# BRIEF FOR THE UNITED STATES

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## AUTHORITIES CITED.



## STATUTES.



# In the Supreme Court of the United States.

OCTOBER TERM, 1918.

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MARK EISNER, COLLECTOR OF INTERNAL Revenue, Plaintiff in Error, *v.* MYRTLE H. MACOMBER. } No. 914.

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

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## BRIEF FOR THE UNITED STATES.

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### STATEMENT OF THE CASE.

This case involves the constitutionality of that provision of the Income Tax Law of 1916 which taxes as income of the stockholder *stock dividends* declared by a corporation *out of earnings and profits accruing subsequent to March 1, 1913.*

The taxes, amounting to $1,376.02, were paid under protest and this suit was brought to recover them.

The District Court, regarding the case of *Towne* v. *Eisner*, 245 U. S. 418, as controlling, rendered judgment for the amount claimed.

STATUTE INVOLVED.

Like the Act of 1913 (38 Stat., c. 16, pp. 114, 167), the Act of 1916 (39 Stat., c. 463, pp. 756, 757) provided that, for purposes of certain taxes and subject to certain exemptions and deductions—

> 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: * * *.

Unlike the Act of 1913, the Act of 1916 contains the following proviso:

> *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.

This proviso makes the two Acts different in two respects: (1) The earlier simply taxed "dividends" without any effort to define them; the later defines them so as to expressly include stock as well as cash dividends. (2) The earlier taxed "dividends" without reference to when the gains and profits represented by them accrued to the corporation; the later confines taxable dividends to those declared out of earnings and profits accruing to the corporation subsequent to March 1, 1913.



THE FACTS.

The defendant in error was the owner of 2,200 shares of the stock of the Standard Oil Company of California. On January 1, 1916, that company had surplus and undivided profits which were invested in its plant and other property required for its business, and which amounted to some $44,000,000. Of this sum, $20,000,000 had been earned prior to March 1, 1913, and the remainder after that date. On January 16, 1916, the directors declared a 50 per cent stock dividend. Accordingly, there was transferred from surplus account to capital stock account all the surplus earned prior to March 1, 1913, and enough of that earned subsequent to that date to make the amount so transferred equal to the par value of the new shares to be issued. The result was that about 18 per cent of each share issued in payment of the stock dividend was paid for out of earnings of the corporation accruing subsequent to March 1, 1913. Defendant in error received 1,100 of these shares. The tax was assessed and collected, however, on only 18 per cent of their par value, thus taxing them only to the extent that they represented earnings accruing to the corporation after March 1, 1913.

**QUESTION INVOLVED.**

Congress has, in unmistakable language, declared its purpose to tax as income dividends of the kind above described. The only question is whether the levying of such a tax is within the power of Congress.

**ASSIGNMENTS OF ERROR.**

The assignments of error, which are found at pp. 11–12 of the record, present simply the question whether earnings accruing to a corporation subsequent to March 1, 1913, when distributed by means of a stock dividend, become taxable income in the hands of the stockholders.

**BRIEF.**

I.

Income, in general, as used in both the Corporation Excise Tax Law of 1909 and the Income Tax Law of 1913 has been defined "as the gain derived from capital, from labor, or from both combined." *Stratton's Independence* v. *Howbert*, 231 U. S. 399, 415; *Doyle* v. *Mitchell Brothers Co.*, 247 U. S. 183, 185.

II.

Stockholders have such an interest in the earnings and profits of a corporation that the same are within the power of Congress to tax as income even before they are divided. *The Collector* v. *Hubbard*, 12 Wall.



1; *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330, 336; *Lynch* v. *Turrish*, 247 U. S. 221, 228; *Bailey* v. *Railroad Company*, 22 Wall. 604, 635, 636; *Lynch* v. *Hornby*, 247 U. S. 339, 343.

III.

Congress having the right to tax undivided profits, this right cannot be destroyed by the issuance of stock certificates to represent such undivided profits, and since the certificates of stock issued in this case represent earnings of the corporation accruing subsequent to March 1, 1913, they are clearly made taxable as income by the Act of 1916, 39 Stat., c. 463, p. 756. *Peabody* v. *Eisner*, 247 U. S. 347; *Bailey* v. *Railroad Co.*, 22 Wall. 604, 635; *Swan Brewery Co., Limited* v. *The King*, Law Reports, Appeal Cases, 1914, pp. 231, 234–236.

IV.

*Towne* v. *Eisner*, 245 U. S. 418, does not control this case.

(1) That case merely decides that the stock dividends then before the court, paid out of earnings accruing prior to March 1, 1913, were not income within the meaning of the Act of 1913. Nothing said in the opinion can be construed as challenging the power of Congress to tax, as the income of stockholders, the profits of a corporation even before they are divided, and much less to tax a certificate of stock issued to represent such profits.

(2) The most that can be said of the opinion is that it holds that the term "dividend" in its ordinary acceptation does not include stock dividends, and that since the Act of 1913 used the term "dividend" without qualification stock dividends were not taxable under it. *Gibbons* v. *Mahon*, 136 U. S. 549, 559, 560.

(3) The Act of 1916, however, expressly taxes stock dividends, and hence *Towne* v. *Eisner* is not controlling.

V.

The case of *Lynch* v. *Hornby*, 247 U. S. 339, holding that cash dividends are to be treated as income for the year in which received, whether paid out of earnings accruing before or after March 1, 1913, in view of the reasons stated for the holding, would not have been inconsistent with a holding that stock dividends were taxable when representing earnings accruing ~~before~~ after March 1, 1913, but not taxable when representing earnings accruing ~~after~~ before that date.

But whether such holdings would have been inconsistent or not, the holding in *Lynch* v. *Hornby* is not controlling in this case, since the Act of 1916 makes it plain that dividends, whether paid in cash or stock, are to be taxed only when they represent earnings accruing after March 1, 1913.

VI.

