

2018

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### Recommended Citation

Newman, Joel S. (2018) "Two New York Tax Cases," *Touro Law Review*: Vol. 34: No. 1, Article 18.  
Available at: <https://digitalcommons.tourolaw.edu/lawreview/vol34/iss1/18>

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## TWO NEW YORK TAX CASES

*Joel S. Newman\**

Benjamin Cardozo wrote a number of opinions on New York State tax issues while he was on the Court of Appeals. I have chosen two, which might be of interest to a modern tax lawyer. They are *People ex rel. Studebaker Corp. v. Gilchrist*,<sup>1</sup> an early transfer pricing case, and *People ex rel. Clark v. Gilchrist*,<sup>2</sup> a case involving the income taxation of stock dividends, when distributed to trust beneficiaries.

### I. STUDEBAKER

#### A. Federal Transfer Pricing and Interstate Allocation of Income

In the late 1950s, Du Pont formed a wholly-owned Swiss sales subsidiary, DISA, to market elastomers, which were some of its most profitable products.<sup>3</sup> Switzerland was, at the time, a tax haven. Du Pont's intention was to shift as much of its profits as possible to the Swiss subsidiary. The scheme was to have DISA sell the products to Du Pont at such a high price that DISA would be taxable on 75% of the profits, leaving only 25% taxable to Du Pont.<sup>4</sup> A Du Pont official actually conceded that "he would have set prices so as to shift 99

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<sup>1</sup> 155 N.E. 68 (N.Y. 1926).

<sup>2</sup> 153 N.E. 39 (N.Y. 1926).

<sup>3</sup> E.I. Du Pont de Nemours & Co. v. United States, 608 F.2d 445 (Ct. Cl. 1979).

<sup>4</sup> *Id.* at 448. For example, if DISA's basis per unit of elastomers was zero, and the retail price per unit was \$100, then DISA would sell each unit to Du Pont for \$75. Therefore, of the total profit per unit of \$100, DISA would be taxed on \$75 (at the low or nonexistent Swiss tax rates), while Du Pont would be taxed on the remaining \$25. In this example, the "transfer price" would have been \$75.

percent of total profits to DISA if he had thought such an allocation would have survived IRS scrutiny.”<sup>5</sup> Du Pont’s scheme failed.<sup>6</sup>

*Du Pont* was a relatively early example of a transfer pricing scheme. These schemes have been the bane of international tax authorities ever since.<sup>7</sup> However, these issues have been around for a long time in state taxation of multistate enterprises. If an American corporation does business in multiple states, then there is a huge incentive to shift corporate income away from a high-tax state to a low-tax or even no-tax state. This issue was faced by the New York Court of Appeals in the *Studebaker* case in 1926.

In the 1920s, some states had corporate franchise taxes, but most did not. The scheme was clear enough:

The fact that only a smattering of states impose such taxes had encouraged several companies whose activities were split among taxing and non-taxing states to set up separate manufacturing and sales corporation, financially interdependent but legally autonomous, and so deprive a taxing state of the power to levy upon the profits thus isolated to one of the processes of a single business.<sup>8</sup>

And that is exactly what *Studebaker* did.

### B. *Studebaker*: The Facts

*Studebaker Corporation* (“Parent”) was a New Jersey corporation,<sup>9</sup> which manufactured automobiles in Indiana and Michigan. The early 1920s were the “golden years” for *Studebaker*.<sup>10</sup> In 1921, it broke its own record, selling 66,643 automobiles.<sup>11</sup> In 1923,

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<sup>5</sup> *Id.* at 448 n.7.

<sup>6</sup> *Id.* at 448.

<sup>7</sup> See I.R.C. § 482 (2017) and accompanying, voluminous regulations.

<sup>8</sup> Case Comment, *Interstate Allocation of Corporate Income for Taxing Purposes*, 40 YALE L. J. 1273 (1931).

<sup>9</sup> The company was originally incorporated in Indiana. It was reincorporated in New Jersey in 1911. THOMAS E. BONSALL, *MORE THAN THEY PROMISED: THE STUDEBAKER STORY* (2000).

<sup>10</sup> DONALD T. CRITCHLOW, *STUDEBAKER: THE LIFE AND DEATH OF AN AMERICAN CORPORATION* 89 (1996).

