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Premiums on Sale of Capital Stock

Editor, The Journal of Accountancy:

SIR: In the January issue of THE JOURNAL OF ACCOUNTANCY you published a letter written by C. V. Rowe, C.P.A., on the subject of capital stock premiums. I venture to add the following:

On July 14, 1914, the court of appeals of the state of New York in *Equitable Life Assurance Society of the United States, appellant, vs. Union Pacific Railroad Co., respondent* (the appellant seeking to restrain the respondent from the payment of an extraordinary dividend out of surplus acquired partly through premiums on capital stock), handed down a decision in favor of the respondent, affirming the decision of the lower court.

The following excerpts from the opinion of the court, written by Judge J. Hiscock (N. E. Rep. vol. 106, page 92) epitomize the decision:

"It is said, because in the retirement of its convertible bonds defendant sold and issued its capital stock at $175 per share of $100 par value, that this entire sum was paid in as capital and must be held and distributed as such. That is not my interpretation of the transaction under the allegations of the complaint. The amount at par value paid for each share of stock undoubtedly became capital, which the corporation was required to preserve and maintain as against its liability on the outstanding share of stock which had been issued for it. Just as undoubtedly the extra $75 paid per share represented the amount of accumulated profits or surplus which it was supposed would be apportionable to each share of new stock after payment and issue as aforesaid. 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 profit and loss and not to capital. . . ." Also: "When a corporation has a surplus, whether a dividend shall be made, and if made how much it shall be, and when and where it shall be payable, rest in the fair and honest discretion of the directors uncontrollable by the courts."

It would be difficult to write a more unequivocal decision, and the point involved appears to be legally settled for the time being, at least so far as New York is concerned.

The interstate commerce commission in its *Classification of Income, Profit and Loss and General Balance Sheet Accounts for Steam Roads,* effective July 1, 1914 (though actually issued somewhat later), page 39, takes cognizance of the decision above quoted in the following phraseology:

"In case the accounting company is permitted and elects to distribute all or any part of the net premium on its capital stock to its stockholders, the amount thus distributed shall be charged to the premium account."

In the *Uniform System of Accounts for Electric Railways,* also effective July 1, 1914, page 75, the identical ruling will be found and in the *Uniform System of Accounts for Express Companies,* also effective July 1, 1914, page 73, the ruling is substantially the same.

Both Hatfield's *Modern Accounting* and Dicksee's *Auditing,* quoted by Mr. Rowe, were published several years prior to the New York decision above mentioned, and Esquerré's *Applied Theory of Accounts* also quoted, was published very shortly thereafter; but the author's statement on page 330 that "the treatment of premiums on capital stock as a profit places the corporation in the position of admitting that it has been guilty of sharp practices upon its stockholders" appears to be substantially concurred in by Mr. Montgomery in a 1916 publication as recited below.

It is of interest to note that the accounting authorities still appear to frown upon the distribution as dividends of premiums on capital stock.

Bennett, in his *Corporation Accounting* (published in 1916), page 88, with reference to the subject, states: "The credit balance of this account [premiums and capital stock], sometimes called capital surplus, shows the amount of premium not yet written off. It is a profit to the corporation, but not one that should be used for the payment of dividends"; and, on page 115, "Speaking generally, however, it would be of doubtful wisdom for the directors to distribute such premiums in the form of dividends even though they may have the technical authority to do so."

Montgomery, in his *Auditing Theory and Practice,* 2nd edition, 1916, page 194, states that premiums on capital stock account should remain open and appear on the balance sheet as a special surplus account. "In no event, however, should the account be transferred to general surplus and thus be looked upon as available for dividends. It would probably be legal to declare a dividend out of funds so raised, but it would be so improper as to sustain a charge of dishonesty against the director who voted therefor"; and, on page 375, "The amount received is clearly a capital receipt and is not available as a fund out of which to pay dividends—that is, from the accounting point of view. There may be no legal obstacle in the way of crediting the premiums to surplus and paying out the entire surplus as dividends, but in effect a board of directors might as well attempt to pay out the remaining portion of the amount paid for stock."

