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Accounting Questions

[The questions and answers which appear in this section of THE JOURNAL OF ACCOUNTANCY have been received from the bureau of information conducted by the American Institute of Accountants. The questions have been asked and answered by members of the American Institute of Accountants who are practising accountants and are published here for general information. The executive committee of the American Institute of Accountants, in authorizing the publication of this matter, distinctly disclaims any responsibility for the views expressed. The answers given by those who reply are purely personal opinions. They are not in any sense an expression of the Institute nor of any committee of the Institute, but they are of value because they indicate the opinions held by competent members of the profession. The fact that many differences of opinion are expressed indicates the personal nature of the answers. The questions and answers selected for publication are those believed to be of general interest.—EDITOR.]

TREATMENT OF DIVIDENDS

Question: An opinion is requested as to whether any of the following dividends should be taken up as income and, if not, how they should be treated by an investment trust which holds small minority interests in the stocks of the various companies:

(1) A dividend on common stock of 50¢ per share in cash or 1/200 of a share of $100 par value preferred stock (no preferred stock having previously been outstanding).

(a) If the trust elects to take the cash.

(b) If the trust elects to take preferred stock.

(2) A dividend on common stock of 3/100 of a share of $100 par value preferred (other preferred stock being already outstanding).

(3) A dividend on common stock of "$2 per share payable in preferred stock of $100 par value" (no preferred stock having previously been outstanding).

(4) A dividend on common stock of $1 per share payable at the option of the shareholder in cash or in common stock at a value per share below the present market value of the stock.

(a) If the trust elects to take cash.

(b) If the trust elects to take stock.

The trust follows the practice of crediting all ordinary dividends to its annual income account and carrying all profits or losses on securities sold direct to surplus.

Answer No. 1: (1) With reference to a dividend on common stock of 50¢ per share in cash or 1/200 of a share of $100 par value preferred

stock (no preferred stock having previously been outstanding), it seems to us that the trust has the option of receiving cash or making a further investment in the stock of the company. If the trust elects to take the cash, we believe that such cash should be taken up as income. If, however, the trust as an alternative chooses to accept the preferred stock, we believe that such stock should then be credited to income account on the same basis.

(2) In the case of a dividend on common stock of 3/100 of a share of $100 par value preferred (other preferred stock being already outstanding), we would credit the preferred stock received as a dividend to income account at its market value.

(3) This refers to a dividend on common stock of $2 per share payable in preferred stock of $100 par value (no preferred stock having previously been outstanding). In this instance we would not credit to income account the preferred stock received as a dividend, but would enter it in the investment account without setting any valuation upon it. The stockholder has received nothing it did not formerly possess; a portion of its investment has merely received certain specified preferences over the balance.

(4) This refers to a dividend on common stock of $1 per share payable at the option of the shareholder in cash or in common stock at a value per share below the present market value of the stock. It seems to us, in this instance as well as in the first one, that the trust has the option of receiving cash or making a further investment in stock of the company. We would, therefore, credit to income account either the cash or the common stock, whichever the trust elects to take.

Answer No. 2: I think it is impossible to give definite opinions as to the proper treatment of dividends in all of the cases outlined in your inquiry and to have the opinions such that they can be relied upon. It may be possible, however, to present some comments which will be helpful.

With reference to dividends received in cash, the practice of taking up such dividends as income has been so generally followed over so long a period that it is probably a fair statement that dividends received in cash should ordinarily be credited to current income. There are conditions, however, as outlined subsequently in this letter, under which it may be improper to credit to current income even dividends received in cash.

With regard to dividends received in stock, we have decisions under income tax law to the effect that in certain cases stock dividends constitute income. This matter is one which is still in a somewhat uncertain state, and it is by no means always advisable to keep accounts fully in accord with the requirements of income-tax law. If, however, there is

no clear reason for following a different rule, and if the income-tax requirements are followed, there would be at least some basis for justifying that procedure. I think that the income-tax requirements should at least be considered in connection with the problem, so far as those requirements can be known.

On the other hand, there is the possibility that decisions of state courts as to what constitutes income for purposes of determining whether dividends have or have not been paid from capital may be in conflict with determination of what constitutes income for Federal income-tax purposes.

To take a specific example—assume that an investment trust bought on January 1, 1936, 100 shares of the preferred stock of Company A, which at that time had outstanding capital stock of $500,000 par value of non-voting preferred and $500,000 par value of voting common stock and had earned surplus of $1,000,000. Then, suppose during the year 1936 Company A lost $100,000 but paid a dividend on its preferred stock within the year of $50,000 par value of voting common stock, charging this dividend to surplus. Assume further that the investment trust received $1,000 par value of the common stock. I believe that the $1,000 would represent income for Federal income-tax purposes, and yet I have been unsuccessful in convincing myself that the investment trust would have received income from Company A in 1936, from any realistic point of view. I cannot help doubting whether a state court, in passing upon such a situation in a case—for example, where question had been raised as to whether the investment trust had or had not paid dividends from capital—would treat the receipt of the $1,000 par value of common stock as having resulted in surplus or income available for dividends.

