall. 294, 309, 319; *United States* v. *B. & O. R. R. Co.,* 17 Wall. 322; *Stockdale* v. *Insurance Companies,* 20 Wall. 323, 329. 337; *Bailev* v. *Railroad Co.,* 22 Wall. 604; *Railroad Company* v. *Collector,* 100 U. S. 595; *Bailey* v. *Railroad Co.,* 106 U. S. 109; *United States* v. *Erie Railway Co.,* 106 U. S. 327, 329, 330, 331; *Memphis & Charleston R. R. Co.* v. *United States,* 108 U. S. 228, 234. See *United States* v. *Louisville & N. R. R. Co.,* 33 Fed. 829, 831, 832; *Pollock* v. *Farmers Loan & Trust Company,* 157 U. S. p. 578.

cided that this was essentially an excise tax on the business of the described corporations (*Railroad Company* v. *Collector,* 100 U. S. 595, 598; *United States* v. *Erie Railway Co.,* 106 U. S. 327, 330). By section 120 of the same Act (13 Stat. 283, 284) provision was made for a similar tax with respect to the earnings of banks, trust companies and insurance companies.

Section 117, which was before the Court in the *Hubbard* case, related to the earnings of all other companies that is, all companies except those above specified, and embraced the manufacturing corporations, the earnings of which were there in question. Section 117 was thus intended to reach corporate earnings not otherwise taxed. As the Attorney General said in his argument (12 Wall. p. 8), after referring to the different methods employed in these sections of the Act of 1864: "In all cases the entire annual gains and profits of every corporation, divided or undivided, seem to be within the aim and purview of the statute as objects of taxation."

There was no attempt to tax both the corporation and the shareholder with respect to the same earnings. The statute under consideration in the *Hubbard* case was plainly a crude method of reaching the corporate earnings and was the only tax imposed with respect to those earnings.

And there can be no doubt as to what was taxed in that case. Hubbard was taxed upon an undivided interest in corporate profits which had been retained by the corporation and invested in the corporate enterprise

or appropriated to the payment of the corporate debts. The fact that the statute directed that the gains and profits of the corporation, although undivided, should be included in estimating the annual gains, profits or income of the shareholder, clearly indicates that the shareholder, during the taxable period and while he was a shareholder, was to be taxed upon the increment supposed to have been added to the value of his share by his proportionate interest in the undivided profits. This, as a matter of statutory construction, is clear enough. But it by no means follows that this increment was income to the shareholder, when it becomes necessary to distinguish between a tax on income and a direct tax on the capital investment including all that is still a part of the capital investment and does not represent any gain separated therefrom and realized by the shareholder.

The fact that the tax is on the supposed increment, by reason of the proportionate interest of the shareholder, through ownership of his shares, in the undivided profits of the corporation, is one thing; the nature of the increment is quite another.

We are not left in doubt as to the nature of that increment. It has been explicitly described in the opinion of this Court in *Gibbons* v. *Mahon* (*supra*). To repeat, the Court there, fully conscious that there were ambiguities expressed in the statements in earlier opinions, set the matters at rest by saying in so many words:

> "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, as between the tenant for life and the remainderman, legal or equitable, thereof." (Italics ours.)

It is manifest that the interest in the undivided profits as between the tenant for life and remainderman, was a capital interest and not income simply because that was the truth of the matter. That is, because it was not income in fact or law. Plainly, that which is not income does not become income by having a tax put upon it.

The reasoning of Mr. Justice Gray in delivering the opinion of the Court in the *Gibbons* case is unassailable.

When the Court is asked to conclude that a tax on the increment through the shareholder's interest in undivided profits, was a tax on *"income,"* the Court is asked to repudiate its explicit declaration to the contrary in the *Gibbons* case.

This repudiation is not required by anything said in the *Hubbard* case. For the *Hubbard* case was dealing with the mere fact of the increment and did not deal with its nature, as the Court in the *Gibbons* case was called upon to deal.

The reason why the Court in the *Hubbard* case was not called upon to define the nature of the increment, beyond the fact that it was *property,* is apparent from the absence of any controversy over a constitutional question, and from the opinion entertained at the time with respect to what was a direct and what was an indirect tax under the Federal Constitution.

It was sufficient in the *Hubbard* case to determine that there was an increment, although unrealized. If there was an increment through the proportionate share in undivided profits of the corporation, the statute was satisfied, and the validity of the statute was not assailed. Moreover, had its validity been assailed, it would have been thought sufficient at that time to say that the tax was on personal property and whatever the nature of the increment, it being a tax upon that increment as an incident to a share which was personal property, it was not a direct tax. Hence, in the view then entertained, before the *Pollock* case, * the tax could be sustained, as it was quite generally supposed that direct taxes were taxes on real estate and capitation taxes.

