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The Taxation of Stock Dividends and the Tax Reform Act of 1969--Foreboding Implications and Constitutional Uncertainties

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NOTES

The Taxation of Stock Dividends and the Tax Reform Act of 1969—Foreboding Implications and Constitutional Uncertainties

I. Introduction

Federal income taxation of stock dividends has followed a diverse course. Since the introduction of a federal income tax on all stock dividends in 1916, five major changes have occurred in this area. The most recent of these changes is embodied in section 421 of the Tax Reform Act of 1969, which amends section 305 of the Internal Revenue Code of 1954.[1] When the 1969 Amendments are compared with the treatment of stock dividends under the Internal Revenue Code of 1954, they can be viewed, in conjunction with the regulations issued in 1969 under the 1954 Code, as initiating a new era in the taxation of stock dividends. Generally, the 1969 Amendments expand considerably the scope of stock dividend taxation, and they reinstate the "proportionate interest" test of stock dividend taxation, which was utilized by the courts with great confusion prior to the enactment of the 1954 Code. Further, the 1969 Amendments grant the Secretary of the Treasury broad power to promulgate regulations under the new provisions. Although the proposed regulations clarify to some extent the application of the new code sections,[2] many problems will undoubtedly still arise. The sweeping nature of the 1969 Amendments, for example, raises numerous questions about the constitutionality of the taxation of certain stock dividends. Moreover, the application of the "proportionate interest" test probably will revive the troublesome problems encountered in the prior use of the test. Since stock dividends have become an increasingly important tool of corporate financial policy, which affects millions of shareholders,[3] the validity of the 1969 Amendments will probably be tested in the courts. This Note, therefore, undertakes to delineate the effects of the 1969 Amendments on shareholders and corporations and to present several

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1. Tax Reform Act of 1969, Pub. L. No. 91-172, § 421, 83 Stat. 614, *amending* INT. REV. CODE of 1954, § 305 [hereinafter referred to as 1969 Amendments].

2. Proposed regulations were issued on March 18, 1971. Proposed Treas. Reg. § 1.305, 36 Fed. Reg. 5221 (1971), *reprinted in* 7 P-H 1971 FED. TAXES ¶ 65,285.

3. *See* D. KEHL, CORPORATE DIVIDENDS 173 (1941). Moody's financial service reports that approximately 2,100 corporations issued stock dividends in 1969 and 1968. 40 MOODY'S DIVIDEND RECORD 164-66 (1969); 39 MOODY'S DIVIDEND RECORD 163-65 (1968).

arguments that may be used to challenge the constitutionality of this new scheme of stock dividend taxation.[4] In order to properly analyze the impact of the 1969 Amendments, a thorough familiarity with the history of stock dividend taxation and the 1969 provisions is essential.

II. History of Stock Dividend Taxation

The taxation of stock dividends has been characterized by confusion and uncertainty that has pervaded both the judicial and legislative branches of government. From this confusion three distinct periods in the evolution of stock dividend taxation can be discerned.

A. *1913-1936: Eisner v. Macomber and Its Progeny*

The passage of the sixteenth amendment in 1913 empowered Congress to tax an individual's income without apportionment among the states.[5] This enactment raised many tax problems, including the question whether a stock dividend was income within the purview of the amendment. The answer to this question was not long in coming. In the Revenue Act of 1916, Congress included the cash value of all stock dividends in a shareholder's net taxable income.[6] This legislative pronouncement was directly contrary to the traditional view of the courts and financial community, which regarded stock dividends as a part of a shareholder's capital investment that did not change his interest in the corporation.[7] The result of this congressional approach was serious criticism that culminated in litigation before the Supreme Court. In *Towne v. Eisner*,[8] the Court held that a stock dividend was not "income" within the meaning of the Revenue Act of 1913.[9] Two years

4. This Note does not undertake to analyze the effects of the 1969 Amendments on the taxation of the distribution of stock rights, which is also controlled by § 305(a). Although distribution of stock dividends and stock rights are similar in some respects, there are substantial differences in taxation, history, and policy considerations that would require an extension of this Note beyond acceptable limits in order to include a consideration of stock rights. For a brief discussion of the taxation of stock rights see notes 148-54 *infra* and accompanying text.

5. U.S. Const. amend. XVI provides: "The Congress shall have the power to lay and collect taxes on income, from whatever source derived, without apportionment among the several States, and without regard to any census of enumeration."

6. "[T]he net income of a taxable person shall include gains, profits, and income derived from . . . dividends . . . *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 . . . payable to its shareholders, whether in cash or in stock of the corporation . . . which stock dividend shall be considered income, to the amount of its cash value." Act of Sept. 8, 1916, ch. 463, § 2(a), 39 Stat. 757.

7. *See, e.g.*, Gibbons v. Mahon, 136 U.S. 549, 559-60 (1890).

8. 245 U.S. 418 (1918).

9. "That there shall be levied, assessed, collected and paid annually upon the entire net income . . . a tax of 1 per centum per annum upon such income . . . ." Act of Oct. 3, 1913, ch. 16, § 11(A)(1), 38 Stat. 166.

later in the landmark decision of *Eisner v. Macomber*,[10] the Court invalidated as unconstitutional a tax levied under the Revenue Act of 1916 on a distribution of common stock in respect to common stock.[11] The Court found that the stock dividend was not "income" within the purview of the sixteenth amendment because the shareholder had not derived a gain that she could employ for her own separate enjoyment and benefit. The dividend shares, the Court concluded, were merely additonal pieces of paper that represented the taxpayer's original investment, not an increase in her investment. The Court also noted that the dividend shares remained "in corporate solution" as an unsevered distribution of capital, not income.[12] The Court concluded that the tax in question was a direct tax on capital and therefore unconstitutional because Congress had failed to apportion it among the states.

Although *Eisner v. Macomber* involved only a stock dividend of common stock on identical stock, the decision was accepted immediately as the basis of a broader exemption. In the Revenue Act of 1921, Congress exempted all stock dividends from income taxation.[13] Subsequent Supreme Court decisions, however, made it increasingly clear that this broad exemption was neither required nor intended by *Eisner v. Macomber*. In a series of cases in the early 1920's,[14] commonly referred to as the "reorganization cases," the Court upheld the taxation of shareholders of acquired corporations who had received dividends of stock of the acquiring corporations.[15] These cases made it clear that a corporate shareholder realized taxable income when the corporation

10. 252 U.S. 189 (1920). For an extensive discussion of this case see Powell, *Stock Dividends, Direct Taxes, and the Sixteenth Amendment*, 20 COLUM. L. REV. 536 (1920).

11. The stock dividend in question was a 50% dividend of common stock issued to the common shareholders by Standard Oil Company of California. The shareholder owned 2,200 shares and received a stock dividend of 1,100 shares valued at $19,887. The Commissioner was trying to tax this amount as income to the shareholder.

12. The Court's statement that the taxpayer had not received income because any gain accruing to her had not been "severed" from the capital that produced it gave rise to the "doctrine of realization." Under this doctrine, a taxpayer did not receive income until the gain was severed from the capital that produced it. This "severence-realization" test was subsequently overruled by the Supreme Court. Helvering v. Brunn, 309 U.S. 461 (1940). For a more extensive discussion of the doctrine of realization and its present application see notes 120-34 *infra* and accompanying text.

13. Act of Nov. 23, 1921, ch. 136, § 201(d), 42 Stat. 228.

14. Marr v. United States, 268 U.S. 536 (1925); Cullinan v. Walker, 262 U.S. 134 (1923); Rockefeller v. United States, 257 U.S. 176 (1921); United States v. Phellis, 257 U.S. 156 (1921).

15. The factual situation of United States v. Phellis, 257 U.S. 156 (1921), is illustrative of these cases. The shareholder-taxpayer owned 250 shares of common stock of E.I. duPont de Nemours Powder Co. The corporation was acquired by the newly formed E.I. duPont de Nemours & Co. for $58,000 worth of common stock of the new corporation. This stock was then distributed to the shareholders of the acquired corporation as a stock dividend. The shareholder-taxpayer received 500 shares, which were taxed as income.

distributed stock that gave him a greater proportionate interest in the corporation than he possessed prior to the distribution.[16] Notwithstanding the Supreme Court's position, every revenue act until 1936 exempted all stock dividends from taxation.[17] Furthermore, the regulations promulgated under the pre-1936 revenue acts provided for an allocation of the basis of the stock on which the dividend was declared to the dividend shares.[18]

B. 1936-1954: Recognition of the "Proportionate Interest" Standard of Stock Dividend Taxation

After fifteen years of tax-free stock dividends under *Eisner v. Macomber* and its legislative progeny, the Supreme Court began the erosion of this tax-free status in 1936. In *Koshland v. Helvering,*[19] the Court held that a dividend of common stock on preferred stock was taxable "income" under the sixteenth amendment.[20] Although the Court seemed to base its decision on the "proportionate interest" doctrine, which emanated from the "reorganization cases,"[21] the language of the decision indicated that a different test was being applied:

> [W]here a stock dividend gives the shareholder an interest *different* from that which his former stock holdings represented, he receives income. [This] type of dividend is taxable as income under the Sixteenth Amendment.[22]

Although it was clear from this decision that a new doctrine of stock dividend taxation had been enunciated, the precise nature of the doctrine remained uncertain. Congressional reaction clearly reflected the

16. *See* Rottschaffer, *Present Taxable Status of Stock Dividends in Federal Tax Law,* 28 MINN. L. REV. 163, 170 (1943).

17. *See* Act of June 2, 1924, ch. 234, § 201(f), 43 Stat. 255; Act of Feb. 26, 1926, ch. 27, § 201(f), 44 Stat. 11; Act of May 29, 1928, ch. 852, § 115(f), 45 Stat. 822; Act of June 6, 1932, ch. 209, § 115(f), 47 Stat. 204; Act of May 10, 1934, ch. 277, § 115(f), 48 Stat. 712.

18. 3 CUM. BULL. 38 (1920).

19. 298 U.S. 441 (1936).

20. In this case, the primary issue was whether the basis of the taxpayer's preferred stock, which had been sold, was allocable to the common shares that she had received as a stock dividend on the preferred stock. The determinative factor in the resolution of the issue was whether the stock dividend of common stock was "income." This question was important because the Secretary of Treasury lacked authority to reduce the cost basis of a capital gain asset by a proportionate part of the income generated by the asset, since the taxation of capital gain income is based solely on the cost of the capital gain asset. *Id.* at 447. Therefore, if the stock dividend shares were considered income, there would be no allocation of the basis of the shareholder's preferred shares and her capital gain would remain the same, rather than resulting in a greater gain if the basis of the preferred stock were allocated to the common shares.

21. *Id.* at 445; *see* notes 14-16 *supra* and accompanying text.

22. 298 U.S. at 446 (emphasis added).

prevailing confusion. The Revenue Act of 1936 hedged on the question of whether stock dividends were taxable income and ambiguously stated:

> A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution.[23]

As a result of this legislation and its subsequent re-enactment in the Internal Revenue Code of 1939,[24] the courts were delegated the task of differentiating between taxable and nontaxable stock dividends.

In undertaking to articulate a precise standard of stock dividend taxation, the courts initially confronted the dilemma of choosing between two existing, antipodal standards. The first rule, enunciated in *Koshland,* provided that a stock dividend was taxable if it represented an interest "different" from the interest formerly possessed by the shareholder.[25] This test was very stringent in its application and encompassed practically all stock dividends except an *Eisner* common-on-common dividend. A dividend of preferred stock on common stock, for example, was taxable because the preferred stock represented an interest different from that formerly held by the shareholder.[26] The second standard, which was first defined in the "reorganization cases"[27] and in *Eisner v. Macomber,*[28] stated that a stock dividend was taxable only if it represented an increase in the shareholder's proportionate interest in the corporation. The application of this test was not as exacting as the "different interest" standard since a shareholder could receive a tax-free stock dividend that did not change his percentage interest but nonetheless represented an interest in the enterprise different from his prior interest. A stock dividend of preferred stock to the sole shareholder of common stock, for instance, was not taxable income because the shareholder's post-dividend interest in the corporation—100 pereent—was no greater than his predividend interest—100 percent.[29] The courts divided over the issue of which standard was proper. The decisions of the Board of Tax Appeals clearly manifested that it had

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23. Act of June 22, 1936, ch. 690, § 115(f)(1), 49 Stat. 1688.

24. Int. Rev. Code of 1939, ch. 1, § 115(f)(1), 53 Stat. 47.

25. *See* notes 19-22 *supra* and accompanying text.

26. Frank J. & Hubert Kelly Trust v. Commissioner, 38 B.T.A. 1014 (1938) (stock dividend of nonvoting, cumulative 7% preferred stock on common stock held taxable income).

27. *See* notes 14-16 *supra* and accompanying text.

28. 252 U.S. 189 (1920). In commenting on the accounting details involved in the issuance of a stock dividend, the Court stated that a stock dividend "does not alter the pre-existing proportionate interest of any stockholder or increase the intrinsic value of his holding . . . ." *Id.* at 211.