So much for examples of opinions on the subject expressed in recent publications.

Dickinson, in his *Accounting Practice and Procedure* (published in 1913), page 128, takes a slightly more lenient view in stating that "premiums on stocks issued may be a source of surplus to the corporation eventually, because they are cash received in excess of the authorized capital which must be maintained intact, but they are not profit on operations and should not therefore be credited as such to income, although they may be applied to make good depreciation in fixed assets or exceptional losses where such depreciation or losses do not arise out of the ordinary business of the corporation. In the case of both discounts (if permissible) and premiums, the proper view would seem to be that the stock is sold for whatever it will fetch, and that any discount or premium should be considered as a deduction from or addition to the par value of the stock on the face of the balance sheet"; and, on page 129, "As long as stock has a fixed par value it is better, theoretically, to treat premiums thereon as receipts on capital account, but no serious objection can be raised to crediting them to profit and loss surplus, preferably under a separate sub-heading."

The income tax ruling on the subject is as follows: (T. D. 2090, dated December 14, 1914.) "The amount received by a corporation for the original issue and sale of its capital stock is held to be the capital of the corporation. In cases where the stock, as originally issued, is sold at a price greater or less than the par value, neither the premium nor the discount will be taken into account in determining the net income of the corporation for the year in which the stock is sold. This is purely a capital transaction and the income is neither increased nor decreased by reason of the sale, per se, of the stock at a price greater or less than its par value."

To summarize: the interstate commerce commission and the court of appeals of the state of New York appear to hold one opinion on the subject, while the commissioner of internal revenue and, so far as I can ascertain, most public accountants take an opposite view, some being more vehement than others in covering the point.

The permission required by the interstate commerce commission ruling abovementioned refers, as I am informed, to state laws, and I feel sure that it would be of general interest to know which states, by statute or otherwise, forbid and which permit the payment of dividends out of surplus acquired through the payment of premiums on capital stock.

Will some subscriber versed in the corporation laws of other states supply this information?

The proceeds from the sale of stock without par value are, I believe, looked upon by lawyers and accountants alike as 100 per cent. capital.

Very truly yours,

EDWARD H. MOERAN,

New York, January 20, 1917.

Editor, The Journal of Accountancy:

SIR: Referring to Mr. C. V. Rowe's letter on pages 77, 78, 79 of the January, 1917, issue of THE JOURNAL OF ACCOUNTANCY, I must say that I certainly agree with the authorities mentioned in his letter and believe that any premium paid for capital stock of a corporation should be treated so that it cannot be used for dividends.

In the case mentioned in his letter we find an accumulated earned surplus of $100,000.00, and it had been possible to make such results with a paid-up capital of $300,000.00. The present stockholders are very willing to sell additional shares of capital stock for its actual present book value and thereby give the new stockholders a pro-rata interest in the $100,000.00 earned surplus. The original stockholders do reduce their pro-rata ownership of such earned surplus and the new stockholders find that they have paid a premium of 33 1/3 per cent., but, after the transaction is completed, they find the value of such pro-rata interest in the present earned surplus to be reduced to 20 per cent. It also reduces the pro-rata ownership of the original stockholders from 33 1/3 per cent. to 20 per cent.

The transaction was not intended to create a condition by which the present earned surplus was to be divided and no further profits were to be expected, but all most likely felt that the additional capital invested would produce a greater earning power and thereby create an earned surplus which would be far in excess of 33 1/3 per cent. of capital invested. Otherwise no conservative investors would desire to be either the original or new stockholders. All business is a gamble and all investors are gamblers, but they have good reasons for assuming any sensible risk.

Furthermore, the creation of an account clearly stating capital stock premium so that it cannot be distributed in dividends does not affect creditors unless the investments made with the money so received are not either available or worth the price paid for them. The stockholder in the state of California owns his pro-rata of all assets and owes his pro-rata of all outside liabilities while he is a stockholder, and he is in the same position on the day he sells his stock; therefore if debts due to outsiders are greater than the proven assets as of the date he sells his stock he is still liable for his pro-rata of any deficiency, but he has no further claim on the assets and simply protects the buyer of the stock formerly owned by him.

