

United States Vs. Phellis

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Appeal No. : 257 U.S. 156

Appellant : United States

Respondent : Phellis

Judgement :

United States v. Phellis - 257 U.S. 156 (1921)

U.S. Supreme Court United States v. Phellis, 257 U.S. 156 (1921)

United States v. Phellis

No. 260

Argued October 11, 1921

Decided November 21, 1921

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APPEAL FROM THE COURT OF CLAIMS

SYLLABUS

1. Substance, and not form, should control in the application of the Sixteenth Amendment and the income tax laws enacted under it. P. [257 U. S. 168](#) .
2. The Income Tax Law of October 3, 1913, in declaring that the tax shall be laid on gains, profits, and income derived from dividends, means not that everything in the form of a dividend must be treated as income, but that income derived in the way of dividends shall be taxed. P. [257 U. S. 168](#) .
3. Income defined (p. [257 U. S. 169](#)) as in *Eisner v. Macomber*, [252 U. S. 189](#) .
4. With the concurrence of 90% of the stockholders of a corporation, a plan of reorganization was effected, pursuant to which a new corporation with an authorized capital stock nearly four times as great in par value as the aggregate stock and bonded indebtedness of the old was formed under the laws of a different state, all the assets of the old were transferred to the new, as a going concern, including the goodwill and a large surplus, and, in consideration, the old corporation retained money enough to redeem part of its bonds and received (1) the new company's debenture stock of par value sufficient to redeem the remainder, retire its own preferred stock, and leave in its treasury an amount equal in par value to its own outstanding common stock, and (2) the new company's common stock of par value double the amount of the old company's outstanding common stock, which the latter immediately distributed to its common stockholders as a dividend, paying them two shares of the new for each of the old. Upon completion of the transaction, October 1, 1915, the personnel of the stockholders and officers of the two corporations was identical, the stockholders having proportionate

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holdings in each, but less than one-half of the new company's authorized stock had been issued. Thereafter, the old corporation continued as a going concern, but, except for the redemption of its bonds and retirement of its preferred stock, and the holding of the debenture stock equal to its common, and collection and disposition of the dividends thereon, did no business.

HELD

(a) The shares of the new company's common stock which passed to the old company and through it to its stockholders as a dividend, representing its surplus, were income of the shareholders, taxable under the Act of October 3, 1913. P. [257 U. S. 169](#) .

(b) And this although the market value of the stockholder's old shares before the dividend was the same as that of his old and new shares after it. P. [257 U. S. 170](#) .

(c) The new company must be regarded not as substantially identical with the old, but as a separate entity, and its stockholders as having property rights and interests materially different from those incident to ownership of stock in the old company. P. [257 U. S. 172](#) .

(d) The new common stock in the treasury of the old company being treasury assets representing accumulated profits and capable of distribution, its distribution transferred to the several stockholders new individual property which they were severally entitled to enjoy or to sell -- their individual income. P. [257 U. S. 174](#) .

56 Ct.Clms. 157, reversed.

Appeal from a judgment sustaining a claim for a refund of moneys paid under protest in discharge of an income tax assessment.

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MR. JUSTICE PITNEY delivered the opinion of the Court.

The court below sustained the claim of C. W. Phellis for a refund of certain moneys paid by him under protest in discharge of an additional tax assessed against him for the year 1915 based upon alleged income equivalent to the market value of 500 shares of stock of a Delaware corporation called the E. I. du Pont de Nemours & Co., received by him as a dividend upon his 250 shares of stock of the

E. I. du Pont de Nemours Powder Company, a New Jersey corporation. The United States appeals.

From the findings of the Court of Claims, read in connection with claimant's petition, the following essential facts appear: in and prior to September, 1915, the New Jersey company had been engaged for many years in the business of manufacturing and selling explosives. Its

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funded debt and its capital stock at par values were as follows:

5% mortgage bonds	\$ 1,230,000
4 1/2% 30-year bonds.	14,166,000
Preferred stock (\$100 shares)	16,068,600
Common stock (\$100 shares).	29,427,100

Total	\$60,891,700

It had an excess of assets over liabilities, showing a large surplus of accumulated profits; the precise amount is not important, except that it should be stated that it was sufficient to cover the dividend distribution presently to be mentioned. In that month, a reorganization and financial adjustment of the business was resolved upon and carried into effect with the assent of a sufficient proportion of the stockholders in which a new corporation was formed under the laws of Delaware with an authorized capital stock of \$240,000,000, to consist in part of debenture stock bearing 6 percent cumulative dividends, in part of common stock, and to this new corporation all the assets and goodwill of the New Jersey company were transferred as an entirety and as a going concern, as of October 1, 1915, at a valuation of \$120,000,000; the new company assuming all the obligations of the old except its capital stock and funded debt. In payment of the consideration, the

old company retained \$1,484,100 in cash to be used in redemption of its outstanding 5 percent Mortgage bonds, and received \$59,661,700 par value in debenture stock of the new company (of which \$30,234,600 was to be used in taking up, share for share and dollar for dollar, the preferred stock of the old company and redeeming its 30-year bonds), and \$58,854,200 par value of the common stock of the new company, which was to be and was immediately distributed among the common stockholders of the old company as a dividend, paying them two shares of the new stock for each share they held

