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On the Nature of the Gain on Treasury Stock

BY D. PAUL MUSSELMAN

CONFLICT OF THEORY AND FACT

THE prevailing theory regarding the acquisition of treasury stock is most succinctly expressed in article 66 of Treasury Regulations 77, and in prior regulations for many years:

"A corporation realizes no gain or loss from the purchase or sale of its own stock."

Whether this is interpreted as "no gain realized," or as no gain at all, the resulting treatment—the posting of the discount on capital stock, if any, to capital-surplus account—merely suffices the requirements of bookkeeping, and explains nothing as to the nature of any gain there might be.

In the face of court decisions to the contrary, and the deliberate excision of the above long-standing rule from the regulations after a realistic consideration of the facts, a committee of the American Institute of Accountants has, in response to an inquiry by the New York Stock Exchange, reiterated the old rule; this opinion was then adopted by the Securities and Exchange Commission in their accounting release No. 6 of May 10, 1938. Moreover, it was included without qualification in *A Statement of Accounting Principles*, prepared under the auspices of the Haskins & Sells Foundation and a subject of extensive discussion at the 51st annual meeting of the American Institute of Accountants (1938). (*Papers on Accounting Principles and Procedure*, published by the Institute, 1938.)

Such preponderance of authority—the authors of the *Statement* were three professors of Harvard, Yale, and California respectively—would seem conclusive were it not for the stubborn economic fact that corporate managers, unhampered by accounting theory, are repeatedly buying in outstanding stock whenever favorable opportunities offer, and solely for the gain (as they believe) that accrues thereby to their corporations. The *Statement of Accounting Principles*, cited above, is authority for the assertion that the balance-sheets of 500 of the largest American corporations for 1933–1936 disclosed that two-thirds of them had employed substantial idle funds in this manner. All accountants know of profitable purchases in close corporations and have indeed abetted in their acquisition.

Neither the Foundation nor the committees of the Institute have attempted to reconcile this conflict. The courts have not attempted to do so, and it is not to be expected that they should; nevertheless, as between the economic facts before them and the prevailing rule of no-profit, they have recognized the former and blasted the latter out of the law in no uncertain terms. For example, in 35 B.T.A. 965, (1937), the Board of Tax Appeals rejects the burden and bluntly denies the taxpayer's contention that no gain was realized in certain transactions in treasury stock, using these colorful words:

"To . . . sustain the petitioner's [i.e., taxpayer's] position that no taxable profit accrues . . . would require us to engage in the exploration of the metaphysical concepts of accounting far beyond the realms of practical legal reasoning. It 'presses accounting theory too far in disregard of plain facts.'"

Thus it behooves the profession to cultivate its own field and support its own theories, or modify them to conform to changing conditions; it is surprising, therefore, to discover an attitude of virtual defiance to the implica-

tions of existing corporate practices and judicial recognition of their economic basis. The Institute's committee on accounting procedure, for instance, in its report of April 8, 1938, said: "it [the committee] is aware that such transactions have been held to give rise to taxable income, but it does not feel that such decisions constitute any bar to the application of correct accounting procedure." [1] Again, at the 51st annual meeting, the leader of the discussion said: "[it is] necessary to stand on firm ground and not be misled by decisions applying to the revenue act." Later, he said: "I have no time to pursue the economic principles involved except to state that I believe my conclusions [substantially those of the committee, but even more conservative] are sound economically." [2]

It is still more astonishing, and illustrative of the neglect to which this corner of the accounting field has been subjected, that there is no logical and workable explanation of the gain in any of the texts available to the writer. The latest text, Gilman: *Accounting Concepts of Profit* (Ronald Press, 1939), which may be depended upon to have reviewed previous opinion, says: "Not even yet have authorities agreed whether such losses or gains are true losses and gains or whether they represent capital adjustments." On the whole, the authorities favor the traditional rule.

