No. 318

IN THE

Supreme Court of the United States,

OCTOBER TERM, A. D. 1918.

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.

BRIEF AND ARGUMENT FOR DEFENDANT-IN-ERROR.

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GEORGE WELWOOD MURRAY,
Counsel for Defendant-in-Error.

The Evening Post Job Printing Office, Inc., 156 Fulton St., N. Y.

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IN THE

Supreme Court of the United States,

October Term, A. D. 1918.

No. 941.

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.

STATEMENT OF THE CASE.

This is a writ of error to review the final judgment in favor of the plaintiff (defendant-in-error here) for the recovery of a tax held to be illegally assessed under the Income Tax Law of 1916.

The judgment was entered upon the overruling of a demurrer to the complaint.

The facts set forth in the complaint, and admitted by the demurrer, are in substance as follows:

On January 1, 1916, the Standard Oil Company of California had capital stock issued and outstanding to the amount of $49,686,656. On that date the Company had surplus and undivided profits, which were invested in its plant, property and business required for the purposes of the Company, amounting to $44,852,263.02. Of this sum $20,353,068.34 had been earned prior to March 1, 1913, and the balance, $24,499,194.68, subsequent to that date (Transcript, p. 3).

On January 16, 1916, the directors declared a 'stock dividend' of fifty per cent. That is, additional shares of the par value of $100 each were to be issued on the basis of one-half a new share to each old share (*id.*).

The total par value of the new shares thus amounted to $24,843,327.74, and this amount was transferred from surplus account to capital stock account. This transfer embraced all the surplus earned before March 1, 1913, and so much of the remaining surplus as was necessary to equal the total par value of the new shares. As a result, 81.9257 per cent of the par value of the new shares was charged against surplus earned before March 1, 1913, and 18.0743 per cent. of the par value of new shares was charged against surplus earned after March 1, 1913, and before January 1, 1916 (*id.* pp. 4, 5).

The plaintiff, owning 2,200 shares previous to January 1, 1916, received 1,100 of these new shares (*id.* p. 4, fol. 8). It follows that 18.07 per cent. of these shares or 198.77 shares of the par value of $19,877, were charged against surplus which had been earned after March 1, 1913, and before January 1, 1916.

The defendant, purporting to act under the authority of the Treasury Department and the Act of Congress of September 8, 1916, levied a tax on the plaintiff as having received income of this amount, that is, to the extent of $19,877, the par value of the shares in question (*id.* pp. 5, 6; fols, 10, 11). There is no question as to the basis of the assessment, as alleged, but a stipulation has been made, at the instance of the Government, to the effect that "the shares of stock which were the subject of the stock dividend", as described in the complaint, "were assessed by the Commissioner of Internal Revenue at the par value thereof" (*id.* p. 10, fol. 20).

The tax was paid under protest and appeal was taken to the Commissioner of Internal Revenue, and, this appeal having been disallowed, this action was brought to recover the money so paid.

The complaint also alleges that while the number of shares of stock owned by each stockholder was increased by fifty per cent, the market value of each share was correspondingly decreased. For the month prior to the declaration of the stock dividend and immediately thereafter, sales of the stock were made in the open market at prices ranging from $360 to $382 per share, while after the closing of the books for the stock dividend the prices ranged from $234 to $268 per share. Two of the parent shares were thus equivalent to three of the shares held subsequent to the stock dividend. It is explicitly alleged in the complaint that "the value of the capital stock owned by each stockholder, including the plaintiff's shares, was substantially unchanged by reason of the declaration of the stock dividend and the issue of additional shares of stock" (*id.* pp. 4, 5; fol. 9).

The complaint alleges that such a tax is in violation of Article I, Section 2, clause 3, and Article I, Section 9, clause 4, of the Constitution requiring that direct taxes be apportioned according to population, and that the tax is not authorized by the provisions of the Sixteenth Amendment permitting the taxation of "incomes" without apportionment.

The applicable parts of the Income Tax Law of 1916 are found in 39 Stat. 756, Ch. 463, Part I, Section 1 (*b*):

> "In addition to the income tax imposed by subdivision (a) of this section (herein referred to as the normal tax) there shall be levied, assessed, collected, and paid upon the total net income of every individual, or, in the case of a non-resident alien, the total net income received from all sources within the United States, an additional income tax (herein referred to as the additional tax) of one per centum per annum upon the amount . . ."

> "For the purpose of the additional tax there shall be included as income the income derived from dividends on the capital stock or from the net earnings of any corporation, joint stock company or association, or insurance company, except that in case of non-resident aliens such income derived from sources without the United States shall not be included."

Section 2 (*a*)

> ". . . the net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever; *Provided*, that the term 'dividends' as used in this title shall be held to mean 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 considered income, to the amount of its cash value."

SUMMARY OF POINTS.

We present the following points:

(1) The tax is sought to be laid upon the property in question solely by reason of ownership and cannot be sustained unless it is authorized by the Sixteenth Amendment.

(2) The fundamental fact is that there was no gain or income to the defendant-in-error by virtue of the receipt of the additional shares constituting the 'stock dividend.' The value of the shares held by the defendant-in-error was not increased by the increase in the number of shares. The shareholder was no richer than before.

(3) The tax cannot be sustained as a tax laid upon the shareholder's interest in the undivided profits of the corporation. Apart from the serious question of the validity of such a tax, as an income tax, that was not the scheme of the Act. It is sought to lay the tax in question upon the so-called stock dividend per se, that is, upon the mere readjustment of the evidence of a capital interest already owned.

(4) So far as the present question is concerned, the word "income" in the Sixteenth Amendment has no broader meaning than the word "income" in the Income Tax Act of 1913 under which the question arose in the Towne case.

(5) Stock dividends of the sort here in question are not income within the meaning of the Sixteenth Amendment.

ARGUMENT.

FIRST. The tax is sought to be laid upon the property in question solely by reason of ownership and cannot be sustained unless it is authorized by the Sixteenth Amendment.

Before the Sixteenth Amendment there were two kinds of income with respect to taxability under the Federal Constitution.

(a) Gains and profits from "business, privileges, employments, and vocations" whether of corporations or of individuals.

Pollock v. *Farmers' Loan & Trust Co.*, 158 U. S. 601, 637.

A tax upon such gains and profits was an excise subject to the constitutional requirement as to geographical uniformity.

Pollock v. *Farmers' Loan & Trust Co.*, 158 U. S. 601, 635;
Brushaber v. *Union Pacific R. R. Co.*, 240 U. S. 1.

The Corporation Tax Act of 1909 fell within this category.

Flint v. *Stone Tracy Co.*, 220 U. S. 107.
Stratton's Independence v. *Howbert*, 231 U. S. 399.
Doyle v. *Mitchell Brothers Co.*, 247 U. S. 179, 182, 183.
Hays v. *Gauley Mountain Coal Co.*, 247 U. S. 189, 191, 192.