Under the understanding at that time of direct and indirect taxes the decision was unassailable. From the beginning until the decision of the *Pollock* case it was generally understood that direct taxes in the constitutional sense embraced only capitation taxes and taxes on land, and that a tax on personal property was in the class of indirect taxes. In the first case which came before this Court involving the meaning of direct taxes (the *Hylton* case†) it was held that a tax on personal property was not a direct tax, and the opinions of the Court, some of whose members had participated in the proceedings of the Constitutional Convention, clearly expressed their

---

* 158 U. S. 601

† 3 Dall. 171

view that direct taxes included only capitation taxes and taxes on land. These expressions, repeated in subsequent decisions of this Court, were in harmony with the views of eminent commentators on the Constitution and were generally accepted as a definition of direct taxes.

> *Veazie Bank* v. *Fenno,* 8 Wall. 533;
> *Pacific Ins. Co.* v. *Soule,* 7 Wall. 433;
> *Scholey* v. *Rew,* 23 Wall. 331;
> *Springer* v. *U. S.,* 102 U. S. 586;
> 1 *Kent's Commentaries,* 254-256;
> 1 *Story on the Constitution,* Sec. 955.

Indeed in 1861 when it was proposed to levy a direct tax, by apportionment, on personal property, a committee of the House of Representatives reported that under the *Hylton case it could not be done* (see 158 U. S. p. 710). So, in 1870, when the *Hubbard* case was decided it was sufficient to sustain the tax that the subject of the tax was personal property.

That we are not misconstruing the *Hubbard* case is apparent from the opinion there delivered by Mr. Justice Clifford. He said:

> "Decided cases are referred to, in which it is held that a stockholder has no title for certain purposes to the earnings, net or otherwise, of a railroad prior to the dividend being declared, and it cannot be doubted that those decisions are correct as applied to the respective subject-matters involved in the controversies. Grant all that, still it is true that the owner

> of a share of stock in a corporation holds the share with all its incidents, and that among those incidents is the right to receive all future dividends, that is, his proportional share of all profits not then divided. Profits are incident to the share to which the owner at once becomes entitled provided he remains a member of the corporation until a dividend is made. Regarded as an incident to the shares, undivided profits are property of the shareholder, and as such are the proper subject of sale, gift or devise. Undivided profits invested in real estate, machinery, or raw material for the purpose of being manufactured are investments in which the stockholders are interested, and when such profits are actually appropriated to the payment of the debts of the corporation they serve to increase the market value of the shares, whether held by the original subscribers or by assignees. But the decisive answer to the proposition is that Congress possesses the power to lay and collect taxes, duties, imposts, and excises, and it is as competent for Congress to tax annual gains and profits before they are divided among the holders of the stock as afterwards and it is clear that Congress did direct that all such gains and profits, whether *divided or otherwise,* should be included in estimating the annual gains, profits, or income liable to taxation under the provisions of that act. Annual gains and profits, whether divided or not, are property, and, therefore, are taxable."

Of course, Mr. Justice Clifford found that there was an increment. But his point was that this increment was "an incident to the shares". He says that "regarded as an incident to the shares, undivided profits are property of the shareholder, and as such are the proper subject of sale, gift or devise." This is true of all capital interests.

And in conclusion the learned Justice says that the annual gains or profits "are property, and, therefore, are taxable."

It was not necessary for Mr. Justice Clifford, in the absence of the debate which about twenty-five years later took place in the *Pollock* case, to go further. When however the Court had occasion to deal with the precise question, in *Gibbons* v. *Mahon*, the Court stated its conclusion emphatically, and without the slighest reservation, that *whatever increment there was, through undivided profits held and invested by the corporation, to the share of the stockholder, was capital and not income.* The Sixteenth Amendment, as stated in the *Brushaber* case, * must be regarded as accepting the *Pollock* case and as virtually making that decision part of the Constitution, except so far as the Sixteenth Amendment itself has modified it.