Scope of the Inquiry

It is believed that this anomalous situation justifies this attempt (1) to make a full and adequate description of what takes place when treasury stock is acquired at a bargain, and (2) to develop the underlying principles, if the old theory proves irreconcilable to the indisputable facts. The scope of the inquiry will be limited to the most elementary transaction, a bargain purchase, with the thought that if the theory so developed be sound, it may be usefully applied in the more complicated situations. It is the writer's experience that most accountants will admit that, in some manner, many of these transactions are profitable, but they are bound by precedent, especially those in administrative positions; the relative infrequency of occurrence and —as the discussion leader said—lack of time, have prevented the rationalization of the feeling. Taxation is, of course, the most urgent of the practical considerations now in the background. The emphasis of this article, however, will be on the economic aspect. The implication as to taxes, regarding which the writer does not speak with official authority, are fairly clear, but only incidental. The thought is that, if the economic aspect is correctly stated and appraised, the principles will ultimately receive authoritative endorsement, and practice will adjust itself accordingly.

What Takes Place

To assist in the clarification of what actually takes place when a corporation buys its own stock below value, it will be helpful to set up a simplified case: The M Co., with five shares and five stockholders, buys in A's share at half its par value, which is also one-sixth of its actual and book value. Before the purchase, the balance-sheet of the company shows:

Net assets,	300x
Capital stock, 5 shares, par 20x,	100x
Operating surplus,	200x
	300x

The purchase of A's share for 10x is recorded in the journal:

Dr. Capital stock, 20x;
  Cr. Net assets, 10x;
  Cr. Capital surplus, 10x.

[1] 65 Journal of Accountancy 417, May, 1938.
[2] *Papers on Accounting Principles and Procedure,* American Institute, 1938, p. 32.

After the transaction, the balance-sheet shows:

Net assets,	290x
Capital stock, 4 shares, par 20x,	80x
Operating surplus,	200x
Capital surplus,	10x
	290x

It is obvious that little can be learned from the journal entry. It adjusts the balance-sheet in the customary way, but conceals the real profit that B, C, D, and E, the remaining stockholders, actually counted upon. Superficially, it appears to be 10x in the capital surplus account; but had the company bought the share for 30x instead of 10x, there would be no capital surplus account, though the stock would still have been acquired below value. Operating surplus would show a reduction of 10x, from which the superficial observer might infer a loss. In short, the accounting terms as customarily employed are inadequate to reflect the change in economic facts.

These facts are very simple, but they are also irrefragable. If accounting theory and practice do not reconcile thereto, it is they that require modification. The economic factors may be stated as follows:

(1) The net assets of the company are reduced by the value expended, 10x;

(2) The corporate liability to A for his share of the original investment, 20x, is eliminated. (Whether A was the original subscriber, or whether he acquired his share in some other way, or at what cost, is a matter of indifference to the M Co. as such);

(3) That part of the net assets of the company formerly apportionable to A's share of stock, less the 10x that he took with him on his departure, are now apportionable to the shares of B, C, D, and E, the remaining shareholders, pro rata.

Interpretation

If neither the accounting record nor the statement of economic facts lend themselves immediately to the reconciliation of the conflict at issue or a formulation of principles for the identification and measurement of the gain, it may be said to be due to the astringency of the one and the turgidity of the other. Later it will be shown how the accounting process may be expanded to fit the facts, but first an attempt will be made to bring the economic factors into focus.

(A) *Corporate "net worth"*

It is generally agreed that all changes in corporate "net worth" may be divided between capital adjustments and economic gains and losses. Part of the obscurity surrounding the problem is due to inexactness in the use of these terms. The chief difficulty in classification occurs when capital stock itself is involved in the gain in question, as a medium of exchange, or otherwise.

As a criterion for reaching a solution of these problems, the term "net worth" is a particularly unscientific tool. In a legal sense, it includes senior issues of stock which, except perhaps in the matter of a maturity date, are economically identical with junior bonds. Actual interchangeability occurs in the case of convertible bonds, and there have been many cases where stocks were held to be bonds, and bonds were held to be stocks,—for instance, the cases cited in Jewel Tea Co. (90 F. 2d, 451).

