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PAUL KIRCHER

1949

ACCOUNTING FOR INVESTMENTS

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PAUL KIRCHER

A Dissertation Submitted in Partial Fulfillment
of the Requirements for the Degree of
Doctor of Philosophy in the
University of Michigan

May 1949

Committee in Charge:
Professor William A. Paton, Chairman
Dean Russell A. Stevenson
Professor Robert L. Dixon
Professor Shorey Peterson
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PREFACE

Many people have aided me in the completion of this work. I have already expressed my gratitude to them individually, to the best of my ability.

Therefore I would rather take this opportunity to record my thanks to those who have helped me indirectly. By this I mean the teachers, the friends, and my family, who encouraged me in my studies, who helped me develop attitudes which made this work largely a pleasure, who have led me to hope that this can be the forerunner of more and better work in the future.

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Chapter I

CONTROL OF INVESTMENTS

Our capitalistic system offers individuals and legal entities many opportunities to invest money not required for present uses. Frequently the investor has nothing more tangible than a piece of paper -- a "security"-- to evidence this investment. When we also consider the risks and uncertainties inherent in economic life, it seems certain that an adequate accounting record is necessary if there is to be intelligent supervision of an investment fund.

The accounting record also supplies data required for reporting to others: the owners of corporations, trusts, or estates; creditors; government and regulatory bodies. Accounting techniques for such reporting have been highly developed as part of the general field of preparation of financial statements. In fact, this development has somewhat overshadowed the more primary need for economic control. Too often the investor, especially the investing corporation, has been legally required to keep books and prepare statements in ways which are inadequate for proper management of investments.

One of our leading tax authorities, J. K. Lasser, states:

> Tax cases over the past four years have created a hopeless maze of distortions of accounting concepts. The growing number of divergences between accounting for tax purposes as prescribed by regulations and court decisions, on the one hand, and generally accepted accounting principles, on the other, is the despair of businessmen, accountants, and tax practitioners alike.[1]

Concerning this conflict between accounting principles and many of the requirements of governing bodies, Kester declares, "Accounting principles and rules dare not run counter to established legal principles,"[2] but Paton and Littleton say, "It [a statement of accounting standards] should avoid any appearance of encouraging violations of existing law, but it need not accept as good accounting all definitions, policies and practices which legislators and courts have added to the accounting structure."[3]

---

[1]J. K. Lasser, in Contemporary Accounting, Editor Thomas W. Leland, American Institute of Accountants, New York, 1945, Chapter 28, p. 11.

[2]Roy B. Kester, "Sources of Accounting Principles," Journal of Accountancy, December 1942, p. 532.

[3]W. A. Paton and A. C. Littleton, An Introduction to Corporate Accounting Standards, American Accounting Association, 1940, p. 4.

Blough sums this point of view:

> Time was when the keeping of two sets of books was viewed with alarm as a breach of business morality, but the ever increasing divergence between tax accounting, as required by our income-tax laws, and generally accepted accounting principles. as required for the presentation of financial data to investors and creditors, has made multiple records a necessity.[4]

Motives of Investors

The psychology of the investor is extremely difficult to analyze. There are too many reasons why investors act as they do. Griffin lists seven general "economic" motives, as well as others which influence investors in special situations. Yet the author confesses, "As to a considerable part of the funds supplied for the expansion of enterprise. it would be quite arbitrary to discuss the motives of the capital suppliers."[5]

He continues, concerning

> ...investment of the surplus funds of one business organization in the establishment or expansion of another. This intercorporate investment in most cases is probably prompted by special considerations, such as mergers or quasi-mergers or by such business motives as the desire to support or control a good supply source or a good distributing outlet.[6]

---

[4] Carman G. Blough, "The Role of Accounting in the Taxing Process," The Accounting Review. July 1947, p. 252.

[5] Clare E. Griffin, Business Incentives and the Expanding Economy, University of Michigan, Ann Arbor, 1947, p.59.

[6] Ibid., p. 59.

The motivation of investors, of course, involves a combination and balancing of considerations. It is worthwhile to recognize, even if we cannot measure, the separate desires of this group of investors:

a. The desire for current income
b. The desire for future income
c. Appreciation of principal
d. The protection of purchasing power
e. The desire for security -- the relative assurance of gaining the rewards of investment or (a matter of degree) the desire to avoid loss of principal
f. Desire for liquidity
g. Special desires, _e.g._, to accumulate fund, leave an estate.[7]

Capital and Income

The "economic" motives listed by Griffin are primarily concerned with two concepts, capital and income. The investor desires a combination of security and profit maximization which expresses itself in an attempt to preserve capital and enjoy a return from it.[8] The financial world expresses the possible variations by speaking of "widow's investments" -- those in which the element of security is predominant, and of "businessman's investments," in which more risk is assumed in the hope of larger returns.