The increment in the *Hubbard* case was nothing but an accretion to capital. It was not a separated, realized gain. It was not income. Hence, under the doctrine of the *Pollock* case and the doctrine now applicable to all cases where a capital interest is taxed, the tax could not validly be laid except as an apportioned direct tax. Take

*240 U. S. 1.

the case of estates where investments in stocks have come into the possession of trustees, would any one have the hardihood to maintain that a tax upon the undivided profits of the corporations was a tax which could validly be laid upon the income of the tenant for life, and that the tenant for life, not receiving any separated or realized gain, could have what he did receive diminished for the purpose of paying such a tax? Suppose in the *Hubbard* case, under the Act of 1864, instead of Hubbard there had been the trustees of Hubbard's estate owning the stock during the period when the undivided profits were made by the corporations and Hubbard's wife had been the tenant for life and entitled to the income, would the tax have been sustained as a tax upon the income? The same discussion which was had later in the *Gibbons* case must inevitably have taken place and we must assume in the light of the *Gibbons* decision that the law would have been declared to be that the increment through the proportionate interest of the shareholder in the undivided profits of the corporation was a capital interest and not income.

We see no reason why the Court should be asked to repudiate the clearly expressed doctrine of the *Gibbons* case in order to give effect to a ruling which is not found in the *Hubbard* case and which if there found would be opposed to sound reasoning and to the Court's later decision.

We do not find that the *Hubbard* case has been followed, in the sense that the Government implies. The Government cites *Bailey* v. *The Railroad*, 22 Wall. 604, 635, 636. We have already referred to the decision in the *Bailey* case (ante, p. 23) and it is that case, and precisely the portion of the opinion to which the Government alludes, that is discussed and limited by the opinion of this Court in the *Gibbons* case (136 U. S., pp. 557-558). Mr. Justice Gray there said, as already noted, that the opinion in the *Bailey* case, which was written by Mr. Justice Clifford, (who also wrote the opinion in the *Hubbard* case) contained "some general expressions" it was necessary to limit and there can be no doubt that the decisions prior to the *Gibbons* case received most careful attention.

As a pronouncement in support of a tax on 'stock dividends' as "income" the *Bailey* case was deprived of any standing or authority by the decision in the *Gibbons* case, and the latter decision expressly holds, as we have seen, that the proportionate interest of a shareholder in the undivided profits of a corporation is capital and not income. Thus, in the light of the *Gibbons* case, there is nothing in the *Bailey* case which can be deemed to be a sanction of what the Government now seeks to deduce from it for the purposes of the present case.

Since the *Gibbons* case, the *Hubbard* case has not been cited, we believe, except in *Southern Pacific* v. *Lowe*, 247 U. S., 330, 336; *Lynch* v. *Turrish*, 247 U. S., 221, 228; and *Lynch* v. *Hornby*, 247 U. S., 339, 343. As these recent cases were decided by this Court as now constituted, the Court needs no suggestion as to the import of the citations. We may say, however, that we do not find anything in the citations to support the Government's contention. In *Southern Pacific* v. *Lowe*, it was cited merely to be distinguished and it was pointed out that the decision was based on the very special language of the Act of 1864. The point now under consideration was not discussed.

In *Lynch* v. *Turrish*, *supra*, it was said that in the *Hubbard* case "the distinction between a corporation and its stockholders was recognized and that the stockholder had no title for certain purposes to the earnings of the corporation, net or other, prior to a dividend being declared, but they might become capital by investment in permanent improvements and thereby increase the market value of the shares, 'whether held by the original subscribers or by assignees'. In other words, it was held that the investments of the corporation were the investments of the stockholders; that is, its stockholders could have an interest, taxable under the act considered, though not identical with the corporation." But we do not find in this statement anything inconsistent with what was explicitly ruled by this Court in the *Gibbons* case, that the interest of the shareholder in profits invested by the corporation was essentially a capital interest. The question now being discussed was not involved in any way in the *Turrish* case. Nor does the case of *Lynch* v. *Hornby*, *supra*, involve the present question.

To conclude, the shareholder who does not realize a gain through the sale of his shares or through the liquidation of the corporation, obtains no separated, realized gain from any increment in value through the enhancement of the value of his shares by reason of earnings of the corporation which are invested and not divided among the shareholders. Before he realizes that gain the shareholder has nothing apart from his capital investment, represented by his shares,—his proportionate interest in the aggregate assets of the corporation. It may be there is an increment to that capital interest in the sense that its value is enhanced, but that value means nothing separately realized by the stockholder. The economic distinction is established beyond controversy. Such an enhancement in the value of a capital interest, through undivided profits, is not income, either in economics or in law. It is not income in law, because it is not income in fact. It is not income in law because it has been judicially determined by this Court not to be income, but to be capital.

THIRD. 'Stock Dividends' do not constitute income. Income is the gain, come to fruition, from capital, from labor, or from both combined. This is sound doctrine both in law and in economics. *a.* Income of a corporation is not income of a shareholder until distributed. *b.* A 'stock dividend' is not income. It does not constitute a distribution of anything; it is a mere readjustment of capital.