To many authorities, corporate "net worth" is analogous to individual net worth, because of the qualities of proprietorship in each case. This contributes to the general obscurity, because equity stock has also many divergent qualities which remove it far from the final and immutable nature of individual net worth. Unlike net worth, capital stock represents a contractual

relationship with other persons; it is susceptible to manipulation apart from equal changes in opposing assets or liabilities. In short, it is not denied that capital stockholders have the right of management, and that their share of the corporate gains are termed "dividends" and not "interest"; but it is also true that at any given time all of the corporate assets are subject to the claims of others. In this sense the corporation, as an economic entity, owns nothing of its own. All its property is "owned" by grace of what Berle and Means aptly describe as a single hierarchy of creditors and stockholders, "all of whom have supplied capital to the enterprise, and all of whom expect a return from it." This hierarchy is represented on the balance-sheet by the schedule of liabilities, ranging from the accrued payroll, which may be due immediately, to the common capital stock, which is due finally. In the economic and financial sense, all are liabilities alike and subject to the same means of measurement. Dispute as to "proprietorship" or "liability" is no dispute as to the premises; both exist at the same time in different fields, mutually exclusive. The one connotes rights, usually as between different groups of claimants; the other denotes the potential, quantitative distributions of corporate property, when, as, and if disbursed. Insofar as the surplus property of the corporation is distributable at any time to the equity stockholders, there is a measurable quantity which comes into play when stock forms a part of the transaction. It is this quantity that has to be measured and identified, and in this respect, the arithmetical process is similar to that used in the case of all other liabilities. For want of a better term, therefore, the writer begs to use the word "liability" in this aspect of equity stock and to regard the corporation economically as a device which holds all its property for the benefit of others. This view of the financial relationships of the corporation is sometimes spoken of as the "entity convention." It is hoped that it is clear that proprietorship qualities, the ability to make contracts, and other such legal relationships are immaterial to the problem of classifying changes in corporate "net worth," as usage terms it. It will be shown that for the economic purposes of this problem, there is no distinction between capital stock and other liabilities. In some cases, interest-bearing obligations come between stock issues in precedence; and even Marple, who insists on the proprietorship emphasis, admits that the line of distinction between capital and other liabilities is "often rather blurred."[3]

So much for a common objection which would substitute qualities of "personality" for measurements of quantity, and which in any event will be found irrelevant and immaterial to the problem at hand.

On the positive side, there are certain facts as to capital stock which must be borne in mind. The first is, that the item as it appears on the balance-sheet is merely a controlling account and a bookkeeping convenience. Fundamentally, the equity liability is divided among a multiplicity of holders. Transfers between these holders are, like other matters of proprietorship, a matter of indifference to the corporation as a financial entity. But the fact not to be overlooked is that transactions do occur in which the number of these units may be contracted or expanded.

A second characteristic of these units of capital liability is that the holders have adverse rights among themselves, as well as rights against other groups of creditors. This force may be described as latent; but it emerges with compulsive effect when capital adjustments of various types occur. In common terms,

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[3] *Capital Surplus and Corporate Net Worth*, Ronald Press, 1936.

the practical effect of this factor is that all equity stockholders must be treated alike.

These qualities of capital stock are not generally apparent in ordinary transactions, but must be reckoned with in distinguishing capital adjustments from economic gains, and measuring them.

(B) *Capital adjustments* v. *economic gains*

With regard to viewing corporate capital as a number of units whose holders have mutual adverse interests, it must be borne in mind that the unit comprises the entire equity. Economically, this includes as one item the capital-stock account, and capital surplus, if any, historically representing the investment, plus all other kinds of surplus, historically representing the accretion thereon. Though practice may have distorted this classification, that is immaterial. However it may happen to be posted on the books, the liability to the shareholder cuts through all the varieties of surplus accounts, as well as the capital-stock par or stated value. Therefore, in dealing with a particular shareholder, as in purchasing A's share of the M Co., he may not be deprived of his full share of the corporate assets without creating certain supplemental effects.

As a preliminary to this, it will be well to consider the nature of capital adjustments. These may be regarded as of two types, each type operating either to increase or decrease the corporate "net worth." Type 1, which might be designated the vertical type, involves changes in the outstanding number of equity units; type 2, which might be designated the horizontal type, involves changes in the content of the unit. The two may operate together in the same transaction, as in a stock split-up, tending to offset each other in their net economic effect.

A purchase of stock is of the first type,—a unit decrease in capital liability. The principle of mutual adverse interest, and the identification of the transaction as a capital adjustment, require that the departing shareholder receive his entire share in the equity (60x for A from the M Co.) and, where there is no element of profit in the transaction, he does so. Viewed from the accounting angle, this requirement cuts through a unit of surplus account (40x) as well as a unit of capital (20x).