In spite of the fact that the concepts "capital" and "income" are so widely used, there is no general agree-

---

[7] _Ibid._, p. 59.

[8] "Preservation of capital is the cardinal investment rule," and "The aims of the trustees, both in investing these funds and in the subsequent financial transactions were clear; _viz._: to maintain the endowment and to secure at the same time a fair return on the capital invested." Officer (anon.) of Carnegie Corporation, quoted in _Your Investments_, January 1945, p. 41.

ment as to the exact meaning of the terms. The problem of income measurement has increased as our economy has grown more complex. With so many interlocking, yet legally separate, entities it is difficult to make sharp distinctions. From one point of view there is income to the individual when a corporation pays him interest on a bond; yet from another there is no income, but only a shifting of purchasing power from one entity to another.

In this dissertation the individual entity is the important subject. The point of view adopted is generally suitable for an individual person, but since corporate investors, trusts, estates, and other legal entities with developed accounting systems are more likely to be interested in this investigation, considerable emphasis is placed on their problems.

Definitions

Before proceeding further it is necessary to examine the terms which will be used frequently. All are in daily use, but unfortunately many of them have had varying definitions, especially by different legal bodies. A single definition is offered for each in the hope that it will help clarify the discussion.

Accounting

"Accounting is a synthesis of concepts, rules, and techniques designed to facilitate understanding and control

of economic activity."[9] This definition, emphasizing economic control, seems more pointed for the investor than the definition offered by the Committee on Terminology, American Institute of Accountants: "The art of recording, classifying, and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the results thereof."[10]

Security

For the purposes of this dissertation, a security is either

> (a) an evidence of indebtedness which has a determinable maturity date when it will be payable in cash on demand, or, lacking a maturity date, bears fixed amounts of interest payable in cash on demand, or
>
> (b) an evidence of ownership coupled with limited liability, together with any option or right to obtain such a security.

According to the courts, it is fundamental that a security cannot be both (a) and (b). The owner is either a creditor or a shareholder.[11]

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[9]William A. Paton, "Recent and Prospective Developments in Accounting Theory," Graduate School of Business Administration, Harvard University, Vol. XXVII, No. 2, 1940, Business Research Bulletin No. 25, p. 1.

[10]Committee on Accounting Procedure, Accounting Research Bulletin No. 9, "Report of Committee on Terminology," American Institute of Accountants, New York, May 1941, p.67.

[11]Bolinger Franklin Lumber Co. 7BTA 402; Angelus Bldg. and Inv. Co. 20 BTA 667, affirmed (CCA-9, 1932); 57 F (2d) 130, 10 AFTR 1515, CT.D. 576; C.B. Dec. 1932, p. 293; cert. den. 5-31-32. Richard N. Owens, "What is a Security?" The Accounting Review, July 1942, p. 307.

Investments

All securities are considered to be investments. Dollar contracts such as life insurance policies and annuities are included in this category.

Capital is the amount of the original fund, services, or property with which an investor acquires a security; or, the value of the security at time of a non-cost acquisition.

Income is "the gain derived from capital (from labor, or from both combined), provided it be understood to include profit gained through a sale or conversion of capital assets."[12] It is thus composed of two parts:

> (a) The recurring returns paid to the investor as either interest for the loan of capital or as dividends representing his distributed share of the earnings derived from the use of capital.
>
> (b) The non-recurring gain or loss which usually results whenever a security is disposed of, or definitely changes in value. This gain or loss may in some instances be anticipated by revaluations of the security.

For both (a) and (b) appropriate expenses should be considered in arriving at a net income. Only when all the factors are known can a final determination be made of the income which has been derived from the ownership of the security.

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[12] Committee on Terminology, American Institute of Accountants, Research Bulletin No. 9, 1941, p. 72, approving definition in Eisner v. Macomber 252 U.S. 189 (parentheses added).

Interest and Dividends

Interest and dividends constitute the periodic income which is derived from the ownership of securities. Interest is paid for the use of capital, on securities evidencing indebtedness, while dividends represent a distribution of earnings to securities evidencing ownership.

Economic Income and the Changing Value of the Dollar

The average investor appears to treat periodic "income" and "capital gain or loss" at maturity (or sale) as though they were intrinsically different. It is here maintained that the separation is mainly psychological and, if allowance is made for time and interest factors, there is no difference of actuarial significance. The important concern of the investor is to measure the present value placed in the investment and then measure and date all subsequent receipts from it. With this data in hand the investment performance can be evaluated.