Yours very truly,

Riverside, California. R. L. McCrea, C.P.A.

Church Accounting Procedure

Editor, The Journal of Accountancy:

Sir: You have asked for any matters of interest to the profession.

In your April, 1915, issue you had an article which quoted from Bishop Lawrence's address on church finances. You may not be aware that at the general convention of the Protestant Episcopal Church held in St. Louis last October canons were passed with regard to business methods in church affairs.

At our recent diocesan convention in California a special committee was appointed to amend our canons to bring them into conformity with those passed by the general convention. I think that the following will be of interest to the brethren in the craft and take pleasure in advising you about it:

"Canon of Business Methods in Church Affairs.

"Section I. The fiscal year shall begin January 1.

"Sec. II. All accounts having to do with the receipt and expenditure or investments of money of all church organizations shall be audited at the close of each year by a certified public accountant; provided, however, that if the amount of income for the year as shown by the account shall be less than $3,000, or if a certified public accountant is not available, the audit may be made by an accountant bookkeeper in no way connected with the subject matter of the account.

"Sec. III. Each diocese and missionary district shall appoint at its next regular convention or convocation—provided one has not heretofore been appointed—and annually thereafter a finance committee for the following purposes:

"(1) To maintain general supervision of the financial affairs of the diocese or district; to secure simplicity and accuracy in collection and disbursement of all funds and co-operation between the various officers, trusts and boards of the convention or district; for which purpose it shall establish its own rules and keep a record of its meetings, all of which shall be submitted annually to the convention or convocation.

"(2) To act as advisor of the bishop in financial matters and, upon request, as advisor to individual parishes within the diocese or district.

"(3) To perform such other duties relating to the business affairs of the diocese or district as may be referred to it."

Yours very faithfully,

Frederic M. Lee, C.P.A.

Assistant treasurer, Diocese of California.

[We are much interested in the details furnished by our correspondent and it is gratifying to know that business methods are spreading among members and officers of church organizations. We should be interested to learn, however, the definition of "accountant-bookkeeper."—*Editor,* The Journal of Accountancy.]

Dividends and the New Income Tax Law

Editor, The Journal of Accountancy:

Sir: I have read with interest the article by John T. Kennedy in the January number of The Journal of Accountancy under the heading *Dividends and the New Income Tax Law,* and being an assiduous student of the law, I take the liberty of adding my views, although, not having at hand Mr. Weiss' article, I cannot presume to continue the discussion. One thing, however, seems clear, and that is that Mr. Kennedy's panacea for the ailment of taxation of stock dividends is faulty, and if he enters on his returns deductions for losses "actually sustained because of the decreased book value due to the dividend" he is flirting with rather severe penalties.

Theoretically all dividends are entirely capital. The corporation engages in business for profit, but in the last analysis the process is merely an accumulation of assets measured by the increase in the surplus. Theoretically the stock appreciates exactly as the additional assets are accumulated and depreciates by the amount of any distribution, by whatever name designated. In practice, however, the stock does not rise in direct ratio with the accumulation of assets and therefore the ordinary distribution tends to equalize values and is called income. The law provides that dividends paid from profits accruing since March 1, 1913, shall be considered income. When the accumulated surplus is greater than the total profits earned since that date, just what profits are being distributed it is rather difficult to say. However, except in the case of an extraordinary dividend the tax is likely to be assessed. The taxation of a stock dividend of large proportions is apt to prove a hardship to the taxpayer, as the market value of his holdings will not change materially nor will the amount of his subsequent income, yet he is required to pay a tax on the distribution and there seems to be no way out of it. Until the department permits adjustments on a basis of market value or probate practice, stock dividends are not likely to be popular.

J. Brooks Keyes, C.P.A.

Boston, Massachusetts, January 19, 1917.