Conversely, the opposite transaction in the same (vertical) type of capital adjustment, may be considered,—the issuing of a share to a new stockholder. It is readily seen that equity, as well as the principles under discussion, require that the incoming shareholder put up sufficient value,—i.e., premium,—above par or stated value of the stock, to equalize his position with the old stockholders. Though this premium is economically identical with the earned surplus, for tax and accounting purposes it is a contribution and not an earning.

So, in the case of a purchase, though the requirements of a capital adjustment cause it to cut through both capital and earned surplus, the resulting decrease in "net worth" is a distribution and not an economic loss.

However, we are confronted with the fact that the purchase was a bargain purchase, and the departing stockholder ("A") did not receive value within reasonable distance of the actual value (60x) of his share. As a result, we have the supplemental effect above referred to,—namely, the remaining shares have automatically received pro rata the asset value (50x) left behind by the departing shareholder. In other words, both from the economic viewpoint and, *constructively*, from the accounting angle, there were *two transactions* involved: (1) the capital adjustment, whereby a unit of equity was cut away from the corporate structure, and (2) an economic gain, whereby the departing stockholder gave back a

portion of the full value of his stock, to which, under his mutual adverse rights as an equal stockholder, he was primarily entitled. This effective discount, affecting surplus and, if deep enough, the capital account also, represents the psychological factor, the motive and the consideration, characteristic of the transaction entered into for profit. It is this discount that justifies the expenditure of the corporate assets, for which the corporate managers are accountable to the remaining stockholders.

That this theory of two constructive transactions is workable, and lends itself to the identification and measurement of both the forces that affect "net worth" will be demonstrated later in the form of expanded journal entries, as applied to the hypothetical M Co. It will be observed, incidentally, that in cutting through earned surplus in respect to the liability to the departing shareholder, and increasing the earned surplus again in respect to the remaining capital liabilities, book net surplus loses its significance, being composed of diverse elements. In other words, it will be found (and later demonstrated in the M Co.) that where capital stock has been used as a medium of exchange in a transaction entered into for profit, earned income and net surplus change will not agree, but may be reconciled in respect to the capital adjustments.

It is also of interest to observe that because par or stated value of capital stock is set up as a separate liability, where a capital adjustment is sufficient to result in a discount of capital as well as surplus, this discount is usually posted visibly to capital-surplus account. But as the discount on the attached surplus is merged in total surplus, this portion of the discount becomes, so far as the books are concerned, invisible. Because of what amounts to a short-cut in practice,—this inconsistency in treating two parts of the same thing,—we have another superficial phenomenon which probably contributes its share to the original obscurity surrounding the problem.

Thus, in respect to matters to be borne in mind as to surplus, it is found that neither book net surplus or capital surplus are evidence of earned income, as customarily used. Historically and economically, capital stock plus capital surplus should represent the investment or contribution initiated (and repeated from time to time) by the stockholders; other surpluses and reserves, however subdivided, should represent the accretion, growing out of the acts of the corporation itself, whether directly earned by its ordinary operations or resulting from fortuitous circumstances. The distinction is lost in practice, partly because of the convention of conservatism, and sometimes the coercion of law, in stating "earned" income, and partly because of the lack of logic in applying distributions and losses against existing credit balances. There is really no identity, for example, between surplus credits from operating profits, and dividend distributions. We are not, that is, receiving and disbursing surplus as such; we receive and disburse cash and "kind," and even these usually lose identity. The various factors which affect surplus should be kept separate, as will be shown by the M Co. These economic factors are actually there, however they may be combined in the accounts. The coercion of law may require the offsetting of distributions against most recent earnings, and custom requires capital-adjustment losses to be applied against earned surplus, if no capital surplus exists. Thus, classification by origin is confused with classification by destination; and where these elements become important, as in a transaction of the kind under review, book balances may require analysis into the elements that have been indicated above, and will be demonstrated below.

(C) *Corporate "profit"*

Consistent with these special qualities of corporate "net worth," capital stock, and surplus, there are certain characteristics of corporate "profit" to be borne in mind.

The concept of gain involves a point of reference,—i.e., the term "gain" in itself implies an increase in something, and the point of reference is the necessary base which, by reason of this gain, finds itself measurably greater. Here the proponents of the old theory find themselves at a loss. If they look to the conventional "net worth" as a base they find a disconcerting instability; if they look to property, they may find an incongruous shrinkage. In fact they raise a triple paradox, for in the same transaction, they find (1) from the managers' viewpoint, a gain (50x); (2) from the theoretical viewpoint, no gain; and (3) from an arithmetical viewpoint, a loss (10x) in terms of property. Instead of taking the variability of capital stock as a factor, they cling to the "personal" view of "net worth," and, abandoning both logic and mathematics, take refuge in the imperative mode and the familiar instructions to bookkeepers to post the capital-stock discount, if any, to "capital surplus."