The task of evaluation is complicated by the fact that the unit used in accounting, the dollar, is not stable in value. Although methods have been suggested for "stabilizing" the accounts to compensate for this factor, they have won little popularity in general accounting because of their complexity. It is suggested that such considerations are of particular significance in studying investments, and that some application of the common-dollar technique would prove beneficial as well as considerably less cumbersome in accounting for investments than it

does for general business operations.

General Outline

In general this dissertation follows the chronological stages of an investment. It begins with the amount of value which the investor utilizes to acquire a security and examines the act of acquisition (Chapter II); estimates the income while it is held, first for certificates of indebtedness (Chapter III), then for certificates of ownership (Chapter IV); discusses the evaluation of periodic income (Chapter V); then concludes with calculation of gain or loss on disposal and interpretation of the overall investment results (Chapter VI). A summary is given in Chapter VII.

Chapter II

THE ACQUISITION OF SECURITIES

In order to measure income it is necessary for the investor to know the value of a security on at least two occasions -- at acquisition and at time of disposal. The difference between the two figures, together with revenue derived during ownership, less applicable expenses, will usually determine economic benefit derived from ownership. On occasion there may be other advantages resulting from a large degree of control of a company, but such circumstances are not of importance in the present discussion.

"Value" of the security does not mean the personal opinion of the corporation official, investment manager, or private investor, but whenever possible the impartial verdict which is expressed in the term, "fair market value."[1]

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[1]"Defined as the price which would result from arm's length negotiation between a willing buyer and willing seller, each fully acquainted with the conditions and each in the same bargaining position, fair market value is the final result of the valuation process and presumably reflects a careful weighing of all the available evidence" -- William A. Paton, Advanced Accounting, Macmillan Company, New York, 1941, p. 323. See also Treasury Regulations 105 Sec. 81.10 (a).

At the time of acquisition the investing entity must have made one of the following decisions:

1. If about to purchase the security, should it part with the money, property or services which are required for acquisition?

2. If it has already acquired the security, for example, as part of a non-cost transfer such as a donation, gift, or inheritance, should it sell immediately or retain the security?

The investing entity, whether corporate or individual, is thus considered as controlling a certain amount of value. It must decide whether it would rather have this value in the form of a security or otherwise. By purchasing or retaining the security it makes the decision that the security has a value at least equivalent to the fair market value, which in almost all cases should be expressible as a certain sum of money.[2]

Once made, this decision stands as a basis for many important calculations. Periodic returns are

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[2]The process of making this decision lies in the field of "Investments" and cannot be elaborated further here. See N. S. Buchanan, The Economics of Corporate Enterprise, Henry Holt and Company, New York, 1940, pp. 234-241; Robert F. Wiese, "Investing for True Values," Barron's, September 8, 1930 -- "The proper price of any security, whether a stock or a bond, is the sum of all the future income payments discounted at the current rate of interest in order to arrive at the present value." See also Benjamin Graham and David L. Dodd, Security Analysis, McGraw-Hill Book Company, New York, 1940.

customarily expressed as a percentage of this initial value. Judgment of the investor's ability to make wise decisions is often based on comparisons between this original sum and values subsequently obtainable for the security. Subject to certain technical limitations, the investor is taxed according to gains or losses measured from this figure. It is apparent that proper measurement of the amount is extremely important.

The Measurement of Fair Market Value

As a rule, the best measure of fair market value is cost.[3] The investor is usually in a position to know whether the agreed price is the result of arm's-length bargaining and should proceed upon that basis. At the moment of acquisition, one of three situations must prevail:

1. The security was acquired at fair market value for that time and those circumstances, or

2. There was a gift to the investor, representing the excess of the fair market value over the value paid, or

3. There was a gift from the investor, representing the excess of the value paid over the fair market value of the security.

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[3]W. A. Paton, "Transactions Between Affiliates," The Accounting Review, July 1945, p. 256: "The proposition that 'accounting is based on cost' means only that when economic goods are acquired by the business and accounting entity the best evidence of recognizable value in the typical or standard case is assumed to be actual cost incurred, either in the sense of purchase price at a specific date (as in the case of a parcel of land) or in the sense of an

In any case, there is no "gain or loss" at the time of acquisition from the act of acquiring a security.

If cost is not easily measurable , as when stock is issued as compensation for services, it may be necessary to make estimates of fair market value. This process is not simple; indeed, the complexity and uncertainty of such appraisals is one of the arguments in favor of using dollar cost whenever possible.