"Income" has been repeatedly defined by this Court. In *Stratton's Independence* v. *Howbert* 231 U. S. 399, at page 415, the Court said:

> " 'Income' may be defined as the gain derived from capital, from labor, or from both combined."

This definition was reaffirmed in *Doyle* v. *Mitchell Brothers Co.*, 247 U. S. 179, 185, where it is said that

> "Whatever difficulty there may be about a precise and scientific definition of 'income', it imports, as used here, something entirely distinct from principal or capital either as a subject of taxation or as a measure of the tax; conveying rather the idea of gain or increase arising from corporate activities. As was said in *Stratton's Independence* v. *Howbert*, 231 U. S. 399, 415: 'Income may be defined as the gain derived from capital, from labor, or from both combined.' "

The "gain" referred to in this definition must exist not only in the sense of "increase"; it must be separated, be realized. Gain as mere unseparated accretion is not income. The gradual increase in value of a parcel of real estate, the appreciation in value of a diamond, may be said to constitute gain in the sense that the real estate or the diamond is at the later time worth more to the owner than at the earlier time, but in no sense does the gain constitute income; it is simply increment of capital. It is essential to "income" that the gain be separated, that it be realized, that it come to fruit. This Court in *Lynch* v. *Hornby*, 247 U. S. 399, at page 343, said that accumulations of corporate profits would be taxable to the stockholder

> "only if and when and to the extent that his interest in them comes to fruition as income, that is, in dividends declared."

Again, in *Lynch* v. *Turrish,* 247 U. S. 221, at page 231, the Court said:

> "Advance in value is not income at all but merely increase of capital and not subject to a tax as income."

And earlier, it had been held that

> "The mere fact that property has advanced in value between the date of its acquisition and sale does not authorize the imposition of the tax on the amount of the advance. Mere advance in value in no sense constitutes the gains, profits, or income specified by the statute. It constitutes and can be treated merely as increase of capital." *Gray* v. *Darlington,* 15 Wallace, 63 at page 66.*

In a recent English decision (July 19, 1919) it was held by the Court of Appeal that there was no liability for a surtax on so-called " bonus shares". Mr. Justice Rowlatt, in delivering the opinion of the Court said:

*Under the British Income Tax Act (16 & 17 Vict. c. 34) it is established that appreciations in value of capital assets, even after the realization of profits by sale, do not constitute taxable income except in cases of transactions by dealers or other persons who buy and sell for purposes of profit. *Tebrau (Johore) Rubber Syndicate, Limited,* v. *Farmer,* S. T., 5 Income Tax Cases, 658; *Stevens* v. *The Hudson's Bay Company,* 5 Income Tax Cases, 424; *The Assets Company, Ltd.,* v. *The Inland Revenue,* Cases in the Court of Session, 4th Series Vol. 24, p. 578.

> "I do not think that there is a payment of a dividend to a share-holder unless a part of the profits of the company is thereby liberated to him in the sense that the company parts with it and he takes it. If, in this case, the company could have found means to capitalize its profits and divide them as capital without adopting the machinery of declaring a bonus and allotting shares by agreement (not a voluntary agreement) in satisfaction of such bonus, I do not think the case would have been arguable."
>
> *Commissioners of Inland Revenue* v. *John Blott,* reported in the "London Times" of July 25, 1919.

These legal definitions of income are firmly supported by the views of leading 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." E. R. A. Seligman, Principles of Economics, 7th Ed., page 16.
>
> "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, page 19.

The nature of a 'stock dividend', economically considered, is well set forth in an article, "The Economic Nature of the Stock Dividend", by Professor Fairchild, in The Bulletin of the National Tax Association, Vol. III, No. 7, April, 1918, at page 163:

"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. The balance sheet, as of a certain date, shows capital; income appears in the income account of a certain year or other period. Capital yields income when it performs some service for its owner. Mere growth in amount of capital is not income. The owner is becoming richer, but he is receiving no income from this capital. The income is being deferred to the future. In fact, it is by this very postponement of income that the capital is allowed to increase in value. A forest plantation increases in value as the trees grow up toward marketable age. But this growth is not income. If, before any timber had been cut, a fire should destroy the forest we could not say that the owner had enjoyed any income from this piece of capital. He would have been just as well off if there had been no growth."

The economic considerations with respect to the nature of 'stock dividends' are ably discussed by Professor Edwin R. A. Seligman in "Are Stock Dividends Income" (American Economic Review, Vol. IX, No. 3, p. 517). With the Court's permission we shall submit a copy of the article with this brief.

