utes requiring the fulfillment of conditions precedent to the exercise of free speech can operate as effectively to restrain an individual as would a penal statute. Where this is the situation, such statutes should, logically, also be invalidated. Consequently, the court in the *Danskin* case might well be serving notice that it will not tolerate any limitation whatsoever upon freedom of expression by a statute calculated to circumvent the judicial test applicable to penal statutes, where the statute in question operates with equal effectiveness to inhibit the freedom of expression. A general adoption of this view would operate to extend the clear and present danger test to all instances where the legislature seeks to regulate freedom of expression, an extension which has been urged by various writers.[19] It has also been suggested that states should actively encourage freedom of expression as a necessary prerequisite for an enlightened society.[20] In many communities the achievement of such a goal is necessarily dependent upon the acquisition of a meeting-place usually under the control of a public agency. Certainly the California Supreme Court, in requiring that where public auditoriums are to be used for meetings they must be made available without prior restraints, is clearing the way for a greater freedom of expression.

Income Taxation—Dividend-on Purchases—Dividends from Capitalized Earnings Taxable to One becoming Stockholder after Capitalization—[Federal].—Between 1916, when it was organized, and 1932, a corporation had sold 8,840 shares of $100 par value common stock at $100 per share. Between 1921 and 1924, corporate earnings were capitalized through the distribution of non-taxable common stock dividends. In 1932, by a reduction of par value from $100 to $25, the capital stock account was written down and a capital surplus was created. Subsequent earnings were carried in an earned surplus account. In 1939 a cash dividend of $9 per share was distributed; $0.4489 of this was debited to earned surplus (thereby exhausting the earned surplus account) and $8.5511 was debited to the capital surplus account. Plaintiff, an officer of the corporation, who had purchased 12,120 of 23,417 outstanding shares at an aggregate cost of $206,845 between 1931 and 1939, treated that part of the dividend which had been debited to capital surplus as a return of capital and reported only the $0.4489 per share as a taxable dividend. The commissioner determined that the entire distribution was a taxable dividend since the source of the capital surplus created by the par value reduction was the undistributed earnings which had been capitalized upon the issuance of the previous stock dividends. The Tax Court upheld the commissioner. On petition of review to the circuit court, *held*, the previous non-taxable stock dividends had not changed earnings to capital, and the fact that the plaintiff was not a distributee of such a dividend but a pur-

[19] Chafee, Freedom of Speech (1920). For a discussion of related problems see Corwin, Freedom of Speech and Press under the First Amendment: a Résumé, 30 Yale L. J. 48 (1920); Willis, Freedom of Speech and of the Press, 4 Ind. L. J. 445 (1929).

[20] Reisman, Civil Liberties in a Period of Transition 88 (1942).

chaser from a distributee did not make the distribution a return of capital to the plaintiff; that the result would be the same whether or not the plaintiff had knowledge of the prior stock dividend. Judgment affirmed. *Long v. Com'r of Int. Rev.*[1]

The instant case presents in a slightly disguised form the familiar dividend-on problem, and raises the question of whether the disguise warrants a different treatment from the somewhat curious results reached in the ordinary dividend-on case.

That the character of corporate earnings cannot be changed by a non-taxable stock dividend so that a subsequent cash distribution will be considered a capital distribution would seem to be an inevitable consequence of the *Eisner v. Macomber*[2] doctrine. However, until recently it had been held that if earnings had been capitalized in good faith[3] or for a valid business purpose,[4] a subsequent distribution out of a capital surplus arising from a capital reduction was not taxable as ordinary income. Recent cases[5] have removed this qualification from Section 115(h)[6] of the Internal Revenue Code.

The petitioner apparently recognized the futility of urging the good faith or valid business purpose argument, but contended that although the distribution might be taxable as ordinary income to the original recipient of the stock dividend, to him it was a return of capital since the earnings had been capitalized before he became a stockholder.

In so doing the petitioner was making the traditional argument of the taxpayer in the dividend-on case: namely, that the purchase price reflects surplus accumulations[7] and hence any distribution of such accumulations, whether out

[1] 155 F. 2d 847 (C.C.A. 6th, 1946).