The remainder of this chapter examines circumstances of security acquisition which are most frequently encountered and suggests the accounting practice most satisfactory in each case.

The Measurement of Cost: Immediate Payment

The simplest method of acquiring securities is by making a single cash payment. Fortunately for the accountant, it is probably also the most frequent. If the

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accumulation of component cost items" (work in process, construction). P. 257: "Cost has validity for accounting purposes only when it is not seriously out of line with economic significance in the market situation in which the transaction is consummated."

James L. Dohr, "Cost and Value," The Journal of Accountancy, March 1944, p. 194: "Since cost and value are substantially the same at the beginning there is, generally speaking, no problem at that time; upon acquisition the property is recorded at cost and as so recorded may be said to express the investment of the purchaser as well as the contemporary value."

transaction is conducted on a recognized market, such as the New York Stock Exchange, there is little doubt of arm's-length dealing, since in most instances the buyer and seller never meet. Unless there are accruals on the securities, the main problem is the determination of the expenses which should be capitalized. Brokerage and other charges directly applicable to the purchase are usually so treated.[4] Similar treatment is given fees or commissions paid by a mortgagee, although such costs are often borne by the mortgagor. In purchasing the stock of an investment trust there is usually a "loading charge" of from seven to ten per cent which is added to the pro-rata asset value of the share and represents the costs of distribution; this should be capitalized by the investor.

There may be some question as to whether indirect expenses should also be considered part of the cost of the security. Certainly no intelligent investor makes a purchase without investigating the security, and such research is frequently expensive. High priced investment counsel may be hired in order to pass on the advisability of

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[4] Accountants' Handbook, p. 459. Roy B. Kester, Advanced Accounting, The Ronald Press Company, New York, 1946, p. 30, pp. 117-8. Helvering v. Winmill, 305 U.S. 79, 38-2 USTC, Para. 9550.

certain purchases. Supervision of the portfolio requires the services of well-paid executives. Nevertheless it seems probable that such payments are better considered as being part of the expense which should be matched periodically with income from the securities. This subject will be discussed further in Chapters III, IV, and V, dealing with periodic income.

The same rules apply to the valuation of securities which are purchased in foreign countries. In such cases the cost should be translated in terms of the exchange rate at the time the purchase is made, which is not necessarily the same as the time the money is transferred abroad.[5]

Serial purchases, in which a block of securities is transferred each time payment is made, may be treated as a group of separate transactions. Although the market price at the date of transfer may be substantially different than the purchase price, there is no gain or loss to be recognized, nor any gift, as long as the contract created a firm liability at the time it was made.

In recording securities, one figure. the total cost, may be shown as the asset. In the case of bonds with a fixed maturity value, however, it is frequently

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[5] *Accountants' Handbook*, p. 1097.

preferable to use two accounts, one for the face value and the other for premium or discount. This procedure is advisable for statement purposes and also facilitates the accumulation of discount or amortization of premium.

The Measurement of Cost: Subscription Agreements and Purchase Contracts

If full payment is not made at the time of acquisition the problem of measurement becomes more difficult. The number and variety of agreements concerning the transfer of securities seems to be limited only by the ingenuity of lawyers. One of the most perplexing problems in this regard is the question as to when a person becomes a stockholder; is it at the time he enters into a subscription agreement, or when he has made payments on it? Or not until such payments are completed?

Wixon gives considerable attention to this problem, viewed from the standpoint of the issuing corporation. He comes to the conclusion that "it is difficult to state specifically just when one legally becomes a stockholder, but it is generally agreed that the issuance of stock certificates is not necessary to make an individual a stockholder.... Neither is full payment necessary." Therefore he decides that it is not possible to rely on the law, so "the accountant must decide whether or not

the subscription agreement constitutes an asset."[6]

After quoting Paton, "Capital Stock represents the amount of money actually invested by the stockholders,"[7] he further states that there is no need to distinguish between so-called subscription contracts and contracts to purchase stock. "From an accounting point of view such a distinction is unnecessary."[8] The subscription agreement is only "potential funds" in much the same fashion as is unissued stock.[9]

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[6] Rufus Wixon, Accounting for Corporate Capital Transactions, University of Michigan, 1945, p. 49, 53.
Cf. Harold F. Lusk, Business Law, Richard D. Irwin, Chicago, 1946, p. 764: "The wording of the subscription agreement is always an important factor in determining the rights of the subscriber.... A stock subscription does not differ in its fundamental aspects from any other offer of contract." P. 765: "Stock is not void even if issued in violation of the rules of full payment of par."

[7] W. A. Paton, "Is It Desirable to Distinguish Between Various Kinds of Surplus?" a symposium, The Journal of Accountancy, April 1938, p. 286.

