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The Undistributed Profits Tax and Stock Dividends and Stock Rights

BY ELLSWORTH C. ALVORD

ADMINISTRATION spokesmen urge, in their defense of the undistributed-profits tax, that dividends need not be paid in cash.[1] Admitting that cash is frequently not available for dividends, they assure us that a corporation may nevertheless gain a "dividends-paid" credit by recourse to suggested alternative devices. Foremost among their suggested devices is the distribution of dividends in stock or stock rights.[2]

One of the first advocates of an undistributed-profits tax as an instrument of social reform was Rexford G. Tugwell. The sponsors of the present law adopted his theory of a corporate-surplus tax for economic reform, although this purpose seems to have been carefully camouflaged in its presentation to Congress. Ironically enough, they overlooked the fact that Professor Tugwell was seeking, among other reforms, an effective curb on stock dividends. He suggested that a tax on corporate surpluses would furnish "a salutary check upon present practices in issuing stock dividends and concealing earnings for manipulative purposes." [3] Now, however, the sponsors of the tax are recommending stock dividends as an unrestricted avenue of escape from all its harsh features!

But, is it true that dividends in stock or stock rights offer an easy escape? Many corporations, having depleted their treasuries by cash distributions to avoid the tax last year, are now strongly tempted to resort to such a dividend. It is particularly appropriate, therefore, to examine the soundness of the suggestion.

Let us suppose that the directors of a small corporation are contemplating the use of such dividends. They will certainly ask

[1] Statement of Arthur H. Kent, acting chief counsel, Bureau of Internal Revenue, House hearings on revenue bill of 1936, at p. 582; statement of Herman Oliphant, general counsel for the Treasury Department, Senate hearings on the revenue bill of 1936, at p. 909; and Arthur H. Kent, address before Economic Club, Chicago, Ill., Feb. 18, 1937, pp. 11–13.

[2] Other devices suggested are dividends in bonds, scrip and other obligations, options of cash or stock, and cash dividends coupled with an attractive offer to purchase new stock. This article, however, is limited to a consideration of dividends in stock or stock rights.

[3] *The Industrial Discipline*, Columbia University Press, 1933.

about the corporation's charter and the applicable laws of the state of incorporation. They will also inquire about the practical aspects of stock distributions. What formalities are necessary? How much time will be consumed? What will be the cost? What will be the effect on the capital structure of the corporation, and on its credit? These are questions which no directorate can ignore.

Finally, they will want to assure themselves that the proposed dividend in stock or rights will be taxable to the stockholders. Indeed, if there is any conceivable doubt as to the taxability of the paper dividend, the corporation cannot afford to use it. There is, first, the risk of a retroactive undistributed-profits tax, if the issue is ultimately decided adversely to the corporation. There is also the unwelcome prospect of battling with the corporation's own stockholders, as well as the Government, over the taxability of the dividend.

It is obvious, then, that a dividend in stock or rights can be used to avoid the undistributed-profits tax in a particular case only if—

(1) It can be legally declared;
(2) It is practicable, and financially sound; and
(3) It is taxable to the stockholders.

Legal Restrictions

Whether a corporation can declare dividends in stock or stock rights will depend, first of all, upon the provisions of its charter. If the corporate charter permits distributions to stockholders only of "cash or property," the dividends in stock or rights are not clearly permissible. While this can be remedied by appropriate charter amendment, the process is a lengthy one, and requires the consent of the stockholders. Often, as a practical matter, the difficulties of charter amendment will bar such dividends.

Even where the issuance of stock dividends is permissible under the corporate charter, some jurisdictions either prohibit stock dividends entirely,[4] or restrict the power to issue them.[5] For instance, a statute providing that stock may be issued only for money, services or property may be found to be a bar to stock

[4] 11 Fletcher, *Cyclopedia Corporations* (1932), section 5360.
[5] See, *Smith* v. *Cotting*, 231 Mass. 42, 120 N. E. 177 (1918).

dividends.[6] In the case of public-utility and other companies subject to governmental regulation, the consent of the governing authority may be required before stock dividends can be issued.[7] It must be remembered, too, that these restrictions are quite likely to be fortified by penalties upon directors who disregard them.[8]

Even where neither the charter nor state law prohibits the declaration of stock dividends, as such, there are other statutory provisions which may prove an effective restraint. The payment of dividends—in stock, as well as in cash or in property—may be prohibited if the capital of the corporation is impaired, or if it has insufficient earnings.[9] Moreover, there is no correlation between the state laws defining the "surplus" or "profits," from which those laws permit dividends to be paid, and the rules of Federal taxation for determining "net income"—an entirely different "animal," but yet the one upon which the undistributed-profits tax is based. Here, again, as indicated above, directors who are motivated by tax considerations in declaring stock dividends may find that they have incurred severe penalties under state laws.