Admittedly the assumption in the foregoing paragraph represents an extreme case (but not necessarily a very unusual case). Admittedly also, in such an extreme case there may be ground for question as to whether, if the dividend of $1,000 had been received in cash instead of stock, the receipt of the cash would really have constituted income to the investment trust.

Coming back to the question presented, if the stock of the investment trust is listed on a stock exchange, then, of course, any requirements of the exchange, or contract with it, should be considered. I have not found any regulation of the Securities and Exchange Commission that appears helpful in connection with this problem.

I think it is essential, in connection with such questions as these, to have advice from the investment trust's legal counsel as to any statutes or decisions under the laws of the state in which the investment trust is organized. I do not think that an investment trust would be safe, in such a matter, in depending solely upon conclusions resulting

from computations of accountants, nor do I think it would be safe in depending alone upon opinions of attorneys based on prior cases without adequate consideration of the facts involved in the particular case, which could probably best be presented by an accountant. In other words, it seems to me that these questions should be considered by an accountant and a lawyer working in coöperation, if they are of sufficient importance, from a practical point of view, to merit serious consideration.

State laws or decisions may not provide clear guidance to the accounting procedure to be followed, but at least the investment trust should avoid such accounting as might subject it to criticism, or worse, under state law or decisions.

If it should develop, as I think it might, that after careful examination of the facts as presented by an accountant and of the legal phases of the matter from the attorney's point of view, there is still substantial doubt as to what a court would hold if the matter were brought before it in a suit, then it seems to me that ordinarily the safer procedure would be not to include doubtful items in the current-income accounts of the investment trust. This method of resolving doubts might result in differences between income as shown by the books of account and income as reported in tax returns. Such differences between the books and tax returns would be disadvantageous, but they might be much less disadvantageous than to risk the payment of dividends from capital or to risk any other possible improper act which might result from overstatement of the income of the investment trust.

The possible dangers in understatement of income should, correspondingly, not be overlooked. I think, however, that at least a part of the danger here might be avoided by disclosure of any dividends received but not credited to current income in any reports issued by the investment trust.

Answer No. 3: (1) (a) If the trust elects to take cash, the amount of the cash received should be credited to dividend income.

(b) The trust would not be likely to take preferred stock unless the market value of such stock (if determinable) was greater than the amount of cash which would have been received had the trust elected to take cash. Where the trust has an option such as that outlined in the foregoing question and elects to take stock, it has, in effect, received a dividend of 50¢ per share on the common stock and then used the money to subscribe to new preferred stock. It is suggested, therefore, that the stock received be taken into the portfolio at an amount equivalent to the cash which would have been received had option (a) been exercised, assuming of course that this be equal to or lower than the value based on current market quotations and that dividend income be correspondingly credited. It might be mentioned that, in view of the

cash option, if the trust takes stock, the taxable income would be the market value of the shares received.

(2) A good rule to apply in this case would be to take the stock into the portfolio and correspondingly credit income at the lower of (a) the market value on the day of receipt, or (b) an amount per share equivalent to that which was charged to surplus by the paying corporation. This dividend would be taxable at the market value on the day of receipt in view of the fact that other similar preferred stock was already outstanding.

(3) The same rule may be applied as in the case of the dividend described under (2) above. The fact that the dividend was "$2 per share" would not need to govern if the equivalent market value of the preferred shares was lower. This dividend is apparently not taxable, inasmuch as no preferred stock was previously outstanding.

(4) (a) If the trust elects to take cash, the amount of the cash received should be credited to dividend income.

(b) If the trust elects to take stock, the accounting treatment should be the same as under (1) (b) above. Assuming that the market value of the common stock which might be received is not so great as to nullify or make only theoretical the "option" given, the taxable income would be the market value of the shares received.

With reference to current periodical stock dividends (as distinguished from the occasional large stock dividend which is, in effect, a stock split-up), the New York Stock Exchange on April 30, 1930, issued an announcement from which the following is quoted:

"The exchange will not knowingly list any of the securities of a corporation which takes up as income upon its books stock dividends received at a larger figure than the proportionate amount charged against earnings or earned surplus by the issuing company. Where the issuing company declines to give this information, objection will be made if the receiving company regards such stock dividends as income to any extent whatever."

In answering the foregoing questions, the problem has been approached from the viewpoint of the receiving company and without regard to the tax or accounting treatment to be accorded the payment of the dividend by the paying corporation. The treatments suggested above for tax purposes are general and might not apply in specific cases; the tax treatment should, therefore, be reviewed by counsel. The answers as to accounting treatment given above would not apply in all circumstances (such, for instance, as in the case of estate accounting or where special charter provisions prohibit the treatment of dividends in stock as income) and, in any event, it is suggested that the method followed and the amount of such income be clearly indicated in the published accounts of the trust where the amount is significant.