[8] Wixon, op. cit., p. 62.

[9] Ibid., p. 55.
The Securities Act of 1933, Release No. 2206, dated March 14, 1940, dealt with Republic Company, an investment trust. In answering the Registration Statement they included shares sold for notes as paid-up capital. There were no dividends paid on the stock. The Commission held it to be an installment sale, and the owners were not stockholders.
Also, for example, cf. Article XV, Sec. 7 of the Constitution of Colorado. "No corporation shall issue stock or bonds except for labor done, services performed, or money or property actually received." A note was held not to be property in Boldt v. Motor Securities Co., 74 Colo. 55, 218 Pac 743 (1923).

The implication seems to be that the corporation should not recognize the stockholder as such until he has made the required payments. Any installment receipts are to be shown on the credit side as resulting in "part-paid Capital Stock,"[10] a distinct form of equity.

This problem has formed the basis for some bitterly fought lawsuits dealing with employee agreements to purchase stock on an installment basis. Dividends on such stock may be held to be ordinary compensation.[11] On the other hand, where there was a firm contract, the basis of the stock was once held to be the original $7,500 contract price, rather than the market value at time of delivery of $59,568.75.[12] Where continued employment was not dependent upon the right to purchase the stock at less than market, the contract also held and there was no income as compensation.[13] In the Hamilton Manufacturing Company case,

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[10] Ibid., pp. 61-62. Cf. also, by same author, "Legal Requirements and Accounting Standards," The Accounting Review, April 1945, pp. 139-143.

[11] O.D. 791 C.B. June 1921, p. 76.
R. E. Kennington Realty Co. 8 BTA 1030.
O.D. 763 C.B. June 1921, p. 76.

[12] Omaha National Bank et al (Exs.) Estate of Farrington v. Commissioner (CCA-8), 75 F (2d) 434, 15 AFTR 209, reversing 29 BTA 817.

[13] Delbert B. Geeseman 38 BTA 258, cited in five other cases given in Prentice Hall Tax Service, Para. 7710 (1947).

treasury stock was issued to employees, who were credited with dividends and charged with interest. Receivables were set up on the company books. The proceedure was approved by the Board of Tax Appeals.[14]

Wixon admits that he is assuming a going concern concept, and "It was stated above that the law is primarily interested in the protection of individual rights."[15] He quotes the law as interpreted by Fletcher:

> Where a subscription to the stock of an existing corporation is regarded as a contract of purchase and sale, so that the subscriber does not become a stockholder until the subscription price is paid, if the subscriber repudiates the contract while it is still executory, the corporation may either cancel or annul the subscription, or maintain an action for damages against him, in which the measure of the damages will be the difference between the amount which he agreed to pay for the stock and its value when the action is brought. Under such circumstances he cannot be held liable for the balance due on the subscription, either by the corporation or its creditors. But this rule has no application where the contract has been partly executed, as, for example, where part of the subscription price has been paid and accepted, and under such circumstances the subscriber may be held liable for the entire unpaid balance of the subscription price.[16]

Wixon believes that the accountant also may be forced to make a distinction between subscription contracts

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[14] Hamilton Manufacturing Company, 3 BTA 1045.

[15] Wixon, op. cit., p. 52.

[16] W. M. Fletcher, Cyclopedia of the Law of Private Corporations, Volume 4, Callaghan and Co., Chicago, 1931.

and contracts to purchase (where title does not pass until payment is made) in the case of defaults.[17]

From the standpoint of general economic welfare it would seem preferable that the subscription contract, or "contract to purchase" new shares, be considered a firm liability of the subscriber. The financing of corporations would be difficult enough without adding the fear among subscribers that others may not live up to their agreements. If a person has little intention of keeping his word, why should he be allowed to join in if things go well but retire if they do not? This point of view is recognized in the Uniform or Model Business Corporation Act, which gives full legal force to pre-incorporation subscriptions (Section 6).

The fact that an issuing corporation chooses to regard the obligation with suspicion and treat it, as Wixon suggests, as "potential funds," should not alter the investor's procedure unless circumstances indicate the contract has not created any liability on his part.[18]

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[17] Wixon, op. cit., p. 66.

[18] The reader will remember that by "his" it is not meant that the above situation applies only to individuals, but also to corporations, investment trusts, etc. The point might be more striking if instead of "his" the text said "General Motors," which was an investor (1946) to the extent of more than $200,000,000, exclusive of consolidated subsidiaries.