While *Gibbons* v. *Mahon*, *supra*, holds that as between a life tenant and a remainderman stock dividends are not income, that case arose in the District



of Columbia, involves no Federal question, and is not controlling in similar cases arising in the State courts. As a matter of fact, most of the State courts have adopted a different ruling and hold that stock dividends are income. In the Act of 1916, therefore, Congress was clearly within its power when it declared that by "dividends" it meant either cash or stock dividends in accordance with the meaning of the term as understood and construed by the courts of most of the States. *Pritchitt* v. *Nashville Trust Co.*, 96 Tenn. 472; *Thomas* v. *Gregg*, 78 Md. 545; *McLouth* v. *Hunt*, 154 N. Y. 179; *Will of Pabst*, 146 Wis. 330; *Lord* v. *Brooks*, 52 New Hamp. 72; *Hite* v. *Hite*, 93 Ky. 257; *Moss's Appeal*, 83 Pa. State, 264; *Paris* v. *Paris*, 10th Vesey, Jr., 184; *Tax Commissioner* v. *Putnam*, 227 Mass. 522; *Matter of Osborne*, 209 N. Y. 450; *Goodwin* v. *McGaughey*, 108 Minn. 248.

VII.

The stock certificates which the defendant in error received represented his share of earnings accruing after March 1, 1913, and under the express terms of the Act constitute a part of his income.

## ARGUMENT.

Congress has clearly enacted that when, out of earnings accruing subsequent to March 1, 1913, a corporation declares a dividend payable in its own stock, the shares of stock so received by stockholders shall be deemed to be a part of their income and taxed accordingly. The Standard Oil Company declared such a stock dividend and paid it by issuing shares of its stock. The defendant in error received 1,100 of these shares, and was required to pay an income tax on 18 per cent, or, in round numbers, 198 of them. Manifestly this tax was properly collected, unless stock dividends can not, under any circumstances, be regarded as income.

**WHAT IS INCOME?**

Under both the Corporation Excise Tax Law of 1909 and the Income Tax Law of 1913 this court has had occasion quite recently to say what constitutes income within the meaning of the tax laws. This is the definition adopted:

> Income may be defined as the gain derived from capital, from labor, or from both combined. (*Stratton's Independence* v. *Howbert*, 231 U. S. 399, 415; *Doyle* v. *Mitchell Brothers Co.*, 247 U. S. 183, 185.)

This definition is extremely broad and would seem to include anything of value which represents a gain derived from capital, labor, or both.

**STOCKHOLDERS HAVE SUCH AN INTEREST IN THE EARNINGS AND PROFITS OF A CORPORATION THAT THE SAME ARE WITHIN THE POWER OF CONGRESS TO TAX AS INCOME EVEN BEFORE THEY ARE DIVIDED.**

It is true that the title to the money and other assets of a corporation is in the corporation and not in the stockholders. It is equally true that a stockholder has no right to receive any part of the profits of a corporation except such as the board of directors,



acting in good faith, see fit to distribute as dividends. But it is idle to say that a corporation can accumulate profits without adding to the wealth of the stockholder, or that the latter do not *gain* by this accumulation. And it is not now open to controversy that such *gains* are within the power of Congress to tax as the income of the stockholders, even though undivided and held by the corporation as surplus. Indeed, this has been expressly adjudged by this court and does not seem to have ever been the subject of doubt.

The Income Act of 1864 required that there should be included in the taxable income of individuals, among other things, their share of the gains and profits of corporations, *whether divided or otherwise.* This court, in *The Collector* v. *Hubbard*, 12 Wall. 1, held the Act valid and said (p. 17):

> Decided cases are referred to, in which it is held that a stockholder has no title for certain purposes to the earnings, net or otherwise, of a railroad prior to the dividend being declared, and it cannot be doubted that those decisions are correct as applied to the respective subject matters involved in the controversies. Grant all that, still it is true that the owner of a share of stock in a corporation holds the share with all its incidents, and that among those incidents is the right to receive all future dividends; that is, his proportional share of all profits not then divided. Profits are incident to the share to which the owner at once becomes entitled provided he remains a mem-

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

True, under the doctrine of the *Pollock* case, that tax would have been held invalid, not, however, because the views just quoted were unsound, but because the tax was a direct tax on property and not apportioned among the States. Since the Sixteenth Amendment has removed the obstacle to levying such a tax, the *Hubbard* case, unless it has been overruled, is and was, when the recent income



tax laws were passed, conclusive authority of the power of Congress to levy a tax on defendant in error's share in the profits earned by the Standard Oil Company, even if they had never been divided by a declaration of a dividend of any kind.

The *Hubbard* case has never been overruled, modified, or questioned, but has been repeatedly recognized by this court. It has been quite recently cited with apparent approval, or at least with acquiescence, in *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330, holding that the act of 1913 did not treat as income of the stockholders undivided profits of a corporation except "in case the company is formed or fraudulently availed of for the purpose of preventing the imposition of such tax by permitting gains and profits to accumulate instead of being divided or distributed." No lack of power to tax such undivided profits, if Congress had seen fit to do so, was suggested. Indeed, the court apparently approved what was said in the *Hubbard* case, and was careful to distinguish that case from the one then being decided, saying:

> The act is quite different in this respect from the Income Tax Act of June 30, 1864, c. 173, 13 Stat. 223, 281, 282, under which this court held, in *Collector* v. *Hubbard*, 12 Wall. 1, 16, that an individual was taxable upon his proportion of the earnings of the corporation although not declared as dividends. That decision was based upon the very special language of a clause of sec. 117 of the act (13 Stat. 282) that "the gains and profits of all

ing the latter, in ordinary circumstances, as a part of his income for the purposes of the surtax, and not regarding the former as taxable income unless fraudulently accumulated for the purpose of evading the tax.

This treatment of undivided profits applies only to profits permitted to accumulate after the taking effect of the act, since only with respect to these is a fraudulent purpose of evading the tax predicable.