The unanimity with which the authorities avoid the subject is unbelievable, but space forbids a review of the empty wordage whereby obeisance is paid to tradition, or—to readapt the adaptation of Thurman Arnold—to the folklore of accountancy. Roswell Magill, in his comprehensive study, *Taxable Income*, (1936), avoids all mention of this type of income, though, during his incumbency as undersecretary of the treasury, some two-thirds of 500 of the largest American corporations were gainfully employing their funds in buying in their capital stock.[4] Only twice, in footnotes or in other connections, is the Woods decision cited. Marple, who wrote a book on *Capital Surplus and Corporate Net Worth* (Ronald Press, 1936), merely echoes Montgomery and Kester; and Gilman, *op. cit.*, conceives the gain as a perpetual deferred credit, and "therefore . . . capital surplus." Among those who do at least recognize the problem and discuss it, Montgomery is probably most representative. He says:

"The fundamental difficulty is that the corporation as an entity cannot gain by giving up property and receiving in exchange only that which does not intrinsically increase its net worth." (*Federal Tax Handbook*, 1932, p. 109.)

Leaving his difficulty unresolved and abandoning the hard facts of reality, he makes his conclusion as follows:

"When the cost is less than par, . . . nothing has happened to justify a credit to earned surplus; on the contrary the only change in the situation is that someone is willing to sell stock at less than book value, thus discrediting asset valuations. (*Auditing Theory and Practice*, 4th ed., p. 244.)

". . . there has been no realization of any profit. The most that has happened is that capital paid out has been less than capital paid in . . ." (p. 247).

It is submitted that these and similar pronouncements are dogmatic rather than logical, negative rather than constructive. The facts given in support warrant a different conclusion. As to the nature of the credit for the discount from par that arises through the implacable operation of the double-entry process, this is disposed of by the familiar bookkeeping instructions.

Space again forbids a seriatim rebuttal, but there appear to be some major omissions in the major premises, such as the factor of the variable stock base and the principle of mutual adverse interest; but the principal "difficulty" seems to arise from an incomplete conception

[4] Cf. Haskins & Sells Foundation's *Statement of Accounting Principles*, American Institute, 1938, p. 90.

of gain, particularly in this problem of the point of reference. In saying that the corporation "cannot gain" by giving up property and receiving nothing in exchange of intrinsic value, Col. Montgomery seems to throw a cloud over the gain attained, for example, through the discounting of bills for merchandise. Or does he, in this case, recognize a constructive payment by the creditor in consideration of prompt liquidation of the debt?

Consistent with the "entity convention," the corporation, having no property of its own at any time, can have neither surplus nor profits of its own in the economic sense of the ultimate individual. Corporate "profits," as usage describes them, pass at once to the credit of the equity stockholders. Though this additional liability is economically divisible pro rata among the individual stockholders from the moment it is "earned," bookkeeping convenience and the preëminent requirements of business control demand a temporary (periodical) nominal classification of such credits based on such extrinsic and interchangeable considerations as origin, object, or function. At the end of the period, these nominal accounts are closed out to one or more surplus accounts. Here, again, considerations of practice require the credits to be treated collectively in one or more ledger accounts, though in reality this surplus is at all times, from the moment it is acquired, an aggregate liability to the individual equity shareholders.

Bearing in mind, therefore, the continuous liability underlying these successive nominal classifications,—instead of saying that the corporation is formed to make "profits," it should be said, strictly and consistently speaking, that the principal purpose of the corporation (acting through its agents, who are normally the representatives of the equity stockholders) is to increase the liability to those several stockholders. This will be found to be more inclusive than the concept of intrinsic value which also connotes the misleading idea of ownership by the corporation itself.

There are three ways, other than by contributions, which are capital adjustments and not "profits," by which the corporate managers may achieve their desired objective,—the increase in the liability to the several stockholders; and these three types of gains correspond with three fundamental steps in the recognition of economic (and taxable) gains by the Supreme Court.