Similarly, under the Income Tax Act of 1913, the tax on mining corporations was found to be a true excise levied upon the results of the corporate business "in carrying on mining operations".

Stanton v. *Baltic Mining Co.*, 240 U. S. 103.

(b) Income from real or personal property, as such, taxed by reason of ownership.

The question involved in the *Pollock* case related to this sort of income, and it was held that as the tax was a direct tax Congress had no constitutional power to impose it without the required apportionment among the States according to population (Const., Art. I, Secs. 2 and 9). It was held that taxes on investments in corporate stocks, laid directly because of ownership, are in this class.

Pollock v. *Farmers' Loan & Trust Co.*, 158 U. S. 601, 637.

The Sixteenth Amendment removed the requirement of apportionment only in the case of taxes on incomes. It provides:

> "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

The history of this Amendment is well known. It was adopted for the purpose of avoiding the effect of

the decision in the *Pollock* case, and of permitting Congress to levy a tax on incomes, from whatever source derived, without apportionment.

Brushaber v. *Union Pacific R. R. Co.*, 240 U. S. 1, 18, 19.

It was, obviously, not the intention to authorize Congress to levy a direct tax on property, except as to income, or otherwise to amend, to qualify, or in any way to restrict the requirements which have existed ever since our Constitution was adopted, that direct taxes on property can be levied by Congress only if properly apportioned among the States.

That any attempt under the guise of an income tax law to levy an unapportioned direct tax on real or personal property, other than income, could not be sustained is evident from the statement in the opinion of the Court delivered by the Chief Justice in the case of *Brushaber* v. *Union Pacific R. R. Co.*, 240 U. S. 1, 19, as follows:

> "We say this because it is to be observed that although from the date of the *Hylton Case* because of statements made in the opinions in that case it had come to be accepted that direct taxes in the constitutional sense were confined to taxes levied directly on real estate because of its ownership, the Amendment contains nothing repudiating or challenging the ruling in the *Pollock Case* that the word direct had a broader significance since it embraced also taxes levied directly on personal property be-

cause of its ownership, and therefore the Amendment at least impliedly makes such wider significance a part of the Constitution—a condition which clearly demonstrates that the purpose was not to change the existing interpretation except to the extent necessary to accomplish the result intended, that is, the prevention of the resort to the sources from which a taxed income was derived in order to cause a direct tax on the income to be a direct tax on the source itself and thereby to take an income tax out of the class of excises, duties and imposts and place it in the class of direct taxes."

See also,

Peck v. *Lowe*, 247 U. S. 165, 172.

Southern Pacific Co. v. *Lowe*, 247 U. S. 330, 335.

It is also apparent that Congress has not been authorized to coin at will definitions of "income" and prescribe that something which is not, in any true sense of the word, income shall be income for the purposes of taxation. Congress cannot by legislative fiat put a subject of a tax in a different category from that in which it properly belongs, for that would be to subject the constitutional restrictions to the legislative will.

In the present case there is no room for disputing the fact that the tax is levied upon property solely by virtue of its ownership. The Standard Oil Company of California had paid its taxes under the Corporation

Tax Act of 1909 and under the Income Tax Laws of 1913 and 1916. There is no pretense here that the present tax is laid upon the corporation, or by reason of any privilege or business of the corporation. The tax is levied upon the individual stockholder, simply because of his ownership of the shares in question. The tax upon these shares by virtue of the stockholder's ownership is, in the very nature of things, a direct tax which must be apportioned unless it can be said that these shares, issued in the circumstances we have stated, constitute income within the meaning of the Sixteenth Amendment. It is our contention that they do not.

SECOND. The fundamental fact is that there was no gain or income to the defendant-in-error by virtue of the receipt of the additional shares constituting the 'stock dividend'. The value of the shares held by the defendant-in-error was not increased by the increase in the number of shares. The shareholder was no richer than before.

The Income Tax Act of 1916 was approved September 8, 1916 (39 Stat. 756). The Act governed income received after January 1, 1916; that is, the year 1916 was the first taxable period to which the Act applied (*id.* p. 761; Sec. 8).

On January 1, 1916, Mrs. Macomber, the defendant-in-error, held 2,200 shares of the capital stock under consideration. The value of these shares as they then stood rested upon the total assets of the corporation. These assets were not segregated with respect to the company's capital as distinguished from its surplus.

The latter, quite as much as the former, was represented by investments in the business (Transcript, p. 3, fol. 6). The assets of the corporation consisted of plant, property and working capital. Mrs. Macomber's interest on January 1, 1916 (or December 31, 1915), by virtue of her ownership of the 2,200 shares, was her proportionate interest in the aggregate assets of the corporation, subject to the payment of debts.

The earnings of the corporation for the years prior to January 1, 1916 had been subject to the Corporation Tax Act of 1909 and to the Income Tax Act of 1913. Mrs. Macomber herself had been subject to the individual income tax, under the Act of 1913, upon all the taxable income she had received prior to January 1, 1916.

What remained to Mrs. Macomber as her property on January 1, 1916, after satisfaction of income taxes applicable to the period antedating January 1, 1916, constituted her capital so far as the income tax for succeeding years was concerned. Her interest as a shareholder in the aggregate assets of the corporation, as these assets stood on January 1, 1916, was a capital interest, and it is none the less to be regarded as such because, from the standpoint of corporate finance, part of the assets represented capital and part represented surplus, or because part of the surplus had been accumulated at one time and part at another time. Her capital interest on January 1, 1916, would have been no greater and no less had the corporation been organized with shares without par value as now is so frequently the case.

The question is, What has the defendant-in-error received in the year 1916 which can properly be considered to be income and hence taxable without apportionment? The Government says she has received 1,100 shares of stock. She answers that these shares of stock did not add to her wealth and in no sense constituted gain or income. The Government admits that the shares are not to be considered income so far as they are based upon surplus earned by the corporation before March 1, 1913, but that they are to be considered income to the extent of the par value of the shares that are based upon surplus earned by the corporation between March 1, 1913, and January 1, 1916. The defendant-in-error answers that this portion of the shares is no more income than the former, and that after the receipt of the shares she was left with precisely the same ownership and actual interest that she had on January 1, 1916.

This fact is not left to mere inference, however plain. It is alleged in the complaint and admitted by the demurrer. The so-called 'stock dividend' of fifty per cent. declared on January 16, 1916 (Transcript, p. 3, fol. 5) increased her number of shares from 2,200 to 3,300, but the 3,300 shares were worth no more than the 2,200. As soon as the books were closed for the stock dividend, the market value went down correspondingly (Transcript, pp. 3, 4; fols. 8, 9). The complaint alleges "that the number of shares of stock owned by each stockholder was increased by fifty per cent. and at the same time the market value of each share was correspondingly decreased", and the figures are given (*id.* p. 4, fol. 9), and then follows this allegation and conceded fact:

> "That the value of the capital stock owned by each stockholder, including the plaintiff's shares, was substantially unchanged by reason of the declaration of said stock dividend and the issue of additional shares of stock" (*id.* pp. 4, 5. fol. 9).