In other words, under the act of 1913 the court found that *ordinarily* undivided profits of the corporation were not taxable as income of the stockholders, not because they were not, equally with dividends, within the power of Congress to tax, but because Congress, in exercising its discretion, had refrained from exerting its power on them.

It is obvious from what has been said that this court has repeatedly sustained the power exercised in 1864 to tax undivided profits of a corporation as income of the stockholders; has, since the passage of the act of 1913, more than once cited as authority the holdings to this effect; and has, by implication, at least, assumed that when, in the act of 1913, Congress, though to a limited extent, exercised the same power its act was valid. It is therefore submitted that the question of the power of Congress to tax the earnings of the corporation represented by the shares of stock involved in this case, even if no dividend of any kind had ever been declared, is foreclosed.



**CONGRESS HAVING THE RIGHT TO TAX UNDIVIDED PROFITS, THIS RIGHT COULD NOT BE DESTROYED BY THE ISSUANCE OF STOCK CERTIFICATES TO REPRESENT THESE UNDIVIDED PROFITS.**

Since Congress had ample power to tax as income of a stockholder his share of the *undivided* profits of a corporation, it follows, as a matter of course, that anything issued by the corporation and delivered to the stockholder to represent these taxable undivided profits must itself be taxable. The point is that the undivided profits being taxable as income of the stockholders, if Congress sees fit to so tax them, can not be placed beyond the power of Congress merely by changing their form. If taxable when they are merely an incident to the original stock of the stockholder, it would be absurd to say that they are placed beyond the same taxing power by having their amount definitely fixed and by issuing a certificate of ownership. As long as they remain merely undivided profits, they are under the control of the board of directors. If the board of directors so wills, they may never be distributed to the stockholders in any form of dividend. What benefits the stockholder may receive from them, aside from the increased value which they give as stock, and what control he may have over them, are matters entirely subject to the will of the board of directors. If while his interest in them is in this uncertain state and subject to the will and discretion of others, they may, as we have seen, be treated as a part of his income, it is much clearer that they may be so treated when he holds, as representing them, a certificate of stock

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which prevents the board of directors from thereafter treating them as anything but capital, which has a market value, and which he is at liberty to dispose of and convert into cash.

It has been held, under the Act of 1913, that a dividend paid out of profits and earnings is taxable income of the stockholder, whether paid in cash or by the distribution in specie of property belonging to the corporation, including the stock of other companies. *Peabody* v. *Eisner*, 247 U. S. 347. The mere fact, therefore, that a dividend is paid in *corporate stock* does not prevent its being taxable income of the stockholder. The reason is that such stock has a value, and, whatever that value is, it has accrued to the stockholder as a result of his ownership of property. If the dividend is paid in the stock of the corporation declaring it, it still has the same value and still comes to the stockholder by virtue of his ownership of stock in the company. In both cases, as we have seen, it is merely the concrete evidence which determines the amount of the stockholder's *gain*. The mere declaration of a dividend, whether paid in cash or stock, does not make the stockholder any richer than he was the moment before the dividend was declared. The question is whether he is richer, to the extent of the amount he receives as a result of the dividend, than he was at the beginning of the taxable period.

To illustrate: If on March 1, 1913, one owned stock in a corporation of the par value of $1,000 and the



company had a surplus which made his stock worth $1,500, the latter amount represented his capital at the time the income-tax law became effective. If on March 1, 1914, it turned out that the company had made a profit of 10 per cent which it declared and paid in a cash dividend his capital would still be the same that it was the year before. If thereupon, and before any other earnings had accrued, the corporation had declared a 50 per cent stock dividend and issued to him stock to the amount of $500, this would not involve any gains on his part and his capital would still be the same. If, however, on March 1, 1913, the par value of his stock had been $1,000 and the company had no surplus, but it turned out that on March 1, 1914, the company had earned 50 per cent and declared a dividend of 50 per cent payable in stock, the earnings of the year would have thus been converted into capital of the corporation. But can it be doubted that the stockholder would have received gains on his investment to the extent of 50 per cent? Would the fact that these gains were invested in the stock of the company prevent Congress from treating them as income any more than if the company had first invested the profits in the stock of another company and then distributed the latter stock to its stockholders? Certainly the stockholder would at the end of the year be $500 richer than he was at the beginning of the year, and this increment would certainly have been derived from the possession of property in the shape of his original capital.

To illustrate again: The defendant in error received 198 shares of the stock of the Standard Oil Company as a dividend. They, of course, had a market value. It is even alleged in the bill that they could have been sold for more than two to one. They had come to him as his share of the earnings of the corporation. They were derived from his ownership of stock in that corporation. Suppose he had immediately sold them. Can it be doubted that every dollar realized would have been *income* received by him during that year? Certainly this would have been true if the dividend had been paid in the stock of another company and he had sold that. It would seem that there is no difference in principle between the two cases. In either event he has first received his gains in property and he has converted this property into cash.

Under former income-tax laws it has certainly never been doubted that a stock dividend is income of the stockholder. In the case of *Bailey* v. *Railroad Company*, 22 Wall. 604, a railroad company whose charter prohibited the declaring of more than 10% annually in dividends, and which had issued all the stock it was authorized to issue, had accumulated large profits which had been invested in the improvement of its railroad and facilities. It desired to distribute this surplus among its stockholders. It could not declare a stock dividend because its power to issue stock had been exhausted. It hit upon the expedient of issuing certificates which it called scrip dividends. This court examined these certificates,



and after setting out their provisions, showed that they possessed practically all the attributes of stock except that they carried no right to vote, and said that the fact that they did not confer the right to vote could not exempt them from liability under the Act, as dividends in stock did not entitle the holder to any additional vote. The whole argument was based on the idea that stock dividends would undoubtedly be taxable as income. Indeed, this was expressly stated as follows, at page 635:

> Stock dividends it is conceded are a proper object of taxation under the Internal Revenue Act, and if so, it is difficult to see why those certificates are not, as they differ from the former only in the fact that they do not confer the right to vote and that they may be cancelled by payment out of the future earnings of the company.