It clearly appears, therefore, that "income" has these invariable characteristics:

(*a*) It must be gain;

(*b*) The gain must be separated from the capital, realized by the recipient;

(*c*) The capital must remain intact after the separation.

Increase in value of a capital asset is mere accretion or accumulation of capital—it can become income only by separation, by realization; for instance, where the property, whether real estate, chattels, securities or what not, is sold, the gain is separated, is realized, is in hand,—in short, is income; so also, accumulations of earnings or profits of a corporation are, until distributed, in nature precisely like the accretion to the value of a chattel; in order to become income they must be separated. For instance, in the case of corporate earnings, they must no longer be under the control of the corporation—they must, on the contrary, be in the sole dominion of the stockholder. This can come about only by distribution,—whether the distribution be called dividend or not and whether it be in money or *in specie*. Ordinarily, the distribution, so far as the stockholder is concerned, is in cash, which is in the absolute control of the stockholder, separated therefore from the corporation, the capital remaining unimpaired. But the distribution need not be in cash so long as there is complete separation. When, as in *Peabody* v. *Eisner*, 247 U. S. 347, the Union Pacific Railroad Company distributed stock of the B. & O. R. R. Co., the Union Pacific stockholder received something separated from the Union Pacific corporation, in his own absolute dominion, and besides he lost nothing of his previous proportionate interest and right in the Union Pacific Company itself.

This Court in *Towne* v. *Eisner* expresses the true doctrine when it says that

> "If the sum [that is some definite amount of the surplus account representing accumulated profits] had been carried from surplus to capital account without 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." *Towne* v. *Eisner,* 245 U. S. 418, p. 426.

Unseparated increment, whether in the value of the property or in the amount of accumulated earnings, is capital; separated and distributed accretion of the one sort or the other is income; it becomes income in the act of separation and distribution, not otherwise.

This is not to indicate that a shareholder's gain through accretion to capital through the earning of corporate profits will not ultimately pay income tax. The tax will be imposed instantly the gain is realized. and that will occur immediately upon sale—and then whatever profit is realized becomes income and is taxable accordingly.

There is a constant assumption on the part of the Government that a 'stock dividend' "represents" only

the surplus earnings of the corporation and that a declaration of a 'stock dividend' constitutes a separation and distribution of those earnings. Both assumptions are erroneous. 'A stock dividend' does not represent the surplus. It is occasioned by the surplus—it would not come into being unless there were a surplus; but it represents its due proportion of the total assets,—that is, its due proportion of the original capital as well as of the surplus. To illustrate: A corporation of $100,000 capital accumulates surplus earnings of $50,000; it declares a 'stock dividend' of fifty per cent.; the new shares, precisely as the old shares—no more, no less, represent a due proportion of the sum of the capital and the surplus.

It is fundamental that a 'stock dividend' distributes nothing; it is a mere readjustment of capital. It cannot be said that there is a distribution unless there be a distributor and a distributee; that something be given and something received—necessarily something that the distributee had not already. The whole thing is a mere bookkeeping expedient. Let us illustrate: A corporation starts with capital of $100,000, and assets $100,000. Its books would show

Liabilities.		Assets.	
Capital	$100,000	Miscellaneous Items	$100,000

Later the corporation makes a profit of $50,000. These profits are crystallized in additional assets and on the books an equivalent amount will appear as a liability. The books will then show the following:

Liabilities.		Assets.	
Capital	$100,000	Miscellaneous Items	$150,000
Surplus or undivided profits	50,000		
	$150,000		

Obviously the stock of this corporation has a book or intrinsic value of one hundred and fifty per cent.—that is $150,000. The company determines that it will not distribute the surplus earnings, but on the contrary will so adjust its affairs that they cannot hereafter be distributed as dividends but must hereafter be retained as capital. To this end the corporation issues a 'stock dividend' of fifty per cent. As a consequence the corporation has now a capital of $150,000 and no surplus earnings. This is expressed upon the books as follows:

Liabilities.		Assets.	
Capital	$150,000	Miscellaneous Items	$150,000

It must be clear as noon-day that here, after the issuance of the 'stock dividend', the total stock, old and new, taken together, is worth and represents precisely the same as the original stock before the issuance of the 'stock dividend'.

The only thing that has happened is that upon the balance sheet of the corporation the item which there stood as "Undivided profits" has disappeared and its amount has been added to the item "Capital". Both, however, are under the general head "Liabilities" and both are balanced by precisely the same assets of precisely the same value. That this constitutes a distribution to the stockholder of anything not theretofore his own is an absurdity. On the contrary, the corporation has determined not to distribute its earnings but to invest them in plant and improvements. This it cannot safely do on any considerable scale save from its capital. It therefore impounds the surplus, uses it as capital and issues the new certificate as evidence that the former surplus is no longer distributable but permanently invested as capital.