<sup>11</sup> BONSALL, *supra* note 9, at 113. For more on the *Studebaker Corporation* and automobiles, see the *Studebaker Museum* website, *STUDEBAKER NATIONAL MUSEUM*, <https://studebakermuseum.org> (last visited Feb. 4, 2018).

it reached its highest point, selling 145,167 vehicles.<sup>12</sup> It completed its acquisition of Pierce-Arrow in 1928.<sup>13</sup>

Parent established sales subsidiaries, including Studebaker Sales Corporation of Ohio, Studebaker Brothers of Utah, Studebaker Bros. of California, and Studebaker Corporation of America, a New Jersey corporation which sold automobiles and automobile accessories in New York and elsewhere (“NJ Sales”).<sup>14</sup> On August 25, 1920, Parent and NJ Sales executed a sales agreement.<sup>15</sup> Parent would sell NJ Sales automobiles at a discount of 25% off retail price, and automobile parts at a 33 1/3% discount. NJ Sales would then resell the automobiles and parts in New York and elsewhere. The discounts, however, were insufficient to allow NJ Sales to make a profit. In 1920, it lost \$449,133.14, while Parent made a net profit of \$11,434,954.41.<sup>16</sup> As luck would have it, all of the other sales subsidiaries, except for the Ohio subsidiary, also lost money in that year.<sup>17</sup> In 1921, NJ Sales lost \$2,168,178.63, while Parent made \$13,684,952.73.<sup>18</sup>

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The following colloquy occurred at the Tax Commission Hearing:

Commissioner Merrill: The business of the Studebaker Corporation during the two years in question [1921 and 1922] and at the close of those two years was the most remunerative that the company ever had, wasn't it?

Mr. Gulesian [accountant for Studebaker]: I do not know; there is no question but what it was remunerative, but whether it was the most remunerative of their existence I am not prepared to say.

Case on Appeal, Return Exhibit V, at 55, *People ex rel Studebaker Corp. v. Gilchrist*, 244 N.Y. 114 (1926) [hereinafter “Hearing”].

<sup>12</sup> BONSALL, *supra* note 9, at 116.

<sup>13</sup> BONSALL, *supra* note 9, at 141.

<sup>14</sup> *Studebaker*, 155 N.E. at 69.

<sup>15</sup> Case on Appeal, Return Exhibit VI, *People ex rel Studebaker Corp. v. Gilchrist*, 244 N.Y. 114 (1926).

<sup>16</sup> *Studebaker*, 155 N.E. at 69.

<sup>17</sup> *Id.*

<sup>18</sup> *Id.* Recall that, in *Du Pont*, the taxpayer attempted to shift 75% of the profits to the Swiss subsidiary. They did not do any more than that, for fear that they wouldn't get away with it. Studebaker, by contrast, arranged for most of its sales subsidiaries to realize a loss. Thus, they were shifting 100% of the profits, and then some. See *supra* note 4.

At a hearing on the New York state tax dispute, Commissioner Merrill commented:

It is pretty evident from the fact that the Studebaker Corporation of America [NJ Sales Corporation] reported the net loss to New York State of \$449,133.14, that the contractual (sic) relation was such that there could not have been a profit to the Studebaker Corporation [NJ Sales Corporation] under the contract?<sup>19</sup>

Mr. Gulesian, accountant for both parent and NJ Sales Corporation, answered:

I am not prepared to answer that question; there was a reduction in retail price in the amount the New York Company paid for the cars; that may have been due to overhead or additional selling expenses, advertising or like reasons.<sup>20</sup>

The State of New York was unimpressed. It levied a tax on NJ Sales Corporation of \$9,398.66 and \$11,936.24, for the two tax years.<sup>21</sup> It arrived at these figures by making an assets to assets comparison:

These figures were arrived at by taking such a proportion of the combined net income of the parent corporation and its subsidiaries as the total determinative assets of those corporations bore to the determinative assets of those corporations allocated to the state of New York.<sup>22</sup>

### C. Appellate Division

The Appellate Division sided with the State Tax Commission: “The question presented is whether our statute under which these taxes were assessed is sufficiently broad to frustrate this plan, obviously devised for the purpose of evading this income tax. . . . We think that it is.”<sup>23</sup> Essentially, the Appellate Division found that the August 1920

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<sup>19</sup> Hearing, *supra* note 11, at 53.

<sup>20</sup> Hearing, *supra* note 11, at 53.

<sup>21</sup> *Studebaker*, 155 N.E. at 69.

<sup>22</sup> *People ex rel. Studebaker Corporation of America v. Gilchrist*, 216 N.Y.S. 208, 214 (App. Div. 1926) (Kellogg, J., dissenting).

<sup>23</sup> *Id.* at 210.

agreement was unfair, and would not have been reached by parties dealing with one another at arm's length. The court's task, then, was to "determine the amount of net income which the relator would have received from its New York business under a fair agreement with its parent company."<sup>24</sup> Having done so, the burden was on the taxpayer to show that the tax was incorrectly assessed.<sup>25</sup> They failed to meet this burden. Judge Kellogg dissented, arguing that the assets comparison accepted by the majority was not a method of allocation authorized by the statute.<sup>26</sup>

#### **D. The Court of Appeals**

The Court of Appeals reversed.<sup>27</sup> Judge Cardozo set out the relevant statute:

Where any corporation liable to taxation under this article conducts the business whether under agreement or otherwise in such manner as either directly or indirectly to benefit the members or stockholders of the corporation, or any of them, or any person or persons, directly or indirectly interested in such business by selling its products or the goods or commodities in which it deals at less than a fair price which might be obtained therefor, or where such a corporation, a substantial portion of whose capital stock is owned either directly or indirectly by another corporation, acquires and disposes of the products of the corporation so owning the substantial portion of its capital stock in such a manner as to create a loss or improper net income, the tax commission may require such facts as it deems necessary for the proper computation provided by this article, and may for the purpose of the act determine the amount which shall be deemed to be the entire net income of the business of such corporation for the calendar or fiscal year, and in determining such entire net income the tax commission shall have regard

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<sup>24</sup> *Id.* at 212.