Interest Payments

The problem is further accentuated by the fact that interest is frequently charged on contracts where full payment is deferred, including margin purchases on the stock exchange. Is this part of the cost of the security, or a current expense? The *Accountants' Handbook* approves the capitalization of interest when the purchase is made on the installment plan: "Nevertheless interest paid on unpaid balances of securities purchased on the installment plan may be viewed as a proper carrying charge and included in the cost of the security. Where this is done, however, any dividends or interest allowed by the issuing corporation (or other party involved) during the period of purchase must be credited to the investment account."[19] This would appear to include cases where title has passed to the purchaser, since he is receiving dividends.

If the purchaser has title to the security and would receive any dividends from it, it would seem better to consider interest payments, no matter to whom, as being current expense. On the other hand, if the purchaser is only in the process of acquiring title, so that he is not yet eligible to receive dividends, then he is in much the same position as one who is constructing a building and

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[19] *Accountants' Handbook*, p. 460.

wishes to capitalize interest until the building is completed and revenue begins.[20] In any case, the investor who has unqualifiedly obligated himself to subscribe or purchase securities should make certain that there is a complete understanding as to the time he will become a legal stockholder.

Stock Issued at a Discount

If the share of stock is issued before a sum equal to par value is received by the corporation, the stock is said to be issued at a discount. Legally this discount, representing the difference between actual payments and par value, can be demanded by the creditors of the company if it is required to protect their interests. Since the introduction of no-par stock and the issue of stock with par of much less than $100, this contingent liability has become rather rare, but investors should always be careful to ascertain whether it exists before purchasing a security. In an attempt to cancel this liability, corporations have charged the discount off to earned surplus, but whether this accomplishes the desired purpose has been held open to question.[21] In cases where the security has been transferred, the transferee is contingently liable for any

---

[20] *Ibid.*, pp. 865-6.

[21] Wixon, *op. cit.*, p. 74.

unpaid balance on the stock, but if the transfer is made to one who cannot be held liable or is insolvent, the transferor will be held.[22]

The situation is not clear where stock issued at a discount has been reacquired by the corporation and after being held as treasury stock is reissued. Paton suggests that from the legal standpoint the transfer would be considered as a purchase and sale, leaving the discount unchanged, but that the general framework of accounting concepts would favor considering the acquisition as reducing the stock outstanding and returning the block acquired to the status of unissued stock.[23]

The Measurement of Cost: Accruals and Arrears

The capital which is invested in a security sometimes can be segregated into two amounts, of which one part represents the maturity promise, or ownership share, and the other part accruals of interest, or dividends or interest in arrears. The purpose of this segregation is to enable the investor to distinguish between the ordinary income payments, which may recur, and unusual payments which represent accruals of the period previous to ownership. Payments which fall in the latter category should

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[22] Lusk, op. cit., p. 798.

[23] Paton, Advanced Accounting, p. 513.

be considered as return of part of the capital.

The segregation is ordinarily accomplished by setting up some account such as "Bond Interest Receivable" at the time of acquisition. It might be noted that this treatment considers the amount temporarily invested in the receivable as not bearing any interest, but since the amounts are usually small and the periods short, there would be little gain from making any adjustment.

No segregation need be made when discount bonds are purchased; it is sufficient to record the price paid without identifying the accrued interest because both elements will be payable on the same date.

When interest is in arrears, bonds are customarily sold "flat." There may be no satisfactory basis on which to allocate the price paid to the two elements of principal and accrued interest, in which case the receipt of all or a part of such previously defaulted interest may be treated as a credit to the investment account rather than as income.[24]

Preferred stock dividends are not considered as accruing until the date of declaration, even if they are cumulative and there is a strong probability that they will be paid. The one exception to this rule is in the case of a new offering of preferred stock, where the accrued

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[24]Securities and Exchange Commission, Accounting Series, Release No. 36.
<u>Accountants' Handbook</u>, p. 490.
Erskine Hewitt, 30 BTA 962.

dividend should be treated in the same manner as accrued interest on a bond purchased.[25]

Tax doctrine follows this rule of non-accrual with a rather interesting result. A preferred stock which has been held for more than six months and which has just declared a large dividend can be sold before the record date, resulting in a long term capital gain (taxable at fifty per cent). Then after the "of record" date the stock will presumably drop an amount equal to the dividend, when it can be repurchased. Since the wash sales rule does not apply in the case of gains, the result is that the dividend is taxed as capital gains and not as ordinary income.

Some accountants appear to favor the idea of keeping dividends accrued at the purchase date out of the investment account, especially when dividends are later paid which exceed the profits earned during the period the stock was held.[26] However, there does not seem to be adequate reason for the investor to attempt such an allocation at the time of acquisition. He should rather keep records which will be sufficient to enable him to segregate income from return of capital when the dividend is received. This problem is therefore deferred to Chapter V.