Non constat that the defendant-in-error will ever realize even the market value of her shares as that value stood on December 31, 1915; certainly by receiving the additional shares she received no gain or income.

The contention of the Government, then, is that the defendant-in-error is to be deemed to have received in the year 1916, by virtue of the increase then effected in the number of her shares, income to the extent of $19,877, when in fact she received no gain or income whatever. The case is thus precisely like that described in *Towne* v. *Eisner*, 245 U. S. 418. There, in 1914, the corporation declared a 'stock dividend' of fifty per cent, that is, 15,000 shares in addition to the existing 30,000 shares, but it was held that these did not constitute gain or income to the shareholder for the reason thus stated by Mr. Justice Holmes in speaking for the Court (*id.* p. 426):

"'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. . . . The proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interest that the original shares represented before the issue of the new ones.' *Gibbons* v. *Mahon*, 136 U. S. 549, 559, 560. In short, the corporation is no poorer and the stockholder is no richer than they were before. *Logan County* v. *United States*, 169 U. S. 255, 261. If the plaintiff gained any small advantage by the change, it certainly was not an advantage of $417,450, the sum upon which he was taxed. It is alleged and admitted that he receives no more in the way of dividends and that his old and new certificates together are worth only what the old ones were worth before. If the sum had been carried from surplus to capital account without a corresponding issue of stock certificates, which there was nothing in the nature of things to prevent, we do not suppose that any one would contend that the plaintiff had received an accession to his income. Presumably his certificate would have the same value as before. Again, if certificates for $1,000 par were split up into ten certificates each, for $100, we presume that no one would call the new certificates income. What has happened is that the plaintiff's old certificates have been split up in effect and have diminished in value to the extent of the value of the new".

It is apparent that the reason that the 'stock dividend' was held not to be income in the *Towne* case was that it did not constitute income in its nature and that no governmental assertion to the contrary could alter that fact. It was because the 'stock dividend' was not income in its nature, and not because the surplus transferred to capital account had been accumulated prior to March 1, 1913, that the court was led to the decision that it was not taxable. The Act of 1913, there in question (38 Stat. 114, 166, 167) taxed income generally. If the 'stock dividend' had been income, there was nothing in the Act which could have saved it from taxation. Moreover, as it has been held by this Court, the Act of 1913 taxed dividends to shareholders although they were distributed out of earnings accumulated before March 1, 1913 (*Lynch* v. *Hornby*, 247 U. S. 339). Even though the corporation distributed, *in specie*, shares of stock of other corporations which it held in its treasury as a part of its surplus prior to March 1, 1913, the distribution thereafter and during the taxable year was held to constitute income (*Peabody* v. *Eisner*, 247 U. S. 347). In the latter case, the Court expressly distinguished such a distribution from the case of a 'stock dividend' (*id.* p. 349), manifestly because of the fact that, in the former case, a part of the corporate assets was segregated and transferred to the separate ownership of the shareholders, while, in the latter case, "the proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares

and the original shares together representing the same proportional interest that the original shares represented before the issue of the new ones". (*Towne* v. *Eisner, supra.*)

If, in the *Towne* case, the 'stock dividend' in 1914 had constituted income, although it had been based on earnings accumulated before March 1, 1913, it would unquestionably have been taxable as income under the Act of 1913 (38 Stat. 167). It was not so taxable simply because it was not income for the reason stated in the opinion. The case here is precisely the same. The shares received by the defendant-in-error in 1916 were not income in their nature; she was no richer because they were received. And not being income, they were not taxable as such.

THIRD. The tax cannot be sustained as a tax laid upon the shareholder's interest in the undivided profits of the corporation. Apart from the serious question of the validity of such a tax, as an income tax, that was not the scheme of the Act. It is sought to lay the tax in question upon the so-called 'stock dividend' *per se*, that is, upon the mere readjustment of the evidence of a capital interest already owned.

It is evident that the Government chiefly relies upon the case of *Collector* v. *Hubbard*, 12 Wall. 1, but we submit that the Government can find no support in the ruling of that case for the tax attempted here.

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."

(1) It may be at once observed that, even if it were assumed (as we do not admit) that an interest in undivided profits of the corporation may be taxable as gain or income to the shareholder, it does not follow that additional shares *per se*, constituting a 'stock dividend', are gain or income. The proposition is a plain *non sequitur*. The two subjects are distinct. The one is an interest in undivided profits; the other is a readjustment of the evidence of an interest already owned. If the additional shares, constituting a 'stock dividend', are income *per se*, then it is unnecessary to consider whether an interest in undivided profits is or is not income. And if additional shares, as a readjustment of the evidence of an existing interest, are not income *per se*, then they do not become income because an interest in undivided profits might have been regarded as income when that interest accrued.

If shares constituting a 'stock dividend' are sought to be taxed as income *per se*, the question arises whether they can be regarded as income. On the other hand, if the tax is sought to be supported as a tax upon an interest in undivided profits, the question necessarily arises whether that is the scheme of the taxing act: whether that interest in undivided profits is, in truth, the subject of the tax and is taxable as such.

For example, in *Lynch* v. *Hornby, supra*, the shareholder's interest in undivided profits accumulated prior to March 1, 1913, was not taxed or taxable. What was taxed was the distribution of these profits in dividends and these were taxable although paid out of the prior accumulation, because they were segregated in 1914, and were then passed into the ownership of the shareholder. Similarly, in *Towne* v. *Eisner supra*, the interest in undivided profits accumulated before March 1, 1913, was not taxed or taxable and the subsequent issue of additional shares, in 1914, was not taxable either, because these shares, unlike the moneys in the *Hornby* case or the securities distributed in the *Peabody* case, constituted a mere readjustment of the evidence of an interest already owned and did not constitute gain or income to the shareholder.

In the present case, as we deem it to be clear (for reasons hereinafter pointed out, *post*, pp. 28-33), there was no attempt to tax an interest in undivided profits. Whether or not it could have been taxed when it accrued is immaterial. It was not taxed, and, further, at the time in question it was not taxable, as from every possible point of view that interest had already become capital and was no longer, if at any time, subject to an income tax (*post*, pp. 29-30). What was sought to be taxed here was the 'stock dividend' or additional shares *per se*, and these did not constitute gain or income.

(2) It is to be noted that the endeavor of the Act of 1864, under which the case of *Collector* v. *Hubbard*

arose, 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 decided 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

[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; *Bailey* 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. 820, 831, 832; *Pollock* v. *Farmers Loan & Trust Company*, 157 U. S. p. 578.

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". And as was said by Mr. Justice Clifford (*id.* p. 18): "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".