The first judicial definitions described gains as something positive, "derived from capital, from labor, or from both combined" (Stratton 231 U. S. 399),—something "proceeding from the property, severed from the capital . . ." (*Eisner* v. *Macomber* 252 U. S. 189), or, to use Montgomery's terms, something of intrinsic value added to the assets.

But this idea proved to be too narrow when substantial gains resulted from the purchase by a corporation of its own bonds below par, and in the Kirby Lumber decision (284 U. S. 1) the second step was taken, whereby it was implicitly recognized that the economic structure of the corporation is an equation of property held against the equal claims of a "hierarchy" of owners and creditors, and that economic gain is found in an increased liability to equity stockholders, whether by an increase in one side of the equation or a decrease in the other. Thus, discounts of creditors' liabilities were brought into the definition of gain as economically identical with simple additions to intrinsic asset values.

The validity of this second type of gain is so obvious, and now so generally accepted, that it is hard to realize that the Kirby case is less than ten years old. Apparently, it required the forthrightness of Justice Holmes to bring about that advance. In his opinion he said:

"We see nothing to be gained by the discussion of judicial definitions. The defendant in error [i.e., the taxpayer] has realized within the year an accession to income, if we take words in their plain, popular meaning, as they should be taken here."

The third step in the recognition of corporate economic gain was taken in the Woods Machine Co. case (57 F. 2nd, 635), certiorari denied, where capital stock was used as a medium of exchange. This company had outstanding 3,000 shares of stock, par $100, or $300,000, and a surplus of $971,624, or a book value per share of $423.87. In settlement of damages, the company accepted 1,022 shares of its own stock, having a total book value of $433,200. Relying on the prevailing theory, the company, as a taxpayer, maintained that it had realized no taxable income; but the first Circuit Court of Appeals held that the $433,200 was income, and the Supreme Court refused to interfere. This gain of $433,200, which would admittedly have been recognized had it been received in cash, increased the book value of the stock from $423.87 on 3,000 shares to $642.88 on the remaining 1,978 shares, a gain (indirectly) to the remaining shareholders of $219.01 per share.

Under the limitations of the gains of type 1, where the point of reference is the company property, this gain would be excluded, because it is clear that, as the Board of Tax Appeals said (before its reversal by the first Circuit Court of Appeals):

"But when it [the taxpayer-corporation] received 1,022 shares of its own common stock, it owned no property which it did not own before."

In other words, before the transaction the net assets of the company were $1,271,624; after the transaction they were exactly the same.

Under type 2, the point of reference,—i.e., the base that is enhanced by the gain,—was shifted to the equity liability, or "net worth." It was found that when the Kirby Lumber Co. bought in its bonds below par, it had no increase in assets, but did have an increase in surplus or "net worth" by reason of the change in proportion of the liabilities due to shareholders as against other creditors and, economically, the increase of asset value allocable to the shares. But in the Woods case it is seen that there was no change in "net worth," the only change being a shift of $102,200 from outstanding capital to surplus (probably the book "capital surplus"). Even the surplus change alone did not reflect the value of the damages actually received. It was, therefore, evident that the gain in this case was of another type. In other words, "net worth" and surplus are not the all-inclusive bases, or points of reference for all economic gains.

In short, inferentially, the final point of reference by which economic gains are to be measured was found to reside ultimately in the aggregate increase in true earned surplus (i.e., not contributed by the individual stockholder) of the several stockholders (included in, but not identical with the net surplus change, because that includes contra capital adjustments). The two constructive transactions were recognized, and the adverse rights of the several stockholders. First, the company constructively liquidated 1,022 units of equity liability, the amount payable as a capital adjustment being $423.87 per share, or $433,200. This affected only the outgoing shares, and represented a constructive distribution, and not a loss. Second, the company then received constructively the whole $433,200 which automatically and immediately passed to the credit of the then remaining 1,978 shares, pro rata, increasing their book value from $423.87 to $642.88, or $219.01 per share. This $423.87 is then the actual point of reference or base which enjoyed the gain of $219.01, aggregating $433,200.

There is no duplication of earnings here, nor any hardship directly or indirectly on the remaining shareholder or the company by reason of the recognition of this $433,200 as additional gain and taxable income. It goes to the credit of the 1,978 shares as a new gain, identically as credits for gains recognized under steps 1 and 2. Though traceable, in a sense, to other earnings, there is no economic identity. The "invisible" portion, or $331,000, was never earned on the capital contributions of the remaining 1,978 shares; in any case, it is inseparable from the investment portion of the outgoing shares, $102,200, which certainly never had even that shadow of a connection with the contributions of the 1,978 shares.