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. Since, as we have seen, a stock dividend, like any other property, may constitute a gain accruing to the stockholder and thus be a part of his income, and since in this case the stock dividend in question is the concrete evidence of the gain accruing to the defendant in error after the 1st of March, 1913, it would seem that a contradiction in terms would be involved in saying that the value of these 198 shares of stock was not a part of his income.

Moreover, as has been repeatedly recognized by this court, these shares represent gains and profits of the corporation which Congress had the power to treat as a part of his income even if they had never been distributed by the declaration of any kind of a dividend.

The holding of this court above cited, to the effect that a stock dividend representing taxable gains and profits may be treated as income, is in accord with the view of the English courts. In *Swan Brewery Company, Limited*, v. *The King*, decided in 1914 and reported in Law Reports, Appeal Cases, 1914, at pages 231–236, the House of Lords, considering a stock dividend with regard to its liability for tax under the Dividend Duties Act of 1902 of Western Australia, said, pp. 234–236:

> The new shares were intended to be and were distributed among the shareholders; they were intended to be and doubtless are advantages to the allottees. The Supreme Court of Western Australia held that they were dividends within the meaning of the Act, and that duty was payable on their amount or value accordingly. What is there wrong in this?



> The argument is that there has been no dividend and no distribution, because nothing has been divided and nothing changed. Where formerly there was one share, enhanced in value by its right to participate in the reserve fund, if the company, being solvent, should be wound up voluntarily, now there are two, possessed of the same right of participation, but for that very reason worth no more and no less together than the one share was worth before. Formerly the company had a certain amount of capital; now it has the same without diminution or increase either temporary or permanent. The change is but one of name. Formerly its funds were so much share capital and so much reserve, all invested in the business; now they are so much more share capital and so much less reserve, all invested in the business still, and still unchanged in total amount. The duty claimed is not, it is said, a duty on or in proportion to any advantage either to the company or the shareholder measured by the increased stability of the company's own position or the increased facility to the shareholder in marketing his shares; it is measured by and is levied upon the whole nominal value of the new shares allotted, which is not the same thing as the value of the advantage distributed. Is this argument sound?
>
> Their Lordships agree with the Supreme Court of Western Australia in thinking that it is not. There can be no doubt that the new shares were distributed and were not the same things as the old ones. They certainly were supposed to be advantages to the members of

the company, none the less that the making of the issue was probably an advantage to the company also. In so flourishing a business doubtless they really were advantages. The new shares were credited as fully paid, and, what is more, they were fully paid, for after the allotment the company held £101,450 as capital produced by the issue of those shares and for that consideration, and no longer as an undivided part of its accumulated reserve fund. True, that in a sense it was all one transaction, but that is an ambiguous expression. In business, as in contemplation of law, there were two transactions, the creation and issue of new shares on the company's part, and on the allottees' part the satisfaction of the liability to pay for them by acquiescing in such a transfer from reserve to share capital as put an end to any participation in the sum of £101,450 in right of the old shares, and created instead a right of general participation in the company's profits and assets in right of the new shares, without any further liability to make a cash contribution in respect of them. In the words of Parker, *C. J.*, "Had the company distributed the £101,450 among the shareholders and had the shareholders repaid such sums to the company as the price of the 81,160 new shares, the duty on the £101,450 would clearly have been payable. Is not this virtually the effect of what was actually done? I think it is."

Their Lordships have therefore humbly advised His Majesty that the judgment of the Supreme Court of Western Australia was right, and that the appeal should be dismissed with costs.



In the present case if the corporation had paid this dividend in cash and the defendant in error had taken the cash received and purchased from the company 198 shares of its stock, no one would doubt for a moment that the cash received would have been taxable as a part of his income. What was actually done was that the company invested the money for him and delivered to him the shares of stock so purchased. Is there any conceivable difference in principle between the case supposed and that now under consideration?

It is respectfully submitted that the right of Congress to tax stock dividends as income is beyond doubt; that the Act of 1916 itself does this in express terms, so far as such dividends represent earnings accruing after March 1, 1913; that the defendant in error received his 198 shares of stock in payment of such a dividend; and that, upon well-established principles, he is liable for the tax collected.

TOWNE V. EISNER, 245 U. S. 418.

It will be insisted that the recent case of *Towne* v. *Eisner* conclusively determines that a stock dividend is not income. The contention is not sound. In the first place, as we have seen, in more than one case under consideration by the court at the same time that *Towne* v. *Eisner* was being considered, this court recognized the power of Congress to tax as income undivided profits and, consequently, stock dividends. Holdings to this effect were cited with apparent, if not express, approval. Cases so holding were cited as authority. Certainly, no dissent from them and no purpose to overrule them was indicated. It can not be supposed, therefore, that the court entertained any idea that the decision or anything said in the opinion in *Towne* v. *Eisner* was in conflict with these cases.

In the next place, *Towne* v. *Eisner* involved only the right to tax under the Act of 1913 a stock dividend declared out of earnings which had accrued prior to March 1, 1913, and had therefore become capital as regards both the corporation and the stockholders before the tax Act became effective. The effect of the stock dividend, therefore, was merely to give to the stockholders certificates evidencing their ownership of profits which, so far as their liability for taxes were concerned, had, in fact, been capitalized on March 1, 1913. Since the Act of 1913 purported to tax only income accruing subsequent to that date, the language of Mr. Justice Holmes in summing up the case, "in short, the corporation is no poorer and the stockholder is no richer than they were before," was entirely logical and conclusive. It was only another way of saying that the new stock certificates merely evidenced the stockholder's title to what he owned when the Act became effective, and that hence they did not include any gain which had accrued subsequent to that date. If, however, the stock dividend in question had, as in this case, represented the stockholder's share of earnings accruing after March 1, 1913, the language quoted would have been inappropriate and, in fact, untrue. It would have been true, of course, that the stockholder was no richer the moment after than the moment before the declaration of the dividend, but this would have been beside the question. The real question would have been, was he richer to the extent of the value of the stock received, than he was on March 1, 1913. If so, he had derived from his ownership of stock in the corporation a gain or profit or income to that extent.