We find no constitutional question raised in the *Hubbard* case. The corporate earnings there in question were the earnings of the year for which the shareholder was making his return. An attempt to tax the shareholder upon his interest in undivided corporate profits accumulated in prior years, after both the corporation and the shareholder had paid all income taxes for which they were then liable, was in no way involved. The actual result was simply to tax all the gains and earnings of the corporation for the tax year. It does not appear that the *Hubbard* case was ever cited in any Federal Court, except upon questions of procedure, prior to 1917. As was said by this Court in *Southern Pacific Company* v. *Lowe*, 247 U. S. 330, 336, the decision in the *Hubbard* case was based "upon the very special language" of section 117 of the Act of 1864. And, in any event, that case furnishes no support for the tax sought to be assessed here.

(3) The point of view taken in the opinion in the *Hubbard* case is clearly indicated in the concluding sentence, in which Mr. Justice Clifford remarks:

> "Annual gains and profits, whether divided or not, are *property*, and, therefore, are taxable". (12 Wall. p. 18; italics ours.)

The same course of reasoning appears in the earlier statement of the opinion:

> "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" (*id.*).

This emphasis upon the fact that the interest of the shareholder in the corporate surplus was *property* is significant, and a consideration of the course of judicial opinion makes it quite evident that this was thought to be sufficient to support the tax, without drawing the distinction between what was a mere *"capital"* interest not realized, and that which could be regarded, properly speaking, as *"income"* to the shareholder. It is not too much to say that at that time a tax upon personal property (and the interest of a shareholder in the assets of the corporation is personal property), was not regarded as a *direct* tax, in the constitutional sense. Certainly, in the light of our constitutional history, it cannot be assumed that it was supposed by the Court, in deciding the *Hubbard* case, that such a tax was a direct tax and ran

counter to the constitutional provision as to apportionment. No such question was presented to the Court.

In the *Hylton* case (3 Dall. 171), it was held that a tax upon carriages, laid without apportionment, was constitutional because not a direct tax. The implications of this decision had general acceptance. When, in 1861, 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). It was pointed out in the dissenting opinion of Mr. Justice White in the *Pollock* case that the view had long been held that direct taxes in the constitutional sense only embraced taxes on real estate and capitation taxes (157 U. S. pp. 636, 639; see *Pacific Insurance Co.* v. *Soule*, 7 Wall. 433, 443; *Veazie Bank* v. *Fenno*, 8 Wall. 533, 541, 546). When the *Hubbard* case was decided it might well have been, and probably was, taken for granted in the absence of contention to the contrary that *personal property* could be taxed without apportionment, and that when it was found that the subject of the tax in that case was property, as Mr. Justice Clifford said, the argument against the tax was answered. The decision was nearly twenty-five years before the controversy and decision in the *Pollock* case.

In the *Pollock* case (158 U. S. 601) it was ruled that the word *"direct"* had a broader significance "since it embraced also taxes levied directly on personal property because of its ownership" (*Brushaber* v. *Union Pacific R. R. Co.*, 240 U. S. 1, 19). The Sixteenth Amendment "at least impliedly makes such wider significance a part of the Constitution" and the purpose of the Amendment was thus "not to change the existing interpretation except to the extent necessary to accomplish the result intended, that is, the prevention of the resort to the sources from which a taxed income was derived in order to cause a direct tax on the income to be a direct tax on the source itself and thereby to take an income tax out of the class of excises, duties and imposts and place it in the class of direct tax" (*Brushaber* v. *Union Pacific R. R. Co., supra*).

It now becomes necessary, as evidently it was thought not to be necessary in the *Hubbard* case, to distinguish between a tax upon ***personal property*** (including investments in corporate stock), which under the *Pollock* case is a direct tax, and the *income* from personal property which is taxable, without apportionment, by virtue of the Sixteenth Amendment. It is plain that the country has entered upon a permanent policy of income taxation, and it is absolutely necessary that "income" within the meaning of the Sixteenth Amendment should be distinguished from the "capital" interest of the taxpayer. In no other way, as we conceive it, can the Constitution be properly applied. The distinction between what is the property and income of the corporation, and what is the property and income of the shareholder, is a vital one.

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.

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 evident that in *Gibbons* v. *Mahon, supra,* the former expressions of this Court, including those in the case of *Bailey* v. *Railroad Company* (22 Wall. 604), had been carefully examined (136 U. S. p. 560). It was remarked that the opinion of Mr. Justice Clifford in the *Bailey* case 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."**

We submit, therefore, that the holding of the Court in the *Hubbard* case cannot be regarded as establishing the proposition that in the light of the Sixteenth Amendment the undistributed earnings of a corporation which have been invested in its plant and property and upon which the shareholder may never actually realize anything, are to be regarded as income to the shareholder. That proposition, we submit, would be wholly untenable; it would be in the teeth of any proper definition of "income" and of the established principles of law governing corporations and the rights of shareholders.

(4) There is in the present case, however, no attempt to tax an interest in undivided profits, and, in any event, the shareholder's interest in the profits of the corporation, accumulated in prior years, was not taxable. The scheme of the Income Tax Acts of 1913 and 1916 is clear.

The Act of 1913 (38 Stat. 166) did not attempt to lay any tax as against the shareholder upon an interest

in the undivided profits of the corporation, save in a single case. That case was where there was a fraudulent withholding of profits evidenced by an accumulation beyond the reasonable needs of the business and certified to be such by the Secretary of the Treasury (See *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330, 336). No such case is presented here. Apart from this exceptional case, the corporation was to be taxed on its earnings, and, for the purpose of the additional tax only, the shareholder was taxed upon his dividends. The Act of 1913 manifestly applied to all dividends that could be considered to be income (38 Stat. 167) and did not apply to so-called 'stock dividends' simply because they were not income. The Act of 1913 governed the years 1913, 1914 and 1915 and was repealed on September 8, 1916, by the new Act then approved.

The Act of 1916 (39 Stat. 756), like the former Act, did not attempt to tax shareholders upon an interest in the undivided profits of the corporation, save in the case of a fraudulent withholding certified to be such (*id.* p. 758; sec. 3). This Act was to operate for the year 1916. It had no relation to prior years. It did not attempt to tax any income for years prior to 1916, and, in the nature of things, it did not, and could not, attempt to reach any interest in the undivided profits of corporations earned in prior years. Such interests, both as to corporations and shareholders, the income taxes having been paid for the years in which the profits were earned, were certainly no longer income, or subject to taxation as income, in subsequent years, but constituted *capital* with reference to the income taxes of such subsequent years. "Capital", as the Government asserted in the *Towne* case (245 U. S. p. 422), "represents the wealth or property of a person at a given instant of time." And 'capital' with reference to the Income Tax Act of 1916, and income thereunder for 1916, represents the wealth or property of a person on January 1, 1916. "Income" is what is received as such during the taxable period. What was income in 1915, and taxable as such, was no longer income in 1916, the next succeeding tax period. To hold otherwise would mean that Congress could now levy a tax of fifty per cent., or any per cent., on the income of 1914. Should Congress so attempt, it would be met by the obvious proposition that the income of 1914 had paid its tax and that the property then remaining was capital and not income with reference to a tax imposed now.

