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Proposed Taxation of Stock Dividends

By Walter J. Matherly

The flood of stock dividends during the year 1922 reached the high-water mark of more than $2,000,000,000.[1] Since such dividends are non-taxable under the federal income-tax law, a demand has arisen in some quarters for the taxation of corporate surpluses out of which stock dividends are distributed. This demand has found expression in a bill introduced on February 6, 1923, into the fourth session of the sixty-seventh congress by Representative Frear of Wisconsin, proposing a levy on accumulated surpluses or undivided profits and apparently intended to compel corporations to pay out all their earnings every year in the form of cash dividends, making such earnings available for taxation as personal income. Since, according to press reports appearing on March 29, 1923, Mr. Frear and "members of the 'progressive' Republican group in Congress are preparing to fight in the next session for this legislation," perhaps it is worth while to reopen the question of stock dividends and carefully to analyze Mr. Frear's proposal. As Mr. Frear's bill (H. R. 14223) is very short, it may not be amiss to quote the language in full.

"Be it enacted * * * that section 230 of the revenue act of 1921 is hereby amended by adding a new subdivision at the end thereof as follows: (3) in addition to the taxes herein above provided there shall be levied, collected and paid, for each of the taxable years 1917, 1918, 1919, 1920, 1921, 1922, and for each year thereafter on that portion of the net income for any such year of every corporation, not distributed in the form of cash dividends, a tax upon the amount of such net income for such year in excess of the credits provided in section 236, and a further deduction of $3,000 for such year at the following rates: five per centum of the amount of such excess not exceeding $20,000; ten per centum of the amount of such excess not exceeding $100,000; fifteen per centum of the amount of such excess not exceeding $200,000; and twenty per centum on all of such excess above $200,000: provided, that if any of such undistributed profits are taxed as above provided and the corporation shall have, after the payment of such tax, distributed in money any of the profits upon which this tax has been paid, then the corporation shall be entitled, in its next income-tax return, to a credit upon its tax so returned to the extent and amount of the tax which it has paid under the provisions of this subdivision."

Since this proposed legislation is evidently intended to strike at stock dividends either by taxing the accumulated

[1] See the author's article entitled "Last Year's Flood of Stock Dividends," in *The Annalist* for March 12, 1923.

surpluses out of which non-taxable stock dividends are declared or by forcing the distribution of such surpluses in the form of taxable cash dividends, it is necessary to examine stock dividends very closely and see whether or not they represent total or permanent escape from taxation. Do stock dividends escape from their share of the burden of taxation? Are they a species of tax evasion, as some people would have us believe? The answer must be in the negative.

To begin with, stock dividends are not real dividends at all. Indeed they are just the opposite of dividends, as the supreme court pointed out in the case of *Eisner vs. Macomber.* They merely represent permanent retention of the profits in the business. They in no way involve a distribution to the stockholders. The shareholders' equity is absolutely unchanged. The asset side of the balance-sheet remains unaffected. Even the total of the liability side retains its original status. The only change is a charge to the surplus account and a concurrent credit to the capital-stock account. The final result is that the stockholder's interest "is simply cut up into a greater number of aliquot parts." While he may have four certificates instead of two, he has no larger interest in the business and no greater claim to corporate assets.

Due to these elementary principles of accounting, stock dividends are correctly held to be non-taxable under the income-tax law. But this does not mean that they are absolutely tax-free nor that they permanently escape taxation. Since shareholders are not subject to normal taxes on income from corporate enterprises any way, the only possible evasion is an evasion to the extent of surtaxes. But even this is only partial and temporary, since the federal government taxes corporations directly and since stockholders must pay a tax on capital gains when the stock received as dividends is sold.

That stock dividends only partly escape from taxation is proved by the fact that under the law an income tax is levied directly on corporate concerns. This tax is assessed upon the net income of incorporated companies and represents a flat rate of twelve and one-half per cent. Corporations whose net profits do not exceed $25,000 are allowed an exemption of $2,000; but for those concerns whose profits are in excess of that amount there is no exemption allowed. The tax must

be paid whether the net earnings are retained in the business and transferred to the surplus account or distributed to the stockholders in the form of cash dividends. Consequently, stock dividends and the corporate surpluses out of which they are declared pass through the door of taxable income once, bearing rather than escaping their share of taxation, and the only evasion that can possibly occur is a partial evasion with reference to surtaxes.

