fer and time of death on stock transferred in contemplation of death should be included in the transferor's estate for tax purposes. The Tax Court there held, with four dissents, that small annual dividends of common stock, representing a capitalization of current earnings, declared on common stock should be so included. The court based its conclusion on the ground that the proportionate interest in the corporation represented by the original shares had not changed; the stock dividends were simply a readjustment of the number of shares expressing that interest. As a result, decedent's gross estate was valued for estate tax purposes as if she had continued to own the original stock and the stock dividends until death.

The Court of Appeal of England reached a contrary result in *Attorney General v. Oldham.*[5] Under a statutory provision[6] essentially similar to Section 2035(a), the court reasoned that the dividend stock was given by the corporation rather than the decedent and thus could not have been part of the original disposition. The *McGehee* result appears preferable. Had the corporation declared a stock split it would seem clear that the donor's gift should include the additional stock. Otherwise the property that is brought back for tax purposes would constitute only a fraction of what was originally given.[7] The only real difference between a stock split and a stock dividend is that the latter is given different accounting treatment—a transfer from retained income to capital account of an amount equal to the fair value of the additional shares.[8] It is difficult to see why the corporation's accounting treatment should affect what is considered the "property transferred."[9]

The four dissenting judges in *McGehee* contended that since the dividends were created out of retained income earned subsequent to the transfer they were not part of the "property" passing under the original gift.[10] But the

[5] [1940]1 K.B. 599, aff'd [1940] 2 K.B. 485. See Inheritance Taxes—Stock Dividend Declared and Paid after Inter Vivos Gift of Shares Held Exempt from Estate Duty on Donor's Death, 54 Harv. L. Rev. 512 (1941).

[6] Finance Act, [1894], §§ I, 2(1)(c); Customs and Inland Revenue Act, [1881], § 38(2), as amended by Customs and Inland Revenue Act, [1889], § II(1), and Finance Act, [1910], § 59(1).

[7] See Eisner v. Macomber, 252 U.S. 189 (1920).

[8] The essential significance of this accounting requirement is "that the directors cannot, without incurring personal liability, pay out in dividends a sum which infringes on the amount designated as 'stated capital.'" Dewing, Corporation Securities 88 (1934). See also Company Manual, New York Stock Exchange, §§ A14-A15 (1955), and Acc. Res. Bull. No. 11, (Rev.), Committee on Accounting Procedure, American Institute of Accountants (1953).

[9] This reasoning would also seem to prevent the drawing of a distinction between a 100% stock dividend and a 1% stock dividend, though it has been suggested that the smaller distribution is analogous to "income." See Cohen, Surrey, Warren and Tarleau, A Technical Revision of the Federal Income Tax Treatment of Corporate Distributions to Shareholders, 52 Col. L. Rev. 1, 11 n.36 (1952).

[10] The effect of the valuation-at-time-of-death rule would be greatly limited by the minority's approach since increased valuation due to current earnings would not be counted in the decedent's estate if capitalized by a stock dividend. This is especially important since most stock dividends are declared out of current earnings. Dewing, note 8 supra at 99.

section taxing transfers in contemplation of death anticipates fluctuations in value between the time of transfer and the date of death; it is the fair market value at death, not at the time of gift, that is included in decedent's gross estate.[11] If a corporation increases its net assets after a transfer and no stock dividends are declared, this increase would presumably be reflected in the market value of the stock originally transferred. The capitalization of this increased value per share by a stock dividend is no reason for different tax treatment.

Since income derived from transferred property is not brought back for estate tax purposes,[12] it could be argued that those stock dividends which are taxed as income under the 1954 Code should not be included in decedent's gross estate. An examination of the present rules, however, indicates that this position is undesirable. The income status of most stock dividends other than common on common[13] is determined by whether, within the shareholder's lifetime, the dividend stock is sold or redeemed while the underlying stock is retained.[14] It would seem inappropriate to determine the question of what property the donor transferred by reference to the behavior of the donee. Also, since estates are usually closed as quickly as possible, it would be impractical to have the estate's tax evaluation await a subsequent disposition of dividend stock.

It has been suggested that the adoption by *McGehee* of the proportionate interest theory may raise difficulties similar to those previously encountered in the income tax field.[15] The theory was first propounded in the leading case of *Eisner v. Macomber*,[16] where it was employed to determine whether stock dividends should be included in the shareholder's taxable income. The Supreme Court held that since a dividend of common on common, with no other class

[11] Treas. Reg. 105, § 81.10, U.S. Code Congressional and Administrative News (1956). Cf. Igleheart v. Commissioner, 77 F.2d 704 (C.A. 5th, 1935).

[12] Commissioner v. Estate of Gidwitz, 196 F.2d 813 (C.A. 7th, 1952); Estate of James E. Frizzel, 9 T.C. 979 (1947), aff'd sub nom. Burns v. Commissioner, 177 F.2d 739 (C.A. 5th, 1949); Proposed Treas. Reg. § 20.2035-1(e) (1956). Cf. Maass v. Higgins, 312 U.S. 443 (1941).

[13] Int. Rev. Code § 306(c)(1)(A) (1954).

[14] Int. Rev. Code § 306 (1954).

[15] Surrey and Warren, Comment on McGehee, CCH Federal Taxation—Current Law and Practice ¶2628 (1957). For a full analysis of the proportionate interest theory and the problems it created, see Magill, Taxable Income, c.2 (rev.ed., 1945); Alvord and Biegel, Basis Provisions for Stock Dividends under the 1939 Revenue Act, 49 Yale L.J. 841 (1940); Eichholz, The Revenue Act of 1939 and the Basis of Stock Dividends and Rights, 40 Col.L.Rev. 404 (1940); Lowndes, The Taxation of Stock Dividends and Stock Rights, 96 U. of Pa. L.Rev. 147 (1947); Rottschaefer, Present Taxable Status of Stock Dividends in Federal Law, 28 Minn.L.Rev. 106, 163 (1944); Simons, Federal Tax Reform, 14 U. of Chi.L.Rev. 20, 47-54 (1946); Dean, The Stock Dividend, 32 Taxes 586 (1954); Kanter, The Present Taxable Status of Stock Dividends, 31 Taxes 418 (1953).