29. Dreyfuss v. Manning, 44 F. Supp. 383 (D.N.J. 1942).

adopted the *Koshland* approach.[30] Nevertheless, several federal courts adopted the "proportionate interest" test.[31]

The confusion resulting from the diversity of opinion among the lower courts forced the Supreme Court to resolve the issue. In 1943, in the companion cases of *Helvering v. Sprouse* and *Strassburger v. Commissioner,*[32] the Court adopted the "proportionate interest" standard. In rejecting the "different interest" test, the Court stated:

> We held [in Koshland] . . . that the dividend was income, but we did not hold that any change whatsoever in the character of the shares issued as dividends resulted in the receipt of income. On the contrary, the decision was that, to render the dividend taxable as income, there must be a change brought about by the issue of shares as a dividend whereby the proportional interest of the shareholder after the distribution was essentially different from his former interest.[33]

In *Sprouse* and *Strassburger,* the Court found that the requisite increase in proportionate interest was not present in dividends of nonvoting common stock on voting common stock and of nonvoting cumulative preferred stock on common stock held by a sole shareholder.[34] An important point in the subsequent evolution of the "proportionate

30. *See* Helms Bakeries v. Commissioner, 46 B.T.A. 308 (1942) (stock dividend of first and second preferred stock on previously outstanding preferred stock is taxable when common stock also is outstanding); Avalon Inv. Corp., 11 P-H B.T.A. & Tax Ct. Mem. Dec. ¶ 42496 (1942) (stock dividend of preferred stock on common stock taxable); Keister v. Commissioner, 42 B.T.A. 484 (1940), *rev'd sub nom.* Sprouse v. Commissioner, 122 F.2d 973 (9th Cir. 1941), *aff'd,* 318 U.S. 604 (1943) (10% stock dividend of nonvoting common stock on voting common stock); Smith v. Commissioner, 39 B.T.A. 80 (1939) (stock dividend of junior preferred stock on common is taxable when senior preferred stock is outstanding); Frank J. & Hubert Kelly Trust v. Commissioner, 38 B.T.A. 1014 (1938) (stock dividend of preferred stock on common stock taxable).

31. Sprouse v. Commissioner, 122 F.2d 973 (9th Cir. 1941), *rev'g* Keister v. Commissioner, 42 B.T.A. 484 (1940) (stock dividend of nonvoting common stock on voting common stock not taxable); Dreyfuss v. Manning, 44 F. Supp. 383 (D.N.J. 1942) (stock dividend of preferred stock to sole shareholder of common stock not taxable).

32. 318 U.S. 604 (1943).

33. *Id.* at 607-08.

34. A more interesting and complex example of the application of the proportionate interest test is found in Winton M. Blount, 12 P-H Tax Ct. Mem. ¶ 43195 (1943). In this case, the corporation had 2 classes of stock, Class A and Class B, that shared equally in dividends. Class A had exclusive voting rights and a liquidation preference, and it shared equally with Class B on any liquidation remainder. Prior to a 30% stock dividend of Class B stock on both classes, there were 400 Class A shares and 100 Class B shares outstanding, and the taxpayer, Blount, held 200 shares of Class A. Prior to the stock dividend, Blount possessed the following interest: 200/500(2/5) in dividends, 200/400 (1/2) in liquidation preference and voting control, and 200/500 (2/5) in liquidation remainder. Blount received a stock dividend of 60 shares of Class B; 150 shares of Class B were distributed to all shareholders. After the stock dividend, Blount held an identical proportionate interest: 260/650 (2/5) in dividends, 200/400 (1/2) in liquidation preference and voting control, and 260/650 (2/5) in liquidation remainder. The Tax Court, therefore, held that Blount had not received an increase in his proportionate interests and therefore no tax was due on the stock dividend.

interest" test was the substantiality of the proportionate increase. An increase in a shareholder's proportionate interest did not constitute taxable income unless the increase represented a substantial change.[35]

Notwithstanding the explicit pronouncements of *Sprouse* and *Strassburger*, the Court's mandate did not resolve all the problems in this area. The most troublesome point was determining whether a distribution effectuated a taxable increase in a shareholder's proportionate interest when the corporation's capital structure was different from the capital structures involved in *Sprouse* and *Strassburger*. The Supreme Court's position indicated that the sole factor was the percentage composition of the shareholder's legal rights vis-a-vis the other shareholders. The Commissioner, however, refused to acquiesce in the use of this criterion. He contended that a shareholder realized taxable income if the stock dividend effectuated a change in his proprietary interests in the corporation, such as his interests in dividends and liquidating distributions.[36] The Commissioner, in essence, was asserting the *Koshland* "different interest" standard. The basic distinction between the two approaches was that the Supreme Court's position focused on a percentage alteration in the strict legal rights of the shareholders, while the Commissioner's position focused on the more practical, pecuniary alterations in the shareholders' interests.

This difference of opinion was evident in the case of *Wiegand v. Commissioner*.[37] The Wiegand Company had declared a 50 percent pro rata stock dividend on its two outstanding classes of stock. This distribution increased the outstanding shares of Class A stock from 4,000 shares to 6,000 shares and of Class B stock from 24,000 shares to 36,000 shares. The Class A stock held exclusive voting rights and was entitled to preferential treatment on dividends and liquidating distributions. Although the stock dividend did not alter any shareholder's percentage of ownership, it did change the shareholders' proprietary interests in dividends and liquidating distributions. After the distribution, the Class A shareholders were entitled to 36,000 dollars annually in dividends before the Class B shareholders were entitled to any dividends; prior to the distribution, the Class A shareholders had

35. *See* Daggitt v. Commissioner, 23 T.C. 31, 34 (1954); George S. Woodward, 12 P-H Tax Ct. Mem. ¶ 43184 (1943). In *Woodward*, the Commissioner argued that a stock dividend was taxable because the shareholder's voting interest had increased from .00442736% to .00484879%. In rejecting this argument, the court commented: "The statement of the contention suggests its answer. The difference is negligible." *Id.*

36. For a discussion of the Commissioner's position see 1 J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 9.91 (1969).

37. 14 T.C. 136 (1950), *rev'd*, 194 F.2d 479 (3d Cir. 1952).

been entitled to only 24,000 dollars of preferential dividends. Similarly, any funds available to the shareholders on liquidation were subject to the preferential claims of 2,000 additional Class A shares. In light of these facts indicating an increase in proprietary benefits, the Tax Court accepted the Commissioner's argument that the shareholders had received taxable income.[38] The Court, however, overlooked the fact that some shareholders, who held only Class B stock, had been detrimentally affected by the distribution and had received no beneficial increase in their proprietary interests.[39] On appeal, the Third Circuit Court of Appeals reversed the Tax Court on the ground that the shareholders' percentage interests had not been altered.[40] In other litigation arising out of the same stock distribution, the Seventh Circuit applied the "proportionate interest" standard and reached the same result as the Third Circuit.[41] These cases illustrate the difficult and complex problems that were encountered and never fully resolved in the application of the "proportionate interest" standard of taxation.

During this same period, the Supreme Court was confronted with the fundamental issue of whether any stock dividend, even the common-on-common *Eisner* variety, should be exempted from taxation. In *Helvering v. Griffiths*[42] the Commissioner argued that a stock dividend of common-on-common was taxable income within the purview of the Internal Revenue Code of 1939.[43] He contended that the stock dividend in question constituted income according to the popular conception of the term and that the theoretical basis of *Eisner,* the "severence realization" principle, had been overruled as a constitutional prerequisite.[44] Although the majority of the Court did not specifically reject these arguments, and indeed seemed hesitant to reaffirm *Eisner,* the Court refused to sustain the tax on the stock dividend. The majority reasoned that it was unnecessary to consider the validity of *Eisner*[45] since

38. *Id.* For an interesting comment on the Tax Court opinion see Comment, *Income Taxability of Stock Dividends and the "Proportionate Interest" Test,* 50 COLUM. L. REV. 999 (1950).

39. This point was noted by Justice Opper in his dissent in the Tax Court. 14 T.C. at 153-54.

40. Wiegand v. Commissioner, 194 F.2d 479 (3d Cir. 1952).

41. Tourtelot v. Commissioner, 189 F.2d 167 (7th Cir. 1951). The percentage "proportionate interest" test was applied in 2 later cases, in which the stock dividend was held taxable. Pizitz v. Patterson, 183 F. Supp. 901 (N.D. Ala. 1960); Masser v. Commissioner, 20 T.C. 264 (1953).

42. 318 U.S. 371 (1943).

43. *See* notes 23-24 *supra* and accompanying text.

44. The Commissioner contended that the principle of "severance-realization" had been discarded by Helvering v. Gowran, 302 U.S. 238 (1937); Koshland v. Helvering, 298 U.S. 441 (1936); and by the "reorganization cases" listed in note 14 *supra.*

45. There was a vigorous dissent written by Justice Douglas, with which Justices Black and

section 115(f)(1) of the Revenue Act of 1936, the predecessor of section 115(f)(1) of the Internal Revenue Code of 1939, had incorporated the *Eisner* doctrine.[46] Although it appears that this decision reaffirmed *Eisner,* a careful reading of the opinion leads to the conclusion that the Court was limiting *Eisner* to its facts.[47]

C. *1954-1969: Section 305 of the Internal Revenue Code of 1954*

The enactment of section 305 of the Internal Revenue Code of 1954[48] marked the beginning of a new period in the taxation of stock dividends. This section established a general rule of nontaxability for stock dividends, which in effect represented a return to the method of taxation that followed the decision of *Eisner v. Macomber.*[49] Section 305 constituted an explicit rejection of the "proportionate interest" standard, which had bred needless confusion in the preceding decade.[50] The new provision was based on the policy decision that an income tax was inappropriate when the shareholder's interest remained "in corporate solution"—in the form of corporate stock.[51] There were,

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Murphy concurred. The dissenters sharply criticized the majority for misinterpreting the legislative history of the Revenue Act of 1936. The dissent also approved the Commissioner's argument that the "severence-realization" principle had been overruled. Helvering v. Griffiths, 318 U.S. 371, 404 (1943).

46. In reviewing the legislative history of the Revenue Act of 1936, the Court quoted a statement by Congressman Vinson, the manager of the House bill: "In no sense is this [section 115(f)(1) of the Revenue Act of 1936] an attack upon the Eisner [v.] Macomber decision." *Id.* at 380.

47. *See* Lowndes, *The Taxation of Stock Dividends and Stock Rights,* 96 U. PA. L. REV. 147, 148-49 (1947). Another problem in the taxation of stock dividends, which arose during this period, involved the application of the "election" exception. According to this provision, a corporate distribution in cash or stock was taxable if the shareholders had an election to choose either cash or stock. Act of Feb. 10, 1939, ch. 2, § 115(f)(2), 53 Stat. 47 (now INT. REV. CODE OF 1954, § 305(b)(1)). Only a few cases were litigated under this provision. The Tax Court held that an election available to only one shareholder fell within the statutory language "at the election of any of the shareholders." Lester Lumber Co. v. Commissioner, 14 T.C. 255 (1950). The Tax Court also made it clear that the requisite election privilege had to be manifest in the dividend declaration issued by the corporation. Southeastern Fin. Co. v. Commissioner, 4 T.C. 1069, 1090-91 (1945); Capital Estates, Inc. v. Commissioner, 46 B.T.A. 986 (1942). Furthermore, the same court ruled that the election proviso was not applicable to an election given to shareholders in a recapitalization that qualified as a tax-free reorganization. Knapp Monarch Co. v. Commissioner, 1 T.C. 59 (1942), *aff'd,* 139 F.2d 863 (8th Cir. 1944). *See also* 1 J. MERTENS, *supra* note 36, § 9.94.

48. Act of Aug. 16, 1954, Pub. L. No. 83-591, § 305, 68A Stat. 90.

49. *See* 1 J. MERTENS, *supra* note 36, § 9.97; Bittker, *Stock Dividends, Distributions in Kind, Redemptions, and Liquidations Under the 1954 Code,* 1955 S. CAL. TAX INST. 349.

50. *See* S. REP. No. 1622, 83d Cong., 2d Sess. (1954), *reprinted in* 3 U.S. CODE CONG. & AD. NEWS 4675 (1954). One commentator predicted that the "proportionate interest" test might arise again in applying the "election" exception embodied in § 305(b)(2). Kumler, *Corporate Distributions of Stock: A Bird's-Eye View of the New Code Provisions,* 41 A.B.A.J. 29 (1955).

51. The Senate Finance Committee expressed this policy as follows: "Your committee has

however, two exceptions to the general rule of nontaxability. First, a distribution of a corporation's stock that was issued to discharge preference dividends for the preceding or current taxable year was included in the shareholder's gross income.[52] Secondly, a distribution that gave the shareholder an election to receive payment either in property or in the corporation's stock also was taxable.[53] In comparison with the prior law, this scheme of taxation was relatively simple and straightforward;[54] consequently, litigation in this area ceased.

This method of taxation allowed corporations more freedom in fashioning and adjusting their capital structures. It became possible to issue a variety of tax-free stock dividends, such as disproportionate dividends of preferred stock on common stock and of common stock on preferred stock. This greater flexibility, however, fostered attempts to circumvent even the limited exceptions to the general rule of nontaxability. Some corporations specifically devised intricate and sophisticated capital adjustment schemes that enabled their shareholders to benefit tax-free from transactions otherwise prohibited by the "election" exception of section 305(b)(2).[55] Although there were several plans that could be employed to achieve this end,[56] the two most popular methods involved recapitalizations that allowed shareholders to choose between distributions of cash or stock of the corporation. The "two classes of common stock" plan, for instance, involved a recapitalization

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followed the policy of the House bill allowing the distribution of equity interests in a corporation as a dividend to the greatest extent possible. As long as a shareholder's interest remains in corporate solution, there is no appropriate occasion for the imposition of a tax. Accordingly, the general rule is that no tax is imposed upon the distribution of stock rights and stock dividends whether or not a particular shareholder's proportionate interest in the corporation is varied, but rather is postponed through the application of the pertinent basis provisions." S. REP. No. 1622, 83d Cong., 2d Sess. 44 (1954), *reprinted in* U.S. CODE CONG. & AD. NEWS 4675 (1954).