[2] 252 U.S. 189 (1920). This has been expressed in Hormann v. Com'r of Int. Rev., 34 B.T.A. 1178 (1936): "The provisions of the statute relating to distribution are concerned with the effect on the corporation. The aim is to tax the stockholder the income realized by him through the distribution of earnings or profits accumulated..... This aim would be defeated if a non-taxable stock dividend were treated as diminishing the amount of earnings and profits available for subsequent distribution." Ibid., at 1183.

[3] Patty v. Helvering, 98 F. 2d 717 (C.C.A. 2d, 1938); Com'r of Int. Rev. v. Cordingley, 78 F. 2d 118 (C.C.A. 1st, 1935); Com'r of Int. Rev. v. Brown, 69 F. 2d 602 (C.C.A. 7th, 1934).

[4] Com'r of Int. Rev. v. Quackenbos, 78 F. 2d 156 (C.C.A. 2d, 1935); Bedford's Estate v. Com'r of Int. Rev., 144 F. 2d 272 (C.C.A. 2d, 1944); De Nobili Cigar Co. v. Com'r of Int. Rev., 143 F. 2d 436 (C.C.A. 2d, 1944).

[5] Com'r of Int. Rev. v. Estate of Bedford, 325 U.S. 283 (1945); Kirschenbaum v. Com'r of Int. Rev., 155 F. 2d 23 (C.C.A. 2d, 1946).

[6] "Effect on earnings and profits of distribution of stock.—The distribution (whether before January 1st, 1939, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities, of stock or securities in another corporation, or of property or money shall not be considered a distribution of earnings or profits of any corporation..... (2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment....." 52 Stat. 496 (1938), 26 U.S.C.A. § 115 (h).

[7] Since the taxpayer in the instant case purchased his shares at a price considerably below book value, it might be questioned whether the purchase price did reflect such accumulations. The exact significance of this fact cannot be evaluated since there is no indication of the rela-

of earned or capital surplus, is really a return of investment and not gain to one becoming a stockholder subsequent to such accumulations.[8] A purchase under these conditions is characterized as dividend-on.[9]

When one buys shortly before the declaration of an earnings dividend it is settled that the purchaser must include the dividend in his gross income, even though the value of his stock drops after such dividend.[10] In what may now be regarded as a dubious holding[11] because of a change in phraseology of a treasury regulation,[12] it was held that dividends received by one who purchased stock after the declaration of a dividend but before the record date would be treated as taxable income to the purchaser. However, purchase of stock and dividend rights after the record date operate as an assignment of an account receivable so that the dividend is not taxable to the purchaser.[13]

Whether the one new characteristic of the instant case—that the source of the distribution was capitalized earnings rather that earned surplus—affords the petitioner a valid distinction, suggests a review of the reasons advanced for the results in the typical dividend-on situation.

The results in the dividend-on situation have been justified on various grounds. In *United States v. Phellis*,[14] Mr. Justice Pitney remarked that the tax was only apparently a tax on capital and that when one purchased dividend-on the purchase price would be discounted by the prospect of a taxable distribu-

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tion between book and actual value. In any event, the court ignored this aspect and hence there is justification for advancing the general proposition.

[8] The fall in market price equals the amount of the dividend received, hence the dividend-on purchaser is in no better position for having received the dividend. Schabacker, Stock Market Theory and Practice 353 (1930). See generally, Magill, Realization of Income Through Corporate Distributions, 36 Col. L. Rev. 519 (1936); Powell, Income from Corporate Dividends, 35 Harv. L. Rev. 363 (1922); Maggs, Computation of Income, 13 Calif. L. Rev. 13 (1924).

[9] United States v. Phellis, 257 U.S. 156, 171 (1921). "In buying at a price that reflected the accumulated profits, he of course acquired as a part of the valuable rights purchased the prospect of a dividend from the accumulations—bought 'dividend on' as the phrase goes—and necessarily took subject to the burden of the income tax proper to be assessed against him by reason of the dividend if and when made."

[10] Rippel v. Com'r of Int. Rev., 12 B.T.A. 438 (1928); Moore v. Com'r of Int. Rev., 22 B.T.A. 366 (1931); Frieder v. Com'r of Int. Rev., 27 B.T.A. 1239 (1933).

[11] Jemison v. Com'r of Int. Rev., 28 B.T.A. 514 (1933).