[16] 252 U.S. 189 (1920).

of stock outstanding, failed to change the shareholder's proportionate interest in the corporation, no income was received.[17] This test left the way open for attempts at converting what might have been ordinary income into capital gain through stock "bail-out" schemes which preserved the current proportionate interests in the corporation.[18] Some of the consequent stock dividend plans became so complex and the test so refined that "in many cases it [was] virtually impossible to ascertain the taxability of a stock dividend."[19] As a result, Congress eliminated the proportionate interest test[20] from the income tax field in the 1954 Code.[21]

However, it seems reasonable to conclude that the problems which the proportionate interest theory brought before the courts in income tax litigation will seldom arise in the estate tax field. There are relatively few instances in which the question arises as to whether stock dividends should be brought back into an estate for estate tax purposes.[22] Moreover, it is difficult to conceive of any tax avoidance planning which would induce transferors to arrange for stock dividends on shares transferred.[23] In support of this conclusion it is worth noting that *McGehee* was a case of first impression.

Nevertheless, the case does present problems. If stock rights are distributed on shares transferred in contemplation of death, under the *McGehee* case the proportionate interest test determines whether the rights should be brought back for estate tax purposes,[24] but it does not aid in evaluating what is brought back. Suppose, for example, a corporation issued to its shareholders stock rights

[17] Conversely, it was later held that dividends of preferred stock to common stockholders, with both classes outstanding, constituted taxable income. Helvering v. Gowran, 302 U.S. 238 (1937).

[18] Typically, the corporation would issue a non-taxable preferred stock dividend with the understanding that it would soon be redeemed, enabling the shareholders to receive cash at capital gains' rates. See Chamberlin v. Commissioner, 207 F.2d 462 (C.A. 6th, 1953).

[19] Report of the House Committee on Ways and Means on H.R. 8300, 83d Cong. 2d Sess., 33–34 (1954).

[20] Id., at A81.

[21] Present income tax treatment of stock dividends is governed by Int. Rev. Code §§ 305–306 (1954).

[22] In addition to gifts in contemplation of death, the issue of includibility arises under the 1954 Code when shareholders transfer stock and retain some right "to designate the persons who shall possess or enjoy" the stock transferred, Section 2036(a)(2); when the transferor retains a reversionary interest in the stock transferred (to a third person or trust) which "immediately before the death of the decedent exceeds 5 percent of the value" of the stock, and "possession or enjoyment of the property can . . . be obtained only by surviving the decedent," Section 2037(a); and when the transfer is revocable, Section 2038(a).

[23] Such tax planning would require: (1) a transfer in contemplation of death; (2) influence with the corporation sufficient to have a stock dividend declared; (3) proportionate interests altered by the dividend; (4) death of the transferor within three years of the gift. See Int. Rev. Code § 2035(b) (1954).

[24] Presumably, includibility of the rights would depend on the kind of stock covered by the rights and the kind of stock with respect to which the rights were issued.

enabling them to purchase for $30 stock then selling at $40. Suppose, further, that on the date of the decedent's death the stock was worth $60. Assuming proportionate interests have not been changed by this issue, the question arises as to what amount should be included in the decedent's estate. The easiest approach would be to bring back $30—the difference between the share's value at the date of death and the amount needed to exercise the right—regardless of what the donee did with the stock right.[25] Support for this position might be gained from the argument that the value of the property transferred should not be determined by the behavior of the donee. However, such an approach appears to be oversimplified. If a stock right was exercised immediately upon declaration it would seem preferable to have its $10 value at that time brought back along with one-fourth of the $20 increase in value of the share purchased. The one-fourth of $20 represents the amount of the gain earned by the stock right; three-fourths represents the amount earned by the donee's investment. If the stock right was not exercised immediately, its value and the ratio between its value and the amount invested by the donee might change but the same rule should apply. It would be inequitable to include in the decedent's estate for tax purposes that portion of the increased value of the share in no way attributable to the "property transferred."[26] On the other hand, if the stock right was not exercised and did not expire, the estate should include the full $30 as the donee has made no investment. And, it follows that if the right had expired nothing can be brought back since the right would have no value at time of death.

Another problem concerns the question of whether the proportionate interest test is an adequate tool when applied to preferred on common, a popular form of dividend. If only common stock is outstanding, it is clear that proportionate interests are not changed. Yet the usual preferred stock protection provisions[27] often given the common shareholder security he did not have before. And it is difficult to see how the decedent can be deemed to have transferred an interest not represented by the shares actually given. Perhaps a better approach would be to consider, in addition to the proportionate interest test, whether a new kind of interest was received by the donee.[28] Such a test, however, might introduce added complexity and vagueness which it would be better to avoid by undeviating application of the proportionate interest test.[29]

[25] Cf. Bensel v. Commissioner, 36 B.T.A. 246 (1937).

[26] Cf. Proposed Treas. Reg. § 20.2035-1(e) (1956) (The value of additions and betterments to property by the transferee is not included in the transferor's gross estate for tax purposes.).

[27] Graham and Dodd, Security Analysis 309–313 (1951).

[28] See Koshland v. Helvering, 298 U.S. 441 (1936).

[29] See Strassburger v. Commissioner, 124 F.2d 315 (C.A. 2d, 1941).