52. Act of Aug. 16, 1954, Pub. L. No. 83-591, § 305(b)(1), 68A Stat. 90, *as amended* INT. REV. CODE OF 1954, § 305(b)(1) (Supp. V, 1970).

53. *Id.* § 305(b)(2).

54. 2 J. RABKIN & M. JOHNSON, FEDERAL INCOME, GIFT & ESTATE TAXATION § 21.18A (1970).

55. Several commentators during this period stated that these plans were excellent tax planning techniques. *See IRS Attempts to Stop 2-Classes-of-Common Tax-Saving Plans; Legality Questioned*, 5 J. TAXATION, Sept. 1956, at 178; *Two Classes of Common Stock; One Gets Cash, One Stock Dividend; A Useful Tax Planning Tool*, 5 J. TAXATION, May 1956, at 312.

56. One method was the "periodic redemption" plan. Under this technique, the shareholders were given the election to have the corporation annually redeem a small percentage of their stock. The shareholder who decided to redeem his stock received cash for the percent redeemed; the shareholders who decided not to redeem received a corresponding increase in their proportionate interest in the corporation. For a discussion of this method as a possible way to avoid the regulations adopted in 1969 see Levin, *New 305 Regs Limit Tax Advantages of 2-Class Common Stock, but Alternatives Exist*, 30 J. TAXATION, Jan. 1969, at 2, 4.

that created two new classes of common stock that shared equally in dividends and liquidating distributions. One class, however, was limited to dividends payable in the stock of the corporation, while the other class was entitled only to cash dividends. The class that received stock dividends also was convertible into the other class. When the recapitalization plan was effectuated, the shareholders could choose either class of stock. Those who chose the convertible stock that paid only stock dividends then had the additional election to convert their stock into the stock paying only cash dividends.[57] Another common plan was the "increasing convertible preferred" method, under which the corporation announced a recapitalization in which all outstanding shareholders had the option of exchanging their stock for a special preference stock. This new preferred stock only paid stock dividends in the special preference stock, and all this stock was convertible into common stock at an ascending ratio. After the shareholders exchanged their old stock for the new preference stock, they had the further option to convert into common stock and receive cash dividends or to retain the preferred stock and receive tax-free stock dividends.[58]

By 1956 the use of the foregoing techniques of adjusting capital structures had so proliferated that the Treasury Department felt compelled to propose regulations that would curb the use of these plans.[59] The proposed regulations and several amendments thereto,[60] however, were severely criticized as being outside the scope of the code provisions authorizing their promulgation.[61] They were not officially

57. A widely publicized application of this plan was employed by Citizens Utilities Corporation. *See* materials cited note 55 *supra.*

58. This technique was used by the huge conglomerate Ling-Temco in 1968. For a description of the Ling-Temco plan see Wall Street J., Feb. 14, 1968, at 20, col. 4. For a general discussion of this plan see Levin, *supra* note 56.

59. Proposed Treas. Reg. § 1.305-2, 21 Fed. Reg. 5104-05 (1956).

60. Proposed Treas. Reg. § 1.305-2, 33 Fed. Reg. 12744-45 (1968).

61. The proposed regulations were criticized on the grounds that they were not supported by the statute and covered many transactions that Congress had intended to be tax-free. The major concern of the critics was the broad definition of "election" in § 305(b)(2). Under the 1939 Code and its accompanying case law, the requisite election consisted of a shareholder's option to receive cash or property on a particular distribution. Under the regulations' broad definition of "election" (*see* notes 62-69 *infra* and accompanying text), the requisite election was considered present in many situations that did not even involve a particular distribution, such as when a corporation had 2 classes of stock outstanding and a shareholder chose either to purchase stock of the corporation or to exchange his stock in a recapitalization. *See* Lee, *The Stock Dividend,* 37 TAXES 959, 967-72 (1959); Comment, *An Analysis of the Taxation of Stock Dividends from 1918 to 1970: Effects of the Tax Reform Act of 1969 on § 305 of the Internal Revenue Code,* 8 DUQUESNE L. REV. 364, 379 & n.61 (1970). *See also* Levin, *supra* note 56, at 4-5; Ray, *Stock Dividends: Section 305(b) and the Conglomerates,* 21 S. CAL. TAX INST. 341, 364-75 (1969).

adopted until January 10, 1969.[62] The regulations were issued under the two exceptions to the general rule of nontaxability embodied in section 305(a). Generally, they broadened the application of both exceptions so that the tax avoidance techniques fell within the purview of one or the other of the exceptions. Two general rules that encompassed a variety of stock plans can be distilled from the explanatory comments and examples set forth in the regulations.[63] First, under section 305(b)(1), which provided that a distribution of stock was taxable if it was made in discharge of preference dividends, the regulations stated that a shareholder's stock would be considered preferred stock and any stock distributed thereon would be considered as made in discharge of preference dividends, when a corporation had two classes of stock outstanding and when an annual distribution of stock was mandatory for one of the classes.[64] This provision, therefore, subjected the "increasing convertible preferred" plan to taxation.[65] Secondly, under section 305(b)(2), which provided that a distribution of stock was taxable if a shareholder could elect to receive the distribution in either property or stock of the corporation, the regulations provided that the requisite election would be considered present when any shareholder was given, expressly or impliedly, a choice to receive either property or additional shares of stock, irrespective of how or when the election was exercised, and notwithstanding the fact that the election was never fully exercised.[66] This definition of "election" was considerably broader than the traditional concept of the term;[67] consequently, many heretofore

62. T.D. 6990, 1969-1 CUM. BULL. 95.

63. For a detailed analysis of the 1956 and 1968 proposed regulations and the regulations adopted in 1969 see Ray, *supra* note 61, at 352-55 and Comment, *supra* note 61, at 369-85.

64. Treas. Reg. § 1.305-3(b)(1) (1969) provides: "If, in the case of a corporation having two or more classes of outstanding stock, the terms of one class requires, in all events, periodic distributions with respect to it of stock or rights to acquire stock, then the stock of such class is preferred stock. Such a distribution of stock or rights with respect to the preferred stock is a distribution made in discharge of preference dividends."

65. Treas. Reg. § 1.305-3(b)(2), example 2 (1969), makes it clear that increasing convertible preferred plans are subject to the "discharge of preference dividend" exception.

66. *See* Treas. Reg. § 1.305-2(a) (1969). Treas. Reg. § 1.305-2(b)(1) (1969) provides: "Section 305(b)(2) refers to every election, whether express or implied, regardless of how or when exercised or exercisable. An election is a choice to receive payment in one medium or another. The point in time at which such choice is made, whether before or after the declaration, is immaterial as long as at some point in time any shareholder, either by action or inaction, has made a choice which permitted the corporation to distribute stock or stock rights with respect to some shares and money or other property with respect to other shares. A choice to receive payment in one medium or another may arise out of the terms of the declaration, the provisions of the stoek certificate, or the circumstances of the transaction. A choice may be exercisable directly or indirectly through action by the shareholder or through his failure to act."

67. *See* note 47 *supra*.

nontaxable stock plans, such as the "two classes of common stock" plans[68] and the "increasing-decreasing conversion ratio" plans,[69] became taxable under section 305(b)(2). These regulations, however, did not cover all stock plans under which a shareholder could elect to receive property or additional stock; specifically, the "periodic redemption" plan was not subject to taxation under the regulations.[70]

Official adoption of the regulations did not toll the criticism that had been voiced against the proposed regulations.[71] The questionable validity of the 1969 regulations and their inability to reach many increasingly sophisticated stock plans undoubtedly were the major factors that influenced the enactment of the 1969 Tax Reform Act provisions dealing with taxation of stock dividends.[72]

III. SECTION 421 OF THE TAX REFORM ACT OF 1969

The 1969 Amendments to section 305 of the Internal Revenue Code of 1954 represent an expansion of the exceptions to the general rule of nontaxability of stock dividends. Whereas the 1954 Code broadened the scope of tax-free stock dividends and rejected the "proportionate interest" standard, the 1969 Amendments narrow the tax-free area and reinstate the "proportionate interest" standard. This departure from prior policy, however, was not unexpected since the policy considerations supporting the 1969 Amendments are identical to the principles embodied in the 1969 regulations, which were promulgated under the 1954 Code. The following explanation of the 1969 Amendments focuses on an interpretation of the amendments, their accompanying legislative history, and the proposed regulations.[73]

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68. Treas. Reg. § 1.305-2(b)(2), example 1 (1969).

69. *Id.* examples 3 & 4.

70. *See* Levin, *supra* note 56, at 3-4.

71. *See id.* 4-5; Ray, *supra* note 61, at 364-80.

72. *See* notes 61 & 71 *supra* and accompanying text. *See also* H.R. REP. NO. 91-413, 91st Cong., 1st Sess. (1969), *reprinted in* 2 CCH 1970 STAND. FED. TAX REP. ¶ 2332. The legislative history of the 1969 Amendments manifests clearly that the revenue-producing potential of the new law was not a major consideration for its enactment. The House Committee stated that the new method of stock dividend taxation would produce about $2,500,000 per year. The Senate Committee noted, however, that even though the new law would not be a big revenue producer, its enactment would prevent a substantial revenue loss that otherwise would have occurred. *See* S. REP. NO. 91-552, 91st Cong., 1st Sess. (1969), *reprinted in* 2 U.S. CODE CONG. & AD. NEWS 2188 (1969); H.R. REP. NO. 91-413, 91st Cong., 1st Sess. (1969), *reprinted in* 2 U.S. CODE CONG. & AD. NEWS 1660, table 6 (1969).

73. For additional explanation of the 1969 Amendments see 94 BNA TAX MANAGEMENT PORTFOLIO: STOCK DIVIDENDS AND STOCK RIGHTS, at A-19 to -26 (3d ed. 1970), Libin & Moorehead, *Stock Dividend Benefits Restricted but not Eliminated by the New Tax Law*, 32 J. TAXATION, May 1970, at 258, 259-63, and Comment, *supra* note 61, at 385-90.

A. The Operative Provisions of the 1969 Amendments

The general rule of section 305(a)—a distribution of stock of a corporation to its shareholders is not included in a shareholder's gross income—is not changed by the 1969 Amendments. These amendments, however, set forth the following distributions that will be included in a shareholder's gross income as dividends under section 301 of the 1954 Code.

Section 305(b)(1) re-enacts the "election" exception previously contained in section 305(b)(2). Under this rule, a distribution of a corporation's stock is taxable if the shareholders have an election to receive payment in either property or stock of the corporation. Although the scope of this exception as it existed in the 1954 Code was expanded considerably by the 1969 regulations, its applicability under the new law will probably be substantially more narrow because the new sections 305(b) and 305(c) control the taxation of distributions previously covered by the old provisions.[74]

Section 305(b)(2) provides for the taxation of disproportionate distributions of stock. This provision represents a return to the "proportionate interest" test since a disproportionate distribution is synonmous with a distribution that increases the proportionate interest of a shareholder. Specifically, this section requires that a distribution of a corporation's stock shall be taxed as a section 301 dividend if the distribution, or a series of distributions of which the distribution is a part, results in the receipt of property by some shareholders and an increase in the proportionate interests of other shareholders.[75] An obvious example of a

74. *See* Libin & Moorehead, *supra* note 73, at 259. The proposed regulations continue the broad definition of "election" that was initially proposed in the 1969 regulations. Proposed Treas. Reg. § 1.305-2(a), 36 Fed. Reg. 5222 (1971); *see* note 66 *supra*. The proposed regulations also set forth 2 examples of the application of this section. Proposed Treas. Reg. § 1.305-2(b), examples (1) & (2), 36 Fed. Reg. 5222 (1971).

75. The proposed regulations state that when more than one class of stock is outstanding, each class is considered separately in determining whether a shareholder has increased his proportionate interest. The individual shareholders of a class of stock will be deemed to have a greater interest if the class as a whole has an increased interest in the corporation. Proposed Treas. Reg. § 1.305-3(b)(6), 36 Fed. Reg. 5222-23 (1971). These regulations also provide that § 305(b)(2) will not apply to stock distributions and cash distributions in lieu of fractional shares, provided the cash was distributed to save the corporation the trouble, expense, and inconvenience of issuing fractional shares. If the total amount of cash distributed annually in lieu of fractional shares is 5% or less of the total fair market value of the stock distributed—determined at the date of declaration—the distribution will be considered made for such a valid purpose. *Id.* § 1.305-3(c), 36 Fed. Reg. at 5223. The proposed regulations further provide that "a series of distributions" encompasses all distributions of stock made or deemed made by the corporation that result in a disproportion among the shareholders. Furthermore, in order for a distribution to be considered as one of a series of distributions it is not necessary that the distribution be pursuant to a plan to

disproportionate distribution is the "two classes of common stock" plan, in which the corporation pays cash dividends on one class of stock and stock dividends on the other class.[76] Another distribution taxable under this section consists of cash payments to holders of convertible debentures or preferred stock that do not contain antidilution provisions, coupled with a common stock dividend to the common shareholders.[77] This distribution is disproportionate because the common shareholders receive a proportionate increase in their stock interests when the interests of the holders of the convertible securities or stock decrease on conversion.[78] The proposed regulations, however, state that a disproportion does not result on this kind of distribution if the conversion ratio of the securities or stock is adjusted to take into account the distribution to the common shareholders.[79] The proposed regulations further provide

distribute cash or property to some shareholders and to increase the proportionate interests of other shareholders. A quarterly stock dividend to one class of stock and cash dividends to another class, for example, constitute a series of distributions that violates § 305(b)(2). *Id.* § 1.305-3(b)(1)-(2), 36 Fed. Reg. at 5222.