However, the point to be remembered is that as a result of the third step in judicial recognition, the heretofore missing base, or point of reference, upon which economic gain is measured, is discovered in the surplus of the individual equity liabilities, exclusive of distributions to or contributions by the holders themselves. The basis of gains established by step 2 included those of step 1, and the basis of the final stage is all-inclusive. The economic effect of gains achieved in any of the three ways open to corporate managers is found therefore to be identical.

Inferentially, the courts have also recognized the principal points reviewed as to the individual nature of capital stock, and the principle of mutual adverse interests, which forces the constructive division of a transaction involving capital stock into two component parts, the equitable capital adjustment, and the supplementary economic gain, if any.

The economic gain may be attributed to many causes without affecting its economic nature. In the Woods case, the gain had its background in a claim for damages. In succeeding cases, the nominal classification of the gain varies, but the effect on the several equity surpluses is the same. There is, therefore, no intrinsic reason why a direct bargain purchase of treasury stock should be excluded from the category. It is quite possible to separate the gain in the financial statements if desired, but the separate statement makes it none the less representative of additional asset value to the outstanding shares, not contributed by the shareholders themselves. As to taxability, the primary reason for nominal classifications is to identify exclusions from taxable income and deductions therefrom. And if there be any degrees in non-exclusiveness, the gain on acquisition of treasury stock at a bargain should be particularly taxable because the former specific exemption has just gone out of the regulations.

Computation

Identification and computation of the economic gain can now be summarized by returning to the example of the M Co., with its net assets of 300x, its earned surplus of 200x, and 5 shares of capital stock, par 20x. It will be recalled that A's share was bought in by the corporation for 10x, and that the journal entry, which proved so deficient in information, read as follows:

Dr. Capital stock, 20x;
    Cr. Net assets, 10x;
    Cr. Capital surplus, 10x.

Translated into economic terms, there were three typical factors involved: (1) decrease of 10x in net assets; (2) decrease in capital-stock liability 20x; and (3) a redistribution of asset value, 50x, to the four remaining shares, increasing the book value of each from 60 to 72½.

The double-entry process lends itself readily to the economics of any transaction if it is desired to record the several factors; if the condensed journal entry above had been expanded to provide for all the elements of the transaction, it

would have appeared in two parts and a closing, reflecting respectively the constructive capital adjustment and the concurrent economic gain, or motivating consideration, as follows:

(I) Capital adjustment:
Dr. Retirement of capital stock [of A], 20x;
Dr. Retirement of surplus [of A], 40x;
Cr. Due to A, 60x.

(II) Economic gain:
Dr. Due to A, 60x [to close];
Cr. Net assets [payment to A], 10x;
Cr. Gain on purchase of treasury stock, 50x.

(III) To close:
Dr. Gain on purchase of treasury stock, 50x;
Cr. Earned surplus on acquisition of treasury stock, 50x.

Posting these items, and preserving the essential elements in the general ledger, we may correspondingly assemble an expanded closing balance-sheet somewhat as follows:

Net assets,		290x Dr.
Capital-stock liability:		
Issued, 5 sh. @ 20x,	100x Cr.	
Retired, 1 sh.,	−20x Dr.	
Net outstanding, 4 sh.,		80x Cr.
Surplus:		
Operating,	200x Cr.	
Retired on capital stock,	−40x Dr.	
Earned on acquisition of capital stock,	50x Cr.	
Net surplus,		210x Cr.
Total liabilities,		290x Cr.

Perhaps the only item which will appear unfamiliar is the journal entry charge to retirement of surplus, and the corresponding debit element "surplus retired," 40x, in the balance-sheet. Primarily, this reflects the economic nonidentity of "distributions of surplus" and earnings, particularly where distributions are of the vertical type. As previously suggested, the reality of this distinction is more readily appreciated when considering the converse transaction of the same vertical type, where an incoming stockholder puts up sufficient value, or premium, to equalize his position with that of the older stockholders. Practically, the premium is identical with the earned surplus, but in its origin it is a contribution and not a gain, and, therefore, a capital adjustment, and true capital surplus. The origin of this contribution should be preserved in the appropriate account. And in the same manner, the distribution of earned surplus by capital adjustment should be segregated as a debit element within net surplus.