Where none of the foregoing prohibitions is applicable, still another obstacle may present itself. As will be pointed out in greater detail below, if a dividend in stock or stock rights is to be taxable, it will generally be necessary for the corporation to pay the dividend upon any given class of shares in stock (or rights to acquire stock) of another class.[10] Such dividends necessarily distort the relative equities of the various classes of securities outstanding, and seldom do the directors have power to effect such a distortion.

Ohio, for example, provides that: "No dividend shall be paid to the holders of any class of stock in violation of the rights of the holders of any other class of shares." [11] Minnesota permits

[6] *United Hosiery Mills Corp.* v. *Stevens*, 146 Tenn. 531, 243 S. W. 656 (1922); *Fitzpatrick* v. *Dispatch Publishing Company*, 83 Ala. 604, 2 So. 727 (1887).

[7] *Public Service Commission* v. *Consolidated Gas, Electric Light and Power Company of Baltimore*, 148 Md. 90, 129 Atl. 22 (1925).

[8] See, e.g., *Grafton County Electric Light and Power Company* v. *State*, 77 N. H. 539, 94 Atl. 193 (1915).

[9] See, Fletcher, op. cit. supra; and *Williams* v. *Western Union Telegraph Co.*, 93 N. Y. 162 (1883).

[10] See, point (3), infra, "Taxability."

[11] Sec. 38 of the Ohio General Code.

such a dividend only with the written consent or vote of two-thirds of the stockholders affected thereby.[12] Several other jurisdictions follow the uniform corporation act by providing that "no dividend payable in shares of any class shall be paid to shareholders of any other class unless the articles so provide, or such payment is authorized by the vote of the holders of a majority of the shares of the class in which payment is to be made." [13]

These restrictions—all having their origin in state law—are not merely scattered examples. They are found in the statutes and decisions of many states. Any corporation they touch will find it difficult, and often impossible, to declare a dividend in stock or stock rights.

Practical Considerations

If state laws present no obstacle, any board of directors which has under consideration the declaration of a dividend in stock or rights must be satisfied that such a dividend is practicable and financially sound.

There is, first of all, the question of time. Where all the authorized stock is outstanding, time must be allotted for stockholders' meetings, amendment of the certificate of incorporation, filing, etc. Often there are complications of fractional shares which require time to resolve. Perhaps the consent of senior stockholders will have to be obtained for a stock dividend on junior classes. Again, it might be necessary to register the stock under state "blue-sky" laws, and in some circumstances, under the securities act of 1933.

The time element is important because the stock dividend must be declared and in the hands of the stockholders before the end of the taxable year. Frequently, the necessity for resorting to stock in lieu of cash will not be apparent until late in the year, when it is too late to take the necessary steps to issue it.

The cost of new stock issues must also be counted. There will be filing fees and other financing charges. The cost burden will

[12] Sec. 21 III (d) of the Minnesota business-corp. act, Minn. Laws 1933, c. 300.

[13] See, for example, sec. 129 of the Idaho Code Ann. (1932) title 29; sec. 12 of the Indiana gen. corp. Act, Ind. Acts 1929, c. 215; sec. 26 V, Louisiana business-corp. act, La. Acts 1928, No. 258, pp. 409 et. seq., as amended; sec. 703 of the Pennsylvania business-corp. laws, Pa. Laws 1933, No. 106, pp. 364 et. seq.; sec. 24 VI of the Washington uniform business-corp. act, Wash. Laws 1933, c. 185.

be particularly heavy if the securities have to be registered. This is probably of little concern to large corporations, but it is the small corporation which, most frequently, must turn to devices for conserving cash.

Again, the corporation may have difficulty determining the amount of the dividends-paid credit it can secure by issuing stock or rights. The credit is based on the market value of the stock or rights at the time of payment, and not by their par value.[14] Corporations in financial straits probably will not be able to claim the full par value of the stock—if they can issue stock dividends at all. Small corporations, whose securities are not listed or traded over the counter, will have no accurate measure of the market value of their stock and rights. A contest with the Bureau of Internal Revenue over the proper value seems inevitable, and possibly litigation will follow. Since only 4,000 out of 400,000 corporations in the United States have stock listed on recognized exchanges, valuation disputes promise to be the ordinary and not the unusual situation.

If the corporation can surmount the hurdles of time and cost and market value, it may still find that its plans for issuing stock or rights are blocked by non-consenting stockholders. An issue of preferred stock on common, for instance, usually requires the consent of holders of the outstanding preferred. How often will preferred stockholders consent to a dilution of their equities?