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in the old company. This plan was carried out by appropriate corporate action; the new company took over all the assets of the old company, and that company, besides paying off its 5 percent bonds, acquired debenture stock of the new company sufficient to liquidate its 4 1/2 percent 30-year bonds and retire its preferred stock, additional debenture stock equal in amount at par to its own outstanding common stock, and also two shares of common stock of the Delaware corporation for each share of the outstanding common stock of the New Jersey corporation. Each holder of the New Jersey company's common stock (including claimant) retained his old stock and, besides, received a dividend of two shares for one in common stock of the Delaware company, and the New Jersey corporation retained in its treasury 6 percent debenture stock of the Delaware corporation equivalent to the par value of its own outstanding common stock. The personnel of the stockholders and officers of the two corporations was on October 1, 1915, identical, the new company having elected the same officers as the old, and the holders of common stock in both corporations had the same proportionate stockholding in each. After the reorganization and the distribution of the stock of the Delaware corporation, the New Jersey corporation continued as a going concern, and still exists, but, except for the redemption of its outstanding bonds, the exchange of debenture stock for its preferred stock, and a holding of debenture stock to an amount equivalent to its own outstanding common and the collection and disposition of dividends thereon, it has done no business. It is not, however, in process of liquidation. It has received as income upon the Delaware

company's debenture stock held by it dividends to the amount of 6 percent per annum, which it has paid out to its own stockholders, including the claimant. The fair market value of the stock of the New Jersey corporation on September 30, 1915, prior to the reorganization, was \$795

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per share, and its fair market value, after the execution of the contracts between the two corporations, was, on October 1, 1915, \$100 per share. The fair market value of the stock of the Delaware corporation distributed as aforesaid was, on October 1, 1915, \$347.50 per share. The Commissioner of Internal Revenue held that the 500 shares of Delaware company stock acquired by claimant in the distribution was income of the value of \$347.50 per share, and assessed the additional tax accordingly.

The Court of Claims, observing that, from the facts as found, claimant's 250 shares of stock in the New Jersey corporation were worth on the market, prior to the transfer and dividend, precisely the same that the same shares plus the Delaware company's shares received by him were worth thereafter, and that he did not gain any increase in the value of his aggregate holdings by the operation, held that the whole transaction was to be regarded as merely a financial reorganization of the business of the company, producing to him no profit, and hence no income, and that the distribution was in effect a stock dividend nontaxable as income under the authority of *Eisner v. Macomber*, [252 U. S. 189](#), and not within the rule of *Peabody v. Eisner*, [247 U. S. 347](#).

We recognize the importance of regarding matters of substance and disregarding forms in applying the provisions of the Sixteenth Amendment and income tax laws enacted thereunder. In a number of cases besides those just cited, we have under varying conditions followed the rule. *Lynch v. Turrish*, [247 U. S. 221](#); *Southern Pacific Co. v. Lowe*, [247 U. S. 330](#); *Gulf Oil Corp. v. Lewellyn*, [248 U. S. 71](#).

The act under which the tax now in question was imposed (Act of October 3, 1913, c. 16, 38 Stat. 114, 166, 167) declares that income shall include, among other

things, gains derived

"from interest, rent, dividends, securities, or the transaction of any lawful business carried

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on for gain or profit, or gains or profits and income derived from any source whatever."

Disregarding the slight looseness of construction, we interpret "gains profits, and income derived *from* . . . dividends," etc., as meaning not that everything in the form of a dividend must be treated as income, but that income derived *in the way of* dividends shall be taxed. Hence, the inquiry must be whether the shares of stock in the new company received by claimant as a dividend by reason of his ownership of stock in the old company constituted (to apply the tests laid down in *Eisner v. Macomber*, [252 U. S. 189](#) , [252 U. S. 207](#)), a gain derived from capital, not a gain accruing to capital, nor a growth or increment of value in the investment, but a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital however invested, and coming in -- that is, received or drawn by the claimant for his separate use, benefit, and disposal.