In addition to the flat rate of twelve and one-half per cent. on the net income of corporations, which takes the place of the normal tax of four per cent. up to $4,000 and eight per cent. above that amount for individuals and partnerships, there is a federal capital-stock tax imposed on corporations for the privilege of doing business. This tax takes the form of a levy of "$1.00 for each full $1,000 of the average fair value of the capital stock for the year preceding the taxable year in excess of the exemption of $5,000." Thus the federal government places not only an income tax but also a capital stock tax on American corporations; and, not content with these taxes, there are those who would impose further taxes.

But even the partial escape of stock dividends from surtaxes is only temporary. When stock received as dividends is sold, it is subject to the tax on capital gains. For example, suppose A buys on January 1, 1921, 2,000 shares of stock in a corporation at a par value of $100, making the total cost of the shares $200,000, and that during the next two years the company, after paying reasonable cash dividends, builds up a surplus to the amount of $200,000 against these shares. This would make A's stock worth approximately $200 a share or $400,000. Again, suppose the corporation declares on January 1, 1923, a stock dividend of 100 per cent. Instead of 2,000 shares, A would now have 4,000 and the market value of the shares would tend to drop to the original price of $100, the government losing in the process the surtaxes which would have been payable in case the $200,000 had come to him in cash.

Moreover, suppose a month or two after A receives his stock dividend of 2,000 shares or 100 per cent., he decides to sell all his stock. He places it on the market and gets $100 a share for the whole 4,000 shares or a total of $400,000.

Under the income-tax act, he is assumed to have secured a capital gain and is taxed accordingly. In computing the capital gain, the cost of each share is deemed to be $200,000 (the original cost) divided by 4,000 (the sum of the old and new shares) which equals $50. Since he has sold 4,000 shares, the cost is $200,000. Since he has sold his shares at the market price of $100 each, the total amount received is $400,000. The difference between the cost price and the sales price, or $200,000, represents his taxable capital gains and is exactly equal to the amount originally diverted from personal taxable income. The same method is followed in calculating the capital gains on any portion of the stock which he sells.

Under the law, what tax is he compelled to pay on such capital gains? He has two alternatives. He can choose the benefit of the twelve-and-one-half per cent. tax on net capital gains or he can choose the regular normal and surtaxes. If he chooses the first, he will pay twelve and one-half per cent. of $200,000, or $25,000. If he chooses the second, he will pay the normal tax of four per cent. on the first $4,000 and eight per cent. on the remaining $196,000 plus the surtaxes on the whole $200,000, all of which are equal to $86,800. If he had received the $200,000 in cash dividends, he would have been subject only to surtaxes and would have paid $70,690. Therefore, if he accepts the first alternative, the government loses $61,800 as against the second, and $45,960 as against what it would have collected on cash dividends. If he selects the second alternative, the government secures $15,840 more than it would have collected on cash dividends. Naturally, one would expect A to select the first method; but if he accepts the first, he cannot deduct capital losses, whereas if he accepts the second, he can deduct such losses. Consequently, if he has had any capital losses during the year in which the stock is sold, he will accept the second. But whichever alternative he chooses, his stock dividends come under the income-tax system, bearing rather than escaping the burden of taxation.

Since stock dividends are already subjected to their full share of taxation, Representative Frear's bill taxing corporate surpluses out of which stock dividends arise or any other proposal with similar intent is unnecessary. Why try to tax a thing which is thought to evade taxation when it is already

taxed? What is the value in attempting to remedy an evil that is imaginary? This is exactly what Mr. Frear and his colleagues would do. In their efforts, they are more or less fighting a straw man. Unless the present income-tax arrangement is changed, there are already adequate provisions for eradicating the alleged evils of stock dividends, and further legislation is a waste of time.