Finally, the effect of dividends in stock or stock rights upon the financial structure of the corporation must be considered. Many financial observers agree with Professor Tugwell that the trend in this direction is unsound and undesirable. Some of their objections may be summarized as follows:

(1) The stock dividend tends to produce over-capitalization. It becomes progressively easier to impair capital and progressively more difficult to market additional stock.

(2) Stock dividends give an impetus to stock-market speculation. An impression is created that the company is in a position to pay cash dividends on an enlarged capital base. Speculators are thus stimulated to bid up the price above the inherent value of the stock.

(3) Preferred stock dividends tend to separate the ownership of the corporation from its control. Ownership is concentrated in

[14] Sec. 27(e) of the revenue act of 1936; and article 27(e)-1, reg. 94.

the preferred without voting rights, while control remains in the common stock with only a speculative interest in the earnings. Many of the abuses of corporation finance have been attributed to this tendency.

(4) Dividends of preferred stock are often only a "stop-gap" solution to the problems of the corporation. If the preferred stock has a fixed rate of return, the corporation must ultimately pay cash dividends on an enlarged base.

(5) Stock dividends and rights put a heavy burden on the stockholder. He receives a "paper" dividend which is taxable, but no money to pay the tax. The small stockholder is often forced to sell his stock or rights in order to pay the tax, decreasing his equity in the corporation.

Taxability

(a) *Stock Dividends*—The taxability of stock dividends is admittedly a subject in which great confusion exists. No lawyer can speak with confidence on all the situations presented, and seldom can a corporation obtain positive assurance that a particular stock distribution will be taxable to its stockholders.

Until recently, it was supposed that all stock dividends were non-taxable, owing to the early decision of the Supreme Court in *Eisner* v. *Macomber*.[15] In May, 1936, the Supreme Court, in *Koshland* v. *Helvering*,[16] held that a distribution of common stock to holders of preferred stock was a taxable dividend, since it altered the relative interests of the stockholders. Following this decision, cases have sprung up like mushrooms, involving all manner and kind of stock dividends. There are a number of recent lower-court decisions, and several cases are on appeal in the Supreme Court. So controversial are the issues, however, that the Treasury Department has refused to take a definite position on any point not yet adjudicated by the Supreme Court.[17]

In so far as it is clear, the present law on the taxability of stock dividends may be summarized as follows:

(1) A distribution of common stock to the holders of common stock is non-taxable.[18]

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[15] 252 U. S. 189 (1920).
[16] 298 U. S. 441 (1936).
[17] See, article 115–7, reg. 94.
[18] *Eisner* v. *Macomber*, supra.

(2) A distribution of common stock to the holders of preferred stock is taxable if both classes of stock are already outstanding and are not held proportionately by the same stockholders.[19]

(3) A distribution of preferred stock to the holders of common stock has likewise been held to be taxable, the conditions being the same as under (2), above.[20]

(4) A distribution of preferred stock to the holders of common stock, there being no preferred stock previously outstanding, has been held to be non-taxable.[21]

(5) It has not been decided whether a distribution of preferred stock to the holders of preferred stock is taxable or non-taxable, although arguments may be made in favor of the taxability of such a distribution.[22] Nor has it been decided whether a distribution of common on preferred stock, or vice versa, is taxable where both classes of stock are held proportionately by the same stockholders.[23]

It is apparent that many corporations, because of limitations of their capital structure, cannot make a constitutionally-taxable stock dividend. Small corporations having only common stock outstanding will be the principal victims.

Other corporations will find that the only available type of stock dividend falls into one of the presently doubtful categories. For them, the device entails too great a risk, an unhappy choice being penalized by the heavy burdens of the undistributed-profits tax.

Still other corporations will find that a proposed stock dividend cannot be readily classified under any of the existing categories. Material variations may exist between the relative rights of their stockholders and those of the stockholders in the cases noted above. Variations of this character may spell entirely different tax consequences. For such corporations, too, the use of the stock-dividend device involves undue risks.

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[19] *Koshland* v. *Helvering*, supra.

[20] *James H. Torrens*, 31 B.T.A. 787 (1934); see *H. C. Gowran*, 32 B.T.A. 820 (1935), rev'd. 87 F. (2d) 125 (C.C.A. 7th, 1937), cert. granted May 17, 1937; *Annie E. Pfeiffer*, unreported decision of B.T.A. (1936), rev'd. 88 F. (2d) 3 (C.C.A. 2d, 1937), cert. granted May 17, 1937.

