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RECENT CASE

FEDERAL ESTATE TAX—GIFTS IN CONTEMPLATION OF DEATH—STOCK DIVIDENDS

A recent decision of the Court of Appeals, 5th Circuit, in *McGehee v. Commissioner* ——— F 2d ———, 58-2 U.S.T.C. ¶ 11,817 (1958) reversed a recent ruling of the Tax Court.¹

The deceased Delia McGhee, prior to her death in 1950, transferred to her husband in several installments, shares of stock in a Florida corporation. The transfers took place during the years 1947-49. The corporation whose stock was transferred followed the practice of capitalizing its earnings and pro rata issuing stock dividends. Both the Commissioner and the executor of the estate agreed that the gifts to the husband were given in contemplation of death and therefore to be included in the gross estate. But the Commissioner and the executor disagreed on the includibility of the stock dividends.²

The court of appeals held the process of evaluating stock dividends in the gross estate of the decedent was not governed by *Eisner v. Macomber*³—one of the metes and bounds of income tax law. A case in which it was said:

[the declaration of a stock dividend] “. . . is no more than a book adjustment, in essence not a dividend but rather the opposite; no part of the assets of the company is separated from the common fund, nothing distributed except paper certificates that evidence an antecedent increase in the value of the stockholder's capital interest resulting from an accumulation of profits by the company; . . . [A] charge is made against surplus account with a corresponding credit to the capital stock account equal to the proposed dividend; the new stock is issued against this and the certificates delivered to existing stockholders in proportion to their previous holdings.”⁴

The court in the instant case pointed out that there the Supreme Court was construing an income tax statute which was restricted in its operation by

¹ *McGehee v. Commissioner* 28 T.C. 412 (1957). For a comment on the Tax Court decision see 62 Dick. L. Rev. 280.

² The applicable statute here is the INT. REV. CODE OF 1939 § 811 (c) (1) (a) 53 Stat. 120. The present code maintains the same language with minor changes. INT. REV. CODE OF 1954 § 2035.

³ 252 U.S. 189 (1919).

⁴ *Id.* at 210.

the Sixteenth Amendment—while here the operative estate tax statute is not so affected.⁵

In the *McGehee* case the Commissioner contended that the “*proportionate interest* of the corporation, its business and its assets” (emphasis added) as represented by the original shares given by the wife, was the interest to be evaluated—and this static segment of proprietary interest was not changed by the issuance of stock dividends—but rather the total percentage of ownership in the hands of the stockholder was never changed by the issuance of the stock dividends, and therefore the stock dividends must be included.

The circuit court rejected this compelling argument which the Tax Court had accepted. But the circuit court was not so emphatic in their decision as to rule out once and for all the “proportionate interest” argument of the Commissioner, and undoubtedly it will be back again to engender further litigation.⁶

The court in the *McGehee* case did emphasize the fact that the stock dividends were based on earnings subsequent to the gift to the husband and therefore should not be included in the gross estate. In view of this decision the method of evaluating shares of stock could take on a new aspect, since under the 1939 regulations, shares of stock are to be evaluated at their fair market value on the applicable valuation date.⁷

Keeping this in mind as the method by which the taxpayer is to arrive at an evaluation—what is to be the resultant figure when earnings subsequent to the date of a transfer, deemed to have been made in contemplation of death, are the genesis of a rise in the fair market value of stock upon which no stock dividends have been declared? The earnings (post transfer) could be utilized in various methods to cause the fair market value to climb; e.g., by merely

⁵ Cf. *New York Trust Co. v. Eisner* 256 U.S. 345 (1921) where the constitutionality of federal estate taxes was questioned. The Court held that direct taxes which under the Constitution must be apportioned do not include a tax upon the net estates of decedents, since such a tax is a duty, or excise.

In this opinion written by Justice Holmes he supported his contention with the remark—“Upon this point a page of history is worth a volume of logic.”

⁶ The proportionate interest argument has previously been raised unsuccessfully by the Commissioner. See *Maas v. Higgins*, 312 U.S. 443 (1941)—rents, dividends and interest payments accruing between date of death and optional valuation date; *Commissioner v. Gidwitz*, 196 F. 2d 813 (1952)—income to an inter vivos trust deemed to have been established in contemplation of death (no control in settlor); *Commissioner v. McDermott*, 222 F. 2d 665 (1955)—income to an irrevocable inter vivos trust deemed to have been set up in contemplation of death—with emergency power in settlor to allocate income to beneficiaries (settlor was not a beneficiary).

⁷ Reg. 105, Sec. 81.10 (c) as amended by T.D. 5351 (1944) C.B. 579. The same treatment is continued under the present regulation. See Reg. 20.2031 (2).

It should be noted that the “fair market” evaluation is to be used where there are bona fide sale prices or bona fide bid and asked prices. Where such figures are not available see Reg. 20.2031-2 (f), which sets out other methods of computation of value, e.g. net worth prospective earning power, Company’s position in the industry etc.

adding to a treasury account by way of securities or cash, by purchasing subsidiary corporations or additional plant facilities, or by expanding the present plant facilities to a point where an improved relative market position is reflected in the fair market value of the stock.

Does the decision in the *McGehee* case mean that an extensive accounting procedure must or could be resorted to, so as to deduct pro rata the amount of earnings subsequent to the transfer in question from the fair market value on the applicable valuation date?⁸ It is the writer's opinion that it does not, and in the future the effect of the *McGehee* case will be limited by the express words of regulations 20.2031(2) which direct that a fair market value be used—and no deduction will be allowed; that the court's statement regarding earnings after the transfer will be limited to the sole situation where earnings *are* separated from stock transferred by means of stock dividends.

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⁸ Compare this argument with a literal reading of Reg. 20.2031-2 (e). . . .

(e) *Where selling prices or bid and ask prices do not reflect fair market value.* If it is established that the value of any bond or share of stock determined on the basis of selling or bid and ask prices provided . . . do not reflect the fair market value thereof then some reasonable modification of that basis or other relevant facts and elements of value are considered in determining the fair market value.