While the court did not find it necessary to go into any elaborate discussion of the facts, obviously Mr. Justice Holmes had in mind the fact that this dividend represented profits which, for the purposes of the income-tax law, had been capitalized on March 1, 1913, when he said, "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." This statement was immediately followed by a quotation from *Gibbons* v. *Mahon*, 136 U. S. 549, 559, 560, in which it was held that where under a will a person was entitled during his life to receive the dividends of stock, this meant cash dividends and stock dividends remained a part of the capital and belonged to the remainderman. As applied to the facts before this court, this holding was pertinent and controlling. The holding in *Gibbons* v. *Mahon* was based upon the view of the court that because the portion of the earnings of a corporation to be distributed among the stockholders was in the discretion of the board of directors, that board had the power, if it saw fit, to retain and use as capital so much of the earnings as it deemed expedient.

In other words, it was held that so long as the board of directors did not decide to distribute earnings in cash they must be considered to have determined to use and treat them as capital; and that the issuance of shares of stock to represent them was a final determination that, as between the corporation and the stockholders, they should permanently be regarded as capital. This could only mean that, the corporation having decided to appropriate earnings to capital, this decision was conclusive upon the stockholders, and that, as between them, such earnings could no longer be regarded as income. So the Act of 1913, for the purposes of taxation, capitalized the earnings which had been accumulated up to March 1, 1913. As, in the case of *Gibbons* v. *Mahon*, the certificates issued to represent earnings which the corporation itself had capitalized were held to be capital as between life tenant and remainderman, so in *Towne* v. *Eisner* shares of stock issued to represent earnings which, for the purposes of taxation, the law had capitalized on March 1, 1913, were held to be capital, since they did not include any element of gain to the stockholder which the Act of 1913 purported to tax. The element, therefore, which made the principle involved in *Gibbons* v. *Mahon* and that in *Towne* v. *Eisner* kindred was the fact that in neither case did the certificates represent anything which had not



already been established as capital. If, as in this case, it had appeared that the certificates in *Towne* v. *Eisner* represented earnings which the law purported to tax there would have been no similarity in principle between the two cases.

In the next place, unlike the Act of 1916, the Act of 1913 did not in express terms tax *stock dividends*. It merely taxed *dividends*. In the case of *Gibbons* v. *Mahon* it had been held that a provision in a will giving to a legatee the "dividends" of stock did not include in its terms stock dividends. That case did not hold, however, that a stock dividend may never or for any purpose be deemed income. It was merely held that "ordinarily a dividend declared in stock is to be deemed capital, and a dividend in money is to be deemed income, of each share." (p. 559.) The most that can be made of this is that it is a ruling to the effect that *ordinarily* the term "dividend," without qualification, means only a dividend paid in cash or its equivalent and not in stock of the company declaring it. Since the Act of 1913 used only the word "dividend," the court could very well feel bound by the ruling in *Gibbons* v. *Mahon*, to regard the language of the Act as excluding an intention to tax anything except a dividend as that word is *ordinarily* understood—that is, a dividend paid in cash or its equivalent, not including stock of the corporation declaring it. In this view, it is possible that under the Act of 1913 this court would have felt constrained to say that, for the want of the expression of a controlling purpose by Congress, the tax did not apply to a stock dividend regardless of when the earnings it represented had accrued. But what the court would have held under the Act of 1913 is not important in this case.

When the Act of 1916 was passed, although *Towne* v. *Eisner* had not been decided by this court, the question had been raised and was the subject of litigation. Congress, so far as the future was concerned, put an end to it by declaring in express terms that it meant in the Act of 1916 by the word "dividend," any distribution of earnings of the corporation accruing after March 1, 1913, whether paid to the stockholder in cash, property, or stock. This court may have intended to decide in *Towne* v. *Eisner* that no stock dividends were taxable under the Act of 1913, but certainly, in view of the authorities to which we have referred and which had the attention of the court while *Towne* v. *Eisner* was under consideration, it cannot be said to have decided, or intended to have decided, that Congress had no *power* to tax them as income. And Congress having now exercised that power, there is nothing in *Towne* v. *Eisner* which can control or affect this case.

LYNCH V. HORNBY, 247 U. S. 339.

It will be insisted that *Towne* v. *Eisner* turned rather upon the nature of stock dividends than upon the fact that the dividends there involved represented earnings accruing prior to March 1, 1913. In support of this contention it will be argued that in



no other way can that case be reconciled with *Lynch* v. *Hornby*, 247 U. S. 339, in which it was held that cash dividends paid after March 1, 1913, were to be treated as income for the year in which received regardless of whether the earnings being distributed accrued prior or subsequent to March 1, 1913. But *Lynch* v. *Hornby* was based upon the fact that Congress had chosen to tax a stockholder's interest in earnings and profits not as they accrued but when they ripened into dividends. Since dividends are the recognized means through which returns on investments in corporate capital are received, just as interest represents the return on money loaned, and rent the return for the use of land, the court was of opinion that Congress intended to tax such dividends whenever received regardless of when they were earned. This was in accord with the well-recognized character of corporate stocks and dividends.

