

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date November 6, 1943

To Chairman Eccles

Subject: Taxation of stock dividends.

From Richard A. Musgrave *R. A. M.*

After checking with Mr. Stam of the Joint Committee for Internal Revenue and with the Bureau of the Comptroller of the Currency, I find that there is no substance in the Pratt statement that a change in the tax treatment of stock dividends is impending.

The Supreme Court has ruled repeatedly that stock dividends are not income in the sense of the 16th Amendment, and, therefore, not taxable unless their distribution results in a definite change in the distribution of the equity of the corporation among the stockholders. Common stock dividends are thus taxable to holders of preferred stocks but not to holders of common stocks and vice versa. Mere differences in certain characteristics, such as voting rights, between the outstanding stock and the stock dividend do not justify taxation. There must be a definite change in the stockholders' equity in the corporation. The Court first established this position in Eisner vs. Macomber in 1920 and reaffirmed it last year in R. A. Sprouse vs. Commissioner of Internal Revenue. Last year's case invalidated a Bureau of Internal Revenue ruling under which a dividend of nonvoting common stock was held taxable to the holders of voting common shares.

Undoubtedly, the tax treatment of stock dividends will have to be reconsidered at some future date when the whole problem of coordinating the taxation of corporate and individual incomes is tackled. However, this is a problem of postwar--and hardly immediate postwar--tax reform. It is entirely unlikely that Congress will act on the matter this year, nor does it seem likely that action will be taken next year.

If stock dividends should become taxable at some future date, the question would arise as to whether banks should be given special treatment. Mr. Upham, Deputy Comptroller of the Currency, told me that his office would no doubt recommend the exemption of national banks from any such rule. According to him, there has been no flood of inquiries by banks, and there has been only the usual number of requests for stock dividend permits.

The prospect of a change in the tax treatment of stock dividends seems much too uncertain and remote to warrant any adjustment in current dividend policies of banks.