<sup>25</sup> *Id.*

<sup>26</sup> *Id.* at 213 (Kellogg, J., dissenting).

<sup>27</sup> *Studebaker*, 155 N.E. at 68.

to the fair profits which, but for any agreement, arrangement or understanding, might be or could have been obtained from dealing in such products, goods or commodities.<sup>28</sup>

Cardozo wrote:

We think the inference is permissible that loss would have been avoided if a contract fair and reasonable in its terms, such as would naturally have existed between independent corporations, had been made between the subsidiary as the agent and the parent as the principal. . . . If the parties had been dealing upon a normal business footing, the discount would have been large enough to allow the selling agent a fair or customary commission upon the sales effected by the agency. There would have been little difficulty, one would suppose, in placing evidence in the record from which a conclusion could be drawn as to the extent of such commissions and the fair profits that would have been earned if such commissions had been paid and a reasonable return allowed on capital invested. Nothing of the kind was proved.<sup>29</sup>

Cardozo's problem was that, under the asset allocation method used by the court below, all of the income attributable to New York—not just some of it—was taxable by New York. In effect, 100% of the New York income was allocated to NJ Sales Corporation. “We find no basis for a holding that a fair agreement between the parent which manufactured and the subsidiary which sold would have given the whole profit to the subsidiary and nothing to the parent.”<sup>30</sup> The Court of Appeals reversed the Appellate Division, and the proceeding was, “remitted to the Commission for the revision of the taxes in accordance with this opinion.”<sup>31</sup>

Judge Crane, dissenting, agreed with the court below. Since it was the taxpayer who created the fictitious loss, all that the Tax

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<sup>28</sup> Tax Law, as amended by L. 1922, c. 507, § 211 subd. 9, *quoted in Studebaker*, 155 N.E. at 69.

<sup>29</sup> *Studebaker*, 155 N.E. at 70.

<sup>30</sup> *Id.* at 70-71.

<sup>31</sup> *Id.* at 72.

Commission could do was to make a reasonable effort at a just allocation. The burden then shifted to the taxpayer to prove them wrong.<sup>32</sup>

Judge Cardozo made it very clear that the Court of Appeals would have been willing to consider piercing the corporate veil—disregarding the subsidiary—if the Tax Commission had asked it to. But the Commission did not ask.

We do not now inquire whether the State of New York might disregard the subsidiary as a mere cover or pretense and lay a tax upon the parent as upon a corporation doing business here through the instrumentality of an agent. [citations omitted] If this or something not unlike might have been done, the Commission has not sought to do it.<sup>33</sup>

In any event, for Cardozo, the crucial inquiry, had the issue been raised, would be directed toward the subsidiary's autonomy. "Before the 'corporation *persona*' may be ignored, the evidence must show that 'the subsidiary is not left with any autonomy.'"<sup>34</sup>

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<sup>32</sup> *Id.* at 73-74 (Crane, J., dissenting).

What were the taxing authorities here in the State of New York going to do?

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I know of nothing in the law which prevents the Tax Commission from adopting this method of allocation in order to determine the net profits when other information is not forthcoming and it is conceded that the books do not correctly show the actual facts.

\* \* \*

What is prescribed, however, is that the Tax Commission must find what the net profit was or would be, if any, under normal conditions on such business done in New York State. To arrive at such a conclusion the Tax Commission could adopt and use any information it had, and this is specifically stated.

<sup>33</sup> *Id.* at 70. Cardozo made this comment as part of his ruling that the first paragraph of subdivision 9 of section 211 did not apply. According to Cardozo, the first paragraph applied only when the parent and the subsidiary were subject to the New York franchise tax.

<sup>34</sup> *Studebaker*, 155 N.E. at 71 (citing Learned Hand, J., in *Procter & Gamble Co. v. Newton*, 289 F. 1013, 1015 (1923)) (emphasis added). Judge Cardozo's opinion was cited for this proposition in Roswell Magill, *Allocation of Income by Corporate Contract*, 44 HARV. L. REV. 935, 943 n.41 (1931); and Case Note, *What is Unitary Organization*, 41 HARV. L. REV. 227, 231 n.27 (1927).