As before mentioned, the stockholder is entitled to receive only such portion of the earnings as the board of directors see fit to distribute. In the ordinary course of business these are received periodically by the payment of dividends, and not infrequently are practically as fixed as to amount and date of payment as interest on loans. They are not necessarily paid out of the earnings of a particular year. Indeed, they may be paid for a year in which, instead of earning profits, the corporation has sustained a net loss. In such cases, if as a result of previous prosperous years, the corporation has accumulated a surplus it may, and often does, declare for the lean year a dividend not earned that year out of earnings of previous years. It may very well be said, then, that when Congress came to tax *dividends* as a source of income it was not necessary to inquire when the profits thus distributed were earned. It was manifestly upon this idea that the decision in *Lynch* v. *Hornby* was based, for, after holding that it was permissible to make the act retroactive to a date not prior to the adoption of the Sixteenth Amendment, the court said, pp. 343-344:

> And we deem it equally clear that Congress was at liberty under the Amendment to tax as income, without apportionment, everything that became income, in the ordinary sense of the word, after the adoption of the Amendment, including dividends received in the ordinary course by a stockholder from a corporation, even though they were extraordinary in amount and might appear upon analysis to be a mere realization in possession of an inchoate and contingent interest that the stockholder had in a surplus of corporate assets previously existing. Dividends are the appropriate fruit of stock ownership, are commonly reckoned as income, and are expended as such by the stockholder without regard to whether they are declared from the most recent earnings, or from a surplus accumulated from the earnings of the past, or are based upon the increased value of the property of the corporation. The stockholder is, in the ordinary case, a different entity from the corporation, and Congress was at liberty to treat the dividends as coming to him *ab extra*, and as constituting a part of his income when they came to hand.



As we have seen, the utmost extent of meaning that can be attached to the opinion in *Towne* v. *Eisner* is that it construes the word "dividend" in the Act of 1913 to include only such dividends as have just been described. If the court, in fact, did intend to go this far, the result is that what was said in *Lynch* v. *Hornby* applies to the only kind of dividends mentioned in the Act, and that the effect of *Towne* v. *Eisner* is to hold that, since Congress had not exercised its undoubted power to tax a share of accumulated profits until distributed by means of such a dividend, stock dividends, which must represent either accumulated profits or capital, were not taxable under that Act. Assuming this to be true, the answer is that neither of these cases is controlling in the present case, which arises under the Act of 1916. Cash dividends representing earnings accruing prior to March 1, 1913, which were taxed in *Lynch* v. *Hornby*, could not be taxed under the Act of 1916, for the reason that that Act defines both cash and stock dividends as a distribution of earnings accruing after that date. Likewise, giving to *Towne* v. *Eisner* the full meaning claimed for it, and thus assuming that, if the dividends there considered had represented earnings accruing after March 1, 1913, they would nevertheless not have been taxable, they would be under the Act of 1916, which, in express terms, puts stock dividends on the same basis with cash dividends.

Conceding, therefore, for the sake of the argument, that, under the Act of 1913, stock dividends were under no circumstances taxable, we have this situation: The stockholders in a corporation had such an interest in the gains and profits of the corporation that Congress had the power to treat each stockholder's share in these profits as they accrued as a part of his income. Congress had in previous Acts done this, and this court had held that its action was valid. But, when it came to pass the Act of 1913, in view of the obvious difficulties of fairly administering such a law without making it unduly burdensome upon and annoying to the taxpayer, Congress decided not to levy a tax upon them until they were divided and something definitely fixing the share of each stockholder delivered to him. It accordingly enacted that the tax should attach to these undivided profits only when they should be paid over to the stockholders in "dividends." Assuming all that is claimed for *Towne* v. *Eisner*, this meant cash dividends as distinguished from stock dividends, and a stock dividend would not be taxable. In that event, if the earnings had accrued subsequent to March 1, 1913, the shares of stock issued in payment of the stock dividend would merely represent undivided profits, which had not reached the point at which Congress had expressed an intention to tax them. They



would still, however, be undivided profits, and when these profits were realized by a sale of the shares of stock the proceeds, of course, would be taxable income.

But when Congress came to pass the Act of 1916, it evidently concluded that there was no reason for postponing the imposition of the tax beyond the time that the stockholder should receive his share of the profits in the shape of stock certificates, which had a market value and could readily be converted into cash. Instead, therefore, of saying that undivided profits should not be taxable until divided by means of a cash dividend, it enacted that the tax should be imposed whenever they were distributed, whether the dividend was paid in cash or stock. As we have seen, unless it can be said that although undivided profits may be taxed while merely an incident to ownership of the original shares, they can not be taxed when they have been converted into separate and distinct shares of stock, there can be no doubt Congress had the power to do what it did in the Act of 1916.

**IT IS WITHIN THE PROVINCE OF CONGRESS TO DETERMINE WHAT ITEMS OF GAIN SHALL BE TREATED FOR THE PURPOSES OF TAXATION AS INCOME.**

In levying an income tax, it is manifestly within the province of Congress to describe and define the items of gain which shall be taxed. It may be conceded that Congress can not arbitrarily call something which in no sense constitutes a gain "income" and tax it as such. But in this case, as we have seen, it is impossible to say that subsequent to March 1, 1913, the defendant in error was not a gainer by the prosperous operations of the corporation in which he held stock. It is settled that these gains could have been taxed, although never divided or distributed. This being true, it can not be doubted that in fixing the time when the tax should be imposed it had as ample power to say that the tax should accrue when the profits should be turned over to the stockholder in the shape of additional shares of stock as to say that it should accrue when the stockholder received his share in cash. Congress used the word "dividend" as indicating when the tax should be imposed. At that time, it is probably safe to say that no court had ever expressly held that, for the purposes of an income tax, a dividend was any less income when paid in stock than when paid in cash. This court had held in *Gibbons* v. *Mahon* that, as between a life tenant and remainderman, a stock dividend was not income, and that, in the ordinary acceptation of the term, a dividend did not include one payable in the stock of the corporation. At the time that case was decided the authorities, even as to the rights of life tenant and remainderman, were by no means agreed. And at present, even in that class of cases, the courts of a great many of the States draw no distinction between cash and stock dividends. *Pritchitt* v. *Nashville Trust Co.*, 96 Tenn. 472, 489; *Thomas* v. *Gregg*, 78 Md. 545; *McLouth* v. *Hunt*, 154 N. Y. 179; *Will of Pabst*, 146 Wis. 330; *Lord* v. *Brooks*, 52 New Hamp. 72;



*Hite* v. *Hite*, 93 Ky. 257; *Moss's Appeal*, 83 Pa. State 264; *Matter of Osborne*, 209 N. Y. 450; *Goodwin* v. *McGaughey*, 108 Minn. 248. And in the English case of *Paris* v. *Paris*, 10th Vesey, Jr., 184, Lord Eldon said:

> As to the distinction between stock and money, that is too thin; and, if the law is, that, this extraordinary profit, if given in the shape of stock, shall be considered capital, it must be capital, if given as money.