[21] See, *August Horrman*, 34 B.T.A. 1178 (1936); *Frances Elliott Clark*, 28 B.T.A. 1225 (1933), aff'd. 77 F. (2d) 89 (C.C.A. 3rd, 1935); *Pearl B. Brown, Executrix*, 26 B.T.A. 901 (1932), aff'd. 69 F. (2d) 602 (C.C.A. 7th, 1934), cert. denied 293 U. S. 570 (1934); *Alfred A. Laun*, 26 B.T.A. 764 (1932).

[22] See, e.g., Magill, *Taxable Income* (1936), p. 48; and *Legislation* (1936) 50 Harvard Law Rev. 332, 335.

[23] Cf. the cases cited in note 21, supra.

The Bureau of Internal Revenue has made a polite gesture toward the solution of some of these difficulties. A statement of bureau policy indicates that a tentative dividends-paid credit will be granted to a corporation making a stock distribution of doubtful taxability—but *only* if the corporation files a waiver of its tax liability pending the final determination of the stockholders' liabilities, either by closing agreements signed by all the stockholders or by final adjudication in court.[24]

But will all stockholders willingly sign closing agreements consenting to the taxability of such a stock dividend in their hands? If even one refuses, the fate of the distribution will be determined only by litigation extending beyond the taxable year in which the dividends-paid credit is claimed. If the dividend is finally held to be non-taxable, the Government will be protected in its claim for undistributed-profits taxes by the waiver furnished by the corporation. It will then be too late for the corporation to make other distributions to avoid the penalty tax.

The bureau policy, therefore, has not cleared the murky air surrounding this subject. The protection is wholly one-sided, assuring the Government of its revenue, but in no way easing the precarious position of the corporation with a borderline case.

(b) *Taxability of Stock Rights*—The Treasury Department regards the taxability of stock rights as following the rules applicable to stock dividends.[25] Rights are therefore taxable only if they relate to stock which would have been taxable if distributed directly.[26]

Thus, all the uncertainties as to the taxability of stock dividends exist with respect to the taxability of stock rights. To add to the confusion, however, a recent case has thrown doubt on the taxability of rights to acquire stock where the taxability of the stock itself is clear. In the case of *Commissioner* v. *Palmer*,[27] rights were issued by a corporation to acquire stock in another corporation. The Government attempted to tax the receipt of such rights as taxable income on the theory that the stock itself would have been taxable[28]. The circuit court of appeals for the first circuit held that income did not arise upon the *receipt* of

[24] I. T. 3037, XVI-1 Int. Rev. Bull. 2 (1937).
[25] Article 115–7, Reg. 94.
[26] *Miles* v. *Safe Deposit & Trust Co.*, 259 U. S. 247 (1922).
[27] 88 F. (2d) 559 (C.C.A. 1st, 1937).
[28] *Peabody* v. *Eisner*, 247 U. S. 347 (1918).

the rights, but only upon the *sale* or *exercise* of such rights. This decision is in conflict with the decision of the seventh circuit on a similar issue.[29] The Supreme Court has granted certiorari in both cases. Until the Supreme Court resolves the conflict—and it may or may not do so before the end of the year—corporations cannot be certain whether the issuance of any stock right will be effective to avoid the undistributed-profits tax.[30]

Conclusion

Summarizing briefly, it appears that the stock dividend is not legally available in a number of states. In some, the device is outlawed completely by state law. In others, there are restrictions which accomplish the same result. Directors of corporations in these states face an unpleasant dilemma: liability under state law if they declare a dividend, or a severe penalty tax upon the corporation if they do not.

As a practical matter, the machinery is costly, cumbersome, time-consuming. It is unpopular with stockholders, who often have the power to prevent its consummation. And many observers regard the device as financially unsound, and damaging to the corporate structure.

Finally, as a tax problem, there is no assurance—with one or two exceptions of limited availability—that a dividends-paid credit will follow from a stock dividend. Moreover, even where a credit is assured, the amount of the credit is likely to be subject to prolonged dispute. If a corporation lacking ready cash turns to the stock dividend, it should realize that the device is not an assured means of escape from the undistributed-profits tax, but a gambling proposition. If a corporation can afford to gamble with its tax liabilities, the stock dividend may offer a solution to its problems—but it should be warned that the odds are heavily against it.

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[29] *Commissioner* v. *Mayer*, 86 F. (2d) 593 (C.C.A. 7th, 1936).

[30] Since the preparation of this article the Supreme Court has decided the *Palmer* case (November 8, 1937). It was held that a distribution of corporate profits (i.e., a dividend) did not take place upon the issuance of rights and their receipt by stockholders, but that such a dividend did take place on the exercise of the rights. It was also held that taxable income might result from the sale of such rights. This holding seems to nullify the effectiveness of the stock-right device as a means of obtaining an immediate dividends-paid credit under section 27 (e) of the 1936 act.