Thus, Cardozo was inviting the Tax Commission in subsequent cases to pierce the corporate veil, as long as it could be shown that the sales subsidiary had no autonomy. Ultimately, Cardozo was not rejecting the reallocation; he was simply objecting to the computational method used by the Commission. Yet, this decision was clearly a victory for the taxpayer. It was, perhaps, not inappropriate for commentators to note that, in cases like *Studebaker*, Cardozo “joined the conservative wing of the court in decisions favoring business interests through what appears to be highly formalistic reasoning.”<sup>35</sup>

Subsequent early decisions tended to view things Cardozo’s way—open to a different result in the case of egregious abuse, but reluctant to find it. In *Fox Film Corp. v. Loughman*,<sup>36</sup> responding to the Commission’s argument that the corporate arrangement was a subterfuge, the court responded:

This contention is not tenable, for the evidence does not establish any misrepresentation or suppression as to facts. There is nothing fictitious as to the apparent situation; the status is one created pursuant to and authorized by law, and the realty corporation must be recognized as a separate legal entity distinction from that of the petitioner.<sup>37</sup>

Similarly, in Wisconsin, the court refused to reallocate income. Cardozo’s opinion in *Studebaker* was quoted at length.<sup>38</sup>

Yet, in a much more recent New York case, income was reallocated. However, in that case, there was a finding that no separate autonomy existed. Therefore, the precise condition stated by Cardozo for piercing the corporate veil had been met.<sup>39</sup>

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<sup>35</sup> Mark Gergen & Kevin Quinn, *Common Law Judicial Decision Making: The Case of the New York Court of Appeals 1900-1941*, 60 BUFF. L. REV. 897, 966 (2012).

<sup>36</sup> 251 N.Y.S. 693 (App. Div. 1931).

<sup>37</sup> *Id.* at 696 (citing *Studebaker*, 155 N.E. at 68).

<sup>38</sup> *Curtis Companies, Inc. v. Wisconsin Tax Commission*, 251 N.W. 497, 501 (Wis. 1933).

<sup>39</sup> *Wurlitzer Co. v. State Tax Commission*, 42 A.D.2d 247 (App. Div. 1973), *aff’d*, 315 N.E.2d 805 (N.Y. 1974):

The key finding made by the Commission, which is dispositive of the case, is that WAC had no separate corporate autonomy and was, in reality, merely the finance department of a unitary

What is curious about the *Studebaker* decision is the method of allocation. To an international tax lawyer, the facts screamed out for transfer price analysis. To consider just the automobiles, NJ Sales' discount was 25%. For example, if the retail price of an automobile had been \$100, then Parent would have sold it to NJ Sales for \$75. From the perspective of NJ Sales, the resale transaction would be:

Retail Price	\$100	
--Basis["transfer price"]	\$75	
--NJ Sales expenses per unit	[\$25+]	(loss) <sup>40</sup>

The question should have been whether the transfer price of \$75 was too high.

In a modern international tax case, the resale price method would be the most likely method of determining the transfer price.

The resale price method evaluates whether the amount charged in a controlled transaction is arm's length by reference to the gross profit margin realized in comparable uncontrolled transactions. The resale price method is . . . ordinarily used in cases involving the purchase and resale of tangible property in which the reseller has not added substantial value to the tangible goods by physically altering the goods before resale.<sup>41</sup>

When Cardozo sought to know the "fair or customary commission upon the sales effected by the agency,"<sup>42</sup> he was seeking to know precisely what the gross profit margin would have been, had Parent

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business, Wurlitzer. WAC had no separate directors, officers or employees—all these positions were held by Wurlitzer personnel in addition to their regular duties; Wurlitzer personnel performed all of WAC's business activity; WAC owned no separate real or tangible personal property. Thus, it is quite clear that, except for the fiction of a separate corporate shell, WAC is the same as the other unincorporated divisions of Wurlitzer; it, therefore, is for all intent and purposes the sixth division of the company.

*Wurlitzer Co.*, 42 A.D.2d at 250-51.

<sup>40</sup> Note that transfer pricing can shift income in either direction. In *Studebaker*, the income was shifted to the parent, while in *Du Pont*, the income was shifted to the subsidiary.

<sup>41</sup> 26 C.F.R. § 1.482(3)(c)(1) (2018). To compute the transfer price, reduce the retail price by the gross profit margin.

<sup>42</sup> *Studebaker*, 155 N.E. at 70.

and NJ Sales dealt with one another at arm's length. That is the resale price method. This information, to the frustration of both Cardozo and the Appellate Division, was not provided by the taxpayer.

The court below, having raised the transfer pricing issue, despaired of answering it. Instead, they simply made an allocation of profits by comparing New York assets with world-wide assets.<sup>43</sup> The Appellate Division was using what is now called the formulary apportionment method. Although the Appellate Division only compared assets to assets, the modern formulary apportionment method uses a weighted average of factors—usually including sales, payroll, and property, in order to allocate the worldwide income to each of the taxing jurisdictions. This method, rejected in *Studebaker*, has since become the predominant method of allocating income among the states of the United States, even in New York.<sup>44</sup>

*Studebaker* represents an early transfer pricing case, one in which a transfer pricing analysis might have been more easily applied than the formulary apportionment used by the Tax Commission and the Appellate Division. Judge Cardozo's opinion was typical of other pro-business opinions of the time. Curiously, the formulary apportionment which was so troubling for Cardozo has now won the day in state taxation.