In fact, in the *Will of Pabst*, 146 Wis. 330, it was said that the courts of nearly all the States now hold that there is no distinction, even in this regard, between the two kinds of dividends, the exceptions being limited, probably, to Rhode Island, Georgia, Massachusetts, Illinois, and Connecticut.

In *Gibbons* v. *Mahon*, *supra*, this court, when called on to decide whether a stock dividend, as between a life tenant and remainderman, was income or capital, found the authorities on that subject conflicting, and after full consideration adopted what has come to be known as the Massachusetts rule and held that *ordinarily* stock dividends are not to be treated as income. It has been seen that, even in this class of cases, that rule does not prevail in most of the States. In confirmation of the contention, moreover, that this rule does not go to the extent of holding that a stock dividend is *necessarily* capital, and therefore cannot, in the exercise of legislative power, be treated as income, it is interesting to know that this contention is in perfect accord with the decisions of the Massachusetts court. That court has quite recently had occasion to consider the power of the legislature to tax stock dividends as income, and, though still adhering to the rule that, as between life tenant and remainderman, such dividends are capital, has unequivocally held that the legislature, for the purposes of taxation, may treat and tax them as income. In the case of *Tax Commissioner* v. *Putnam*, 227 Mass. 522, it was said, at page 532:

> In the management of trusts as between a life tenant and remainderman rights to subscribe for stock, *Atkins* v. *Albree*, 12 Allen, 359, 361, *Davis* v. *Jackson*, 152 Mass. 56, 61, and stock dividends, *D'Ooge* v. *Leeds*, 176 Mass. 558, 560, *Rand* v. *Hubbell*, 115 Mass. 461, are regarded as capital and not as income in this Commonwealth. The rule of this Commonwealth, to the effect that as between life tenant and remainderman stock dividends are treated as capital and not as income, perhaps may have grown up in part at least by reason of its convenience and it appears to be widely adopted. *Gibbons* v. *Mahon*, 136 U. S. 549.
>
> But, however that may be, it is manifest that there is no inherent, necessary and immutable reason why stock dividends should always be treated as capital. This is apparent because in several jurisdictions they are treated either in whole or in part as income and not as capital.



The court then cited many of the cases which have been cited in this brief, and said:

> It seems impossible to say, when a kind of gain is in many States held even as between life tenant and remainderman to be income and not capital, that the word "income," used in an amendment to the Constitution adopted for the express purpose of enabling a tax to be levied broadly on all that rightly may be described as income, should be construed as excluding such gains simply because this court has held that it was not income in a single branch of law while numerous other courts have held the contrary even upon that point. However strong such an argument might be when urged as to the interpretation of a statute, it is not of prevailing force as to the broad considerations involved in the interpretation of an amendment to the Constitution adopted under the conditions preceding and attendant upon the ratification of the Forty-fourth Amendment. The rights to subscribe for stock, when sold and converted into cash, rightly may be treated as taxable as a gain on the sale of intangibles under section 5 (c) of the income-tax act. These rights commonly are represented by certificates and pass by indorsement. They are a species of intangible property. They are not regarded ordinarily as a profit from the prosecution of the business, but are an inherent and constituent part of the shares. *Atkins* v. *Albree*, 12 Allen 359, 361; *Hyde* v. *Holmes*, 198 Mass. 287, 293. Their sale resulted from an exercise of judgment to that effect on the part of the stockholder.

> They are indistinguishable in principle from a sale of the stock itself, and gains derived from sales of such rights fall within the same class of income.

And speaking directly of stock dividends, the court said, at page 535:

> But the words "distribution of capital" do not readily lend themselves to an issue of new stock, which in its last analysis represents surplus earnings of the corporation for the time being applied to increase of plant and which are intended to be continued to that use. In essence the thing which has been done is to distribute a symbol representing an accumulation of profits, which instead of being paid out in cash is invested in the business, thus augmenting its durable assets. In this aspect of the case the substance of the transaction is no different from what it would be if a cash dividend had been declared with the privilege of subscription to an equivalent amount of new shares. The stock dividend was declared strictly out of an accumulation of earnings applied to business uses and not out of increased market value of capital investment. See *Thayer* v. *Burr*, 201 N. Y. 155. That which the stockholder had before was a fractional interest in the property of the corporation. So far as concerned the accumulation of profits, there was a possibility that they might be paid out in whole or in part as a cash dividend by authority of the corporation. By the issue of the stock dividend that possibility is gone and the stockholder now has evidence of a permanent interest in



> the corporate enterprise of which he can not be deprived. It is a thing different in kind from the thing which the stockholder owned before. From the viewpoint of the stockholder, he has received in the form of dividend in stock a thing with which theretofore he could have no tangible dealings. The certificate for the new shares of stock representing the stock dividend may have a materially greater value than the less tactile right to a share in the accumulated profits which he had before. * * *
>
> The contention that stock dividends are not taxable as income, because in this Commonwealth they are treated as capital and not as income as between life tenant and remainderman, has been disposed of by what has been said already in discussing the second question here raised respecting the taxability as income of rights to subscribe for new shares of stock.
>
> The stock dividends, so far as regards the source from which they come to the stockholder and the impassive nature of his receipt of them, are derived from the same class of property from which are derived ordinary dividends and rightly may be classified with them under section 2 of the income-tax act. The two should be taxed, as they are in the statute, at the same rate.