Claimant's capital investment was represented by his New Jersey shares. Whatever increment of value had accrued to them prior to September 30, 1915, by reason of the surplus profits that theretofore had been accumulated by the company was still a part of claimant's capital, from which as yet he had derived no actual and therefore no taxable income so far as the surplus remained undistributed. As yet, he had no right to withdraw it or any part of it, could not have such right until action by the company or its proper representatives, and his interest still was but the general property interest of a stockholder in the entire assets, business, and affairs of the company -- a capital interest, as we declared in *Eisner v. Macomber*, *supra*, p. [252 U. S. 208](#) .

Upon the face of things, however, the transfer of the old company's assets to the new company in exchange for the securities issued by the latter, and the

distribution of those securities by the old company among its stockholders,

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changed the former situation materially. The common stock of the new company, after its transfer to the old company and prior to its distribution, constituted assets of the old company which it now held to represent its surplus of accumulated profits -- still, however, a common fund in which the individual stockholders of the old company had no separate interest. But when this common stock was distributed among the common stockholders of the old company as a dividend, then at once -- unless the two companies must be regarded as substantially identical -- the individual stockholders of the old company, including claimant, received assets of exchangeable and actual value severed from their capital interest in the old company, proceeding from it as the result of a division of former corporate profits, and drawn by them severally for their individual and separate use and benefit. Such a gain resulting from their ownership of stock in the old company and proceeding from it constituted individual income in the proper sense.

That a comparison of the market value of claimant's shares in the New Jersey corporation immediately before with the aggregate market value of those shares plus the dividend shares immediately after the dividend showed no change in the aggregate -- a fact relied upon by the Court of Claims as demonstrating that claimant neither gained nor lost pecuniarily in the transaction -- seems to us a circumstance of no particular importance in the present inquiry. Assuming the market values were a precise reflex of intrinsic values, they would show merely that claimant acquired no increase in aggregate wealth through the mere effect of the reorganization and consequent dividend, not that the dividend did not constitute income. There would remain the presumption that the value of the New Jersey shares immediately prior to the transaction reflected the original capital investment plus the accretions which had resulted through the company's

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business activities and constituted its surplus, a surplus in which, until dividend made, the individual stockholder had no property interest except as it increased the valuation of his capital. It is the appropriate function of a dividend to convert a part of a surplus thus accumulated from property of the company into property of the individual stockholders, the stockholder's share being thereby released to and drawn by him as profits or income derived from the company. That the distribution reduces the intrinsic capital value of the shares by an equal amount is a normal and necessary effect of all dividend distributions, whether large or small and whether paid in money or in other divisible assets, but such reduction constitutes the dividend nonetheless income derived by the stockholder if it represents gains previously acquired by the corporation. Hence, a comparison of aggregate values immediately before with those immediately after the dividend is not a proper test for determining whether individual income, taxable against the stockholder, has been received by means of the dividend.

The possibility of occasional instances of apparent hardship in the incidence of the tax may be conceded. Where, as in this case, the dividend constitutes a distribution of profits accumulated during an extended period and bears a large proportion to the par value of the stock, 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 was called upon to pay a tax upon the dividend received, it might look in his case like a tax upon his capital. But it is only apparently so. 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

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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. He simply stepped into the shoes, in this as in other respects, of the stockholder whose shares he acquired, and presumably the prospect of a dividend influenced the

price paid, and was discounted by the prospect of an income tax to be paid thereon. In short, the question whether a dividend made out of company profits constitutes income of the stockholder is not affected by antecedent transfers of the stock from hand to hand.

There is more force in the suggestion that, looking through and through the entire transaction out of which the distribution came, it was but a financial reorganization of the business as it stood before, without diminution of the aggregate assets or change in the general corporate objects and purposes, without change of personnel either in officers or stockholders, or change in the proportionate interest of any individual stockholder. The argument, in effect, is that there was no loss of essential identity on the part of the company, only a change of the legal habiliments in which the aggregate corporate interests were clothed; no substantial realization by individual stockholders out of the previous accumulation of corporate profits, merely a distribution of additional certificates indicating an increase in the value of their capital holdings. This brings into view the general effect of the combined action of the entire body of stockholders as a mass.

