Journal of Accountancy

Volume 66 | Issue 2 Article 7

8-1938

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Recommended Citation

May, George O.; York, Thos.; Seidman, J. S.; Snyder, Ralph W.; Kohlhepp, J. W.; and Montgomery, R. H. (1938) "Correspondence: Dealings in Treasury Stock; Board of Tax Appeals; Accounting Principles; Liabilities of Accountants," *Journal of Accountancy*: Vol. 66: Iss. 2, Article 7.
Available at: https://egrove.olemiss.edu/jofa/vol66/iss2/7

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This article is available in Journal of Accountancy: https://egrove.olemiss.edu/jofa/vol66/iss2/7

CORRESPONDENCE

Dealings in Treasury Stock

Editor, THE JOURNAL OF ACCOUNTANCY:

DEAR SIR: In my article on treasury stock which appeared in the June issue of THE JOURNAL, I tried to make it crystal clear that I quoted from court decisions solely because I had explored them in order to find authoritative definitions of "income" and of "capital." I stated in no uncertain language that when the courts were deciding what is and what is not taxable, under our weird tax laws, they could not be depended upon as authoritative as far as common sense and economics are concerned.

It was therefore with much surprise that I read the note appended to Mr. May's article in the July issue of THE JOURNAL. It is the unusual which attracts attention. I read Mr. May's article with pleasure and profit. I think we are in agreement in most particulars. But I do not care for the implication inherent in the statement that in the Reynolds case (in which the Board of Tax Appeals had held that gains arising from the sale of treasury stock are taxable) the Circuit Court of Appeals for the Fourth Circuit had reversed the tax board and held that such gains are *not* taxable.

I fully agree with the decision and also the opinion. I hope all readers of THE JOURNAL will read it. The court very properly held that, during a time when the Treasury regulations were to the effect that such gains were *not* taxable, taxpayers were entitled to rely on the regulations.

It is clear to me that, if the Reynolds transaction had taken place in 1934 instead of in 1929, the court would have held that the gain was taxable. So much for the Reynolds decision, which was handed down on June 6, 1938.

Now for the Chrold decision, which was handed down on May 26, 1938 (11 days earlier than Reynolds) by the Circuit Court of Appeals for the Third Circuit.

If tax decisions are to be referred to at all, I think that Chrold is much more important than Reynolds because in the former case Judge Dickinson said:

"A corporation which purchases shares of its own stock for less than the sum for which it was issued and then retires the stock may have been advantaged by the transaction in a sense, but the real gain is by its remaining stockholders and not by the corporation as such. The change affected is merely a change in the capital structure.

"A corporation, however, if so authorized by law, may make the stock of other corporations the subject of purchase and sale precisely as in the case of any other form of property. Any gain from such a transaction is clearly taxable income. A corporation may, in fact, thus buy and sell its own stock. The gain, if any, is as much a gain as if the transaction was in property other than its own stock. The corporation receives this profit. Its capital structure is not affected. Whether transactions by a corporation in its own stock is a capital or income transaction thus depends upon what the transaction was. The amended regulations recognize this distinction.

"The answer of which we are in search to the question presented may be made to turn on the nature of shares in the capital stock of a corporation. They are what the word 'shares' implies. The relation of corporation and shareholder is not the relation of debtor and creditor otherwise, perhaps, than in a secondary and remote sense. It is not easy to get in theory the concept of a corporation owning a share of itself and is perhaps not possible. Corporate shares are, however, easily thought of as property which may be bought and sold as are other kinds of property. A corporation may in a practical sense so deal in its own stock. When it does, the fact that it is its own stock is ignored. We know this because corporations do so deal in their own stocks by buying and selling as they buy and sell other property, and this corporation did that very thing here. We are unable to accept the proposition that what it did in fact may be by the use of mental gymnastics turned into the theory that it was not buying and selling its stock as property but, when it purchased, was reducing the total sum of its capital stock and, when it sold, expanding its

capital. A fairly good test of whether a gain is an income gain or a capital gain is whether it is distributable in dividends payable out of profits. This corporation bought shares of its stock at a price and sold it at a higher price. It in fact had taken in more than it had paid out and had the gain in hand. This was considered of itself properly distributable in dividends payable out of profits.