76. The proposed regulations set forth several examples of taxation under "2 classes of common stock" plans. When a corporation has 2 classes of common stock, Class A and Class B, that share equally in the earnings and assets of the corporation, and the corporation pays a dividend to Class A shareholders in Class A stock, and cash to Class B shareholders, the stock dividend is taxable to the Class A shareholders since their interests in the corporation have been increased. This is true even to those shareholders who may own Class A stock and Class B stock in the same proportion. *Id.* § 1.305-3(e), example (1), 36 Fed. Reg. at 5223. If the 2 classes of stock are not equal—Class A is common stock and Class B is nonconvertible preferred stock—and the corporation pays a dividend to Class A shareholders in Class B stock, and cash to Class B shareholders, the stock dividend is taxable since the Class A shareholders have increased their interests in the corporation. *Id.* at example (3). If the stock dividend in the preceding example were made in Class A stock instead of Class B stock, the dividend would not be taxable since the Class A shareholders have not increased their proportionate interests in the corporation. *Id.* at example (2).

77. *Id.* at example (4). In this example the corporation has a class of common stock and outstanding convertible securities that do not contain an antidilution provision. The corporation distributes to the common shareholders rights to acquire the common stock. The distribution of the rights is taxable because the proportionate interests of the sharebolders are increased. This same reasoning is applicable to a stock dividend of common stock to the common shareholders. The taxation of this kind of distribution as a disproportionate distribution derives from the new definition of shareholders in § 305(d)(2), whicb provides: "For the purpose of subsections (b) and (c), the term 'shareholder' includes a holder of rights or of convertible securities." In practice, the great majority of convertible securities and stock contain antidilution provisions. If these provisions were not included, the convertible securities or stock would have little value because the interest in common stock that they represent could be diluted to an insignificant amount by successive stock dividends on the outstanding common stock. Since most convertible securities and stock contain antidilution provisions, the example posed by the regulations probably will rarely occur.

78. *See* notes 157-58 *infra* and accompanying text.

79. Proposed Treas Reg. § 1.305-3(e), example (4)(ii), 36 Fed. Reg. 5223 (1971). The proposed regulations, however, place several requirements on the exercise of these adjustments. For this kind of distribution and adjustment of conversion ratio to be nondisproportionate the adjustment must be made no later than the earlier of: (1) 3 years after the date of the stock dividend;

that it is not necessary that both elements of this section—receipt of cash or property by some shareholders and an increase in proportionate interests of other shareholders—occur in the form of a distribution or series of distributions. If a corporation, for example, distributes stock to its shareholders, and a related corporation, pursuant to a prearranged plan, purchases this stock from those shareholders who want to obtain cash, a taxable disproportionate distribution results.[80] The proposed regulations also provide that noncontemporaneous distributions that occur within 36 months of each other or pursuant to a prearranged plan, irrespective of the dates of the distributions, will be "tacked" together for section 305(b)(2) purposes.[81] Under the regulations, therefore, a stock dividend of common-on-common, issued within 36 months of a cash payment on either convertible securities or stock that do not contain an antidilution provision, will be taxable as a disproportionate distribution.

Section 305(b)(3) establishes the principle that a distribution of a corporation's stock is considered a section 301 dividend if some common shareholders receive preferred stock and others receive common stock. Under this section, it seems that all shareholders who receive such a stock dividend will be taxed on the receipt of the stock.[82] Moreover, distributions on preferred stock are brought within the sphere of taxation by section 305(b)(4), unless the distribution takes the form of

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or (2) the date that the aggregate stock dividends, for which adjustment of the conversion ratio has not previously been made, total at least 3% of the stock issued and outstanding on the date of the first stock dividend. *Id.* § 1.305-3(d(1), 36 Fed. Reg. at 5223. This latter requisite refers to a convertible stock or security that is adjustable only when several small stock dividends or stock splits on the common stock total 3%. Suppose, for example, that a corporation issues convertible stock and then, in successive years, issues an annual stock dividend of 1% on its common stock. The conversion ratio will not be adjusted until the third year, when the stock dividends aggregate 3%. Although the annual, pre-adjustment stock dividends appear to be taxable since the convertible stock was not adjusted to account for them, the proposed regulations state that these distributions will not be taxable if the conversion ratio is later adjusted according to Proposed Treas. Reg. § 1.305-3(d), 36 Fed. Reg. 5223 (1971). *Id.* § 1.305-3(e), example (5), 36 Fed. Reg. at 5223.

80. *Id.* § 1.305-3(b)(3), 36 Fed. Reg. at 5222. The examples set forth in the proposed regulations indicate, however, that a distribution is disproportionate only if it involves separate distributions or transactions, one in property and another resulting in an addition to the shareholders' proportionate interests. *See* Libin & Moorehead, *supra* note 73, at 261.

81. Proposed Treas. Reg. § 1.305-3(b)(4), 36 Fed. Reg. 5222 (1971).

82. *Id.* § 1.305-4(b), example (1), 36 Fed. Reg. at 5224-25. Evidently, even common shareholders who receive preferred stock and thereby effectively decrease their proportionate interests in some aspects of the corporation are taxed. The language of this section would appear to encompass a recapitalization in which some of the common shareholders receive all the common stock and other common shareholders receive preferred stock. Senate debate on this point, however, clearly indicates that this kind of recapitalization does not fall within the purview of this section. *See* 94 BNA TAX MANAGEMENT PORTFOLIO: STOCK DIVIDENDS AND STOCK RIGHTS, at A-21 (3d ed. 1970).

an increase in the conversion ratio of convertible preferred stock in order to increase the value of the stock by an amount equal to a stock dividend or stock split on the stock into which the preferred stock is convertible. This provisions is basically a re-enactment of former section 305(b)(1), which provided that stock dividends on preferred stock were taxable if they were issued in discharge of preference dividends.[83] New section 305(b)(4), however, encompasses more distributions than the old provision·because its limiting condition—an antidilution increase in the conversion ratio—is more narrow than the limitation in the old section. The proposed regulations delineate an interesting example of the broader application of this section. They provide that a distribution of preferred stock that may be redeemed after a specified period at a price higher than the issue price, which does not represent a reasonable call premium, will be considered a distribution on preferred stock.[84] Suppose, for example, that a corporation issues preferred stock for 100 dollars per share, and the stock pays no dividends and is redeemable in five years for 185 dollars. Ten dollars is considered a reasonable call premium. Since the redemption price exceeds the sum of the issue price and the reasonable call premium by 75 dollars, this excess amount is deemed a substitute for the distribution of dividends on the stock and is therefore taxable under this section.[85]

Section 305(b)(5) provides that a distribution of convertible preferred stock is a taxable section 301 dividend unless the shareholder can prove that the distribution will not result in a "disproportionate distribution," under section 305(b)(2). The proposed regulations give several guidelines concerning whether a distribution of convertible preferred stock is disproportionate. They provide that a distribution is likely to result in a disproportionate distribution under the following conditions: (1) When the conversion right is exercisable within a relatively short period of time after the date of distribution; and (2) when it may be anticipated, after considering the dividend rate, the redemption provision, the marketability of the stock, and the conversion price, that only a part of the shareholders will exercise their conversion rights.[86]

83. The proposed regulations state several examples of distributions in discharge of preference dividends. Proposed Treas. Reg. § 1.305-5(c), examples (3) & (4), 36 Fed. Reg. 5225 (1971).

84. *Id.* § 1.305-5(b)(1)-(2), 36 Fed. Reg. at 5225.

85. *Id.* § 1.305-5(c), example (8), 36 Fed. Reg. at 5226. The proposed regulations, however, state that a redemption premium not in excess of 10% of the issue price on stock that is not redeemable for 5 years from the date of issue will be considered reasonable. *Id.* § 1.305-5(b)(2), 36 Fed. Reg. at 5225. For other examples of the application of this section see *id.* § 1.305-5(c), examples (2) & (9), 36 Fed. Reg. at 5225-26.

86. *Id.* § 1.305-6(a)(2), 36 Fed. Reg. at 5226.

Under these guidelines, a disproportionate distribution might occur, for example, when a corporation issues a stock dividend on its common stock of convertible preferred stock, which is convertible into common stock within four months. The issue price of the convertible preferred stock is slightly higher than the market price of the common stock on the date of distribution. The disproportion results because the shareholders who wish to obtain a greater interest in the corporation convert their preferred stock into common stock during the four-month period, while the shareholders who desire to obtain cash sell their preferred stock at the higher price. This entire example is based on the premise that the price of the common stock will not have risen sufficiently within the four months to make it worthwhile for every shareholder to convert his preferred stock into common stock instead of selling it at the higher price.[87] This same distribution, however, would not be taxable as a "disproportionate distribution" if the mandatory conversion period were twenty years.[88] According to the assumption made under the proposed regulations, the price of the common stock will have risen sufficiently over a twenty-year period so that every shareholder will find it advantageous to convert his preferred shares into common stock. The determination whether a distribution of convertible preferred stock is disproportionate, therefore, will be a fact question, and it will probably be extremely difficult for taxpayers to prove that a particular distribution will not result in disproportion among the shareholders.

Section 305(c) grants the Secretary of the Treasury extensive power to promulgate regulations under which shareholders will be deemed recipients of taxable section 301 dividends if they receive increments in proportionate stockholdings as a result of transactions that do not involve distributions of stock. This section and the proposed regulations indicate several "deemed distributions" that may increase a shareholder's proportionate interest, such as increases and decreases of conversion ratios,[89] increases in and differences between redemption

87. H.R. REP. No. 91-413. 91st Cong., 1st Sess. (1969), *reprinted in* 2 CCH 1970 STAND. FED. TAX REP. ¶ 2332. *See also* BNA TAX MANAGEMENT PORTFOLIO: STOCK DIVIDENDS AND STOCK RIGHTS, at A-22 (3d ed. 1970). A similar example is set forth in the proposed regulations. Proposed Treas. Reg. § 1.305-6(b), example (2), 36 Fed. Reg. 5226 (1971). The proposed regulations also provide that this kind of distribution is taxable under § 305(b)(3), since some common shareholders receive preferred stock—those shareholders who do not convert—and other common shareholders receive common stock—those shareholders who do convert. *Id.* § 1.305-4(b), example (2), 36 Fed. Reg. at 5225.

88. Proposed Treas. Reg. § 1.305-6(b), example (1), 36 Fed. Reg. 5226 (1971).

89. The proposed regulations set forth the following example of a taxable decrease in conversion ratios: "(i) Corporation N has two classes of stock outstanding, class A and class B. Each class B share is convertible, at the option of the holder, into class A stock. However, in accordance with a specified formula, this ratio is decreased each time a cash dividend is paid on the

prices,[90] recapitalizations,[91] redemptions that are treated as taxable dividends under section 301,[92] and "any transaction having a similar effect [disproportionate distribution] on the interest on any shareholder." Although the examples set forth in the proposed

class B stock to reflect the amount of the cash dividend. The conversion ratio is also adjusted in the event that cash dividends are paid on the class A stock to increase the number of class A shares into which the class B shares are convertible to compensate the class B shareholders for the cash dividend paid on the class A stock. (ii) A $1 cash dividend per share is declared and paid on the class B stock. On the date of payment, when the conversion ratio is decreased a distribution of stock is considered as made with respect to each share of class A stock reflecting each share's increased proportionate interest in the assets and earnings and profits of the corporation. The distribution is a distribution to which section 301 applies." *Id.* § 1.305-3(e), example (7), 36 Fed. Reg. at 5223. For examples of taxable increases in conversion ratios see *id.* at examples (6) & (7); *id.* § 1.305-5(c), example (2), 36 Fed. Reg. at 5225.

90. *See* notes 84-85 *supra* and accompanying text.

91. The proposed regulations set forth several examples that involve recapitalizations. For an example of a taxable recapitalization see Proposed Treas. Reg. § 1.305-5(c), example (3), 36 Fed. Reg. 5225 (1971). For examples of nontaxable recapitalizations see *id.* § 1.305-3(e), example (12), 36 Fed. Reg. at 5224; *id.* § 1.305-5(c), examples (4)-(6), 36 Fed. Reg. at 5225. Other than these examples, the proposed regulations do not indicate what kind of recapitalizations will fall within the purview of §§ 305(b), (c).