The Act of 1916, in its reference to 'stock dividends', manifestly attempted to treat such issues of shares as income *per se*. There is no basis in fact or law, we submit, for the argument that Congress was attempting to reach, or could then reach, the interest of a shareholder in undivided profits, which, if income at all, was income only in years prior to 1916. If the 'stock dividend' was income *per se*, it was taxable as such; but if it was not income, it was not taxable as such. The tax upon the shares cannot be sustained as a tax upon a previously accrued interest in undivided profits. That interest was not taxable and there was no attempt to lay such a tax.

This is clearly apparent from the following considerations:

(*a*) Congress had before it the question of taxing, as against shareholders, interests in the undivided profits of the corporation, in framing both the Act of 1913 and that of 1916. But, in each Act, such a tax was limited to the interests in undivided profits where these had been fraudulently withheld. No tax was laid upon the interests of the shareholder in undivided profits where these were properly invested in plant or were needed as working capital for the company's business. This must be deemed to be deliberate.

Now, what happened when a corporation thus invested its undivided profits? The corporation paid its annual income tax upon its earnings; and there was no tax laid upon the shareholder as to the interest in the profits thus invested. Accordingly, at the end of the tax year, what the corporation had left was its capital, so far as the Income Tax Law for the succeeding tax year was concerned. The distinction between corporate capital and corporate surplus had in that aspect no significance. Similarly, what the shareholder had left at the end of the tax year was his capital; and, so far as it represented an interest in the aggregate assets of the corporation, it was equally his capital whether these assets represented corporate capital or corporate surplus, or whether the surplus had been accumulated in the preceding year or earlier. What was subsequently taxable was what he received as income, including what his capital might earn and what might be paid him in dividends. And Congress, in attempting to treat the subsequent 'stock-dividend' as income, did not, and could not, go back to tax what had become a capital interest.

(*b*) To treat the attempted tax on 'stock dividends' as an effort to pursue the policy of taxing interests in undivided profits, would be to impute to Congress the intent to perpetrate a gross inequity.

Corporations throughout the land have invested their surplus earnings in plants, in betterments and extensions, and employed these earnings as working capital, but the shareholders are not taxed upon their interests therein. In short, in the absence of a 'stock dividend' it is admitted that no such interest of a shareholder is taxed where the corporate surplus has been properly invested in the plant or business of the corporation. Instances of such investments of surplus are very numerous and vastly outnumber cases of 'stock dividends' which are relatively few.

If Congress had intended to tax interests of shareholders in undivided profits, assuming for the moment that Congress could do this, Congress undoubtedly would have done so. It may be supposed that, if Congress had adopted such a policy, Congress would lay that tax with a decent regard for fairness and at least would tax the shareholders in all corporations of the same class according to their respective interests in undivided surplus.

It is plain that a mere tax on 'stock dividends' would

never be laid in pursuance of a policy of taxing shareholders upon their interests in corporate surplus which had been invested in the corporate plant or business, for that would mean that, unless there was a 'stock dividend', the property sought to be reached, or the increment or gain sought to be reached, would not be taxed at all. On the other hand, such a tax laid simply in the case where a 'stock dividend' was issued would mean a grossly unequal tax reaching shareholders in only a few corporations, and which, from the standpoint of an effort to tax interests in undistributed surplus, would be obviously partial, inadequate and lacking in ordinary good sense.

Again, such an effort, limited to the case of 'stock dividends', would never reach shareholders in corporations having stock without par value. These important business corporations would be immune, and although the professed object was to reach interests in undivided surplus, these corporations might hold their surplus for business purposes to any extent without subjecting their shareholders to the tax.

The tax which Congress did lay is not to be sustained by invoking a tax which Congress did not lay or attempt to lay.

Instead of following the method of the Act of 1864, Congress taxed corporations upon their earnings and did not seek to tax shareholders upon interests in undivided surplus properly invested.

Congress undertook to tax 'stock dividends', not in a fatuous endeavor thus to impose a tax, which would operate unequally and in a limited field, upon interests in undisturbed surplus, but in the view that 'stock dividends' or shares thus issued constituted income *per se.* If 'stock dividends' *per se* do constitute income, then Congress achieves its end; but if *per se* they do not constitute income, then Congress could not make them income by describing them as such. Congress is constitutionally debarred from taxing "capital" interests under the guise of "income", and it cannot treat that as income which is a mere readjustment of the evidence of a capital interest and makes the shareholder no richer.

The Government discloses what we cannot but regard as the fallacy of its contention when it says in its argument (Govt. brief, p. 19):

> "It must be remembered that it is not claimed that a stock dividend is always and necessarily income. The illustrations used above show that a stock dividend may be declared out of earnings and gains which had become the capital of both the corporation and the stockholder before the tax law became effective, and hence do not represent a gain accruing to the stockholder during the taxable period. The insistence simply is that such dividends are income whenever they, in fact, represent an actual gain to the stockholder during the taxable period."

In short, it is here recognized that corporate earnings may have become the capital of both the corporation and the shareholder before the tax law became effective, and hence do not represent a gain accruing to the shareholder during the taxable period; and it is said that 'stock dividends' are income whenever they do represent an actual gain to the shareholder during the taxable period and not otherwise.

But it conclusively appears that the 'stock dividend' in this case did not represent any gain to the shareholder during the taxable period.

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."

But the Act of 1913 had its taxable periods, to-wit, each calendar year (unless there was a different fiscal year for the individual or corporation concerned), and thus there were the separate taxable periods of the year 1913, of 1914, and of 1915, under that Act. In September, 1916, Congress passed another tax law which was to govern the year 1916 and later years until changed. Within the precise limits of the Government's statement, the gains and earnings in question *had* become "the capital of both the corporation and stockholder" before the tax law in question became effective": that is, before the first tax year or period to which it related, that is, before January 1, 1916.

Nor does it make any difference when the particular tax law became effective. The point is as to the tax year, or the taxable period; and earnings or profits, or corporate surplus, which have paid their tax for a given taxable period, become "capital" both as to the corporation and the shareholder at the end of that period, and, according to the Government's own statement, the subsequent 'stock dividend' based thereon is not income.

To repeat, the tax upon the 'stock dividend' in this case is not a tax, and cannot be a tax, upon an interest in undivided profits. It is an attempted tax upon shares, which are a mere readjustment of the evidence of a capital interest already owned and do not constitute income, and the provision of the Act could not alter that fact.

FOURTH. So far as the present question is concerned, the word "income" in the Sixteenth Amendment has no broader meaning than the word "income" in the Income Tax Act of 1913 under which the question arose in the *Towne* case.

In the *Towne* case (245 U. S. 418), the Government endeavored to dismiss the writ of error on the ground that no constitutional question was involved. The plaintiff-in-error in that case insisted that the tax law as construed by the District Court was unconstitutional. The Court held that the fact that the construction of the statute was involved did not eliminate the constitutional question, for while the Government "keeps the money it opens the question whether the Act construed as it has construed it can be maintained" (*Towne* v. *Eisner*, *supra*).