It might appear superficially that this 40x is a part of the 200x already earned and taxed, and when it is constructively returned to the corporation (together with the 10x investment) there is a duplication of earnings. It must be remembered that this 200x, from the moment it was earned, became five separate liabilities to the five shares of stock, and the 40x assignable to A was never at any time claimable by B, C, D, or E. Also, as previously stated, we do not disburse earnings and surplus as such, but we do disburse cash and "kind." The contra debit to surplus has no logical connection with the previous credits. Though earnings and dividends may be traceable in a sense, they have legally and for accounting purposes lost their identity. The value constructively returned by A again has a separate identity, and is in fact a different amount, made up in part of the original investment, and it will not be contended that the constructive receipt of the 10x portion of A's investment represents any duplication of earnings. As the stockholders' equity is

an indivisible unit, the 40x is seen to be of the same character as the 10x in respect to economic gain. The 10x is new to the remaining shares, without question, and the 40x was never earned on the investment of B, C, D, and E, but on A's. There is no duplication of earnings any more than there is a duplication in "turnover" within a given period. And if the 50x is to be taxed as well as the 200x, there is no hardship on the corporation, or on the remaining shareholders. The latter never felt the imposition of the tax on the 40x when it became part of A's equity, and they will feel the imposition of their respective shares of the 50x only once. If this 50x were excluded from the taxable income of the M Co., these remaining shareholders would (indirectly) escape a share of the general burden of taxation equitably assessable against their equity.

From the expanded journal entries it is readily seen that the gain is the difference between the value due to the departing shareholders and the amount they accept,—conversely, the discount retained by, or constructively returned to the corporation. This requires a footnote on the question of valuation. Theoretically there should be a closing of the accounts; but in practice, if the price paid for the stock is reasonably near the book value, and if, in fact, it was the intention of the parties to effect a capital adjustment without gain or loss to the corporation, no gain or loss will ordinarily be computed because of the tolerance permissible in the valuation of much of the property. If the purchase is a bargain, however, and the book assets are not overvalued, the surplus acquired and shifted as described will be that at the date of, and immediately prior to, the acquisition. No one will ask that inventories be taken and the books actually closed for a small purchase; a reasonable estimate can be made, usually by applying the year's gain, exclusive of the gain on treasury stock, and modified by any other nonrecurring items of importance, and apportioning the same on the basis of time elapsed from the last closing. If the book assets are substantially over- or undervalued, the measured gain on the stock acquired will proportionately reflect the same variance. The fault here is with the book values, not with the method of measurement of the gain, and appropriate remedies will suggest themselves.

In conclusion, the expansion of the journal entry has its effect in stockholders' equity accounts. However the book accounts for capital and surplus may be divided, they actually comprise in their aggregate balance some or all of the following elements:

(I) Accounts relating to the investment (coupled with equal contributions from or distributions to the holders),—i.e., capital adjustment accounts:

(1) Vertical adjustments:
- (a) Capital stock issued (cr.)
- (b) Capital stock liquidated (dr.)
- (c) Premium on capital stock issued (cr.)
- (d) Surplus liquidated (dr.)

(2) Horizontal adjustments:
- (e) Contributions, assessments, etc. (cr.)
- (f) Distributions, dividends, liquidation, etc. (dr.)

(II) Accounts relating to the accretion on the investment,—i.e., economic gains:
- (g) Discount on surplus liquidated (cr.)
- (h) Discount on capital stock liquidated (cr.)

It will be seen that normally economic gains occur only in vertical adjustments in liquidation. Horizontal adjustments offer no opportunities for violation of the adverse-interests principle. Inequalities in premiums on vertical credits would be reflected indirectly in the shares of old and new stockholders, but since both now form the corporation, the inequality is leveled off, so far

as the corporation is concerned. Such inequalities may reflect real appreciation or depreciation of book values, and the reason for the inequality lies there.

No provision is made in the list for losses on vertical adjustments, because such losses would either be frauds on the remaining shareholders, or would more probably be tantamount to a charge for services or other values received, and should be so classified in the nominal accounts. But whether described as a loss or expense, it is an economic loss and not a capital adjustment. The underlying principles described herein work both ways.