"The answer to the question presented depends upon whether it is made to turn upon a theory or a fact. In theory, a corporation cannot own a share in itself. When it purchases shares in itself, it thereby reduces its capital. When it reissues the stock it increases its capital. The transaction is a capital transaction. In fact, corporations do buy and sell their own corporate shares, as they buy and sell other forms of property, ignoring, as we have said, the fact that the shares are their own. These are 'as if' transactions. The shares are bought and sold as if they were not the corporation's own shares. The capital of the corporation is not affected and the transactions are not capital transactions. If the subjects of purchase and sale were, as is assumed, not the corporation's own shares, the gain, if any, would be an income gain.

"The real question thus becomes one of what the transaction, in truth, was. Here it was one of the purchase and sale of property."

I am told that this subject should be settled and closed. I agree. Compare the two decisions!

Yours truly,
R. H. Montgomery

New York, N. Y.

Editor, The Journal of Accountancy:

Dear Sir: Mr. Montgomery has been good enough to let me see a copy of his letter which is published elsewhere in the current issue. I am sorry I did not know of the Chrold case when I wrote the footnote which appeared in the July issue—otherwise, I should, of course, have mentioned it, though it throws no light on the nature of income. The decisions in the Reynolds, Chrold, and (still more recent) Squibb cases admirably illustrate Mr. Montgomery's statement that court decisions cannot be depended upon "as authoritative as far as common sense and economics are concerned."

I cited the Reynolds case because it did undertake to discuss the nature of income, and held that a definition of income which excluded gain on the resale of capital stock was at least inherently reasonable. In the Chrold case, apparently the primary purpose of the corporation was to buy out dissatisfied stockholders. It did so, and later brought in new stockholders at a higher price per share. Surely both were capital transactions. The weakness of the taxpayer's case was, seemingly, that the corporation itself treated the "gain" as "properly distributable in dividends payable out of profits."

Yours truly,
George O. May

New York, N. Y.

Editor, The Journal of Accountancy:

Dear Sir: In the June number of The Journal, Colonel Robert H. Montgomery takes sharp issue with the committee on accounting procedure with respect to the position taken by the latter concerning the proper treatment of the difference between the purchase and the resale price of treasury stock. Colonel Montgomery in general insists that such difference is profit or loss as the case may be, whereas the committee's position is substantially that the purchase by a corporation of its own stock effects its retirement, and that resale of the stock is a new stock subscription.

Some light can perhaps be shed on the controversy by considering first the fundamental nature of outstanding shares of stock in general, and of treasury stock in particular. As is well recognized by the courts, outstanding shares of stock are contracts between the corporation and the stockholders, and the stockholders with each other. In their broadest aspect as contracts, shares of stock embrace the subscription agreement, the stock certificate, by-laws (if adopted by the stockholders), the charter, and the general law under which the corporation has been organized and is operating, including the pertinent provisions of the constitution of the state. The rights, powers, duties, and liabilities of the corporation, and of the stockholders, taken collectively and individually, can be ascertained only by a collective consideration of all these constitutent parts of one contract. While I do not recall having ever seen it so stated in any court opinion, it can nevertheless be argued with a considerable show of logic that the real articles of association are not the document ordinarily filed with the secretary of state, but the outstanding shares of stock as defined above.

Inasmuch as it takes two persons to make

a contract, it is very obvious that when a corporation reacquires, by purchase or otherwise, its own shares of stock, the contract with the selling stockholders is canceled and so-called "treasury shares" are a nullity. They are in reality no longer shares of stock. The contract is terminated by the stockholders' surrendering their rights against the corporation in return for some form of consideration, which may be cash, property, remission of debts owed to the corporation, or anything else of value.

The only significance which "treasury shares" have is with respect to the power which the corporation has to replace the canceled contracts with new share contracts entered into with other individuals, that is to say, to reissue or resell the shares, to use the common expression. Basically considered, the only difference between "treasury shares" and "authorized (by the charter) and unissued shares," whether representing shares which have never been issued, or shares which have been issued but reacquired and retired by vote of the stockholders, although still remaining charter-authorized shares, lies in the conditions of their issue or reissue. Issuance of authorized but unissued shares is subject to several restrictions to which the reissuance of treasury shares is not subject, namely:

1. The preëmptive right of stockholders, unless that has been taken away by statute or charter provision, or special agreement;
2. The par value rule in the case of stock with par value, according to which such stock may not ordinarily be issued for less than its par value; and perhaps also
3. Authorization of the actual issuance by a vote of stockholders.

