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L. L. Briggs

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Dividends from Stock Premiums

By L. L. Briggs

If purchasers of capital stock in a corporation pay more than par value for the shares, the question may arise as to the availability of this premium for dividend purposes. The purpose of this article is to state the main facts of the leading court decisions directly or indirectly involving the payment of dividends from such paid-in surplus.

Most accountants consider stock premium to be a special surplus in the nature of a capital contribution which is unavailable for distribution to stockholders in the form of dividends. Sir Arthur Lowes Dickinson, the eminent English accountant, admits that it is surplus, but he insists that premium on stock is not profit on operations and should not be credited to income (*Accounting Practice and Procedure*, p. 128). Accountants agree that if such paid-in surplus is paid to stockholders they should not be led to believe that the distribution is a part of the current profits.

The rules of the interstate commerce commission state that premiums received upon the stock of railroads are not to be credited to income but to a special account. However, provision is made for the accounting when a railroad is permitted and elects to distribute the premiums to its stockholders.

The general corporation laws ignore the availability of capital-stock premiums for dividends. However the statutes of Louisiana specify that corporate directors must notify stockholders of the source of the distribution when a cash dividend is made from paid-in surplus, and Ohio makes the same requirement when dividends are from any source other than earned surplus.

The German statutes provide that premium on capital stock is not a part of ordinary profits and must be credited to a special surplus account instead of profit and loss.

So far as I am aware, the only English decision touching upon the availability of stock premiums for dividends is *In re Hoare and Company* (1904) 2 Ch. 208. According to the facts of this case, Hoare & Co. had built up a reserve composed partly of premiums received for leases, partly of premiums received on the issue of preference shares and partly of ordinary business profits. The concern had sustained a loss arising from depreciation of its

public-houses below the amount stated in the balance-sheet, and it asked the court to allow a reduction in part of the capital stock and in part of the reserve of an amount equal to this loss. In giving the decision granting the request, Lord Justice Romer said:

"In other words, the surplus which was carried to the reserve fund represented that which might have been properly applied at the time, if the company had so thought fit, in paying further dividends to the stockholders, and no person could have complained if they had done so."

In the same decision, Lord Justice Vaughn Williams made the following statement:

"Supposing, for instance, there had been no scheme for reduction at all, what could the company have done? Could they have distributed this sum as a dividend? Theoretically, I think they could."

The reader should bear in mind, however, that the legal principle under consideration in this case is whether or not both capital stock and reserves may be reduced to offset a capital loss, so the above quotations are dicta and may have no authority as law in regard to stock premiums.

Union Pacific v. *Ferguson* (1913) 64 Or. 395, is often cited as authority for the rule that premium on capital stock may be distributed to shareholders as dividends. Let us consider the facts of this case. The Oregon statute provides that no insurance corporation can transact business until it has a paid-up capital of $100,000. The Union Pacific Life Insurance Company sold 7,541 shares of its capital stock for $100,000 and claimed that this complied with the provision of the statute. Justice Eakin said:

"This $100,000, mentioned in the statute, must be the trust fund that can not be withdrawn or in any manner diverted by the corporation. It is the fund with which the corporation transacts its business and stands as security to the stockholders. It does not include profits or surplus until they have been made capital in some legal way."

The court held that the requirements of the statute were not satisfied because $24,590 of the selling price represented premium on stock which is profit on the sale of stock and is subject to withdrawal at any time.

If a corporation with a surplus sells additional stock at the book value of the old, it seems reasonable to credit the premium to surplus so that the amount available for dividends on the original shares will not be diminished. Ignatius, on page 74 of his *Financing of Public Service Corporations*, says:

"The generally accepted theory is that the premiums represent a payment by the purchasers of the stock for the privilege of acquiring a new or added

interest. If this theory be given its logical effect, the premium will accrue to the favor of the existing stockholders, among whom it could be distributed as a special dividend, and there will be no reason for carrying the amount as a permanent reserve. The reason why a premium is paid is either that the value of the proportionate interest of the shares in the corporate assets exceeds their par value or else the assurance of earnings is such as to assign a high investment value to the shares. In the final analysis the last reason becomes merged with the first, for in most cases the value of the corporate assets as a whole is predicated upon earning power. Under these circumstances the premium is collected on the new shares to equalize the interests of the old and new stockholders. Let us assume that the old stockholders paid par, and thereafter put back enough earnings in the plant to give the stock a certain value above par; the new stockholders pay par also, and in addition an amount approximating the amount of earnings not taken out by the old stockholders. The two sets of stockholders are thus put upon an equal footing; they could turn around and divide the corporate assets above the par of the total capital stock with absolute equity to both the old and the new stockholders."

It has been held that premium on stock issued is not income for the purposes of the federal income tax (*Boston and Maine Railway* v. *United States* (1920) 265 Fed. 578). In *New York* v. *United States* (1920) 269 Fed. 907, Circuit Judge Manton held that paid-up capital stock under the federal income-tax law does not include stock premiums. According to the court:

"The excess paid in price is, in fact, a premium paid for the stock; for when such shares of stock are at face value, they are at par, and when more is paid, they are above par or at a premium. The total of the par value has always been considered capital stock. The term 'capital stock' has thus been used not only in banking and commerce, but in the corporation acts of the several states. Full force and effect must be given to the term 'paid-up' as used in the statute, and its use in connection with 'not exceeding.' We think that the employment of those words made the intention of congress clear as obviously meaning paid up to par value, and not exceeding that. The premiums received were used, in carrying on the business of the corporation, as if surplus. . . ."

Ohio v. *Franklin Bank of Columbus* (1840) 10 Ohio 91, is a taxation case which incidentally involves the status of stock premiums. The Franklin Bank of Columbus sold new stock at a premium of $10,160, which was paid to the old stockholders in proportion to their holdings at the time of the sale. The bank paid a tax of $508 on this distribution, under a law taxing dividends from bank profits, and later brought an action against the state to recover the tax paid on the ground that stock premium is not profit. In giving the decision in favor of the bank, Justice Hitchcock said:

"This premium was not divided as ordinary profits but distributed among those who had been stockholders at the time the capital was increased, and was in effect the same as a price paid to them by those who purchased the new stock, for the privilege of coming into, what was considered to be, a profitable concern."

Apparently the court did not favor adding the premium to surplus for it made the following comment:

"If this stock is above par in the market, it is the gain of the stockholder, and not of the corporation. If it is below par it is the loss of the stockholder. The value of the stock, it is true, will depend upon the condition of the corporation, but the corporation so far as its own property is concerned is not affected by that value."

According to the facts of *Miller* v. *Payne* (1912) 150 Wis. 354, the trustees of an estate held shares of capital stock of the First National Bank of Milwaukee. The question before the court was whether or not dividends had been declared from earnings since February 5, 1906. On May 15, 1911, the bank declared a dividend which was larger than the earnings between that date and February 5, 1906. However, between these dates the institution had sold $500,000 par value stock at 170 at a time when the book value of the $2,000,000 par of old stock was $153.50 a share. The court reasoned that it would take 53½% of $500,000, or $267,500 of the $350,000 premium, to place the new stockholders on a parity of investment with the old. After the book values of both classes of stockholders were equalized, the $82,500 balance of the premium was a profit and might be proportionately divided between the old shareholders and the new. Since the old shareholders held four-fifths of the stock they were entitled to four-fifths of the profit of $82,500 or $66,000. This amount added to the earnings from the business over the period in question made a total which was larger than the amount of dividends declared on May 15, 1911. Therefore, this dividend was from earnings. In the decision, Justice Vinje said:

"The distribution of the premium made on the sale of the new stock is an equitable and just one. Fifty-three-and-five-tenths per cent. of that went to make the book value of the new stock equal the old. The difference between that and 170 per cent. at which the new stock sold, represented a net profit to be distributed ratably between old and new stock."

The decision implies that the $267,500 was available for dividends, although the court made no definite statement to that effect.