[12] In 1936, Treas. Reg. 74, Sec. 22(a) (1928), which stated that if stock were sold between dividend dates the entire amount of the dividend would be income to the vendee, was reworded so that it now reads: "The fact that a dividend is declared shortly after the sale of corporate stock and the sale price is influenced by the expectation of the payment of a dividend, does not make such dividend when paid taxable to the vendor as a dividend . . . ." Treas. Reg. 111, Sec. 29.22(a)–1 (1946). Thus the current Regulation leaves in doubt the tax consequences of a dividend when there has been a sale after declaration but before record date. See Mertens, Law of Federal Income Taxation § 9.129 (1942); C.C.H. Fed. Tax. Serv. ¶51.674 (1946).

[13] Gladstone Co., Ltd. v. Com'r of Int. Rev., 35 B.T.A. 764 (1937).

[14] 257 U.S. 156 (1921).

tion.[15] This rationalization has been criticized for failing to recognize that the uncertainty attendant dividend distributions both as to size and time makes an informed discount impossible and also that the individual purchaser cannot discount for his own tax liability when purchasing through an impersonal market.[16]

The argument of Mr. Justice Pitney, however, does suggest a valid justification—that the possibility of a taxable distribution is one of the risks to be considered by the purchaser. The essence of this rationale is that the purchaser has knowledge that there exist accumulated earnings from which a taxable distribution can be made. If such earnings have been capitalized a mere examination of the corporate balance sheet will not reveal a potential taxable distribution and hence notice would not be brought to the purchaser. The notice requirement might be satisfied even here, however, since it could be said that the prospective purchaser is under a duty to investigate the corporate financial operations to determine whether earnings have ever been capitalized. Notice could have been readily imputed to the petitioner in the instant case because of his position as an officer and controlling stockholder of the corporation. However, the court did not rely on the notice argument but stated that "whether or not the petitioner had knowledge of the prior stock dividends is immaterial."[17]

Another justification supporting the separation of gain and tax burden is the administration problem which would be presented were the Treasury Department to determine in each instance which part of a dividend was accumulated before a taxpayer became a stockholder and which part was accumulated subsequent to that time.[18] One writer advancing this position recognizes that although this argument has merit in the case of ordinary recurrent dividends, the administrative burden would not be quite so great in the case of extraordinary dividends which would be less frequent and would have greater tax consequences to the recipient.[19] The distribution in the instant case would seem to qualify as an extraordinary dividend and hence could justify the administrative investigation necessary to determine that the earnings had been accumulated prior to the time when the petitioner became a stockholder.

None of these justifications approaches the basic problem pointed up by the taxation without gain which results from dividend-on purchases. It is suggested

[15] ". . . . if an investor happened to buy stock shortly before the dividend, paying a price enhanced by an estimate of the capital plus the surplus of the company, and after distribution of the surplus, with corresponding reduction in the intrinsic and market value of the shares, he were called upon to pay a tax upon the dividend received, it might look in his case like a tax on capital. But it is only apparently so . . . . presumably the prospect of a dividend influenced the price paid, and was discounted by the prospect of an income tax to be paid thereon." United States v. Phellis, 257 U.S. 156, 171–72 (1921). The dividend-on problem was discussed only by analogy to the main issue—the tax consequences in a corporate reorganization following the distribution of stock of the new corporation as a dividend to the stockholders of the old corporation.

[16] Powell, op. cit. supra note 8, at 371.

[17] Long v. Com'r of Int. Rev., 155 F. 2d 847, 850 (C.C.A. 6th, 1946).

[18] Maggs, op. cit. supra note 8, at 26; Magill, op. cit. supra note 8, at 531–32.

[19] Maggs, op. cit. supra note 8, at 26.

that they are not persuasive since they are concerned only with the plight of the purchaser. The problem arises out of the capital gains system, which treats any increase between cost and selling price of stock as a capital gain and not ordinary income to the seller, despite the fact that such gain may be attributable in part, at least, to undistributed corporate earnings which have been accumulated while the seller has been a stockholder. Unless, then, such earnings are to escape taxation as ordinary income completely they must be taxable to someone other than the one who has received the benefit of such earnings. To hold otherwise would mean that revenue from the taxation of dividends would depend on the fortuitous timing of the sale of stock just prior to dividend distributions. On this analysis the element of notice or assumption of risk is not material, and that the earnings have been capitalized does not offer any protection to the purchaser. The only significant inquiry is whether or not earnings are being distributed.