It is clear, however, that if a 'stock dividend' constituted income, it was taxed by the Act of 1913 which embraced "the entire net income arising or accruing from all sources" (38 Stat. 166). The text appears in the margin.[1] The Act included "dividends" without

[1] "A. Subdivision 1. That there shall be levied, assessed, collected and paid annually upon *the entire net income* arising or accruing *from all sources* in the preceding calendar year to every citizen of the United States, whether residing at home or abroad, and to every person residing in the United States, though not a citizen thereof, a tax of 1 per centum per annum upon such income, except as hereinafter provided; and a like tax shall be assessed, levied, collected, and paid annually upon *the entire net income* from all property owned and of every business, trade, or profession carrried on in the United States by persons residing elsewhere.

"Subdivision 2 (providing for the surtax).

. . . .

"Every person subject to this additional tax shall, for the purpose of its assessment and collection, make a personal return of his *total net income from all sources*, corporate or otherwise, for the preceding calendar year.

. . . .

"B. That, subject only to such exemption and deductions as are hereinafter allowed, the *net income* of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, *dividends*, securities, or the transaction of any lawful business carried on for gain or profit, or *gains or profits and income derived from any source whatever*, including the income from but not the value of property acquired by gift, bequest, devise, or descent: . . .

"That in computing net income for the purpose of the normal tax there shall be allowed, as deductions: . . . seventh, the amount received as dividends upon the stock or from the net earnings of any corporation, joint stock company, association, or insurance company which is taxable upon its net income as hereinafter provided; . . .

. . . .

"D. . . . *Provided further*, That persons liable for the normal income tax only, on their own account or in behalf of another, shall not be required to make return of the income derived from dividends on the capital stock or from the net earnings of corporations, joint-stock companies or associations, and insurance companies taxable upon their net income as hereinafter provided" (38 Stat. 166-168. Italics ours).

qualification and plainly covered every dividend which could be considered to be income.

It was in this view that it was held in *Lynch* v. *Hornby* that the Act reached extraordinary dividends from surplus which had been accumulated before March 1, 1913, even where the surplus embraced the increased value of the property of the corporation. While the distribution was an extraordinary one, the shareholder had received the money and it was held to be within the comprehensive words of the Act covering income from all sources. The Court expressly overruled the contention that the words of the Act of 1913 could be read in connection with the explicit provision of the later Income Tax Act of 1916 so as to exclude dividends declared out of earnings or profits which had accrued prior to March 1, 1913. The later Act of 1916 expressly excluded dividends out of earnings or profits which had accrued before March 1, 1913, but the Court held that no such qualification could be read into the broad words of the Act of 1913 (*Lynch* v. *Hornby*, 247 U. S. 344-345). The only ground for holding the 'stock dividend' in the *Towne* case not to be taxable, although the shares were issued in the year 1914 under a corporate resolution of December, 1913, was that the 'stock dividend' was not income in its *nature*. And this being so, it necessarily follows that it was just as much excluded from the authority conferred by the Sixteenth Amendment as it was from the provision of the Act of 1913. If Congress had the power to tax the 'stock dividend', because

the 'stock dividend' was *income*, there is no escape from the conclusion that it did tax it in the Act of 1913. And, if the 'stock dividend' in the *Towne* case was not within that Act, it was only by virtue of the fact that it was not income in truth. The Court had jurisdiction to determine the meaning of the word 'income' both as used in the statute and as used in the Constitution, but in determining that the 'stock dividend' did not fall within the description of income, it based its conclusion upon reasoning which had no reference to the special time or circumstance of the statute but to the nature of the property itself, and its conclusion that the 'stock dividend' was not income was thus based upon a ground applicable both to the Constitution and to the statute. In fact the statute was enacted immediately after the Sixteenth Amendment was adopted and manifestly with the same intent.

And here it may be pertinent to observe, with respect to the decision in *Swan Brewery Company, Limited*, v. *The King*, Law Reports [1914] A. C. 231, that the Dividends Duty Act of 1902 of Western Australia, there under consideration, was in this respect like our Income Tax Act of 1913. The Australian Act of 1902 taxed "dividends" as our Income Tax Act of 1913 taxed "dividends". Similarly, the Massachusetts Act, which was the subject of decision in *Tax Commissioner* v. *Putnam*, 227 Mass. 522, arose under a statute which used the term "dividends" without any special mention of 'stock dividends' and the Court referred in its opinion to the provisions of the Federal Income Tax Act of

1913 (*id.* p. 528), the statute being similar, so far as the present question is concerned. The decision in the *Swan Brewery* case was rendered over three years before, and the decision in Massachusettts six months before, the decision of this Court in *Towne* v. *Eisner.*

These earlier decisions, cited by the Government, can in no way affect the decision or reasoning of this Court in the *Towne* case, for this Court rested its decision on the fundamental and clear proposition that that was not income which left the shareholder no richer than before, but merely readjusted the evidence of an interest already owned,—a proposition which the Courts upon whose decisions the Government relies saw fit to ignore.

FIFTH. 'Stock dividends' of the sort here in question are not income within the meaning of the Sixteenth Amendment.

In view of the explicit ruling of this Court as to the nature of a 'stock dividend', we should suppose that the question was no longer open to argument. But in view of the statements contained in some of the opinions of other courts, which the Government cites, we shall briefly review the considerations which, as we view it, lead to the conclusion that 'stock dividends' are not income. And 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 cont.. e 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.

These plain incidents of the transaction have been repeatedly and authoritatively described.

> "The corporate property remains the same after the stock is increased as before, and the interest of each stockholder in the corporate property is also unchanged."
>
> *Kaufman* v. *Charlottesville Woolen Mills Co.*, 93 Va. 673, 675.

> "After a stock dividend a corporation has just as much property as it had before . . . After such a dividend the aggregate of the stockholders own no more interest in the corporation

than before. The whole number of shares before the stock dividend represented the whole property of the corporation, and after the dividend they represent that and no more. A stock dividend does not distribute property, but simply dilutes the shares as they existed before."

Williams v. *Western Union Telegraph Co.*, 93 N. Y. 162, 189.

"There is a clear distinction between the ordinary cash dividend, no matter when earned, and a stock dividend declared as in the case at bar. The one is a disbursement to the stockholder of accumulated earnings, and the corportion at once parts irrevocably with all interest therein. The other involves no disbursement by the corporation. *It parts with nothing to the stockholder.* The latter represents not an actual dividend, but certificates of stock which evidence in a new proportion his interest in the entire capital, including such as by investment of accumulated profits has been added to the original capital."

DeKoven v. *Alsop,* 205 Ill. 309.

"It is the characteristic feature of a stock dividend that the property of the corporation itself remains unchanged, but that each one of the new shares of the increased capital stock represents a smaller fractional interest than before in the total amount of the corporate property. On the other hand it is the characteristic feature of a dividend declared and paid wholly from the net profits or undivided earnings that it does

diminish the property of the corporation by exactly the amount of the dividend so paid out, while it leaves the fractional interest represented by each share of the capital stock exactly what it was before. *Gibbons* v. *Mahon,* 136 U. S. 549, 559, 560."