92. This provision was enacted to authorize the Commissioner to promulgate regulations that will impose a tax on nonredeeming shareholders who receive increases in their proportionate stockholdings through a corporation's utilization of a periodic redemption plan. H.R. REP. No. 91-413, 91st Cong., 1st Sess. (1969), *reprinted in* 2 CCH 1970 STAND. FED. TAX REP. ¶ 2332. *See* note 56 *supra*. The proposed regulations authorize specifically the taxation of a shareholder's increase in proportionate interest that results from a periodic redemption plan. The following example is set forth in the proposed regulations: "Corporation T has 1,000 shares of stock outstanding. C owns 100 shares. Nine other shareholders each owns 100 shares. Pursuant to a plan for periodic redemptions, T offers to redeem up to 5 percent of each shareholder's stock each year. During the year, each of the nine other shareholders has 5 shares of his stock redeemed for cash. Thus, C's proportionate interest in the assets and earnings and profits of T is increased. Assuming that the cash received by the nine other shareholders is taxable under section 301, C is considered to have received a distribution under sections 305(b)(2) and 305(c) of 5.25 shares of T stock to which section 301 applies." Proposed Treas. Reg. § 1.305-3(e), example (8), 36 Fed. Reg. 5223-24 (1971). The proposed regulations also delineate the mechanics for computing the amount of the taxable "deemed distribution" received by the nonredeeming shareholder. *Id*; *id.* at example (9). These regulations, however, state clearly that isolated redemptions of stock that are taxable as dividends under § 301 do not give rise to taxation of the nonredeeming shareholders. A 30% minority shareholder, for example, would not be deemed to have received a taxable increase in proportionate interests if a 70% shareholder redeems 21% of his holdings. *Id.* at examples (10) & (11). This redemption, which would be taxable under § 301, indicates that not all redemptions taxable under § 301 will give rise to taxation under § 305(c). Since the language of § 305(c) refers only to "a redemption which is treated as a distribution to which § 301 applies," a redemption that qualifies for capital gain treatment under § 302(b) probably will not result in taxation of the nonredeeming shareholders. The rationale for excluding § 302(b) redemptions is somewhat unclear since § 302(b) redemptions, which are substantially disproportionate or terminate a shareholder's interest, will often greatly increase the proportionate interests of the nonredeeming shareholders. As these comments and examples imply, the treatment of redemptions and disproportionate stockholdings is not totally clear.

regulations are indicative of the scope of section 305(c), future regulations may exceed the intended scope of this section, since the broad and undefined language of the section could encompass many transactions. Moreover, several questions are not fully answered by the proposed regulations. What type of "recapitalizations" fall within the purview of this section? What transactions are "transactions having a similar effect on the interest of any shareholder"? Section 305(c), therefore, may indeed foreshadow ominous consequences.

B. Transitional Rules Applicable to the 1969 Amendments

The full impact of the 1969 Amendments is delayed by special transitional provisions that were enacted with the amendments. These provisions provide a limited grace period for corporations to readjust their capital structures and stock dividend policies in relation to the new law. Under these rules, the 1969 Amendments apply to all distributions and deemed distributions made after January 10, 1969, except for distributions under sections 305(b)(2) and 305(b)(4).[93] Section 305(b)(2) is not applicable to a distribution of stock made before January 1, 1991, on one of the following types of stock: (1) stock that was outstanding on January 10, 1969; (2) stock that was issued pursuant to a contract binding on the distributing corporation on January 10, 1969; (3) stock that is additional stock of the class of stock with the largest fair market value of all classes of stock of the corporation as of January 10, 1969; (4) preferred stock containing an antidilution provision that is convertible into stock meeting the requisites of (3) above; or (5) stock that was issued in a prior distribution described in the above sections.[94] This transitional rule applies only if the following requirements are satisfied: (a) the stock on which the distribution is made falls within one of the first two categories above; and (b) the stock was outstanding on January 10, 1968, a distribution of property on the stock was made on or before January 10, 1969, and a distribution of stock on the stock outstanding on January 10, 1969, was made on or before that date.[95] This latter requisite has been denoted the "lookback" rule. It was enacted to

93. Tax Reform Act of 1969, Pub. L. No. 91-172, §§ 421(b)(1), (2), (4), 83 Stat. 615. The proposed regulations provide that the transitional rules applicable to § 305(b)(2) also are applicable to § 305(b)(5), to the extent that the latter section requires a determination whether a distribution is disproportionate. Proposed Treas. Reg. § 1.305-8(b)(1), 36 Fed. Reg. 5227 (1971).

94. Tax Reform Act of 1969, Pub. L. No. 91-172, § 421(b)(2)(A), 83 Stat. 615. Subsection (e) means that the stock in question was a stock dividend on previously distributed stock that itself qualifies under the transitional rules as stock distributed with respect to stock described in (1)-(4).

95. *Id.* § 421(b)(2)(B).

prevent the application of the transitional rules for section 305(b)(2) to distributions by corporations that had no history of prior distributions covered by section 305(b)(2).[96] The application of the transitional rules for section 305(b)(2) is further complicated by another set of provisions that, if satisfied, terminate the effectiveness of the transitional rules. Under these provisions, the transitional rules cease to apply if the distributing corporation, anytime after October 9, 1969, issues convertible preferred stock, stock that is not additional stock of stock meeting the requirements of (3) above, or preferred stock without an antidilution provision that is convertible into stock meeting the requirements of (3) above.[97]

The 1969 Amendments set forth two additional transitional rules.[98] First, section 421(b)(4) of the 1969 Amendments provides that section 305(b)(4) is inapplicable to any actual or deemed distribution on preferred stock made before January 1, 1991, provided that the stock was issued pursuant to terms that were in effect on January 10, 1969. Secondly, section 421(b)(5) provides that section 305 of the Internal Revenue Code of 1954, which was in effect prior to the 1969 Amendments, is applicable to all distributions made after January 10, 1969, that are exempted from the application of the 1969 Amendments by the transitional rules.

IV. Effect of 1969 Amendments on Corporate Stock Dividend Policy

The 1969 Tax Reform Act, which marks a new era in taxation of stock dividends, may have far-reaching effects on corporate financial policy. Although final regulations will ultimately determine the full significance of the 1969 Amendments, it is possible at this point to discern several consequences that may result from the 1969 changes. This section will focus on an analysis of the impact of these statutory changes on certain corporations and their normal stock dividend policies. Specifically, the influence of the changes brought about by the 1969 Amendments is considered with reference to three types of corporations: the acquisition-minded, growth-oriented corporation; the closely-held corporation; and the widely-held corporation. In the discussion of each type of corporation, both the size of the corporation

96. *See* Libin & Moorehead, *supra* note 73, at 260.

97. Tax Reform Act of 1969, Pub. L. No. 91-172, § 421(b)(2)(C), 83 Stat. 615-16. The termination provisions, however, are inapplicable if the issuance of the corporation's stock represents a distribution of a dividend on identical stock. *Id.*

98. *Id.* §§ 421(b)(4), (5).

in terms of the number of shares outstanding and the corporation's history of stock dividend distributions are important considerations.

Before an analysis is undertaken to determine which corporations will be affected by the 1969 Amendments, an initial question must be asked: does the tax treatment of a corporation's shareholders upon the receipt of stock dividends affect the corporation's issuance of stock dividends? Unless this interrogatory is answered affirmatively, there is no necessity to proceed further with this analysis. Unfortunately, the information on this point is rather scarce. The only extensive survey directly in point, conducted in 1949, revealed that stock dividend policy is dictated basically by economic factors, such as high annual earnings and expanding capital expenditures.[99] The survey concluded that except for closely-held corporations, the relatively preferential tax treatment of shareholders had little, if any, influence on stock dividend policy.[100] Although the conclusion of this survey cannot be dismissed, it cannot be fully accepted when the same question is considered in the context of the harsher tax treatment imposed by the 1969 Amendments. Under present conditions, it seems reasonable to conclude that the adverse tax treatment of shareholders will affect a corporation's decision on whether to issue stock dividends. After an examination of the regulations issued in 1969, which expanded the scope of stock dividend taxation, one commentator intimated that the stock dividend policy of "conglomerate" corporations would be affected by the taxation of their shareholders upon the receipt of stock dividends.[101] Furthermore, a limited survey conducted in conjunction with this Note revealed that the adverse tax treatment of shareholders is a factor that influences corporate stock dividend policy.[102] In light of these findings, it may validly be stated that adverse tax treatment of shareholders under the 1969 Amendments will influence stock dividend policy.

A. The Acquisition-Minded, Growth-Oriented Corporation

Since acquisition-minded, growth-oriented corporations have a history of disproportionate stock distributions, they probably will feel the greatest impact of the 1969 Amendments. As previously noted, some

99. Zang & Thompson, *Why Stock Dividends Are Declared*, 27 TAXES 883, 884-85 (1949).

100. *Id.* at 886.

101. *See* Ray, *supra* note 61, at 344.

102. A questionnaire concerning the effect of the 1969 Amendments was sent to 50 corporations that have recently issued stock dividends. Ten replies were received. Six corporations indicated that adverse tax treatment of its shareholders would significantly affect its stock dividend policy. The results of the survey are on file in the office of the *Vanderbilt Law Review*.

growth corporations, during the past decade, have distributed their stock by plans that in effect gave shareholders an election between the receipt of cash or stock.[103] These plans were devised to create a very attractive, high value stock that would be valuable to the corporation in any future stock acquisitions undertaken by it.[104] The regulations under the 1954 Code were promulgated specifically to arrest the increasing issuance and distribution, through stock dividends, of this speculative, tax-free stock.[105] The 1969 Amendments were similarly enacted to curb this abusive practice. Concerning the adoption of the 1969 Amendments, the Senate Committee on Finance stated:

> In recent years, considerable ingenuity has been used in developing methods of capitalizing corporations in such a way that shareholders can be given the equivalent of an election to receive cash or stock, but at the same time permitting stockholders who choose stock dividends to receive them tax free. . . . To counter the various devices by which the effect of a distribution of stock can be disguised, both versions of the bill give the Treasury Department regulatory authority to treat [such distributions as taxable.][106]

Under the 1969 changes, therefore, many of the heretofore nontaxable transactions engaged in by growth companies will now result in the receipt of taxable income to the shareholders. Since all these plans were commonly used by many acquisition-minded corporations, the taxation of the plans will probably impede their future use.

These stock plans, however, will not be completely eliminated until 1991, when the special transitional rules of section 305(b)(2) terminate.[107] The transitional rules applicable to disproportionate distributions are especially important to growth corporations because several of the frequently used tax-free plans, such as the "two-class common stock" plan and the "noncontemporaneous disproportionate distribution" of stock and property plan, fall within the purview of section 305(b)(2). The transitional rules provide generally that section 305(b)(2) will not apply

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103. *See* notes 55-58 *supra* and accompanying text.

104. *See* Ray, *supra* note 61, at 345-46. The stock created by these plans was an attractive investment and frequently maintained a high market value for 2 reasons. First, this stock, either by corporate policy or express provision of the articles of incorporation, paid an annual stock dividend, a factor often interpreted by the financial community as evidence of sound stock. Thus, since the price of stock varies directly with its financial soundness, the value of the stock was often increased. Secondly, the election that the new stock afforded its holders—either to retain the stock and receive tax-free stock dividends or convert the stock into common stock and receive cash dividends—made this stock very attractive to investors and therefore increased its value.

105. *See* notes 59-62 *supra* and accompanying text.

106. SENATE COMM. ON FINANCE, 91ST CONG., 1ST SESS., SUMMARY OF H.R. 13270: TAX REFORM ACT OF 1969, *reprinted in* P-H FED. TAXES REP. BULL. NO. 47, at 54-55 (Nov. 20, 1969).

107. *See* notes 93-97 *supra* and accompanying text.

to distributions made prior to January 1, 1991, provided the distribution is made on certain previously outstanding stock and the corporation has had a prior history of stock distributions on the stock in question.[108] These rules have produced an ironic result since the very provisions that were passed to stop the tax avoidance practices of growth corporations have, to a certain degree, rewarded these corporations for their past plans by prohibiting the tax-free use of these attractive stock plans by future competitors.[109] The framers of the 1969 changes predicted this possible loophole because they provided that the prior law under section 305 remained applicable to all distributions subject to the special transitional rules. The major fallacy in this provision, however, is that the prior law may not be effective to subject these distributions to taxation since the effectiveness and validity of the 1969 regulations under prior section 305 are indeed questionable.[110] Effective restraint, therefore, will be delayed until 1991 when section 305(b)(2) becomes applicable to all distributions. Since growth corporations and their shareholders are given favorable tax treatment by the transitional rules, it will be to their advantage to study these rules carefully to insure that they comply with all the necessary requirements.

B. Closely-Held Corporations

The stock dividend policies of closely-held corporations probably will be significantly influeneed by the 1969 changes. This impact will result primarily because closely-held corporations afford their shareholders an especially fruitful area for tax planning, since the interests of a relatively few amicable shareholders can be advantageously adjusted without interference from minority, dissenting shareholders. Although closely-held corporations have not engaged extensively in formulating stock plans that circumvent the limited taxation of stock dividends under section 305 of the Internal Revenue Code of 1954, these corporations have utilized some of the plans that now fall within the area of taxable stock dividends. Closely-held corporations, for example, have probably utilized adjustments in conversion ratios and redemption values, periodic redemption plans, and recapitalizations in order to

108. *See* notes 93-97 *supra* and accompanying text.

109. *See* Ray, *supra* note 61, at 382. Mr. Ray made a similar statement concerning the effect of the 1969 regulations, which had a similar transitional rule with a 1991 termination date: "In summary, what started out to be an attack upon certain 'growth companies' and their issuance of the 'new securities' may have served to reward their enterprise by limiting the utilization of those securities by new issues and by removing doubts until 1991 as to the tax status of stock dividends on 'new securities!'" These remarks are equally applicable to the 1969 Amendments.