It appears, therefore,

(a) That until separated from the corporation, distributed to the stockholder, corporate earnings are mere accretion of capital;

(b) That a 'stock dividend' is not income because it does not constitute a distribution of anything:

(c) That a 'stock dividend' is a mere readjustment of capital.

'Stock dividends' are not income within the meaning of the Sixteenth Amendment.

We have shown, as we think, in the preceding point, that economically considered a 'stock dividend' is not income, but in view of the statements contained in some of the opinions of other courts, which the Government cites, we shall here briefly review some of the further considerations which, as we view it, lead to the conclusion that 'stock dividends' are not income. If they are not income in the sense that they make the shareholder richer than he was before it can hardly be contended that they should be regarded as income within the meaning of the constitutional provision.

The situation here presented is a typical one and the facts to which the question is addressed are familiar.

A corporation is not bound to distribute all its earnings in dividends. The directors may properly decide to use a portion of the earnings for the development of business, for the extension of plant, for betterments and for working capital. The undivided surplus of a corporation is not, normally, idle money; it is, normally, invested money. It is money invested in property, or embarked in the corporate enterprise; that is the reason it is not paid out in dividends. If the directors have not transcended the broad limits of their judgment, the shareholders cannot complain because earnings are invested instead of being distributed.

The interest of the shareholders, with respect to the property of the corporation, is not an interest in the segregated portion representing the original subscriptions; it is not an interest limited to an amount equal to the par value of their shares; it is not an interest limited to any particular portion of the corporate property, in the absence of special charter provisions, but is simply an interest in all the corporate assets. When these assets are swelled by the addition of undivided profits,

the interest of the shareholders in these accumulations is precisely the same as their interest in any other property of the corporation. "The property of every company may consist of three separate distinct things, which are its capital stock, its surplus, its franchise; but these three things, several in the ownership of the company, are united in the ownership of the shareholders. The share stock covers, embraces, represents all three in their totality, for it is a business photograph of all the corporate possessions and possibilities" (*People ex rel. Union Trust Co.* v. *Coleman*, 126 N. Y. 433, 438).

When dividends are declared the amounts of the dividends are separated from the corporate property and are received by the shareholders respectively as their separate property. But until dividends separating money or property from the corporate assets in this way are declared, the shareholders continue to retain the interest in all these assets represented by their stock, the extent and value of their aggregate interests depending not upon the sums originally contributed to capital, but upon the extent and value of all the assets of the corporation, including its accumulations, after deducting liabilities. When a so-called 'stock dividend' is declared, the company does not distribute but continues to hold the property upon which the stock issue rests. Its undivided profits previously invested in the enterprise continue to be so invested. Instead of being a "dividend" in any proper sense, the effect of the action is that there shall be no dividends of the accumulations capitalized. The aggregate interests of the shareholders remain unchanged and their proportional interests remain unchanged.

Thus, a 'stock dividend,' or increase of capital stock against surplus accumulations, accomplishes two things:

(1) The amount represented by the 'stock dividend' is permanently classified so that it cannot be paid out as dividends.

(2) The number of shares is increased without affecting the title of the corporation to any part of the corporate property and without adding to the ratable interests of the shareholders.

Upon a liquidation immediately before the 'stock dividend' the shareholder would have received precisely the same amount as he would have received upon a liquidation immediately after the 'stock dividend'. So far as the paper, or stock certificate, issue is concerned, it is an evidence of an interest already owned and permanently capitalized.

It is frequently said that the shareholder secures new rights or advantages. But the contention will not bear analysis. We are concerned here with the *property interest* represented by the stock in question upon which the plaintiff had been taxed. This stock represents (1) the right to have the corporate property managed according to the fundamental compact or contract of membership; (2) the right to receive dividends, when duly declared, that is, amounts separated from the corporate assets and vested in the shareholders individually; and, (3) the ratable interest in the aggregate of the corporate assets to which the shareholders would be en-

titled upon liquidation.

With respect to management, the shareholders rights are unchanged save to the extent that the accumulated surplus, which is represented by the new stock, is no longer subject to the discretion of the directors in distribution but is classified as capital and must be retained by the corporation as such.

With respect to dividends that may be declared upon this stock,—whenever any such dividend is declared and there is thus segregated from the corporate property an amount which the shareholder receives, he will be taxable accordingly.

With respect to the right to receive his ratable interest upon a winding-up, there is no change.