## II. CLARK

### A. Stock Dividends as Taxable Income; Stock Dividends as Fiduciary Accounting Income

When one thinks of dividends, one usually thinks of cash dividends. The corporation distributes some of its earnings and profits to its shareholders in cash—so many dollars per share. But then there are stock dividends. Instead of distributing cash, the corporation

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<sup>43</sup> *Id.* at 73 (Crane, J., dissenting). See also *Studebaker*, 216 N.Y.S. at 210.

<sup>44</sup> *Matter of Disney Enterprises, Inc. v. Tax Appeals Trib. of State of N.Y.*, 10 N.Y.3d 392 (2008). See N.Y. TAX LAW § 210-A (Franchise Tax on Business Corporations: Apportionment). See also *Barclays Bank PLC v. Franchise Tax Board of California*, 512 U.S. 298 (1994). In theory, either transfer pricing or formulary apportionment should work equally well. In practice, formulary apportionment works less well in the international context, because such factors as payroll and property values can be so starkly different in first and third world countries. There are, admittedly, differences in payroll and property values in the various states of the United States, but they are not so extreme.

distributes its own stock. For example, the corporation distributes one share of its own stock, for each ten shares already owned by the shareholder.

Are dividends income? With cash dividends, the answer is easy. Of course they are.<sup>45</sup> However, with stock dividends, the answer is more complex. With a cash dividend, the shareholder can spend the cash, immediately. With stock dividends, in order to realize the benefit of the dividend, the shareholder must first sell the extra stock, and then spend it. So, are stock dividends immediately income, or are they more like unrealized appreciation, taxable only upon a later realization event?

But wait. There's more. Income has different meanings for different purposes. First, there is tax. One cannot have an income tax unless one knows what income is. A receipt is taxable income only if that receipt was income in the first place. Are stock dividends taxable income?

Then there is fiduciary accounting. What is income, and what is principal, for fiduciary accounting purposes? Imagine a trust which provides that income is payable annually to the Income Beneficiary ("IB") for life, with the remainder payable upon IB's death to the Remainderman ("R"). This year, the trust receives some payments. The Trustee, in order to administer the trust properly, must determine which of those payments are income, and which are principal. Income payments, such as interest and rent,<sup>46</sup> should be distributed this year to IB. In contrast, principal payments, such as most sales proceeds,<sup>47</sup> must be accumulated, to be paid out to R upon the death of IB. Are stock dividends income, or principal?

### *1. Stock Dividends as Taxable Income*

The tax question came up in the United States Supreme Court in the famous case of *Eisner v. Macomber*.<sup>48</sup> Mrs. Macomber owned shares in Standard Oil of California.<sup>49</sup> She received a dividend of one share of stock for every two shares already owned.<sup>50</sup> Although the

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<sup>45</sup> See I.R.C. § 61(a)(7) (2017).

<sup>46</sup> Uniform Principal and Income Act, § 401(b) (1997).

<sup>47</sup> Uniform Principal and Income Act, § 404(2) (1997).

<sup>48</sup> *Eisner v. Macomber*, 40 S. Ct. 189 (1920).

<sup>49</sup> *Id.* at 191.

<sup>50</sup> *Id.*

1913 tax law did not mention stock dividends, the 1916 tax statute specifically provided that they were taxable income.<sup>51</sup> Mrs. Macomber argued that it was unconstitutional to tax her stock dividends as income.<sup>52</sup> The Court agreed, in a five to four decision. It held that stock dividends were not income.<sup>53</sup> Therefore, if they were to be taxed, they could not be taxed under the Sixteenth Amendment. They could only be taxed under Article I, Section 8, in which case, the tax would have to be apportioned among the states. The essence of income, according to the majority opinion, was that it must be derived from capital, and separated from that capital.<sup>54</sup> There was no such separation in the form of a stock dividend.

*Eisner v. Macomber* was very big news in 1920. A significant amount of federal tax revenue was at stake. The financial markets were in disarray for months before the decision was announced, because no one knew how stock dividends would be treated for tax purposes.<sup>55</sup> As it turned out, *Eisner v. Macomber*, though still famous, is no longer good law. The Supreme Court came up with a much more workable definition of income in *Glenshaw Glass*,<sup>56</sup> and the taxability of stock dividends is now addressed in I.R.C. § 305, in all of its complexity. But Macomber's case was a very big deal at the time.

## 2. *Stock Dividends as Fiduciary Accounting Income*

The fiduciary accounting question has its own complications. The share of stock is the principal—the asset which generates the income. The dividend on that stock, if in cash, is clearly income generated by that principal. However, a stock dividend—perhaps splitting one share of stock into two shares—would appear to be a mere reconstitution of the principal stock. It is hard to see how a splitting of the principal into smaller pieces can turn that principal into income.

Yet, at the time of the stock dividend in *Clark*, New York followed the “Pennsylvania Rule.”<sup>57</sup> Under that formulation, stock

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<sup>51</sup> *Id.*

<sup>52</sup> *Id.*

<sup>53</sup> *Macomber*, 40 S. Ct. at 195.