In practically all other respects, the status of authorized and unissued shares on the one hand and of treasury shares on the other is identical. They all simply represent the power of the corporation to enter into additional share contracts, as outstanding shares may be referred to. It is customary to distinguish these two types of unissued shares by referring to the one as neither "issued nor outstanding," and to the other as "issued but not outstanding." Use of such words may be convenient, but of themselves they convey very little meaning.

Colonel Montgomery, in the article referred to, confesses to his inability to ascertain precisely the meaning of stock retirement. It is true that the word "retirement" is used in this connection with considerable ambiguity in law and elsewhere, and frequently its exact meaning can only be determined from the general context. It is, however, generally used in either one of two senses—(1) the reduction, by vote of stockholders, of reacquired stock, which upon first acquisition is in the condition of treasury stock, to the status of charter-authorized but unissued stock, and (2) the diminution by charter amendment of the number of charter-authorized shares, which in the case of par value shares is usually expressed in terms of dollars. Shares which are charter-authorized but unissued may be issued by the corporation, but it does not appear very clear whether or not in the absence of any statutory or charter provision on the point, such issuance requires the approval of stockholders.

It is very evident that purchase of its stock by a corporation, canceling as it does previously outstanding contracts, represents a closed transaction or the complete performance of executory contracts, and that, when and if the stock is reissued, new executory contracts are entered into. If, therefore, any profit or loss is to be computed on the shares, the logical time for such computation would be upon the termination of the share contract, that is to say, on the basis of the purchase price and not the resale price of the shares. The analogy between the purchase and sale of shoes, on the one hand, and purchase and the subsequent resale of shares of stock, on the other, on which Colonel Montgomery rests a good deal of his case, will not bear analysis. Shares of stock can under no circumstances be legitimately regarded as assets of the issuing company, and that is generally recognized by the courts except in the cases pertaining to the federal income tax.

If one is to seek for a more logical and consistent analogy, it will be found between the purchase of stock and the retirement of bonds, since both stocks and bonds represent rights or claims against the corporation and are, therefore, comparable things. No one will dispute the propriety of considering the difference between the issue price of bonds (assuming it to be par) and the price of their repurchase or retirement to be profit or loss, as the case may be. Consistency would require, therefore, that if a corporation is to be taken as making a profit or suffering a loss in

a transaction in which the subject matter is its own stock, the profit or loss be considered as realized when the stock is repurchased. The error, it seems to me, into which Colonel Montgomery has fallen is in drawing an analogy between things which belong to entirely different categories and, therefore, are not comparable—namely, assets (shoes) and equities (stock), the latter of which may be looked upon as liabilities, although of a different order from liabilities to creditors.

However, there is no basis in sound reason for computing profit or loss by a corporation in its own stock, particularly its common stock, under any circumstances. The argument which Colonel Montgomery uses in justification for such computation can be used in favor of making such calculation in transactions involving bonds, but not stock. The gist of his argument is the corporation's being a separate legal entity—something quite independent of its members, the stockholders. The doctrine of the separate corporate entity is frequently stated so broadly, but as a matter of fact it is subject to very material qualifications. There is in fact a partial identity between the corporation and its members. Thus, while the corporation as an independent artificial person holds title to the assets in its possession, the title is qualified, because the stockholders have a certain interest in those assets. The corporation, for example, may not make a pure gift of any assets to strangers, except perhaps with the unanimous consent of its stockholders. Moreover, minority stockholders can by suit interfere with the management of the corporate enterprise if majority stockholders and directors exceed their authority or act in bad faith. In the last analysis the stockholders are the corporation, and that is well recognized by the courts. Colonel Montgomery applies the term "outsiders" to stockholders. That is exactly what they are not. That expression and also the words "strangers" and "third persons" are regularly applied by the courts to creditors and others having dealings with the corporation, but not to stockholders. The relation which is considered to obtain between a going corporation and its stockholders is one of a fiduciary character, the corporation conducting the business for the benefit of its stockholders.

In conclusion, I may call attention to the fact that of the prominent countries of the world only in this country are directors allowed to purchase the corporation's stock on their own authority. The practice is bound to result in inequalities and abuse. Purchase of stock is essentially a distribution to stockholders, and is on that account subject to more or less the same restrictions as dividends, which differ, however, in being ratable distributions. If a corporation has an excess of funds, the proper method of disposal is by retirement of debt or by disbursing dividends to stockholders, reducing stated capital with the consent of the stockholders if necessary, and not by purchasing stock or making nonratable distributions to stockholders.

THOS. YORK

New York, N. Y.