In such matters, what was done, rather than the design and purpose of the participants, should be the test. However, in this case, there is no difference. The proposed plan was set out in a written communication from the president of the New Jersey corporation to the stockholders, a written assent signed by about 90 percent of the stockholders, a written agreement made between the old company and the new, and a bill of sale made by the former

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to the latter, all of which are in the findings. The plan as thus proposed and adopted, and as carried out, involved the formation of a new corporation to take over the business and the business assets of the old; it was to be and was formed under the laws of a different state, which necessarily imports a different measure of responsibility to the public, and presumably different rights between stockholders and company and between stockholders *inter sese* than before. The articles of association of neither company is made to appear, but in favor of the

asserted identity between the companies, we will assume (contrary to the probabilities) that there was no significant difference here. But the new company was to have authorized capital stock aggregating \$240,000,000 -- nearly four times the aggregate stock issues and funded debt of the old company -- of which less than one-half (\$118,515,900) was to be issued presently to the old company or its stockholders, leaving the future disposition of a majority of the authorized new issues still to be determined. There was no present change of officers or stockholders, but manifestly a continuation of identity in this respect depended upon continued unanimous consent or concurrent action of a multitude of individual stockholders actuated by motives and influences necessarily to some extent divergent. In the light of all this, we cannot regard the new company as virtually identical with the old, but must treat it as a substantial corporate body with its own separate identity, and its stockholders as having property rights and interests materially different from those incident to ownership of stock in the old company.

The findings show that it was intended to be established as such, and that it was so created in fact and in law. There is nothing to warrant us in treating this separateness as imaginary, unless the identity of the body of stockholders and the transfer *in solido* of the manufacturing business and assets from the old company to the

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new necessarily have that effect. But the identity of stockholders was but a temporary condition, subject to change at any moment at the option of any individual. As to the assets, the very fact of their transfer from one company to the other evidenced the actual separateness of the two companies.

But, further, it would be erroneous, we think, to test the question whether an individual stockholder derived income in the true and substantial sense through receiving a part in the distribution of the new shares, by regarding alone the general effect of the reorganization upon the aggregate body of stockholders. The liability of a stockholder to pay an individual income tax must be tested by the

effect of the transaction upon the individual. It was a part of the purpose and a necessary result of the plan of reorganization, as carried out, that common stock of the new company to the extent of \$58,854,200 should be turned over to the old company, treated by it as assets to be distributed as against its liability to stockholders for accrued surplus, and thereupon distributed to them "as a dividend." The assent of the stockholders was based upon this as a part of the plan.

In thus creating the common stock of the new company and transferring it to the old company for distribution *pro rata* among its stockholders, the parties were acting in the exercise of their rights for the very purpose of placing the common stockholders individually in possession of new and substantial property rights *in esse*, in realization of their former contingent right to participate eventually in the accumulated surplus. No question is made but that the proceedings taken were legally adequate to accomplish the purpose. The new common stock became treasury assets of the old company, and was capable of distribution, as the manufacturing assets whose place it took were not. Its distribution transferred to the several stockholders new individual property rights which they

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severally were entitled to retain and enjoy, or to sell and transfer, with precisely the same substantial benefit to each as if the old company had acquired the stock by purchase from strangers. According to the findings, the stock thus distributed was marketable. There was neither express nor implied condition, arising out of the plan of reorganization or otherwise, to prevent any stockholder from selling it, and he could sell his entire portion or any of it without parting with his capital interest in the parent company or affecting his proportionate relation to the interests of other stockholders. Whether he sold the new stock for money or retained it in preference, in either case, when he received it, he received as his separate property a part of the accumulated profits of the old company in which previously he had only a potential and contingent interest.

It thus appears that, in substance and fact, as well as in appearance, the dividend received by claimant was a gain, a profit derived from his capital interest in the old company, not in liquidation of the capital, but in distribution of accumulated profits of the company; something of exchangeable value produced by and proceeding from his investment therein, severed from it and drawn by him for his separate use. Hence, it constituted individual income within the meaning of the Income Tax Law, as clearly as was the the case in *Peabody v. Eisner*, [247 U. S. 347](#) .

Judgment of the Court of Claims reversed, and the cause remanded, with directions to dismiss the suit.

MR. JUSTICE Mc REYNOLDS dissenting.

In the course of its opinion, citing *Eisner v. Macomber*, [252 U. S. 189](#) , [252 U. S. 213](#) , the Court of Claims declared:

"We think the whole transaction is to be regarded as merely a financial reorganization of the business of the company, and that this view is justified by the power and duty of the court to look through the form of the transaction

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to its substance."

And further:

"It seems incredible that Congress intended to tax as income a business transaction which admittedly produced no gain, no profit, and hence no income. If any income had accrued to the plaintiff by reason of the sale and exchange made, it would doubtless be taxable."

There were perfectly good reasons for the reorganization, and the good faith of the parties is not questioned. I assume that the statute was not intended to put an embargo upon legitimate reorganizations when deemed essential for carrying on important enterprises. *Eisner v. Macomber* was rightly decided, and the principle which I think it announced seems in conflict with the decision just announced.

MR. JUSTICE VAN DEVANTER concurs in this dissent.

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