<sup>54</sup> *Id.*

<sup>55</sup> Marjorie E. Kornhauser, *The Story of Macomber: The Continuing Legacy of Realization*, in PAUL CARON, TAX STORIES 93 (2d ed., 2009).

<sup>56</sup> *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955).

<sup>57</sup> Jesse Raymond, *Trusts—Division of Extraordinary Dividends Between Cestuis For Life and In Remainder*, 10 TEX. L. REV. 75, 82 n.22 (1931).

dividends were treated as income, but only if payable from the accumulated earnings of the corporation. Otherwise, they were treated as principal, and accumulated for the benefit of the R. In this way, the integrity of the corpus was preserved.<sup>58</sup>

Assume that a corporation has earnings. If it pays them out as cash dividends this year, they should be fiduciary accounting income, payable to IB. If the corporation accumulates those earnings and pays them out in some subsequent year, should they not still be income? In fact, shouldn't they be fiduciary accounting income whether they are paid out as cash dividends or stock dividends? That was the position taken by the Pennsylvania Rule. Pursuant to this Rule, it can often be the case that stock dividends are principal for fiduciary accounting purposes but income for tax purposes.

So, in 1926, stock dividends were not taxable income under the federal income tax, pursuant to *Eisner v. Macomber*. They were, however, sometimes fiduciary accounting income, pursuant to the Pennsylvania Rule, then adopted in New York. These two notions came together in *Clark*.

### B. The Case: Facts

Alfred Corning Clark's father was the partner of Isaac Singer, of the Singer Sewing Machine Company.<sup>59</sup> Alfred Corning Clark put a substantial amount of the stock of the Singer Sewing Machine Company in trust, for his son, Robert Sterling Clark, for life.<sup>60</sup> In 1920, the Singer Sewing Machine Company declared a stock dividend. As a result, 10,642 shares of Singer Stock were payable to the Trust.<sup>61</sup> The Trustees duly distributed those shares to Robert Sterling Clark, the life tenant.<sup>62</sup> The issue was the taxability of those shares.

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<sup>58</sup> Case Note, *Interpretation of Deed of Trust: Distinction between stock dividends and dividends of stock*, 43 YALE L.J. 1181 (1934); Case Note, *Conflicting Claims of Life Tenant and Remainderman to "All Stock—No Cash" Dividends*, 46 HARV. L. REV. 298 (1932); Raymond, *supra* note 57.

<sup>59</sup> See generally NICHOLAS WEBER, *THE CLARKS OF COOPERSTOWN: THEIR SINGER SEWING MACHINE FORTUNE, THEIR GREAT AND INFLUENTIAL ART COLLECTIONS* (2007).

<sup>60</sup> *People ex rel Clark v. Gilchrist*, 153 N.E. 39, 39 (N.Y. 1926).

<sup>61</sup> *Id.*

<sup>62</sup> *Id.*

### C. Authorities

The *Macomber* case was cited both by the Appellate Division and the Court of Appeals. In the Court of Appeals, Judge Cardozo commented: “The Income Tax Law of New York is framed upon the model of the Federal Income Tax Act, though the two differ in some particulars. The correspondence is so close, however, that decisions under the Federal Act are important aids to the construction of the statute of the State.”<sup>63</sup> Recall that *Macomber* held that stock dividends were not income.<sup>64</sup>

There was also the Opinion of the New York Attorney General, which stated that stock dividends, subject to exceptions not relevant to this case, were not income.<sup>65</sup> This Attorney General’s opinion was accepted by Article 61 of the state regulations.<sup>66</sup> These regulations had remained in place unchallenged for some years. Things looked good for the taxpayer.

There was, however, the statute. Section 359 of the New York tax law (the “1919 Statute”) stated that dividends were taxable.<sup>67</sup> Subdivision 8 of Section 359 went on to say that stock dividends were dividends.<sup>68</sup>

### D. The Appellate Division

For the Appellate Division, the statute was enough. The *Macomber* ruling was crucially important under federal law, when the

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<sup>63</sup> *Id.*

<sup>64</sup> *Macomber*, 40 S. Ct. at 195. Charles Evans Hughes had a curious and continuing relationship with these cases. He wrote the opinion in *Towne v. Eisner*, 245 U.S. 418 (1918), which paved the way for the *Macomber* decision. After resigning from the Supreme Court in order to run for President, he represented the taxpayer in *Macomber*. Kornhauser, *supra* note 55, at 100. When *Clark* was argued in the New York Court of Appeals, Hughes joined in an amicus brief. Br. of Murray, Aldrich & Roberts and Hughes, Rounds, Schurman & Dwight, as Amici Curiae, from records and briefs for *People ex rel. Clark v. Gilchrist*. Not surprisingly, Hughes would have liked the New York Court of Appeals to have shown even more deference to *Macomber*. The brief quoted the opinion of Hughes, J., in *Towne v. Eisner*.

<sup>65</sup> *Clark*, 153 N.E. at 40.

