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Accounting Questions: Stock in Company Reorganization

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ACCOUNTING QUESTIONS

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STOCK IN COMPANY REORGANIZATION

Question

I shall appreciate it very much if you will give me an opinion on the following:

Company A has outstanding—

1. 10,000 shares of common stock of no par value on books at $25 a share.
2. 1,000 shares no-par preferred on books at $100 a share.
3. 1,000 shares $100 par preferred.

Company B owns all common stock, its book cost being $11 a share.

Company A, having paid no dividend on preferred since B.D. (before depression) proposes to preferred holders that it will issue for each share of preferred—

1. A $100—25-year income debenture.
2. One share of common stock, which share will be donated by company B out of its holdings.
3. A cash dividend of $5.

All preferred holders—both classes—accept the proposal and the plan is accomplished. These questions arise:

1. Company B donates 20 per cent of its common-stock holdings to preferred holders to compensate them for unpaid cumulative dividends. This stock is on A's books at $50,000 and on B's books at $22,000. What entries should B make? What is its position in connection with its 1938 income tax return? This conversion was effected in 1938.
2. A, of course, retires preferred stock and sets up debentures dollar for dollar. What entry does it make in connection with, in effect, paying a dividend with stock donated by its parent company?
3. What entry does the former preferred stockholder make? For each share of preferred on the books at $100, he receives:

a. A debenture for $100 maturing in 25 years.
b. A share of common stock on books at $25 which with surplus has book value of $28.
c. A dividend check for $5.

4. No market value has ever been determined for common stock and thus far none for newly issued debentures. What is the stockholder's income tax status?

Answer No. 1

As to 1: Company B should make no entry other than a memorandum in its journal and in its investment account of the fact that 20 per cent of its common stock in Company A has been transferred to the former preferred stockholders of Company A, in pursuance of the plan of recapitalization. Company B has, in effect, made a donation of such 20 per cent to Company A, to enable it to refinance its outstanding preferred stock, and the cost of such donated stock is therefore to be regarded as an additional cost of the remaining Company A common shares held by Company B.

As to 2: Company A need make no entry with respect to the transfer of 20 per cent of its common stock from Company B to the former preferred stockholders other than to make a memorandum notation as part of the explanation of the entry by which the preferred stock is replaced by the debentures.

As to 3 and 4: Under the facts stated, the preferred stockholder should debit a new investment account in debentures and common stock of Company A, and should credit the old investment account in Company A preferred stock, both debit and credit being in the amount of the cost to the preferred stockholder of his preferred stock. The dividend check should be recorded by a debit to cash and a credit to dividend income.

Under the facts stated, it would appear that the transaction is a recapitalization and thereby falls within the statutory definition of reorganization and hence the receipt by the preferred stockholder of debentures and common stock in Company A for his preferred stock in Company A results in neither taxable gain nor deductible loss. The cash dividend received constitutes taxable income, if it be assumed that Company A had on hand undistributed earnings or profits accumulated since February 28, 1913, in an amount sufficient to cover the dividend payment. In this connection, it should be noted that if the cash payment, while made in lieu of dividends, was not made pursuant to an express declaration of dividends, the income-tax result may be different. Some reference to this situation is made on pages 226–227 of the report of the proceedings of the Fiftieth Anniversary Celebration of The American Institute of Accountants, 1937, as part of the round-table discussion on "Reorganization under the Revenue Acts."

In determining gain or loss upon subsequent disposition by the former preferred stockholder of the common stock or of the debentures, his original cost should be apportioned between the debentures and the common stock in proportion to their respective market values at the time of receipt thereof. In the absence of available market values, the rule stated in the last sentence of the first paragraph of article 22(a)(8) of regulations 94 would appear to apply.

It should be noted that the foregoing expression of opinion, so far as it relates to the income-tax status of the transactions, is predicated upon the provisions of the revenue act of 1936 and available administrative and judicial interpretations and decisions. Since the transactions in question occurred during 1938, they will be affected by the provisions of the revenue act of 1938 as and when the same will be passed. The foregoing conclusions, therefore, are subject to such applicable changes as the 1938 act may bring about in the existing law.

Answer No. 2

We submit below the answers we have drafted in reply to the questions set forth in your letter of recent date.

1. In view of the fact that Company B gives up part of its equity in Company A, we feel that Company B should reduce the value of its investment in the common stock of Company A by its cost of the 2,000 shares it contributes for distribution to preferred stockholders of Company A. The investment account would be credited and profit and loss debited with $22,000 on the books of Company B. The charge to profit and loss should be fully explained in the next report to stockholders by Company B. We think that Company B would not realize any taxable loss on this transaction under the existing tax law, as the entire transaction would qualify as a nontaxable reorganization.

2. Company A should make entries recording the declaration and payment of a cash dividend of $5 per share on its outstanding preferred stock; also entries recording the redemption of its total outstanding preferred stock of $200,000 par and stated value in exchange for the issuance of income debentures of $200,000 principal amount.

In regard to the stock donated, we would normally expect Company A to make an entry debiting treasury stock and crediting donated surplus for common stock donated by Company B and a further entry debiting donated surplus and crediting treasury stock for common stock distributed to preferred stockholders under plan of reorganization. Such entries might not, however, be appropriate if the plan specifically provides that the shares shall be contributed by Company B direct to the preferred stockholders of Company A.

3 and 4. We believe that the tax situation and good accounting practice are in agreement in regard to the position of preferred stockholders.

The preferred stockholders should record the cash dividend of $5 per share as income. We think the preferred stockholders would not realize any profit or loss on the exchange of preferred stock for income debentures and common stock of Company A. The cost or other basis of their investment in preferred stock should be apportioned to the new securities upon the basis of the fair value (estimated market value) of the new securities at the date of exchange and future profit or loss on disposition of the new securities would be based upon this apportionment.