Smith v. *Cotting* (1918) 231 Mass. 42, among other things, incidentally involves the status of an extra cash dividend payable from surplus derived from premiums on capital stock. The stock was sold at various times at several different prices and there was no evidence that premiums were received on all the shares. Part of the premiums was directly credited to surplus while the rest reached the same account by way of profit and loss. The total amount of the premiums was more than sufficient to meet the

requirements of the dividend. The main issue in the case was whether this dividend was capital or income. The court decided that it was income. Justice Braley said:

"Whatever might be said as to premiums paid on shares originally issued, it is obvious, that the very large premiums received by the corporation on some subsequent issues were paid not as capital, but for the right to share in the profits, surplus and other earnings which had been accumulated and remained undistributed. . . . We find nothing which would have prevented the corporation by appropriate votes from using this surplus, profit and loss, undivided profits, or however the premiums may be designated, for any legitimate purpose. Not having been segregated as capital it could be appropriated for the payment of dividends. . . ."

The court added:

"If by reason of the apparent prospect of great financial success the corporation not only at its inception but subsequently was enabled to sell its stock for more than par, the money obtained . . . was not an accretion of the fundamental capital, which could be increased only in the manner provided by statute. It represents a portion only of treasury assets in the nature of gains, or profits, which the corporation could distribute without reducing the value of its remaining property below the par value of the entire capital stock including the proposed increase, or impairing its resources which remained amply sufficient for the satisfaction of all indebtedness."

In *Equitable Life Assurance* v. *Union Pacific* (1914) 212 N. Y. 360, the plaintiff, a large holder of Union Pacific preferred stock, initiated an action to restrain the distribution of an $80,000,000 dividend to the common stockholders. Part of this amount came from the retirement of convertible bonds at the rate of one share of stock for $175 in par value of bonds, which gave a premium of $75 on each share of stock. The plaintiff claimed that this premium was an increase of capital which should be distributed to both the common and the preferred stockholders. As the court allowed the payment of the dividend it apparently thought that the premium was not an increment of capital but was an ordinary distributable profit. In the decision, Justice Hiscock made this statement:

"The extra $75 paid per share represented the amount of accumulated profits or surplus which it was supposed would be apportionable to each share after payment and issue. In other words, as I think we must assume, the payment of this premium was not for permanent capital, but for the purpose of equalizing as between new and old stockholders their respective rights in accumulated profits, which, so far as we know, were current and distributable in dividends. When paid in, this premium became part of such accumulation of profits and surplus and distributable as such. It was credited to the profit-and-loss account, and not to capital."

Justice Hiscock also said:

"The proposition that these profits because resulting from what was perhaps an unusual transaction are not profits, but an accretion which 'belongs to capital,' notwithstanding the painstaking argument of counsel, does not seem to have any foundation on which to rest except earnest assertion."

The court distinguished this class of stock premium from that paid on stock at incorporation but gave no opinion as to the status of the latter.

The distribution of stock premiums to stockholders may be regarded as a capital return instead of a dividend. Since there is no rule against capital contributions greater than the par value of the stock sold there should be no objection if the excess is returned to the contributors. In other words, if the stock purchasers wish to pay more than par for their stock it may not be fair to require them permanently to invest the extra amount.

People v. *Knight* (1904) 89 N. Y. S. 72, is a case in which the stockholders paid $500,000 into the treasury of the corporation for working capital, for which no extra additional stock was issued, and this amount was virtually a stock premium so far as the corporation and the stockholders were concerned. Later, to facilitate the carrying out of a merger, $200,000 was returned to the stockholders of this corporation in order to equalize the holdings of the two groups of stockholders. In the decision in which the court held that this distribution was not a dividend for tax purposes, Justice Chester made this statement:

> "It seems to me clear that the $200,000 so returned can not fairly be regarded as from the 'surplus profits' of the company, for it did not in any sense arise from its profits or earnings in the course of its business, but was contributed solely for the purpose of strengthening the company and adding to its working capital. That being so, it was not a dividend, within the meaning of the law."