<sup>66</sup> *Id.*

<sup>67</sup> Laws 1919, c. 627, § 359 subd. 1, *cited in* *People ex rel. Clark v. Gilchrist*, 211 N.Y.S. 679, 679 (App. Div. 1925).

<sup>68</sup> Laws 1919, c. 627, § 359 subd. 8, *cited in* *People ex rel. Clark v. Gilchrist*, 211 N.Y.S. 679, 679 (App. Div. 1925).

applicability of the Sixteenth Amendment was in play. But there was no counterpart to the Sixteenth Amendment in New York. Perhaps, said the Appellate Division, the use of the word “income” was a “misnomer” when applied to stock dividends.<sup>69</sup> But it did not matter, because the New York State taxing power was not limited to income. The New York legislature had explicitly stated that stock dividends were taxable, and so they were. The State Tax Commission argued that the court should distinguish the case of stock dividends received by shareholders, and stock dividends received by trust beneficiaries. However, the Appellate Division pointed out that there was no such distinction in the statute. The taxpayer lost.<sup>70</sup>

### E. The Court of Appeals

On appeal, Judge Cardozo also paid homage to the U.S. Supreme Court decision in *Macomber*, but again pointed out that *Macomber*, with its constitutional dimension, was distinguishable. When the issue came before the Court of Appeals, however, there were new state statutes in play. In 1926, the New York State legislature, presumably reacting to the Appellate Division decision in *Clark*, passed a new tax statute, retroactive to January 1, 1919 (the “1926 Statute”).<sup>71</sup> For the purpose of the new statute, “stock dividends” were “new stock issued, for surplus or profits capitalized, to shareholders in proportion to their previous holdings.”<sup>72</sup> Such stock dividends were, pursuant to the 1926 Statute, not taxable to the recipient until the corporation redeemed or cancelled them, or the shareholder sold them.<sup>73</sup>

Also, the 1926 Legislature amended the state Personal Property Law, providing that “under any will or deed hereafter made, unless

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<sup>69</sup> *Clark*, 211 N.Y.S. at 681.

<sup>70</sup> *Id.* at 682.

<sup>71</sup> Judge Cardozo ruled that there was no constitutional problem with the retroactivity of the 1926 Statute. *Clark*, 153 N.E. at 42.

<sup>72</sup> L. 1926, ch. 543, § 1.

<sup>73</sup> L. 1926, ch. 543, § 2, *quoted in Clark*, 153 N.E. at 41:

Stock dividends when received by a shareholder shall not be subject to tax but if before or after the distribution of any such dividend the corporation proceeds to cancel or redeem its stock 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 shall be treated as a taxable dividend and included in gross income.



otherwise therein provided, stock dividends shall be principal and not income of a trust.”<sup>74</sup> Thus, the 1926 Legislature prospectively abandoned the Pennsylvania Rule.

The Attorney General again argued that the new statute should not apply when the stock dividend was paid to a trust beneficiary, rather than directly to a shareholder—especially when the stock dividends were actually paid to the life beneficiary, and hence, treated by the Trustee as income.<sup>75</sup> Again, no such distinction had been raised in the new statute.

In fact, the Legislature had considered making such a distinction in 1926, but rejected it. An earlier draft of the bill contained the following: “Where a stock dividend is received by a fiduciary shareholder, and is paid under a will, deed of trust, or other agreement, to a beneficiary taxable under this article, it shall constitute taxable income and be included by the beneficiary in gross income for the year of its receipt.”<sup>76</sup> This language was dropped from the legislation as enacted.<sup>77</sup>

Judge Cardozo also took note of the change in the Personal Property Law. In his view, the Pennsylvania Rule had been appropriately rejected because:

The rule previously applied had resulted in so many complications and obscurities as to be almost unworkable in practice. It involved elaborate accountings for the purpose of determining how far the dividends were the result of profits accumulated before the creation of the trust, and how far the result of profits accumulated thereafter. The Legislature evinced its will that there should be an end to these complexities hereafter in the administration of the law of trusts. It had no thought of keeping them alive in the administration of the Tax Law.<sup>78</sup>

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<sup>74</sup> L. 192, Pers. Prop. Law, § 17-a, cited in *Clark*, 153 N.E. at 41.

<sup>75</sup> *Clark*, 153 N.E. at 41.