In addition to the fact that it is unnecessary, Mr. Frear's proposed law is opposed to the principles of corporation finance. In the successful management of every corporate enterprise, it is essential to put back into the business every year a large part of the current earnings. It is an extremely short-sighted policy to pay out in annual dividends everything that is earned. Edmond Lincoln very forcefully argues that "it is absolutely essential at all times to pay out less than is earned and in good years to 'plow' in a large proportion of the earnings in order to strengthen the company for the inevitable lean years."[2]

Likewise, Professor Mead, after laying sound rules, first as to the payment of dividends in the early history of the corporation and second as to the management of expense accounts, says: "The third rule or principle which we find to govern the dividend policy of well-managed companies is to pay out in cash dividends only a portion of the balance of income remaining in any year available for distribution to stockholders. Even after a large surplus has been accumulated to safeguard the dividend rate, and with the most careful management of depreciation and renewal accounts, the amount of this 'balance for dividend' is subject to wide fluctuations, which, in view of the desirability of maintaining a fixed rate of dividends, makes the distribution of the entire amount in any year unwise."[3] These conclusions are so sound that it hardly seems necessary to offer any further proof. Thus any proposal to tax corporate surpluses is opposed to sound financial policy and is in direct conflict with the principles of safe financial management.

Again, Mr. Frear's bill involves double taxation. If it were enacted the national government would be taxing the

[2] *Applied Business Finance,* 1923. p. 174.

[3] *Corporation Finance.* Fourth edition. 1920. p. 225.

same thing twice. Since corporations are already required to pay a flat rate of twelve and one-half per cent. on their net income, an additional tax of from five to twenty per cent. (depending upon the amount) on that portion of the net income retained in the business and transferred to surplus would be equivalent to placing a double burden upon the same income or property by the same civil unit. This we have always designated in this country as duplicate taxation and have always looked upon it as inequitable and unjustifiable.

But it may be objected that under Representative Frear's proposed legislation, corporations do not necessarily have to pay the tax. If they care to, they can escape by paying out all their surplus in the form of cash dividends. In fact, this seems to be the exact purpose of the bill, since it would prevent the distribution of non-taxable stock dividends and would make the cash dividends available for surtaxes as personal income in the hands of stockholders. But even this is a sort of double taxation. While it is perfectly clear that the corporation and the shareholders are separate legal entities, nevertheless, when they are both taxed on substantially the same thing, there is double taxation.

According to the revenue act, the partnership's existence as an independent entity is ignored and only the partners are taxed. The same is true with reference to the individual enterprise. Why, then, tax both the corporation and the shareholders when both the partners and the partnership and the individual and the single enterprise are not taxed? While there is a legal difference between corporations and partnerships and single enterprises, yet there is no essential economic difference. To tax both the corporation and the shareholders is like taxing a bank on the interest accruing in favor of its depositors and in addition taxing the balance to the depositors; or it is like levying on the income in the hands of trustees and then also levying on the same income paid to beneficiaries. If such things were done, we would consider it highly inequitable; yet we follow substantially such a method of procedure in the case of corporations. Consequently, whether incorporated concerns under the proposed law paid the tax and retained their surpluses or paid out the surpluses and made them taxable

under the surtaxes as individual income to the stockholders, the law in effect would be productive of duplicate taxation.

Finally, Representative Frear's proposed legislation ignores the subsequent history of a great many corporate enterprises which accumulated surpluses during the war years. Since it calls for the taxation of corporate surpluses from 1917 to 1922 and each year thereafter, it leaves out of consideration entirely the large number of corporations that had their profits of earlier war years almost wholly wiped out by big deficits during 1920-21 when post-war depression set in. As illustrations of this, one needs to glance only at the annual reports of such concerns as B. F. Goodrich Co., American Rolling Mill Co. and General Motors Corporation. In other words, were corporate surpluses subjected to a tax dating back to 1917, a multitude of corporations would be compelled to pay heavy taxes on the surplus earnings of former years in spite of the fact that they suffered huge losses in later years, giving up practically all gains accruing from the period of war-time prosperity.

The proposed taxation of stock dividends, then, is unsound. Like the surtax itself, it is productive of double taxation. It is directly opposed to the principles of corporation finance. It is unnecessary under the present income-tax system, since stock dividends do not permanently escape from taxation and since corporate surpluses out of which stock dividends are declared are already subject to a net-corporate-income tax and a capital-stock tax.