It may be added that in this case, after placing stock dividends in the same class with cash dividends, the court upon the same reasoning, afterwards applied by this court in *Lynch* v. *Hornby*, held that both cash and stock dividends were taxable as income of the year in which received, regardless of whether the earnings thus distributed had accrued to the corporation before or after the beginning of the taxable period

The case of *Gibbons* v. *Mahon* arose in the District of Columbia. It announces a rule of property involving no Federal question, and therefore is not controlling when similar questions come before the courts of the various States. The result is that in nearly all the States the term "dividend," even as used in the Act of 1913, would be understood and held to include both cash and stock dividends, while in cases arising in the District of Columbia and a few of the States the holding would be to the contrary. What Congress did in the Act of 1916 was not to call "income" something which had not theretofore been recognized as a gain, but merely, in view of the conflicting opinions of the courts as to what was meant by the word "dividend," to say what it intended by that word in the Act it was framing, namely, *any distribution of profits accruing after March 1, 1913, whether paid in stock or cash.* Surely, it cannot be said that in doing this Congress went beyond its power.

## CONCLUSION.

It is respectfully submitted that the District Court was in error in supposing that this case was controlled by *Towne* v. *Eisner* and its judgment should be reversed.

Respectfully,

William L. Frierson,
*Assistant Attorney General.*

April, 1919.

# MOTION

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No. 914318

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IN THE

# Supreme Court of the United States,

OCTOBER TERM, A. D. 1918.

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

*against*

MYRTLE H. MACOMBER,
*Defendant-in-Error.*

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## MOTION TO ADVANCE.

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

MURRAY, PRENTICE & HOWLAND,
*Attorneys for Defendant-in-Error.*

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

IN THE

# Supreme Court of the United States,

## October Term, A. D. 1918.

No. .

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MARK EISNER, AS COLLECTOR, ETC.,
PLAINTIFF-IN-ERROR,

AGAINST

MYRTLE H. MACOMBER,
DEFENDANT-IN-ERROR.

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## MOTION TO ADVANCE.

NOW COMES MYRTLE H. MACOMBER, THE DEFENDANT-IN-ERROR, AND MOVES THE COURT THAT THIS CAUSE BE ADVANCED ON THE DOCKET AND SET DOWN FOR HEARING UPON A DAY CERTAIN.

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## STATEMENT OF FACTS.

The writ of error in this case is brought to review the final judgment of the United States District Court for the Southern District of New York entered upon an order overruling the Collector's demurrer to the complaint. The action was brought by a taxpayer to recover a tax assessed under the Income Tax Law of 1916 on the ground that it was illegally assessed. The plaintiff paid the tax under protest and took an appeal in due time to the Commissioner of Internal Revenue.

No technical question of practice is involved; the sole question is whether or not the tax was wrongfully assessed and collected.

The tax in question amounted to $1,367.02 and was paid as income tax for the year 1916. The plaintiff had received certain stock from the Standard Oil Company of California and the receipt of this stock was the sole basis for the tax. The question presented by the writ of error is whether that stock, which has been designated a "stock dividend", constituted taxable income.

Briefly the complaint alleges the following facts:

On January 1, 1916, the Standard Oil Company of California had outstanding capital stock in the amount of $49,686,656. and had accumulated a large surplus which was invested in its plant, property and business. In 1916 the Board of Directors of the corporation, for the purpose of readjusting the capitalization of the company, decided to issue additional shares of stock in the proportion of one-half of a share for each share of stock then owned by each stockholder, and in accordance with the resolution of the directors there was transferred from surplus account to capital stock account the sum of $24,843,327.74, being the equivalent



of the par value of said stock dividend. Of this sum $20,353,068.34 was charged against and represented surplus of the company earned prior to March 1, 1913, and $4,490,259.40 was charged against and represented surplus earned after March 1, 1913. The plaintiff held 2,200 shares of stock and received 1,100 shares of the new stock, which to the extent of 18.0743% represented earnings of the company since March 1, 1913. The remaining 81.9257% is not in question in this case. The defendant, acting under instructions from the Treasury Department, contended that all the new stock so received by the plaintiff constituted taxable income and levied a tax thereon on the theory that this stock was legally equivalent to a cash dividend at the rate of $100. a share.

By the receipt of this new stock the plaintiff's share or interest in the assets of the Standard Oil Company of California was not changed but the transaction merely increased the number of shares or parts into which her interest was divided; the market value of the plaintiff's total number of shares remained substantially the same and unaffected by the new issue of shares; before the surplus was capitalized the stock was selling at the price of from $360. to $382. per share, and after it was capitalized by this increase of fifty per cent in the number of outstanding shares the market price was from $234. to $268. a share.

The complaint alleges that the stock did not constitute taxable income under the Income Tax Law of September 9, 1916, and that no tax was due on it, and that the Act of Congress under which said sum of $1,367.02 was levied on said additional shares, representative of the Company's earnings since March 1, 1913, and its payment compelled,—to wit: Title I of the Act of September 9, 1916,—is invalid and void in so far as the same may be asserted to confer power to make such levy on said additional shares constituting said stock dividend or to compel such payment because in violation of the provisions of Article I, Section 2, clause 3 of the Constitution of the United States and not within the terms of the Sixteenth Amendment.

The District Court expressly passed upon the constitutional question, following the decision of this Court in *Towne against Eisner, Collector*, 245 U. S. 418, and also referred to *Peabody against Eisner*, 247 U. S. 347.

The special and peculiar circumstances involved in the case and requiring a speedy hearing of the cause are as follows:

The Income Tax Law of 1916, Title I (39 Stat. 756, Chap. 463) provides:

> In 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 from all sources within the United States, an additional income tax * * *".



In Section 2 (*a*):

> "The net income of the 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, trades, commerce or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in any 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."

The Collector, plaintiff-in-error, acting under instructions of the Treasury Department, required the defendant-in-error to pay the tax of $1,367.02 above mentioned, being that proportion of her total tax upon the stock in question representative of the company's earnings since March 1, 1913, upon the theory and claim that the stock above referred to was income.