Board of Tax Appeals

Editor, THE JOURNAL OF ACCOUNTANCY:

DEAR SIR: Mr. Allen R. Smart's article in the April issue of THE JOURNAL on "Evolution of the Board of Tax Appeals," fundamentally calls for what many of us are undoubtedly yearning, in connection with the disposition of tax cases: namely, finality conjoined with informality.

In that regard, the following excerpt, from a letter I sent Judge Morris, may be of interest. The letter was directed to Judge Morris in his capacity as chairman of a special committee formed to review the rules and procedure of the Board of Tax Appeals with the objective of expediting the disposition of cases.

"Cases involving small sums could undoubtedly be in substantial measure disposed of informally through conference with a board member or representative, thereby dispensing with the formalities and time and cost entailed in trial. Exceptions would, of course, have to be made where basic principles are involved though the deficiency amounts are small, or where the deficiency though small in amount may involve substantial amounts by way of asserted overpayment. Such cases could probably be taken care of by motion to put them on the formal calendar upon proper showing made. Likewise, if either party were dissatisfied with the decision and desired to perfect a record for appeal, the case could be calendared, if agreement could not be reached by the parties themselves as to the facts.

"While these exceptional situations might involve an element of double tracking, they would undoubtedly be in the minority and be far submerged in the supervening time

advantages that the bulk of the small cases would be accorded through the informal processes. Many of the state courts have adopted such procedure and it seems to have worked very satisfactorily. I can see that in its ultimate analysis this may have the effect of transferring to the board the activities now undertaken by the technical staff in the commissioner's office, except that the board will have the finality that the technical staff inherently cannot possess because of the staff's administrative, rather than judicial, character."

Yours truly,

J. S. SEIDMAN

New York, N. Y.

Accounting Principles

Editor, THE JOURNAL OF ACCOUNTANCY:

DEAR SIR: The recent discussions in THE JOURNAL concerning accounting principles, distinction between different kinds of surplus, etc., seem to me to be the most significant contributions to accountancy in many years—with one exception. That exception is an article in the May, 1936, JOURNAL, by an accountant on the Pacific Coast—the same young man who last year distinguished himself by daring to talk back to one of the Elders on the subject of the proper place to show a nonexistent asset, and by refusing to be squelched by "Ss-sh!" from awed bystanders.

The name of the article to which I refer was "Primary Accounting Concepts," and the author was Lewis A. Carman. In the light of the symposium on surplus and of the comments on *A Statement of Accounting Principles*, as well as of the *Statement* itself, I have just reread Mr. Carman's article. When it first appeared I thought it was fine, but too theoretical. Now I believe it to be as important to accountancy as—well, yes, I'll make it strong—as Newton's studies on gravitation were to physics. Mr. Carman offers us something rare: some truly original thinking on the proposition of what all our figuring's about.

In my opinion, and without the qualifications usually hedging accountants' opinions, Mr. Carman has really got something. To every accountant interested in the progress of his profession, I say: Dig out and study "Primary Accounting Concepts" in the May, 1936, JOURNAL.

Yours truly,

RALPH W. SNYDER

Indianapolis, Ind.

Liabilities of Accountants

Editor, THE JOURNAL OF ACCOUNTANCY:

DEAR SIR: The June, 1938, issue of THE JOURNAL OF ACCOUNTANCY contains an article by Wiley Daniel Rich entitled "Civil Liabilities of Accountants under the Securities Act," wherein, on page 489, the following sentence appears:

"If the registration statement names an accountant as having prepared or certified the financial statements (balance-sheet and profit-and-loss statement) of the issuer for registration purposes, the written consent of the accountant for the issuer or other person so to use the financial statements must be filed with the Securities and Exchange Commission; but if the registration statement does not name the accountant as having prepared or certified the financial statements of the issuer for registration purposes, then the commission may dispense with the filing of the written consent of the accountant so to use the financial statements, where such filing would be impracticable or work hardship upon the person filing the registration statement."

The purpose of this letter is to point out that the consent of an accountant or other expert referred to in section 7 of the act is not to the use of the financial statements or other documents prepared by such person, but to the use of the name in connection with such financial statements or documents. In the case of accountants, this point is well exemplified in the language of most certificates which usually state, "We have examined the financial statements listed in the accompanying index. . . ." The financial statements as such are, therefore, those of the company, but certified by the independent accountant.

Yours truly,

J. W. KOHLHEPP

Securities and Exchange Commission
Washington, D. C.