In *People* v. *Travis* (1916) 157 N. Y. S. 943, the court reached the same conclusion. Presiding Justice Kellogg said that:

> "A corporation may begin business with a surplus contributed by its stockholders, and may thereafter divide that surplus, and such division is treated as a distribution of original capital and not as a dividend. In such a case the stockholders are only withdrawing from the company the moneys which they paid to it for temporary use, over and above the capital stock."

Merchants' and Insurers' Reporting Company v. *Youtz* (1918) 178 Pac. 540, is a California decision which apparently holds that stock premiums are capital which must be retained by the corporation for the benefit of creditors and, consequently, are not available for distribution to stockholders as dividends. The plaintiff company sold capital stock at a premium of $28,169.17 and credited this amount to the profit-and-loss account. Evidence showed that there had been no net profit from operations. The plaintiff charged that in spite of this Youtz and other members of the board of directors declared and paid dividends amount-

ing to $34,000 in violation of the California civil code, which provides that dividends must come from profits. The plaintiff brought this action to recover the amount of the dividends from the defendants. In giving the decision for the plaintiff, Presiding Justice Conrey said:

"Without further details of items shown, suffice it to say that the corporation never had any surplus profits out of which dividends could have been paid, unless the moneys received as 'premiums' above the par value of the stock sold might be segregated from the assets of the corporation and treated as profits of its business. We are satisfied that the entire proceeds of sales by a corporation of its own stock, even when sold for more than par value, are part of its original assets or capital stock and therefore can not be profits earned through the conduct of its business. The phrase 'capital stock,' as used in section 309 of the civil code, means 'not the shares with which the nominal capital is composed, but the actual capital; i.e., assets, with which the corporation carries on its corporate business.' . . . The sole purpose of selling stock is to acquire assets with which to carry on that business. This is equally true, whether the stock be sold at par, or below par, or above par. The capital stock referred to in said section 309 'is the actual property of the corporation contributed by the shareholders.' . . . It is, in brief, the 'capital of the corporation.'"

Corliss v. *United States* (1925) 7 Fed. (2d) 455, is a case in which a creamery company rapidly expanded operations and increased its capital stock from $164,000 in 1917 to $3,000,000 in 1920. In a prosecution of the concern by the federal government, it was shown that the company promised that it would pay 11% dividends and would return the purchase price of the stock to any buyer who became dissatisfied. During the period when this stock was sold the company operated at a loss and the dividends paid in 1918 were from funds arising from capital stock premiums. Although the company was not held criminally liable, District Judge Amidon said:

"As a general rule, corporations have no right to pay dividends out of any fund except the excess remaining from the conduct of the business after paying taxes, operating expenses, and fixed charges."

However, the court admitted that this rule is not universally followed and cited *Smith* v. *Cotting* (supra) as authority for the legality of dividends from premiums on capital stock.

It is interesting to note that eminent legal writers do not agree upon the dividend status of capital-stock premiums. In 37 *Harvard Law Review* 475, C. W. Wickersham suggests that if more than par value is received from the sale of capital stock the premium constitutes capital, while Attorney-General W. D. Mitchell, in 11 *American Bar Association Journal* 380, disagrees with this suggestion and concludes that surplus should be available for dividends regardless of its source.

A brief summary is now in order. Although many leading accountants agree that premiums on capital stock are not available for dividends, the general corporation statutes give little or no light on the subject and the court decisions touching the point are not only scarce but conflicting and inconclusive. Most of the cases which have been quoted contain mere dicta, which may show a tendency on the part of the courts but may not be authoritative as law, while the rest of the cases have decisions based upon the interpretation of a particular statute or contract. It seems to me that this phase of corporation law is still in the process of development, and that it is extremely difficult at the present time to determine which way the weight of authority inclines. However, it is hôped that the courts eventually will set their approval upon what accountants consider to be conservative practice, that is, the prohibition of dividends from capital-stock premiums unless the stockholders are informed of the source of such distributions.