Gray v. *Hemenway,* 212 Mass. 239.

"The word 'dividends', if unqualified, signifies dividends payable in money. The word 'income' has a broader meaning, but hardly broad enough to include things not separated in some way from the principal. It is not synonymous with 'increase'. The value of stock may be increased by good management, prospects of business, and the like. But such increase is not income. It may also be increased by accumulation of surplus; but so long as that surplus is retained by the corporation, *either as surplus or as increased stock,* it can in no proper sense, be called, income."

Spooner v. *Phillips,* 62 Conn. 62, 68. (Italics ours.)

"It is also one of the incidents of a stock dividend that the stockholder, who receives his pro rata proportion of the new issue while he acquires the ownership of more shares, adds nothing to his proportionate ownership of the assets of the corporation. His holding, after the new issue, bears precisely the same ratio to the total of the outstanding shares of the corporation as did his previous holding to the previous total. *Terry* v. *The Eagle Lock Co.,* 47 Conn. 141, 165. The underlying idea of a cash dividend, on the other hand, is the distribution to shareholders, as the rewards of the corporate enterprise, of a portion of the profits or surplus assets of the corporation. . . . Whatever form the distribution takes, the result always is the reduction of both the corporate assets and surplus by just the amount of the distribution. Something is taken from the corporation and given to the stockholders. That which is distributed becomes released from all corporate control and comes under the dominion of the shareowner."

Green v. *Bissell*, 79 Conn. 547, 551.

See also,

Terry v. *Eagle Lock Co.*, 47 Conn. 141.
Brinley v. *Grou*, 50 Conn. 66.
Bouch v. *Sproule*, 12 App. Cas. 385.
Jones v. *Evans* (1913), 1 Ch. 23.
In re *Carson*, Irish Reports (1915), Vol. I, p. 321.
Guinness, Trustee, v. *Guinness*, Cases Ct. of Session, 5th Series, Vol. 6, p. 104.
Minot v. *Paine*, 99 Mass. 101.
Davis v. *Jackson*, 152 Mass. 58.
D'Ooge v. *Leeds*, 176 Mass. 558.
Hyde v. *Holmes*, 198 Mass. 287.
Brown v. *Larned*, 14 R. I. 371, 373.
Billings v. *Warren*, 216 Ill. 281.
Lancaster Trust Co. v. *Mason*, 152 N. Car. 660.
Great Western Mining &Mfg. Co. v. *Harris*, 128 Fed. 321, 326.

A genuine dividend constitutes a debt between the corporation and the shareholders;[1*] once declared it may not be rescinded [2*] and an action may be brought on the debt.[1*]

It is otherwise with a stock issue made to shareholders (commonly called a 'stock dividend'), for, as the directors do not divide anything and in substance merely readjust the symbols by which the shareholders own the net assets, they may recall their own action and leave the shareholders without grievance.

In *Staats* v. *Biograph Co.*, 236 Fed. 454, the Circuit Court of Appeals for the Second Circuit, holding that the action of a board of directors in declaring a 'stock dividend' might be rescinded, said (p. 457):

> "In this case it does not escape observation that the plaintiff's right to a stock dividend, if he has such a right and can enforce it, would gain him nothing. We say it would gain him nothing, because, while a stock dividend would increase the number of his shares, it proportionately diminishes the value of each of his shares, leaving the aggregate value as it was before. He acquires the ownership of more shares, but he adds nothing to his proportionate ownership of the assets of the corporation."

The case of *Gibbons* v. *Mahon*, 136 U. S. 549, was one of a will bequeathing stock in a corpora-

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[1*] *King* v. *Paterson*, 29 N. J. L. 504; *Hunt* v. *O'Shea*, 69 N. H. 600; *Lockhart* v. *Van Alstyne*, 31 Mich. 76; *Stoddard* v. *The Shetucket Foundry Co.*, 34 Conn. 542.

[2*] *Beers* v. *Bridgeport Spring Co.*, 42 Conn. 17; *Staats* v. *Biograph Co.*, 236 Fed. 454.

tion and government bonds in trust to pay "the dividends of said stock and the interest of said bonds as they accrue" to a daughter of the testator, and directing that upon her death "the said stocks, bonds, and income shall revert to the estate" of the trustee. The corporation accumulated earnings from time to time, before and after the death of the testator, which were invested in its permanent works and plant. It declared a 'stock dividend' representing these accumulated earnings and the question was whether this 'stock dividend' was income. It was held to be capital and that it should go to the remainderman, only the dividends which might be received on such stock being payable to the tenant for life.

After reviewing the authorities of other jurisdictions, Mr. Justice Gray discussed the nature of a 'stock dividend' (*id.* pp. 559, 560, 569):

> "Therefore, when a distribution of earnings is made by a corporation among its stockholders, the question whether such distribution is an apportionment of additional stock representing capital, or a division of profits and income, depends upon the substance and intent of the action of the corporation, as manifested by its vote or resolution; and ordinarily a dividend declared in stock is to be deemed capital, and a dividend in money is to be deemed income, of each share.
>
> **"A stock dividend really takes nothing from the property of the corporation, and adds nothing to the interests of the shareholders. Its property is not diminished, and their interests are not increased. After such a dividend, as before, the corporation has the title in all the corporate property; the aggregate interests therein of all the shareholders are represented by the whole number of shares; and the proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interest that the original shares represented before the issue of new ones. . . .**
>
> "The resolution is clearly an apportionment of the new shares as representing capital, and not a distribution or division of income. As well observed by Mr. Justice James, delivering the opinion of the Court below: 'Certificates of stock are simply the representative of the interest which the stockholder has in the capital of the corporation. Before the issue of these two hundred and eighty new shares, this trustee held precisely the same interest in this increased plant in the capital of the corporation, that she held afterwards. She merely had a new representative of an interest that she already owned, and which was not increased by the issue of the new shares. A dividend is something with which the corporation parts, but it parted with nothing in issuing this new stock. It simply gave a new evidence of ownership which already existed. They were not in any sense, therefore, dividends for which this trustee had to account to the *cestui que trust*. She stood after the issue of the new shares just as she had stood before; and the

trustee was obliged to treat them just as she did, namely, as a part of the original, and to pay the dividends to the *cestui que trust*'."

