2 T.C. 147 (1943)

The receipt and exercise of pro rata stock rights to purchase preferred stock by a common stockholder does not constitute a taxable dividend if a pro rata distribution of the preferred stock itself would not have been a taxable dividend.

Summary

Charles M. Cooke, Ltd. (Petitioner), a common stockholder in Hawaiian Electric Co., Ltd. (Electric), received rights to purchase Electric's newly issued preferred stock. The rights had a fair market value. The Tax Court held that the receipt and exercise of these rights did not constitute a taxable dividend to the Petitioner. The court reasoned that because a direct distribution of the preferred stock would not have been a taxable dividend under the Supreme Court's decision in *Strassburger v. Commissioner*, the distribution via stock rights was also non-taxable. This case clarifies the tax implications of stock rights in relation to dividend taxation.

Facts

Electric had 250,000 shares of common stock outstanding. Electric's shareholders voted to increase its capital stock by creating 50,000 shares of series A preferred stock. Electric's directors then offered these preferred shares to existing common stockholders via subscription rights, pro rata, at $20 per share. Petitioner, owning 99,000 shares of Electric common stock, received 99,000 rights to purchase 19,800 shares of the preferred stock. The fair market value of these rights was $0.36 per right. The Petitioner exercised these rights, purchasing the preferred stock.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in the Petitioner's income tax, arguing the stock rights constituted a taxable dividend. The Petitioner appealed to the Tax Court. The Tax Court ruled in favor of the Petitioner, holding that the receipt and exercise of the stock rights did not result in a taxable dividend. The decision was entered under Rule 50, requiring a recomputation of the deficiency due to the abandonment of another issue by the Petitioner.

Issue(s)

Whether the receipt and exercise of stock rights to purchase preferred stock, issued pro rata to common stockholders, constitutes a taxable dividend when a direct distribution of the preferred stock itself would not have been a taxable dividend.

Holding

No, because under the Supreme Court's ruling in *Strassburger v. Commissioner*, a pro rata distribution of preferred stock to common stockholders (where the common stock is the only class outstanding) is not a taxable dividend; therefore, the

© 2025 SCOTUSreports.com. All rights reserved.

distribution of rights to purchase that stock is also not a taxable dividend.

Court's Reasoning

The Tax Court relied heavily on the Supreme Court's reversal of *Strassburger v. Commissioner*, which held that a distribution of preferred stock to common stockholders was not a taxable event. The court reasoned that to be taxable, "there must be a change brought about by the issue of shares as a dividend whereby the proportional interest of the stockholder after the distribution was essentially different from his former interest." Because a direct distribution of the preferred stock would not have been taxable under *Strassburger*, the court concluded that distributing rights to acquire that stock also could not be a taxable dividend. The court distinguished the case from situations where the sale of unexercised rights might alter the proportional interests of stockholders, noting that such a change would be due to the sale itself, not the issuance of the rights. The court explicitly declined to follow *Helen Whitney Gibson, 44 B.T.A. 950*, which had held a similar distribution to be taxable.

Practical Implications

This case provides a clear rule regarding the taxability of stock rights. It establishes that if a direct distribution of stock would not be a taxable dividend, then the distribution of rights to acquire that stock is also not taxable. This decision impacts how corporations structure stock offerings and how investors evaluate the tax implications of receiving and exercising stock rights. Legal practitioners must analyze whether the underlying stock distribution would be taxable under the principles established in *Strassburger* to determine the taxability of related stock rights. Later cases have further refined the concept of what constitutes a change in proportional interest, but this case remains a key precedent for understanding the basic principle.

© 2025 SCOTUSreports.com. All rights reserved.