1920

Stock dividends

Haskins & Sells

Stock Dividends

Stock dividends have perhaps received as much attention and discussion as any other topic connected with revenue legislation and administration. The recent decision of the United States Supreme Court appears not to have settled all the questions relating to stock dividends. Already there is evidence of attempts to offset the advantages accruing to taxpayers under the decision.

The following letter addressed recently to one of our clients sets forth the present status of the stock dividend situation and contains some conservative advice on the subject:

Dear Sirs:

Replying to your request of the 15th instant for our views on the following question:

> "On March 1, 1913, our surplus was approximately $1,300,000. On June 30, 1920, it is estimated that this surplus will be approximately $6,000,000. Can we, on that date, declare a stock dividend of $5,000,000 and a cash dividend of $1,000,000? When paying stock dividends does the Government consider that this covers the most recent earnings in the same manner as cash dividends would be held?"

Under the Revenue Act of 1918, a dividend was defined as "any distribution made by a corporation to its stockholders or members whether in cash or in other property, or in stock of the corporation out of its earnings or profits accumulated since February 28, 1913." It was provided that "any distribution made in the year 1918 or any year thereafter shall be deemed to have been made from earnings or profits accumulated since February 28, 1913, but any earnings or profits accumulated prior to March 1, 1913, may be distributed in stock dividends or otherwise, exempt from the tax, after the earnings and profits accumulated since February 28, 1913, have been distributed."

Under these provisions a dividend, either stock or cash, might be declared to exhaust the profits accumulated since February 28, 1913, and that thereafter tax free distributions might be made from earnings accumulated prior to March 1, 1913.

The Supreme Court having declared stock dividends not taxable, it would appear to follow that a corporation might declare a stock dividend to exhaust the earnings accumulated subsequent to February 28, 1913, and then declare a cash dividend from earnings prior to March 1, 1913, which cash dividend would not be taxable to the recipients.

Two broad questions arise in this connection—(1) whether under the existing law, as interpreted by the Supreme Court, such a tax exempt cash dividend could be declared; and (2) whether Congress will amend the law so as to tax such dividend or provide a special tax for the privilege of declaring a stock dividend.

Under the first broad question there are two subsidiary questions to be considered: (1) Is a stock dividend a distribution of profits? (2) Is a dividend necessarily deemed to be out of the most recently accumulated surplus?

In the discussion of the first subsidiary question, it should be noted that section 201 (b) provides that earnings or profits accumulated prior to March 1, 1913, may be distributed exempt from tax after the earnings or profits accumulated since February 28, 1913, have been *distributed.* It is chiefly under this provision that a dividend declared out of earnings accumulated before the incidence of the Income Tax Law would be tax exempt. Under the Revenue Act as it was passed, a stock dividend was a distribution of earnings and profits. It would appear, however, that the Supreme Court in its decision in the case of Eisner *vs.* Macomber does not consider a stock dividend to be a distribution. This is evident from the following words —"The surplus may increase until it equals or even exceeds the par value of the outstanding capital stock. This may be adjusted upon the books in the mode adopted in the case at bar—by declaring a stock dividend. This, however, 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 that 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, but profits so far absorbed in the business as to render it impracticable to separate them for withdrawal and distribution." And again in the following quotation—"A stock dividend shows that the company's accumulated profits have been capitalized instead of distributed to the stockholders or retained as surplus available for distribution in money or in kind, should opportunity offer. Far from being a realization of the profits of the stockholder, it tends rather to postpone such realization in that the fund represented by the new stock has been transferred from surplus to capital, and no longer is available for actual distribution."

If a stock dividend is not a distribution of profits, then its declaration could not distribute the earnings and profits accumulated since February 28, 1913. The condition required by law "that earnings or profits accumulated since February 28, 1913, must be distributed before declaring tax exempt dividends out of prior earnings" cannot be met.

It might, therefore, be held that a cash dividend, such as you propose, could not be made tax exempt.

This situation could only be held logical under the present Revenue Act by treating stock dividends as distributions of earliest and not latest surplus, which brings us to a discussion of the second sub-question.