It is argued that the effect is the same as though a cash dividend had been declared, and its amount received by the defendant-in-error, and she had then invested this amount in the new stock. The same argument was made unavailingly in *Towne* v. *Eisner*. It is manifest that the two things mentioned, instead of being the same, are different, both legally and practically. When the cash dividend is declared and the amount is received, the shareholder obtains something which he owns and which he may reinvest or not as he pleases. He receives property in his exclusive ownership, and he exercises the freedom of choice. In the case of a 'stock dividend', he obtains nothing but an evidence of what he already owns; he has no freedom to invest or not invest; and the investment is permanently capitalized. This distinction was pointed out in *Davis* v. *Jackson*, 152 Mass. 58.

It is argued further that the certainty that these earnings of the corporation could thenceforth never be distributed as dividends, was a valuable assurance of the continued solvency of the company to the stockholder, and that this assurance was subject to a tax as income of the individual shareholder. But before the 'stock dividend' the shareholder's interest in the corporate assets could not be taken away, except through mismanagement or losses, and his interest continues to be subject to these contingencies as before. Previously, if there were distribution in cash, he would receive his dividend and own the amount. The proposition that the certainty that a man will never receive a given fund is equivalent to his actual receipt of that fund will appeal less to the shareholder's sense of logic than to his sense of humor.

Nothing could be a greater fallacy than to treat a recipient of a 'stock dividend' as being in the position of a recipient of a like amount of cash. In fact, he may never receive anything but a piece of paper, for the corporation may become insolvent and his stock worthless. In the present case, the shares had a market value and, as might be expected, the market value of all the shares remained unchanged. But it may be, and frequently is, the case that at the time of the 'stock dividend' the shares do not have a market value, or have a market value below par. The corporation may have surplus, and may capitalize it, but it may be engaged in a hazardous enterprise or for other reasons

its shares may not have a value corresponding to their book value. Illustrations of this may readily be found. There are today selling on the New York Stock Exchange shares which are below par, although the corporation has a surplus and could issue 'stock dividends'. Such 'stock dividends' would not only make the shareholders no richer, but the latter would have to pay a tax, under the contention of the Government, as an income tax upon an assumed or par value which was greater than the actual value of the shares themselves. The fact that the corporation may have accumulated profits, or surplus, does not mean that the shareholders can realize that amount. It is a misnomer to call 'stock dividends' a *distribution*; it is not a distribution but a capitalization. The capitalization of surplus does not transfer it to shareholders. If the new shares have market value, the 'stock dividend' will make the shareholders no richer, and, if the shares have no market value, the shareholders will not be able to realize even that which they are falsely assumed to have received.

The argument that a 'stock dividend' is income fails to distinguish between the effect of the dollar sign printed on the certificates of stock as indicating the amount contributed to "capital", and the interest of the shareholder in the aggregate corporate assets, with which this dollar sign, or the par value of his shares, has nothing to do. As to the corporation, its net assets are divided into two groups, "capital" and "surplus", with different legal attributes, and the dividing line between the two groups is shown by the nominal or par value of the company's stock, or the amount of the contributed "capital".

In the case at bar, for example, the Standard Oil Company of California had \$49,686,656 of capital stock, and \$94,538,919. of assets. The \$49,686,656 of capital was divided into 496,866 shares of the par value of \$100 each. These \$49,686,656 represented in a general sense a trust fund to be used by the corporation in the conduct of its business and for the payment of its debts; none of it could lawfully be separated from the company and paid to its shareholders. The other \$44,852,263 of its assets represented surplus which the company was free to dispose of in any manner that it saw fit. There were 496,866 shares of stock outstanding; the dollar mark on each certificate, indicating the par value of each share; was of importance in indicating the amount of the contributed capital stock, and therefore the dividing line between these two groups of its net assets.

But there was no such distinction with regard to the shareholder's interest in the aggregate corporate assets. As to this the dollar mark on his certificate was immaterial. Each share of stock represented 1/496,866 part of the net assets of the corporation, and those assets might amount to \$1,000,000 or \$50,000,000, and this was true whether his stock had a nominal par value or whether, as is permitted in various States, it was 'no par value' stock.

When it is argued that in receiving a 'stock dividend,' a shareholder receives from the corporation something of value which must therefore be income, there is an inaccuracy in terms. If I exchange a two-

dollar bill with the money changer for two one-dollar bills, I have, it is true, received from him something of value, but my property interest remains entirely unchanged, and I have surely not received any "income."