Gibbons v. *Mahon* was long held under advisement by the Court, and it is apparent that it was decided after the most thorough consideration. We have quoted at length from the opinion, because the *ratio decidendi* renders unavailing the efforts which have been made to distinguish this case. The Court explicitly rested its decision upon *the essential nature* of the transaction—that is, upon a consideration of the essential quality of a 'stock dividend' based there, as here, on accumulated surplus invested in plant and property and by appropriate resolution permanently classified as capital. The opinion makes it clear that it was not a rule particularly applicable to wills, or trusts, but the nature and effect of the corporate action which determined the conclusion of the Court. If the 'stock dividend' was not receivable as income, when if income the claimant would have been entitled to receive it, it could hardly be said that it should be taxed as income. Had it been income, the *cestui que trust* would have succeeded, but because the Court considered it *not* to be income she lost her suit. If the 'stock dividend' was not income for the purpose of distribution to the beneficiary of the income, we cannot conceive that it could have been regarded, had an income tax law been in operation, as income for the purpose of taxing it.

As already stated, the statements which had been made in the case of *Bailey* v. *Railroad Co.* (22 Wall. 604), to which the Government refers, were carefully considered in the *Gibbons* case.

Gibbons v. *Mahon* was an exposition by which the final authority defined to this extent, by exclusion, the meaning of "income". The usual rule is that when a word which has received judicial construction is subsequently used in Federal legislation it should be presumed to have been used in the sense determined by the Court (*Kepner* v. *United States,* 195 U. S. 100, 124; *Latimer* v. *United States,* 223 U. S. 501, 504). The same principle may be applied in construing the Sixteenth Amendment. If there is to be resort to judicial definitions or expositions with respect to what is "income" as distinguished from "capital", we can think of no justification for ignoring the deliberate ruling of this Court. It is to be observed that State decisions, which are invoked for a contrary rule, almost invariably turn on an effort to effect the intention of the testator, or donor in a trust, with respect to the disposition of his property. Rarely are these decisions concerned with the question of what is income in its nature. And there has been a general agreement that 'stock dividends' declared during a trust life estate, which are based on earnings made by the corporation prior to the creation of the trust, are not income,—a position fatal to the contention that stock dividends are income *per se.* (See *Matter of Osborne,* 209 N. Y. 450, 477; *Day* v. *Faulks,* 81 N. J.

Eq. 173.) Thus, in the *Matter of Osborne, supra,* cited by the Government, it was said that to give a 'stock dividend' to the life tenant which was earned prior to the creation of the trust would "shock the sense of justice". But, of course, there would be nothing that was at all shocking if the stock dividend was income *per se* and the life tenant was therefore entitled to it.

It would be extraordinary to disregard the explicit decision, as to what is income, made by this Court before the adoption of the Sixteenth Amendment, and to substitute therefor State views as to the intention of testators.

Moreover, if Congress is authorized to deal in a particular manner with "black", it cannot deal in this manner with "white" by calling it "black". However important the legislative taxing word, it cannot extend a constitutional provision. It cannot add a cubit to a man's stature or a dollar to his income. It is enough to tax one upon what he has received, but if he is to be taxed upon what he has not received, and may never receive,—upon what in truth makes him no richer,—then we submit that some other word must be found to justify this unhappy result than the word "income".

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 entitled upon liquidation.

With respect to management, the shareholder's 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 a 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 to-day 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 corportion 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 holdings 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 Government says that "'income' represents the advantage, service or use actually rendered by 'capital' to its owner during a period of time". Such a definition leads one quite afar. Thus a very important 'service' or 'advantage' of capital, which every business man would be swift to recognize, is the advantage or service that it gives in enabling him to have a line of credit at his bank. He gives his bank a statement of his resources and he is allowed a line of credit "during a period of time". If, at the end of this 'period' he is able to make good his obligations but has no gain, it would strike him as extraordinary to say that this line of credit constituted 'income' on which he should pay a round sum to the Government through an income tax. Perhaps, following the analogy of the present case, if a man had a line of credit for a year of $100,000 he should pay an income tax upon this 'advantage' or 'service' of his capital as amounting to $100,000.

A better definition, which embraces the essential element of '*gain*', is found in *Stratton's Independence* v. *Howbert*, 231 U. S. 399, 415, where it is 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. 339, 415: 'Income may be defined as the gain derived from capital, from labor, or from both combined.'"

Or, it may be said, quoting the language of Professor Seligman:

> "Strictly speaking, 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 on Income Tax, p. 19.)

Of course it is not denied that income may be in the form of property, although it is well settled that in construing an Income Tax Act income is taken to mean money in the absence of any special provision of law to the contrary, and not the mere expectation of receiving it (*United States* v. *Shillinger*, 14 Blatchf. 71). If, however, the Act reaches property and not simply money, it must still be property that constitutes '*gain*' or, '*income*'. It is not 'income' simply because it is property.

The Courts have always recognized that mere appreciation in value of capital assets is not to be called income.

> "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."
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> *Gray* v. *Darlington*, 15 Wall. 63, 66.*

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*Under the British Income Tax Act (16 & 17 Vict. c. 34) it is established that applications 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 profits. *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.

In the words of Mr. Justice McKenna in *Lynch* v. *Turrish*, 247 U. S. 221, 231, speaking with approval of *Gray* v. *Darlington*:

> "Indeed, the case decides that such advance in value is not income at all, but merely increase of capital and not subject to a tax as income."

In the case of the *Baldwin Locomotive Works* v. *McCoach* (3 C. C. A. 1915), 221 Fed. 59, which arose under the Corporation Tax Law of 1909, which measured the tax by the income of the corporation, the Court said:

> "We agree with the District Court that this increase of valuation was not income within the meaning of the statute. Nothing whatever was added to the corporate property, which remained exactly the same after the appraisement as before. The only thing done was to put upon the company's books an expression of expert opinion that certain property was worth a certain sum, and this can hardly be said to be income, or even gain, in any proper sense. The company could not become either riche. or poorer by making a few book entries that merely recorded a new estimate of how much it was worth."

Exactly the same situation is presented when the market value of a share of stock increases because of accumulated earnings. Until *separation* takes place, which happens when a cash dividend is declared, there is no taxable income. Again the courts have recognized that such appreciation is not income, for nothing

has come in, part of which can be taken by the government for revenue purposes.

In *Lynch* v. *Hornby*, 247 U. S. 339, the Court said, through Mr. Justice Pitney, in reference to the undivided surplus:

> "As to these, however, just as we deem the legislative intent manifest to tax the stockholder with respect to such accumulations only if and when, and to the extent that, *his interest in them comes to fruition as income*, that is, in dividends declared" (p. 343; italics ours).

Finally, the same reason exists for holding that 'stock dividends' shall not be included within the term "income". It is not necessary to show again what happened when the Standard Oil Company of California declared its 'stock dividend', it is merely sufficient to show that the defendant in error has not received anything with which to pay the tax. She 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. Whether she does or not will depend on the ultimate liquidation so far as the shares themselves are concerned. If dividends are received *on* the new shares, so that she does receive gain in this way, she will be taxable on such dividends. But until that point is reached the plaintiff is immune from taxation under an income tax law. She 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.

It is submitted therefore that when Congress was authorized to tax "incomes" it was not the intention to allow it to tax a change in the evidence of ownership which is all that a 'stock dividend' represents.

It is submitted that the judgment of the District Court should be affirmed.

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