20 T.C. 264 (1953)

A stock dividend is taxable as income if it results in a change in the stockholder's proportionate interest in the corporation.

Summary

The Webb Furniture Company, with both common and preferred stock outstanding, redeemed some of its preferred shares for the purpose of distributing them as a dividend on the remaining preferred stock. The petitioner, John A. Messer, Sr., owned both preferred and common stock. The distribution changed Messer's proportionate interest in the corporation, as well as that of other preferred stockholders. The Tax Court held that the dividend constituted income under Section 115(f)(1) of the Internal Revenue Code, as the distribution altered the proportional interests of the shareholders.

Facts

John A. Messer, Sr. was a stockholder, board member, and chairman of the board of Webb Furniture Company. In 1947, Webb Furniture had 3,000 shares of no par value common stock and 3,000 shares of $100 par value preferred stock. In June 1947, the company reacquired 450 preferred shares from Galax Mirror Company and 422 preferred shares by canceling stock accounts of Messer's relatives. Subsequently, Webb issued 872 shares of its preferred stock as a dividend to its preferred stockholders. Messer, who previously owned 479 shares of preferred, received 193 additional shares as his portion of the dividend. This increased his percentage of ownership of preferred stock from 15.9667% to 22.4%.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Messer's income tax for 1947, arguing that the stock dividend constituted taxable income. Messer contested this determination, leading to a case before the United States Tax Court.

Issue(s)

Whether the stock dividend received by the petitioner in 1947 constitutes income under Section 115(f)(1) of the Internal Revenue Code and is thus includible in his gross income.

Holding

Yes, because the distribution of the stock dividend resulted in a change in the proportional interests of the stockholders, making it taxable as income under Section 115(f)(1) of the Internal Revenue Code.

Court's Reasoning

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The court relied on the principle established in *Koshland v. Helvering*, which states that a stock dividend is taxable as income if it gives the stockholder an interest different from that which their former stock holdings represented. The court distinguished this case from *Eisner v. Macomber*, which held that a dividend of common stock upon common stock is not income if it does not change the stockholder's proportional interest. In *Messer*, the distribution of preferred stock to preferred stockholders increased their percentage of ownership. Specifically, Messer's percentage of ownership in the preferred stock increased from 15.9667% to 22.4%. The court stated, "Here the percentages of stock ownership did not remain the same. We have here '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.'" The court rejected Messer's argument that the dividend resulted in a loss to him because it placed an additional burden on the common stock, of which he owned a substantial portion. The court reasoned that dividends are taxed when distributed, even if the distribution reduces the value of the stock.

Practical Implications

This case reinforces the principle that stock dividends are not always tax-free. Attorneys must carefully analyze the impact of stock dividends on shareholders' proportionate interests in the corporation. If a stock dividend alters the proportional interests of shareholders, it is likely to be treated as taxable income. This ruling clarifies that even if a shareholder argues that the dividend negatively impacts the value of their other holdings, the dividend is still taxable if it increases their proportional ownership in the class of stock on which the dividend was paid. Later cases applying this ruling would focus on whether the distribution resulted in a demonstrable change in proportionate ownership to determine tax implications.

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