If the Standard Oil Company of California had outstanding 496,866 shares of capital stock of the nominal or par value of \$100. each. and had issued in exchange therefor 993,732 shares of the nominal or par value of \$50. each, each shareholder would have received an increased number of tangible evidences of his ownership in the assets of the corporation. He would have no greater interest in the assets of the corporation than he had before, and the dividends he might thereafter receive on his holding of \$50. shares would be just as large as if he received dividends on his original \$100. holdings. But the Government would not contend that such an alteration of the shareholder's certificates constituted income.

It undoubtedly will be conceded by the Government that if a corporation having a million dollars of capital and with no surplus, waters its stock and issues a 50 per cent. 'stock dividend' to its shareholders, the new stock not representing an increase of assets would not constitute taxable income in the hands of the shareholder; the receipt by the shareholder of certificates of stock having an increased nominal or par value does not increase the stockholder's real interest in the corporation, and therefore the change does not constitute income.

The effect of this concession cannot be overcome. It is conceded that the increase of the number of shares into which the assets of the corporation are divided, or the issue of a new series of fractional certificates does not constitute income to the shareholder if the corporation has no accumulated surplus, even though the nominal or par value of the shares of stock owned by each shareholder is thereby increased. It is conceded that mere increase in the number of shares into which the capital of a corporation is divided does not constitute income, and this regardless of the question whether the corporation has available accumulated surplus or not. And it is just as true that the shareholder's interest in the aggregate corporate assets remains unchanged when there is an increase of stock based on accumulated surplus. The change is simply that the amount is permanently capitalized so that it cannot be distributed without liquidation; on liquidation the shareholder would receive no more than before.

Of course the salability of the new shares presents no more argument for the existence of "income" than does the salability of the old shares at an increased price because of the accumulated earnings back of them. A sale in either case would have the same effect.

If one had 9,000 shares previously, and received 4,500 additional shares through a 'stock dividend' based on surplus accumulations he, of course, could sell any portion of the total 13,500 shares. And if he sold 4,500 of the 13,500 shares he would receive the equivalent in cash. But he could have realized the same

amount prior to the 'stock dividend' by selling 3,000 shares of his original 9,000 shares. His intrinsic interest is the same, and the transaction has not affected its value.

The defendant-in-error has received new shares but her old shares represented precisely the same value; in fact she is no richer at the end of the year than at the beginning; and as in all the cases discussed above, the one thing necessary has not taken place—realization of gain. She may never realize any gain. If dividends are received *on* the new shares, so that she does receive gain in this way she will be taxable on such dividends. The defendant-in-error objects to the payment of a tax as having received some income when just the opposite thing has happened—she has been definitely assured that she will not receive it in the way of dividends. If she sells any of her shares, she will be taxable on whatever profit is made.

FOURTH: The Tax in question is an income tax and cannot be sustained as anything else.

There is just a suggestion in the Government's Supplemental Brief (p. 41) that the tax might be sustained "as an excise tax on the privilege of receiving dividends", even although it could not be sustained as an income tax. The Government merely makes the suggestion in two lines, without argument, and we may assume that if the Government had any confidence in the point it would have been presented in a different way.

However, it is apparent that there would be no basis for such a contention.

The tax in question is not an isolated tax which is sought to be construed as an income tax for the purpose of defeating it.

The tax not only is laid as an income tax but it is laid on the 'stock dividend' as a *portion* of the taxable income of the taxpayer.

The tax is a graduated surtax. The rates are graduated not according to the amount of the 'stock dividend', whether considered with respect to par value or, as the statute says, cash value, but according to the *total net income* of the taxpayer, of which the stock dividend is directed to be considered a part. Thus if A receives a stock dividend of shares having a par value of $25,000 and his total net income, including this $25,000 of stock, is deemed to be $1,000,000, he is taxed upon this sum of $1,000,000 as his total net income at rates increasing upon a graduated scale, paying on the last $500,000 at the rate of eleven per cent. In this way the tax is laid upon the sum of $25,000, the par value of the 'stock dividend', as a part of his income. On the other hand if B received a similar 'stock dividend' of $25,000 and had other income making his total net income $50,000, he would be subject to a surtax the highest rate of which would be but two per cent. C, who had the same 'stock dividend' but received shares of $15,000 par value and had no other income would be subject to no surtax at all. The figures we have here given are drawn from the Act of 1916; under

the later Acts the disproportion would be greatly increased.

Of course it is impossible to consider a tax of this sort as anything but an income tax. It is laid upon the 'stock dividend' as constituting income in itself and the rates are fixed by reference to the total net income of the taxpayer.

As the 'stock dividend' is not income the tax cannot, we submit, be sustained.

Charles E. Hughes,
George Welwood Murray,
Counsel for the Defendant-in-Error.

Murray, Prentice & Howland,
Attorneys for Defendant-in-Error.