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[25] Accountants' Handbook, p. 461.

[26] Howard S. Noble, Wilbert E. Karrenbrock, Harry Simons, Advanced Accounting, Southwestern Publishing Company, Cincinnati, 1941, p. 144.
Accountants' Handbook, pp. 461-2.

The Measurement of Cost:

Property or Services Exchanged for Securities

When property or services form all or a part of the payment for securities, the problem of valuation is usually more difficult than in cases involving only cash. The general rule is that the exchange should be recorded at fair market value of the property given up; i.e., the payment made. The determination of this value requires different approaches in different circumstances. If other conclusive evidence of the value of the property or services is lacking, the value of the stock received may usually be accepted, but, before using this figure, the investor should make certain that it does represent a fair measurement.

The problems of valuation are too intricate for a full discussion in this dissertation. An indication of the difficulties and further references are given in Appendix I.

The Measurement of Cost:

Restrictive and Repurchase Agreements

Restriction on the right of a stockholder to transfer his stock may be imposed by statute, by the articles of incorporation, by by-laws or by agreement between the stockholder and the corporation. The transfer

of stock may be prohibited altogether by provisions in the articles of incorporation. Usually such restrictions on the transfer of stock provide that a stockholder must first offer his stock to the corporation or the other stockholders, or that the person to whom the stock is transferred must first be approved by the directors. But a by-law or agreement between the corporation and its stockholders which would attempt to make the stock of the corporation non-transferable or impose unreasonable restrictions on its transfer would probably not be upheld.[27]

Cohen states that such agreements are used to:

1. Insure continuity of control
2. Prevent outsiders from becoming stockholders, even as a minority
3. Promote stability of management
4. Interest and retain able employees
5. Fix price and procedure for disposing of stockholder's interest upon death or retirement[28]

Where such legal restrictions exist, it is obvious that the fair market value of the stock will be affected, since the number of potential buyers is deliberately limited. The leading case is the Tex-Penn Oil Company,

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[27] Penthouse Properties v. 1158 Fifth Ave. Corp. Inc. et al, 11 N.Y.S. (2d) 417 (1939).

[28] Edwin S. Cohen, "Restrictive Agreements for Purchase of Stock: Effect on Estate and Gift Tax Valuations," New York Certified Public Accountant, March 1947, p. 162.

where an agreement was made, in reorganizing, that the holders would not resell for ninety days, with an extension for ninety days. The Court decided that the shares "regard being had to their highly speculative quality and to the terms of a restrictive agreement making resale impossible, did not have a fair market value, capable of being ascertained with reasonable certainty, when they were acquired by the taxpayers."[29]

Restrictive agreements are frequently in the form of options to repurchase the stock, setting some definite price or formula for arriving at the amount for which the stock must be relinquished. In several cases the courts have held that such amounts constitute the fair market value. Where part of the stock was subject to repurchase, then that part was valued at the option price and the rest at market. On the other hand, if the owner, though restricted as to the persons to whom he can sell, nevertheless has the right to will the securities to his heirs, then he has a valuable right of retention.[30]

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[29]Tex-Penn Oil Co. 300 U.S. 481 (1937). Cf. also Heriser v. Guinner 114 F (2d) 723 (CCA 3rd 1940) cert. den. 311 U. S. 714.

[30]Wilson V. Bowers 57 F (2d) 68 2 (1932) affirming 51 F (2d) 261 (S.D. N.Y. 1931).

Lomb. v. Sugden 82F (2d) 166 (CCA 2d, 1936) rev'g 11 F. Supp 472 (W.D. N.Y. 1935).

Helvering v. Salvage 297 U.S. 106 (1936) (an agreement not to compete).

Worcester County Trust Co. v. Comm. 134 F (2d) 578 (CCA 1st, 1943) reversing 46BTA 337 (1942). The option price was $15.46; the Commissioner estimated the value at $35. He was not upheld by the Court, which agreed that the option had a depressing effect, but not to the option price.

For both restrictive and repurchase agreements it would appear that at the time of acquisition the holder is more interested in this right of retention than in any price obtainable from immediate sale, and the securities should be valued on that basis. Resale values are only a means of determining the valuation set upon any property acquisition; emphasis ordinarily should rather be on the payment made. If there is no payment in money, property or services, then an estimated value can be used, but the mere fact that the estimate is difficult to make, as the Tex-Penn case, is no excuse for indefinitely postponing a record of the acquisition. All valuations are uncertain to a degree, and even a price agreed upon in full and open negotiation, with immediate cash payment, would usually be altered somewhat if the process of bargaining were to be repeated later. For convenience it may be preferable to postpone valuation of an acquisition temporarily, but it should be remembered that proper accounting control is based upon recognition as soon as possible after assuming economic control.