110. Ray, *supra* note 61, at 382. *See also* notes 61 & 71 *supra* and accompanying text.

adjust favorably the stockholdings of their shareholders. These stock plans and similar plans that have been used by closely-held corporations to increase the proportionate interests of some of their shareholders will now be taxable under the 1969 Amendments. Through careful tax planning, however, closely-held corporations may obtain the tax advantages made available by adherence to the transitional rules applicable to sections 305(b)(2) and 305(b)(4).[111]

C. *Widely Held Corporations*

The 1969 changes in stock dividend taxation probably will have little, if any, effect on the stock dividend policies of widely-held corporations that have no history of or future plans for the implementation of disproportionate stock plans. Most widely-held corporations that issue stock dividends usually distribute pro rata dividends of less than ten percent, characteristically about two-to-three percent;[112] however, a larger stock dividend—twenty percent or more—may be distributed if the corporation desires to reduce the per share value of its stock.[113] Furthermore, most widely-held corporations are deterred from pursuing a stock dividend policy that increases the proportionate stockholdings of only a few shareholders because of both the pre-emptive rights doctrine[114] and general policy to treat all shareholders equally. Distributions of ordinary stock dividends are usually motivated by the corporation's desire to retain funds for expansion or to satisfy shareholder demands for dividends.[115] The 1969 Amendments, therefore, will have little effect on most of these corporations because the amendments generally subject to taxation only those distributions that disproportionately increase stockholdings. The widely-held corporations that responded to the survey conducted in conjunction with this Note reported unanimously that the 1969 Amendments would not significantly affect their stock dividend policies.[116] Widely-held corporations, however, must be carful not to

111. *See* notes 93-98 *supra* and accompanying text.

112. H. GUTHMANN & H. DOUGALL, CORPORATE FINANCIAL POLICY 544 (4th ed. 1962); E. SCHWARTZ, CORPORATION FINANCE 136-37 (1964).

113. *See* H. GUTHMAN & H. DOUGALL, *supra* note 112, at 543.

114. 11 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5135 (perm. ed. rev. 1958): "This doctrine of equality which underlies the pre-emptive right, if not the right itself, clearly applies when a corporation increases its capital stock by making a stock dividend. It cannot discriminate between stockholders, but each stockholder is entitled to receive new shares in proportion to the stock held by him at the time the dividend is made."

115. *See* E. DONALDSON, CORPORATE FINANCE 625 (1957).

116. Vanderbilt Law Review Survey, *supra* note 102.

fall within certain provisions that might be applicable to them once the regulations are adopted. These provisions include: (1) taxation under section 305(b)(2) of a stock dividend of common-on-common accompanied by interest payments on convertible debentures or stock; (2) taxation of recapitalizations and redemptions under section 305(c); (3) taxation of distributions of convertible preferred stock under section 305(b)(5); and (4) taxation of distributions that give the shareholders an election between property and stock under section 305(b)(1).

V. Challenges to Taxation of Stock Dividends Under the 1969 Amendments

The broad sweep of stock dividend taxation under the 1969 Amendments encompasses many shareholders who previously received tax-free treatment on the receipt of dividend stock. Many of these shareholders will undoubtedly respond by seeking to frame arguments that can be utilized to avoid imposition of a tax. When shareholders receive significant increases in their proportionate stock interest, taxation under the 1969 Amendments appears immune from successful challenge, since the increase would clearly fall within the current conception of taxable income.[117] Under the 1969 Amendments, however, numerous situations may arise in which it is questionable whether a shareholder has received taxable income or has experienced an increase in his proportionate stockholdings. When these cases arise, the arguments set forth in the following sections may be applicable in order to avert taxation.

A. Nontaxability of Potential Income

Since the inception of a federal tax on income, courts have struggled with the troublesome and elusive concept of taxable income. The judicial opinions and scholarly literature concerning this issue, however, have seldom mentioned the concept of "potential income." Although never precisely defined, "potential income" may be described as an economic gain that may accrue to a taxpayer on the occurrence of a contingent, future event to be performed by another individual. When the concept of potential income has been mentioned by authorities, their observations have resulted in the inference that it is not taxable.[118] The paucity of

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117. *See* notes 120-26 *infra* and accompanying text.

118. *See* Lowndes, *Current Conceptions of Taxable Income,* 25 Ohio St. L.J. 151, 180-81 (1964). "The real difficulty seems to be finding a sufficient gain to justify the imposition of an income tax. Of course, a right to income, or an appreciation in the value of property, represents at

controversy and comment on this subject can be easily explained. A taxpayer will seldom, if ever, report an item as income until he is certain that the value will be forthcoming or until the funds are in his possession. Furthermore, until the taxpayer reports income, the Internal Revenue Service usually will have no way, short of a complete audit, to discover that the taxpayer may have an income item.[119] The potential income issue, however, is clearly raised in several instances by the 1969 Amendments, since they provide for immediate taxation of several items that may give rise to taxable income only if a contingent, future event occurs. Before proceeding to an analysis of the 1969 Amendments, it is necessary to examine "potential income" in the context of current concepts of taxable income.

1. *Potential Income in Relation to the Concept of Taxable Income.*—Congressional authority to lay and collect taxes on income without apportionment among the states proceeds from the sixteenth amendment to the United States Constitution.[120] The key concept in this scheme of taxation is "income." A precise and all-inclusive definition of this term that would be useful to the courts, however, has never been and probably cannot be formulated.[121] At an early date in the history of income taxation, the Supreme Court recognized that because no definition could encompass every possible situation in which income might arise, the courts should decide the issue on a case-by-case

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least a potential gain, and perhaps this is a sufficient basis for the tax . . . . This presents the question of realization because there has been no completed transaction, as well as the question of whether a potential gain is sufficient gain to sustain an income tax." *Id.* Concerning the taxability of a stock dividend of preferred stock, several scholars have noted: "The shareholder has two pieces of paper in place of one, but he possesses no greater interest than he had before, other than the power now to move on to a tax advantage through a sale. Until he so moves, is the potentiality enough to warrant treating the receipt of the dividend [as taxable income]?" *See* Cohen, Surrey, Tarleau, & Warren, *A Technical Revision of the Federal Income Tax Treatment of Corporate Distributions to Shareholders*, 52 COLUM. L. REV. 1, 13 (1952).

119. Although the IRS can audit a taxpayer's income tax return in order to discover any unreported income items, an audit will seldom reveal potential income items since these items are so uncertain that they will not be reflected in the taxpayer's tax return or financial records.

120. Although the sixteenth amendment authorizes Congress to levy a tax on income, some scholars have stated that congressional power to tax income also derives from U.S. CONST. art. 1, § 8, cl. 1. *E.g.*, Lowndes, *supra* note 118, at 159; Mullock, *Current Conceptions of Taxable Income—A Comment*, 26 OHIO ST. L.J. 43, 44 (1965).

121. In Eisner v. Macomber, 252 U.S. 189, 207 (1920), the Court enunciated the following definition of income: "Income may be defined as the gain derived from capital, from labor, or from both combined . . . ." This definition, however, was not extremely helpful to the courts in deciding whether an item was taxable income. *See* notes 122-23 *infra* and accompanying text. The *Eisner* definition did give rise to several other important doctrines of tax law, such as realization and taxable gain. *See* notes 127-40 *infra* and accompanying text.

approach.[122] Proceeding in an ad hoc fashion, the courts created a broad area of taxable income that excluded few items.[123] This expansive approach can be attributed to the Supreme Court's interpretation of congressional intent in the enactment of section 61 of the Internal Revenue Code of 1954.[124] The Court repeatedly has stated that this definition evidences a congressional intent to exert "the full measure of its taxing power"[125] and to tax "all gains except those specifically exempted."[126]

Although the breadth of the concept of income is expansive, there are limitations on it. These limitations originated from the judicial definition of income set forth in *Eisner v. Macomber*—that income is "the gain derived from capital, from labor, or from both combined."[127] The most familiar limitation is the doctrine of realization, which evolved from the language "derived from" in the *Eisner* definition. Under this doctrine, an item is not realized until it has been "severed" from the capital asset that produced it. This traditional doctrine of realization, however, has been repudiated by many courts,[128] including those that imposed a tax on stock dividends that increased a shareholder's proportionate interest.[129] Moreover, on several occasions the Supreme Court held that taxable income accrued to a taxpayer even though the gain remained unsevered and indistinguishable from the capital asset.[130]

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122. *See, e.g.*, Commissioner v. Wilcox, 327 U.S. 404, 407 (1946); United States v. Kirby Lumber Co., 284 U.S. 1, 3 (1931).

123. *See, e.g.*, Commissioner v. LoBue, 351 U.S. 243 (1956) (stock options); Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955) (punitive damages); Helvering v. Horst, 311 U.S. 112 (1940) (assignment of bond interest coupons); Helvering v. Brunn, 309 U.S. 461 (1940) (lessee's improvements); United States v. Kirby Lumber Co., 284 U.S. 1 (1931) (cancellation of indebtedness). One commentator has stated: "Today the Court's tolerance of the tax has reached the point where it would be very surprising if anything which there was a reasonable basis for taxing under the income tax was found to be beyond Congress' constitutional competence." Lowndes, *supra* note 118, at 152-53.

124. INT. REV. CODE OF 1954, § 61(a) provides: "Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items . . . ."

125. *See, e.g.*, Helvering v. Clifford, 309 U.S. 331, 334 (1940).

126. *See, e.g.*, Commissioner v. Glenshaw Glass Co., 349 U.S. 426, 430 (1955).

127. 252 U.S. at 207.

128. *See* Hanrahan, *A Proposal for Constructive Realization of Gain and Losses on Transfers of Property by Gift and at Death*, 15 U. KAN. L. REV. 133, 155 (1967); Lowndes, *supra* note 118, at 171-72.

129. *See, e.g.*, Koshland v. Helvering, 298 U.S. 441 (1936).

130. *E.g.*, Helvering v. Brunn, 309 U.S. 461 (1940) (lessee improvements); Koshland v. Helvering, 298 U.S. 441 (1936) (stock dividends). In *Helvering v. Brunn* this point was made explicitly clear: "The fact that the gain is a portion of the value of property received by the taxpayer in the transaction does not negative its realization. . . . It is not necessary to recognition of taxable gain that [the taxpayer] should be able to sever the improvement begetting the gain from his original capital." 309 U.S. at 469.

Even though the "severence" doctrine of realization is no longer constitutionally required,[131] it is clear that an altered form of the principle of realization continues as a prerequisite of a taxable event. This new tenet of realization frequently has been expressed as an event that establishes economic gain with sufficient certainty that it is not unreasonable to tax the gain at that time.[132] In *Helvering v. Horst,* the Supreme Court described the event as the "last step . . . by which [a taxpayer] obtains the fruition of the economic gain which has already accrued to him."[133] A more descriptive definition of this event, which takes into account the economic objectivity that is the basis of income taxation, states that it is an occurrence that measurably changes the taxpayer's economic position.[134] The essence of this concept of realization, although not explicitly stated in the opinions, is the certainty of the taxpayer's gain.

A second limitation on the concept of taxable income is the *Eisner* requisite of a derivation of "gain."[135] Under this principle, an item is taxable income only if it represents an increase in the economic status of the taxpayer. Although a few courts have suggested that the necessary gain may take the form of non-economic, emotional gain,[136] most courts and legal scholars have stated that the required gain must confer or be connected with an economic benefit accruing to the taxpayer.[137] Since an income tax is a tax on increments to an individual's material wealth, it is only logical to require that the gain affect the economic status of the taxpayer. A taxable gain may be produced by a variety of transactions,

131. *See generally* Lowndes, *supra* note 118, at 171-72; Mullock, *supra* note 120, at 44-46.

132. *See* Lowndes, *supra* note 118, at 171-74, 182. Commenting on *Helvering v. Brunn,* Professor Lowndes states that "the Supreme Court made explicit what had formerly been implied when it declared that realization . . . require[s] . . . merely some event that freezes or fixes the gain with sufficient certainty so that it is [reasonable] to tax it." *Id.* at 173.

133. 311 U.S. 112, 115 (1940).

134. *See* Mullock, *supra* note 120, at 46-47.

135. *See* Lowndes, *supra* note 118, at 162.

136. *Cf.* United States v. Davis, 370 U.S. 65 (1962) (transfer of appreciated shares for release of marital rights constitutes taxable event); Helvering v. Midland Mut. Life Ins. Co., 300 U.S. 216 (1937) (mortgagee realized income to the extent of the interest obligations applied to acquire mortgaged property at foreclosure sale).

137. *E.g.,* James v. United States, 366 U.S. 213 (1961) (gain constitutes taxable income when its recipient derives readily realizable economic value from it); Helvering v. Brunn, 309 U.S. 461 (1940) (while it is true that economic gain is not always taxable as income, it is settled that the realization of gain need not be in cash derived from the sale of an asset); Simmons v. United States, 308 F.2d 160 (4th Cir. 1962) (taxpayer realized taxable gain because he received a permanent economic benefit). "The [whole] question is not whether there is a gain but whether there is an adequate gain . . . to sustain the tax, the criterion of which is some sort of economic objectivity . . . ." Mullock, *supra* note 120, at 46-47.

such as cancellation of indebtedness,[138] improvements to a building by a lessee,[139] and the exercise of stock options.[140] Furthermore, in appraising the nature of taxable gains, the courts have implicitly recognized that the requisite gain must be one that the taxpayer presently possesses and controls.

When "potential income" is analyzed in the context of these conceptions of taxable income, its nontaxability becomes apparent. If a taxpayer anticipates the receipt of an economic gain that is conditioned upon the future performance of an act by another individual, prior to the occurrence of that event any gain remains contingent and uncertain. The future event that is supposed to "trigger" realization of income might never occur. Consequently, a tax on this item should be constitutionally permissible only when the income potentiality becomes a reality. Suppose, for instance, that an individual owns a tract of land that he offers for sale. A prospective purchaser informs the owner that he desires an option to buy the property, which he will purchase if he can establish sufficient credit arrangements. When the option is sold, the owner clearly does not receive a taxable gain from the sale of the property; a taxable gain arises only when the purchaser exercises the option and signs a contract that fixes the legal certainty of the purchase obligation. Until the purchaser executes the purchase contract, the owner possesses only a "potential income asset" that is not taxable.