A comparison of the treatment accorded dividend-on purchasers with the tax consequences of other distributions of corporate earnings indicates, however, that the earnings distribution criterion is not consistently applied; a different treatment has been permitted if the distribution has been to an "intervening purchaser" in a stock redemption, or even to an original stockholder in liquidation.

The "intervening purchaser" is protected when stock originally issued as a non-taxable dividend involving the capitalization of earnings is redeemed under circumstances indicating that the redemption is "essentially equivalent to the distribution of a taxable dividend."[20] It has been held in this situation that the redemption price, although taxable as ordinary income to the extent that it represents previously capitalized earnings if the stock is redeemed from an original recipient of the non-taxable dividend, is a return of capital if redeemed from an "intervening purchaser" of the stock.[21] The criterion applied here is not whether the distribution is one of corporate earnings but whether it is gain to the recipient.

A valid reason can perhaps be advanced for the different treatment accorded taxpayers in these similar situations. The intervening purchaser in the stock redemption situation loses his entire equity since he exchanges his stock interest for the cash distribution, hence to him the stock redemption, although a distribution of corporate earnings, is a final return of capital. The dividend-on purchaser, however, does not lose his equity interest after a dividend is paid. Future corporate earnings may restore the value of his stock, but if he sells before

[20] "Redemption of Stock.—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend." 52 Stat. 496 (1938), 26 U.S.C.A. § 115(g).

[21] Parker v. United States, 88 F. 2d 907 (C.C.A. 7th, 1937); see Com'r of Int. Rev. v. Cordingley, 78 F. 2d 118 (C.C.A. 1st, 1935).

that time the capital loss which he will be allowed will be some compensation for the tax he had to pay on the dividend. The dividend-on purchaser, hence, is in a better position to recoup the tax expense than would be the purchaser in the stock redemption situation, and although in each case corporate earnings are being distributed, the interest of each taxpayer, when weighed against the general interest of all taxpayers in seeing that the tax-burden is fairly distributed, might justify a different treatment.

Solicitude for the interest of the individual taxpayer as opposed to that of taxpayers generally seems to be carried too far in a third type of corporate distribution—total liquidation of the corporation. Here the entire distribution is treated as a return of capital,[22] even though earnings are being distributed and even though the distribution may be to one who was a stockholder while such earnings were accumulated. Such treatment could be justified if it was limited in its application only to "intervening purchasers" whose position would be that of "intervening purchasers" in the stock redemption situation. If either the distribution of earnings test or the individual gain test were applied to the liquidation situation, at least part of the corporate earnings would not escape taxation as ordinary income.

The unintentional, rough balancing of individual and general interests, and the conflicting results which have been pointed up, are an unavoidable consequence in a tax system which accords special treatment to capital gains and losses. Taxation without gain and distribution of earnings without taxation result from a failure to tax corporate earnings to those who were stockholders at the time such earnings were accumulated. The only solution would seem to be to remove stock transactions, insofar as they reflect accumulated corporate earnings, from the capital gains concept, for it is this special treatment accorded stock sellers which makes necessary stop-gap rules in the treatment of distributions to stock buyers. A number of ways of accomplishing this result have been suggested,[23] such as taxing earnings through the corporation or treating any gain or loss on sale as ordinary gain or loss.[24] The instant case suggests once again that particular tax problems cannot be solved without regard to more radical changes necessary in the entire tax structure.

[22] 52 Stat. 496 (1938), 26 U.S.C.A. § 115(c). "Distributions in Liquidation.—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. . . . ."

[23] Simons, Personal Income Taxation 153 (1938); Twentieth Century Fund, Facing the Tax Problems 164–71, 476–84 (1937); James, Irascible Comments on the Revenue Laws, 9 Univ. Chi. L. Rev. 58, 67 (1941); Simons, Federal Tax Reform, 14 Univ. Chi. L. Rev. 20, 49 (1946).

[24] The latter plan would be combined with an averaging-out system of income determination so that there would be no unreasonable burden in any one tax period. Corporate distributions would not be taxable as such, but would reduce the stockholder's basis; the reduced basis would result in a greater gain on sale or other realization—such as death or gift transfer—thereby correlating tax burden and individual gain.