The law refers to "most recently accumulated surplus" only in connection with stock dividends received between January 1 and November 1, 1918. It is true, of course, that it is only in the case of dividends received between such dates that there is any necessity for determining the surplus from which the dividends were declared, and this provision might by analogy be held to refer to all dividends. The Revenue Act of 1916, as amended by the Act of October 3, 1917, provided for the taxing of certain dividends at the rates in effect in the years in which the earnings from which the dividends were distributed were accumulated, and in this Act and the accompanying Regulations of the Department, the practise to treat dividends as being from the most recently accumulated surplus was established.

It has therefore, been the practise of the Department to treat dividends as being from the most recently accumulated surplus, but it should be noted in this respect that such practise was most productive of revenue.

Even the Regulations of the Department relating to the present Revenue Act have allowed certain leeway in the determination of the surplus from which dividends have been distributed. Article 1543 of Regulations 45 Revised provides "In determining whether a distribution is made out of earnings or profits accumulated after or before March 1, 1913, due consideration must be given to the facts and mere book entries increasing or decreasing the surplus will not be conclusive."

The spirit of the decision of the Supreme Court in Eisner *vs.* Macomber is that stock dividends are declared because capital has been locked up in the business year by year and cannot be released for distribution. This is apparent in the following quotation—"Often, especially in a growing business, only a part, sometimes a small part, of the year's profits is in property capable of distribution; the remainder being absorbed in the acquisition of increased plant, equipment, stock in trade, or accounts receivable, or any decrease of outstanding liability. When only a part is available for dividends, the balance of the year's profits is carried to the credit of undivided profits, or surplus, or some other account having like significance. If thereafter the company finds itself in funds beyond current needs, it might declare dividends out of such surplus or undivided profits; otherwise it may go on for years conducting a successful business, but requiring more and more working capital, because of the extension of its operations, and therefore unable to declare dividends approximating the amount of its profits."

It appears to us that the common viewpoint would be that the stock dividend was a capitalization of the earliest accumulation of surplus, and that a cash dividend was a distribution of the latest and most current surplus. The balance sheet of a company when compared for a number of years would ordinarily add weight to this opinion.

In view of the discussion above, it appears to us that the Treasury Department, being bound not by law but merely by previous practise and by previous laws, might contend that stock dividends represent a capitalization of the earliest surplus, regardless of statements which might be made on the books of the company, and that it would be difficult to overthrow this contention of the Department.

The discussion of the second broad question as to the future action of Congress is, of course, based on conjecture. It should be noted, however, that the Supreme Court in their decision emphasized the power of Congress to tax a dividend at the rates in force in the year in which received, whether or not this dividend was paid from surplus accumulated prior to March 1, 1913. The Court took this position in the previous case of Lynch *vs.* Hornby, and has emphatically reaffirmed it in Eisner *vs.* Macomber. It would, therefore, appear within the legislative powers of Congress to so amend the Revenue Act as to tax a cash dividend declared out of surplus accumulated prior to March 1, 1913. We cannot, of course, forecast the action of Congress in this respect, but it would seem reasonable to assume that an effort would be made to replace the revenue which will be lost by the stock dividend decision.

In conclusion we believe that great caution should be exercised in the declaration of dividends until Congress has declared itself as to taxation for the year 1920, and until the attitude of the Treasury Department resulting from the decision of the Supreme Court has been more clearly ascertained.

Yours very truly,
(Signed) HASKINS & SELLS.

Effect of Foreign Exchange on Economic Problems

The present day economic problems are no longer the domestic problems of by-gone days. They are extensively complicated by foreign elements.

The whole subject of foreign relations as affecting the United States and as reflected by the foreign exchange situation, was so clearly set forth and presented in such a scholarly manner by Mr. Alexander Dana Noyes, financial editor of the New York Evening Post, in a recent paper before the Economic Club in New York, that we have, through the courtesy of Mr. Noyes, had the article reprinted from the Evening Post for distribution.

Copies are being sent out with the April Bulletin. Additional copies may be obtained upon request.