<sup>76</sup> *Id.*

<sup>77</sup> *Id.*

<sup>78</sup> *Id.* (internal citations omitted). Cardozo’s linking of the two 1926 changes might suggest that he thought that the change to the Personal Property Law, as well as the change to the tax laws, was retroactive. The change to the Personal Property Law was not retroactive. In *Pratt v. Ladd*, 253 N.Y. 213 (1930), a unanimous decision joined by Judge Cardozo, the Pennsylvania Rule was applied to a stock dividend paid

Judge Cardozo had other administrative concerns as well. Recall that, pursuant to the Opinion of the Attorney General and the ensuing regulation, many recipients of stock dividends had omitted those receipts from their state tax returns. Holding now that such stock dividends should have been taxable would create an administrative nightmare:

There existed a situation fraught with opportunities for confusion and injustice. Returns had been made in reasonable reliance on the Comptroller's regulation. If there had been mistake, it was mistake induced by agents of the State itself. Taxpayers thus misled had regulated their affairs on the assumption that their tax accounts were closed. To reaudit returns so made might impose a grievous burden.<sup>79</sup>

Furthermore, Judge Cardozo pointed out that the taxation of the stock dividends was not being exempted, but merely deferred, until such time as the stock was cancelled, redeemed, or sold. For Cardozo, the 1926 Statute was clear. The Appellate Division was reversed, and the taxpayer prevailed.<sup>80</sup>

#### **F. Who Was Right?**

Both the Appellate Division and the Court of Appeals were right in their ultimate holdings. They reached opposite results, but the statute had changed in the meantime. Perhaps, then, a more appropriate question would be which legislation was better—the 1919 Statute, or the 1926 Statute?

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in 1925—despite the abandonment of the Pennsylvania Rule in 1926. *See also* Raymond, *supra* note 57, at 82 n.22 (“Trusts established prior to its [the 1926 abandonment of the Pennsylvania Rule] enactment are apparently still governed by the Osborne case [the Pennsylvania Rule].”).

<sup>79</sup> *Clark*, 153 N.E. at 42.

<sup>80</sup> *Id.* at 43. Cardozo's *Clark* opinion has stood the test of time rather well. It is cited perhaps more often to support the notion that the state legislature can enact retroactive tax laws without violating constitutional norms. *Yeaton v. Levitt*, 244 N.Y.S.2d 334 (App. Div. 1963). The ruling applies to “extraordinary stock dividends.” *In re Villard's Will*, 147 Misc. 472, 474 (Surr. Ct. Westchester Cty. N.Y. 1933); Attorney General Jacob Javits, under somewhat different facts, wrote approvingly of Cardozo's opinion in a 1955 Attorney General's Opinion. 1955 Op. Atty Gen. No. 237.

Both statutes ignored the distinction between shareholder and trust beneficiary. Ironically, when the statute favored the government in the Appellate Division, the taxpayer argued that the statute should not apply to trust beneficiaries. Yet, when the revised statute favored the taxpayer in the Court of Appeals, it was the government making that argument.

Both courts rejected the argument. Both courts were correct, in that neither statute recognized the distinction between shareholder and beneficiary. The Court of Appeals was on even firmer ground, since the legislature by that time had considered recognizing the distinction, but rejected it. Were the two legislatures correct in ignoring this distinction?

The fact that the recipient of the dividend was a trust beneficiary rather than a mere shareholder did indeed make a difference. For the shareholder, both cash dividends and stock dividends benefited the same recipient—the shareholder. However, for trust beneficiaries, they might not have done so. Cash dividends were clearly fiduciary accounting income, and therefore payable when received to IB. However, under the Pennsylvania Rule in place in New York at the time, stock dividends might have been fiduciary accounting income, payable to IB, or they might have been fiduciary accounting principal, payable to R.

Moreover, there was a timing difference. Cash dividends, whether payable to a shareholder or a trust beneficiary, were payable to IB when declared and paid by the corporation. However, stock dividends, under the Pennsylvania Rule, might have been payable to IB when declared and paid by the corporation, or, perhaps, they were not to be beneficially enjoyed until the expiration of the income interest. And yet, both statutes treated all cash dividends the same, and all stock dividends the same.

Once the Pennsylvania Rule was abandoned, the 1926 Statute made sense.<sup>81</sup> Both the complexities of the taxation, and fiduciary accounting, were removed. Perhaps fairness in all possible situations was not achieved, but administrability was. Now, things are even clearer, for the State of New York has abandoned its own, separate income tax entirely, in favor of bootstrapping itself to the provisions

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<sup>81</sup> The Pennsylvania Rule has since been abandoned in most states. NORMAN LANE & HOWARD ZARITSKY, *FEDERAL INCOME TAXATION OF ESTATES AND TRUSTS* ¶ 3.04 (1988).

of the federal tax. Now, at least, there is only one level of complexity, not two.<sup>82</sup>

One cannot blame either the Appellate Division or the Court of Appeals for failing to achieve a fairer result in light of the difficulties caused by the differences between cash dividends and stock dividends, tax accounting and fiduciary accounting, and shareholders and trust beneficiaries. The two courts merely applied the statutes as they were written. One might have wished that the New York State legislature, both in 1919 and 1926, had been more keenly aware of the complexities it faced. Yet, by abandoning the Pennsylvania Rule, and eventually abandoning even a separate New York State income tax system, the New York State legislature ultimately came up with something that works reasonably well.

### III. CONCLUSION

One could design an entire three-year law school curriculum exclusively around Cardozo opinions.

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<sup>82</sup> N.Y. TAX LAW §§ 607, 611 (McKinney 2018). For federal tax treatment, *see* I.R.C. § 643(a)(4) (2017). Good luck.