2. *Potential Income in Relation to the Taxation of Several Special Transactions.*—Although the principle of nontaxability of potential income has been accorded implicit recognition, courts generally have not expressly acknowledged it. A more concrete recognition of this principle, however, may be discerned by examining the judicial treatment of several special items. The first example concerns the tax treatment of stock options. Two Supreme Court decisions established the general rule that a holder of a stock option realized taxable gain at the date the option was exercised, not when the option was granted.[141] Under this standard, the amount of the gain, commonly denoted the "spread," is the difference between the option price and the fair market value of the stock on the date the option is exercised.[142] This rule was codified with

138. United States v. Kirby Lumber Co., 284 U.S. 1 (1931). INT. REV. CODE OF 1954, §108, however, specifically excludes a discharge of indebtedness from gross income under certain conditions.

139. Helvering v. Brunn, 309 U.S. 461 (1940). INT. REV. CODE OF 1954, § 109, however, specifically excludes lessee's improvements from gross income.

140. Commissioner v. LoBue, 351 U.S. 243 (1956).

141. *Id.*; Commissioner v. Smith, 324 U.S. 177 (1945).

142. Cases cited note 141 *supra*.

modification in the Internal Revenue Code of 1954, which established a category of "qualified" stock options. Generally, the holder of a qualified stock option, who has held the option for three years, realizes income at the date the option stock is sold to the extent of the difference between the option price and the sale price, and his gain is taxed at capital gains rates.[143] If, however, the option does not qualify for special tax treatment and does not have a readily ascertainable market value, the holder will be subject to taxation at ordinary rates on the date the option is exercised.[144] The language of section 421(a) of the 1954 Code and the regulations thereunder are subject to the interpretation that Congress and the Treasury Department did not believe that income was realized until the qualified option stock was sold or the nonqualified stock option exercised.[145] The rationale for the postponement of realization of income from either a qualified or nonqualified stock option is three-fold. First, the extent of the gain, if any, is uncertain until the date of exercise, since the stock market is subject to rapid and reversible fluctuations. Secondly, in the case of a nonqualified stock option, the Commissioner desires to postpone any taxation until the date of exercise in order to tax the appreciated value of the stock option at ordinary income rates. If he taxes the option when it is granted at ordinary rates, any subsequent appreciation will receive capital gains treatment when the option is exercised.[146] Lastly, even if it is assumed that there will be a gain when the option is exercised, it is uncertain whether the holder will ever exercise the option. Concededly, the uncertainty of the market value of the stock and the Commissioner's desire to tax any subsequent appreciation at ordinary rates are the paramount considerations that dictate the postponement until the date of exercise; the uncertainty of whether the option will be exercised, however, was undoubtedly a consideration in the formulation of the present tax treatment. The origin of this later consideration can perhaps be traced to the Supreme Court's decision in *Commissioner v. Smith,* in which the Court stated: "If the options had never been exercised, the

143. INT. REV. CODE OF 1954, §§ 421-25; *see* T. NESS & E. VOGEL, TAXATION OF THE CLOSELY-HELD CORPORATION § 8.53(a) (1967).

144. Treas. Reg. § 1.421-6 (1969); *see* Frank v. Commissioner, 54 T.C. 75 (1970).

145. INT. REV. CODE OF 1954, § 421(a) provides that "no income shall result" on the exercise of the qualified option, and the regulations governing the taxation of nonqualified stock opitions states that the holder of the option "realizes" income at the date of exercise. *See* Treas. Reg. § 1.421-6(d)(1) (1969).

146. For an example of the Commissioner's position on this issue see Frank v. Commissioner, 54 T.C. 75, 97 (1970).

optionees would never have received any additional compensation [income]."[147]

A second example of the nontaxability of potential income may be ascertained by analyzing the tax treatment accompanying distributions of stock rights. Section 305(a) of the 1954 Code excludes from a shareholder's gross income the value of stock rights received in a distribution with respect to his stock,[148] provided that the stock into which the right is convertible also would have been nontaxable if it had been distributed directly.[149] Even if the stock right is taxable, its value is not included in the shareholder's gross income until the right is exercised or sold.[150] Furthermore, this principle is applicable under the 1954 Code and the 1969 Amendments[151] even though the amount to be included in the shareholder's gross income is determined by reference to the fair market value of the rights on the date of their distribution.[152] The postponement of taxation until the date of exercise or sale is based expressly on the principle that a shareholder possesses only potential income until he exercises or sells his stock rights. In *Palmer v. Commissioner,*[153] the Supreme Court stated:

> The mere issue of rights to subscribe and their receipt by stockholders, is not a dividend. No distribution of corporate assets or diminution of the net worth of the corporation results in any practical sense. Even though the rights have a market or

147. 324 U.S. 177, 180 (1945).

148. "[G]ross income does not include the amount of any distribution of the stock of a corporation made by such corporation to its shareholders with respect to its stock." INT. REV. CODE OF 1954, § 305(a). Although § 305(a), as amended by the 1969 Amendments, refers only to "stock", the general rule of § 305(a) applies to the distribution of stock rights because stock is defined to include "rights to acquire such stock." *Id.* § 305(d)(1). A stock right is an option to buy at a specified price unissued or treasury stock of the corporation issuing tbe right. *See* Treas. Reg. § 1.305-1 (1969).

149. This exception manifests the distinction between taxable and nontaxable stock rights. The distinction was derived from the distinction between taxable and nontaxable stock dividends that developed under the Internal Revenue Code of 1939. Accordingly, the principle developed that a stock right was not taxable if the stock into wbich it was convertible would have been nontaxable if it had been distributed. A stock right to acquire common stock that was distributed to common shareholders, for example, would not be taxable since it was essentially a stock dividend of common-on-common. *See* Lowndes, *supra* note 47, at 157-58.

150. *See, e.g.,* Palmer v. Commissioner, 302 U.S. 63 (1937); Choate v. Commissioner, 129 F.2d 684 (2d Cir. 1942).

151. *See* 94 BNA TAX MANAGEMENT PORTFOLIO: STOCK DIVIDENDS AND STOCK RIGHTS, at A-40 (3d ed. 1970). *See also* Commissioner v. Gordon, 391 U.S. 83, 98 (1968).

152. *See* Treas. Reg. § 1.305-2(c) (1969); 94 BNA TAX MANAGEMENT PORTFOLIO, *supra* note 151, at A-40. Under prior law the amount of the taxable income resulting from a distribution of stock rights was the difference between the cost of exercising the right and the fair market value of the stock at the date of issue or the date of exercise, whichever was lower. *See* Choate v. Commissioner, 129 F.2d 684 (2d Cir. 1942).

153. 302 U.S. 63 (1937).

> exchange value, they are not dividends within the statutory definition . . . . They are at most options or continuing offers, *potential sources of income* to the stockholders through sale or the exercise of the rights. Taxable income might result from their sale, but distribution of the corporate property could take place only on their exercise.[154]

Another example of a situation in which a potentiality postpones taxation is presented by the tax treatment of a recipient of crop rents. Although section 61 of the Internal Revenue Code of 1954 includes rents in gross income, the regulations provide that crop rents are excluded from gross income until the crops are reduced to cash.[155] A taxpayer who receives crop rents obtains a valuable asset; however, the potentiality that the crops may spoil before their disposition or may subsequently bring a different price on the date of conversion demands that taxation be delayed until the contingencies disappear. Commenting on this aspect of the taxation of crop rents, the Court of Claims stated:

> Crops received as rent exist in the hands of the lessor as a unique kind of property which can be described, like a right to receive future income, as a potential income asset.[156]

3. *Potential Income and the 1969 Amendments.*—When the potential income analysis is applied to the 1969 Amendments, several of

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154. *Id.* at 71 (emphasis added). In *Choate,* the court made a similar statement: "But the options [rights] are merely offers to distribute such earnings. Unless and until such an option is exercised, no distribution of corporate earnings occurs. . . . The options are *potential dividends* but, in and of themselves, are not dividends taxable under § 115." Choate v. Commissioner, 129 F.2d 684, 687 (2d Cir. 1942) (emphasis added).

155. Treas. Reg. § 1.61-4(a) (1969).

156. Davison v. United States, 292 F.2d 937, 942 (Ct. Cl. 1961). *See also* Tatum v. Commissioner, 46 T.C. 736 (1966). The concept of potential income also was recognized by the Court of Claims in 2 other cases. In these cases, which involved respectively the elimination of a reserve for bad debt, and an exchange of accounts receivable for stock of equivalent value, the court decided that a tax on income was appropriate because the potentialities that heretofore had warranted the nontaxability of the income items had disappeared. Citizens Fed. Sav. & Loan Ass'n v. United States, 290 F.2d 932 (Ct. Cl. 1961) (in light of a recent decision by the Supreme Court, it appears that a portion of a bad debt reserve may be considered as taxable income only if the accounts receivable are sold or transferred at their gross value. *See* Nash v. United States, 398 U.S. 1 (1970)); Williamson v. United States, 292 F.2d 524 (Ct. Cl. 1961). Commenting on the case involving the reserve for bad debt, one observer has said: "It appears from the opinion that the Court of Claims conceived that the monies received by [the taxpayer corporation] and sheltered from annual taxes by the reserve credits were indelibly stamped as 'potential income.' When it appeared that the diverse contingencies upon which these monies might be lost to the corporation would not occur and that the prediction of bad debts represented by the reserve account was erroneous, the full potential for producing taxable income to the corporation had been achieved." Garbow, *"Potential Income" is Being Taxed Under New Concept Evolving in Court of Claims,* 16 J. TAXATION, Apr. 1962, at 206-07. Although these decisions stand for the proposition that untaxed earnings subject to contingencies that may dissipate the item completely will be taxed when the contingencies disappear, they can logically be cited for the proposition that possible taxable items that may produce income if a future event occurs will not be taxed until the contingency occurs and the income is realized.

the distributions and "deemed" distributions that are subject to taxation fall within the purview of the nontaxable potential income concept. "Potential income," as it relates to stock dividends, can be defined as a distribution or "deemed distribution" of stock that will result in a direct increase in the shareholder's wealth or proportionate interest in the corporation on the discharge of a future contingency by another individual. The actual and "deemed distributions" taxable under the 1969 Amendments that fall within this definition are: (1) pro rata stock dividends of common stock to common shareholders accompanied by cash payments on convertible debentures or convertible preferred stock; (2) decreases in the conversion ratios of convertible securities or stock; (3) disparity between issue-redemption prices; and (4) distributions of convertible preferred stock. An examination of these distributions clearly reveals the potentiality upon which they rest.

First, the proposed regulations indicate that under section 305(b)(2) pro rata dividends of common stock to common shareholders, contemporaneous with interest payments or cash dividends to holders of convertible debentures or convertible preferred stock that do not contain antidilution provisions, will result in taxation of the common shareholders to the extent of the increases in their proportionate holdings of common stock.[157] Close analysis of the common shareholders' position, however, reveals that they will receive an increase in their proportionate interests only if the holders of the convertible issues exercise the conversion privilege at a future date. Until then, the increase in the common shareholders' interests is completely contingent and, in fact, does not exist. The following example clearly illustrates this potentiality. *X* Corporation has 1,000 shares of common stock outstanding, held equally in 500 share lots by *A* and *B*. *C* holds 2,000 shares of convertible debentures, convertible at *C*'s option at a four-for-one ratio. If *C* exercises his option, the total amount of outstanding stock will be 1,500 shares, which will make A, B, and *C* each one-third

157. Since most convertible stock and securities contain antidilution provisions, the example set forth in the committee reports and the example explained in this section will rarely occur. *See* note 77 *supra* and accompanying text. When an antidilution provision, however, applies only to large stock dividends, the distribution of a small stock dividend, contemporaneous with cash payments to holders of convertible stock or securities, may result in taxation since there is no adjustment of the conversion ratio. The paper manufacturing corporation, Boise Cascade, recently encountered this situation. Boise Cascade had been paying annually a 2% stock dividend and its certificate of incorporation did not provide for adjustment of the conversion ratios of its preferred stock if the stock dividend were 2% or less annually. To avert possible taxation under the 1969 Amendments on the distribution of its annual 2% stock dividend, the certificate of incorporation was amended to provide for the adjustment of the conversion ratios of the preferred stock on the distribution of all stock dividends. 34 J. TAXATION, Apr. 1971, at 256-57.

owners of the common stock. Suppose, however, that before *C* exercises his option the corporation issues a 25 percent pro rata stock dividend on the common stock, and an interest payment to *C*, making the total outstanding common stock 1,250 shares. This distribution raises *A*'s and *B*'s holdings to 625 shares, but *A* and *B* each retain the same 50 percent ownership. If *C* subsequently exercises his conversion privilege and receives 500 shares, his interest will be diluted to a 28 percent interest—500 of 1,750—and the interest of *A* and *B* will be increased to a 36 percent interest, rather than the 33 percent interest that would have existed if the stock dividend had not occurred. If, however, *C* never exercises his conversion privilege, *A* and *B* will not experience any increase in their proportionate interests.[158] Commenting on the questionable constitutionality of taxing stock dividends similar to the above example, one writer has stated:

> Since the determination of taxability must be made at the moment of the common stock distribution, before any future conversions occur, it is difficult, from a constitutional standpoint, to see how it can be said that the common stockholders received anything other than more pieces of paper reflecting their identical, totally unchanged interests in the corporation.[159]

The taxation of common stock distributions also may be challenged as a violation of the principle, established by *Eisner v. Macomber*, that a stock dividend of common-on-common is not taxable income. This general rule of nontaxability has never been overruled, and it is codified in section 305(a).[160] This approach also may be sufficient to defeat the Commissioner's attempts to tax another distribution under section 305(b)(2). When a corporation issues a pro rata stock dividend of common-on-common, followed by a cash dividend on convertible preferred stock within 36 months, the Commissioner may, in certain situations, "tack" these noncontemporaneous distributions together

158. The conclusion that *A* and *B* have not experienced an increase in their proportionate interest if *C* never exercises his conversion privilege may be subject to challenge on the ground that *C*'s conversion is irrelevant as far as *A*'s and *B*'s interests are concerned since *C*'s convertible debentures are considered the economic equivalent of common stock even though unexercised. *See* APB Opinion No. 15 (1969). The equation of unexercised convertible securities and common stock may well be justified when the convertible securities contain an antidilution provision because if no dilution can occur, it may be assumed that the convertible securities will be converted into the underlying common stock. If a convertible security does not contain an antidilution provision, however, it cannot be assumed that the holder of the convertible securities will convert and obtain a "diluted interest," especially if the convertible securities contain preferences other than the conversion privilege. In this latter case the unexercised convertible security should not be characterized as the economic equivalent of the underlying common stock.

159. Libin & Moorehead, *supra* note 73, at 263.

160. *See* S. REP. No. 1622, 83d Cong., 2d Sess. (1954), *reprinted in* 3 U.S. CODE CONG. & AD. NEWS 4675 (1954).

and tax the stock dividend as a disproportionate distribution. Under the above rationale and precedents, however, a tax on the recipients of the stock dividend would appear unconstitutional.

Section 305(c), which authorizes the taxation of shareholders whose proportionate interests in a corporation are affected by a decrease in the conversion ratios of convertible preferred stock, is another example of an unconstitutional effort to tax "potential income." This tax evidently is rationalized on the ground that a common shareholder's interest is increased because the holders of convertible securities are entitiled to a smaller percentage of stock if they elect to exercise the conversion privilege. In this situation, however, any gain received by the common shareholder is wholly dependent upon whether the holders of convertible preferred stock or debentures choose to exercise their conversion privilege. Obviously, if the conversion privilege is never used, which is not unlikely when the ratio is lowered, the common shareholders realize no increase in their proportionate stockholdings. One commentator has stated:

> It is difficult to discern the element of income that inures to the holders of common stock when all that happens is that those holding senior convertible securities suffer a reduction in their potential ability to convert their holdings to common stock. The decrease in the conversion ratio would not appear—at the moment of decrease—to have resulted in any economic gain to the common stockholders.[161]

Thus, until the convertible stock is converted pursuant to the decreased ratio, the common shareholders have only a potential income asset that is not within the scope of taxable income.

The proposed regulations under section 305(b)(4) provide for the taxation of shareholders who are issued preferred stock that is redeemable after a specific period at the election of the corporation or the shareholders at a price higher than the issue price. This distribution represents a gain that may accrue to a shareholder provided a contingent event occurs. If the redemption privilege is vested with the corporation, as it is in most cases,[162] it is likely that the corporation will be unwilling or financially unable to exercise the right, especially if the redemption price is fairly substantial. At the date the shareholder receives the stock, therefore, the proposed taxable increment—the amount that the redemption price exceeds the sum of the issue price and a reasonable call premium—is only "potential income" and does not constitute a taxable gain.

The taxation of certain distributions of convertible preferred stock under section 305(b)(5) also is questionable because of the nontaxability

161. Libin & Moorehead, *supra* note 73, at 264.

162. *See* D. HERWITZ, BUSINESS PLANNING 297-99 (1966).

of "potential income." As mentioned previously, a stock dividend of convertible preferred stock may be taxable as a disproportionate distribution if the conversion privilege is available for only a short period. In this situation, however, any income to shareholders rests upon the contingency that only some of the shareholders will exercise the conversion privilege. At the date of distribution, the shareholders have not realized a taxable gain because the only event that will give rise to an increase in proportionate interest—other shareholders selling their convertible preferred stock—will occur, if at all, at a future date. Moreover, it is foreseeable that favorable stock market conditions might encourage all shareholders to exercise their conversion privilege, in which case there would be no change in the proportionate holdings of stock.

In addition to the challenge that "potential income" is not within the concept of taxable income, the taxation of "potential income" can be challenged under the fifth amendment. The substantive due process requirements of the fifth amendment preclude the federal government from using arbitrary and unreasonable measures to obtain the property of individual citizens.[163] In applying this prohibition to the field of taxation, however, the courts have adopted a strict standard for determining unreasonableness. In order for a taxpayer to prevail, he must show that the tax in question is "a wholly arbitrary thing . . . unrelated to privilege or benefit."[164] It could be argued that the taxation of "potential income" under section 305 is palpably unreasonable and therefore violates the fifth amendment's substantive due process requirements.[165] Although the courts traditionally have been unreceptive to similar challenges to federal tax laws, the soundness and reasonableness of this argument might prove persuasive to future courts.

Although many shareholders may be in a position to challenge taxation of stock dividends and "deemed distributions," these shareholders should realize that several disadvantages may result from the successful use of these arguments. Since the basis of these arguments is the potential nature of the gain, it logically follows that a shareholder holding potential income items receives taxable income when the

163. *See* 1 C. ANTIEAU, MODERN CONSTITUTIONAL LAW § 3:11 (1969); 16A C.J.S. *Constitutional Law* § 568(b)(1) (1956).

164. Burnet v. Wells, 289 U.S. 670, 679 (1933).

165. This approach was perhaps suggested by Professor Lowndes when he stated: "From this point of view the constitutionality of taxing a particular item as income resolves itself into an inquiry into whether congress has acted reasonably in imposing the tax." *See* Lowndes, *supra* note 118, at 182.

potentiality disappears. At this date, the shareholder realizes income to the extent of the fair market value of the stock, taxable at ordinary income rates, and the Commissioner will undoubtedly take this position.[166] Taxation in this manner would be detrimental to a shareholder if the stock had appreciated in value since the distribution date. If the distribution had been taxed on the date it was made, the shareholder would have bcen taxed at ordinary income rates on the stock's current fair market value, and any subsequent appreciation in value would have been taxed at capital gains rates. Delaying taxation until the potentiality disappears, however, results in the shareholder losing favorable capital gains treatment on the appreciated value. It is advisable, therefore, for shareholders who receive an actual stock dividend and foresee its appreciation to refrain from ehallenging any attempt to immediately tax the distribution.

The postponement of taxation on a stock distribution, however, will be advantageous to other shareholders. A shareholder who believes the potentiality will never disappear, for example, will certainly want to challenge attempted taxation at the date of distribution. A shareholder might fall within this category if he receives stock with a wide disparity between the issue price and the redemption price and if he suspects that the corporation will never redeem his stock. Moreover, if the distribution in question involves stock that may depreciate in value, shareholders would be wise to try to postpone the tax until the stock's value is less than its value at the date of distribution. Further, shareholders who receive "deemed distributions" should challenge the initial taxation. By postponing the tax, these shareholders are not foregoing favorable capital gains treatment since they received no new tangible asset that they can subsequently sell.[167] Additionally, the possibility always exists that the stock underlying the "deemed distribution" will depreciate in value, which will reduce the value of the distribution when it is taxed. Furthermore, those shareholders who find it inconvenient to absorb additional income at the date of distribution will want to challenge any initial taxation of the distribution.

166. The Commissioner takes a similar position on the taxation of stock options that do not have readily ascertainable market values. *See* note 146 *supra*.

167. Shareholders in this category, however, should note that they may in effect be foregoing capital gains treatment by the postponement of a tax if the Commissioner asserts the following argument: the percentage increase in proportionate interest "deemed" to the shareholder becomes a part of the value of his stock and, upon the subsequent sale of that stock, the portion of the proceeds equal to the pereentage increase is taxable at ordinary income rates, with only the remainder of the proceeds taxable at capital gains rates.

B. *Challenges to the Commissioner's Determination of Increases in Proportionate Interests*

The 1969 Amendments reinstate the "proportionate interest" standard of stock dividend taxation. Although this standard is the basis of all the 1969 Amendments, sections 305(b)(2), 305(b)(5), and 305(c) are the only provisions that expressly specify that shareholders who receive increases in their proportionate stockholdings realize taxable income. The immense difficulty encountered prior to 1954 in deciding whether a particular distribution resulted in the requisite proportionate change will undoubtedly again plague the courts,[168] since the 1969 Amendments provide no definition of an increase in proportionate interest. Several arguments against taxation under the proportionate interest standard are available to taxpayers. First, a shareholder should argue, in an appropriate situation, that he did not receive any increase in his proportionate interest. This contention brings into direct conflict the Commissioner's and the shareholder's methods of determining the requisite increase. This antipathy, however, is not novel, since it arose frequently prior to 1954, and the contentions of the parties are familiar. The Commissioner probably will argue, as he did prior to 1954, that the shareholder experienced an increase in his proportionate interest because the distribution increased his proprietary interest in the corporation. The shareholder, on the other hand, will contend that the proper approach is a strict legal percentage test, under which the shareholder receives the requisite increase only if his percentage interest in the corporation materially changes. Strong authority to support the shareholder's argument is supplied by the companion cases of *Strassburger v. Commissioner* and *Helvering v. Sprouse*,[169] in which the Supreme Court expressly adopted the legal percentage test. Two Circuit Courts of Appeals subsequently affirmed this standard over the objection of the Commissioner.[170] Since these cases have not been overruled, they should be persuasive authority to sustantiate the shareholder's position.

Shareholders also can contend that although they experienced an increase in their proportionate interests, the increase was not substantial and therefore not a sufficient gain to support an income tax. The case

168. *See* Libin & Moorehead, *supra* note 73, at 264.

169. 318 U.S. 604 (1943). For a discussion of these and similar cases see notes 32-34 *supra* and accompanying text.

170. *See* Wiegand v. Commissioner, 194 F.2d 479 (3d Cir. 1952); Tourtelot v. Commissioner, 189 F.2d 167 (7th Cir. 1951). For a discussion of these cases see notes 37-41 *supra* and accompanying text.

law prior to 1954 supports this position.[171] Furthermore, during the formulation of the 1969 Amendments the Senate Finance Committee mentioned that a de minimis approach might be applicable to the taxation of disproportionate distributions under section 305(b)(2). Specifically, the Committee stated that a distribution should not be taxed if it, together with all distributions during the prior 36-month period, did not increase the shareholder's proportionate interests more than one-tenth of one percent.[172] Although the Committce's maximum limit of one-tenth of one percent appears somewhat arbitrary, the principle cannot be questioned. If the increase in the shareholder's stock interest is minimal, his proportionate interest in the corporation has not really changed and he has, in effect, merely received additional stock certificates that represent his same interest in the corporation. Under the rationale of *Eisner v. Macomber* and the general rule of nontaxability embodied in section 305(a), a de minimis distribution would not produce taxable income. The following example illustrates a possible application of this theory. Suppose a shareholder owns 250 shares of common stock of a corporation that has 2,000,000 shares of common stock outstanding. The shareholder holds a one-eightieth of one percent interest in the corporation. If he receives or is "deemed" to receive a disproportionate distribution of 250 shares of common stock, his interest will be increased by one-eightieth of one percent, giving him an interest of approximately one-fortieth of one percent. Although the shareholder might experience a sizeable economic benefit as a result of this distribution, if the stock he receives maintains a high market value, under the de minimis approach the increase in his proportionate interest would be too insubstantial to warrant the imposition of a tax.[173]

VI. Conclusion

The 1969 Amendments mark the beginning of a new era in the taxation of stock dividends. Although the full impact of the Amendments cannot be determined until final regulations are promulgated, several general conclusions can be made at this time that will be applicable irrespective of the positions taken by the regulations. The 1969 Amendments, for instance, will not significantly affect either the

171. *See* note 35 *supra* and accompanying text.

172. *See* S. Rep. No. 91-552, 91st Cong., 1st Sess. (1969), *reprinted in* 2 U.S. Code Cong. & Ad. News 2186 (1969).

173. One writer apparently supports this view: "For example, how can taxable gain result from imputing a stock dividend to a shareholder who has 10 shares out of 35,000,000?" *See* Comment, *supra* note 61, at 391.

stock dividend policies of most widely held corporations or the taxation of their shareholders, at least as long as these corporations issue only pro rata stock dividends and implement methods of capital adjustment that do not alter the proportionate interests of their shareholders. On the other hand, closely-held and acquisition-minded corporations that have previously utilized stock plans to create disproportions among shareholders will be significantly affected by the 1969 Amendments, which were enacted specifically to arrest the present and future use of these stock plans. Although some corporations will be able to qualify their disproportionate stock plans under the transitional rules applicablc to 305(b)(2), many will probably find that these rules are inapplicable to their plans and therefore will have to alter their current policy of stock distributions. For corporations that desire to continue the use of disproportionate stock plans, however, there are alternatives other than the complete abandonment of their plans. The taxation of several disproportionate stock plans, for example, is constitutionally questionable on the ground of the nontaxability of "potential income." Moreover, the Commissioner's determination that a shareholder has experienced an increase in his proportionate interests may be subject to attack in certain situations. If the taxation of a proposed stock plan is open to challenge on thcse grounds, it might be wise, if the shareholders agree, to implemcnt the plan and litigate the validity of any resulting taxation of the shareholders. Irrespective of the nature of a corporation and its prior stock dividend history, all corporations that plan to issue stock dividends or adjust their capital structure should carefully study section 305 and the regulations promulgated thereunder. If planning and study are not undertaken, the complexity and breadth of section 305 will unfortunately become another of the "tax traps for the unwary" that are replete in the law of federal taxation.

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