Sometimes repurchase agreements may be worded in such a way that the sale amounts to little more than a loan, with the security as collateral. In one case, to obviate the limit on loans to one company, a bank "purchased" municipal bonds subject to repurchase. The company guaranteed no loss on the sale of the bonds, the proceeds of the

bonds were credited to the company, which returned a different amount to the bank. It was properly held that the transaction was not a sale.[31]

The Measurement of Cost: Options, Puts and Calls

Instead of acquiring a security directly, an investor may acquire an option which permits him to purchase the security at a specified price. Usually a time limit is also specified. These options can be acquired either from

(a) the company, as a result of
1. prior security holdings
2. cash
3. other consideration--often services

or, (b) brokers, or, less frequently, other investors.

Options acquired as a result of prior security holdings (a,1), called "rights" or "warrants," will be discussed in a succeeding section. Options acquired from brokers (b), called "puts" or "calls," will be investigated in this section following a discussion of (a,2) and (a,3).

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[31] First National Bank in Wichita v. Comm. (CCA-10), 57 F (2d) 7. See also McAuliffe 29 BTA 624, Dec. 8334 (Acq.).
But real sales: Irving Fisher 30 BTA 433, Dec. 8519; Bank of California, National Association, 30 BTA 556 affirmed (CCA-9), 80 F (2d) 389.

Because of the nature of an option, the security in question is almost always some form of stock. If the person does not receive the option as a result of some prior security holding, he usually must give the company or broker valuable consideration for the option. Wixon considers the procedure where there is no consideration at the time of granting, and comments that there should be no entry on the corporation books.[32] Still, it is difficult to imagine an option which had absolutely no value to the recipient and yet was a business transaction. In at least one case the courts have negated an option which was a gift with no business purpose.[33] The fair value of the option should be determined by the investor and recorded at time of acquisition.

Some types of options are not exercisable until a future date, and then only if some specified event has occurred, such as continued employment of the officer granted the option. In such cases there has been support for the exercisable date as the proper time to record the security, an interpretation which ignores the fact that

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[32] Wixon, op. cit., p. 88.

[33] Cem Securities Corporation v. U.S. (1944) 55 F Supp 109, 32 AFTR 796.

the option has a real value before that time. It can frequently be sold or traded, and the purchaser may take out insurance to protect his interests. Once more, if accounting control is to reflect economic control, the valuation and record should be made as soon as possible.

The holder may wish to revalue the option on the date it becomes exercisable, in view of the changed conditions at that time. But there seems to be no advantage in pretending that it has no recordable value until then, merely because the value is uncertain. It is true that death or dismissal might make a particular option worthless, but if so it would not be the first security which suffered that fate.

When the option is exercised, the cost of the stock acquired is then the value of the option relinquished plus the value of any additional consideration at the time of exercise. If the option is not exercised, it represents a capital loss. (However, for tax purposes, this loss is always considered to be short-term.) The sale of an option should be treated like the sale of any ordinary security.[34]

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[34]Since this dissertation was prepared, the Committee on Accounting Procedure approved Bulletin #37, supporting use of the date the option becomes the property of the investor. For further discussion refer to:

Wixon, op. cit., p. 97.

George G. Tyler, "Stock Options," Taxes, July 1946, p. 611.

Abraham S. Guterman, "New Problems under Section 126 in Income and Estate Taxes," Taxes, July 1946, pp. 635-6.

James L. Dohr, "Accounting for Compensation in the Form of Stock Options," Journal of Accountancy, December 1945, p. 439.

Valuation of Options

The estimation of the present value of stock options is almost universally inadequate. Writers frequently state that the value of the option at acquisition is the difference between the market price and the option price, if the former is higher. Where it is lower they seem somewhat baffled.[35] Yet it should be obvious that if a person has an option to buy a stock at $22 any time in the next year, and the market price is at present $23, the value of the option is more than $1. His loss might be $1, while his possible gains are theoretically unlimited.

As a matter of fact, this situation is recognized by the actual market to a degree which is surprising. A situation like that described above occurred in 1945 in the case of Pan-American Airways' warrants, which were for the purchase of stock at $18 per share any time before December 30, 1947. Occasionally these warrants were sold for more than $15 each, though Pan-American stock never sold over $30 per share. Moreover, at a later date when

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34 (continued)
E. R. Dillavou, "Employee Stock Options," Accounting Review, July 1945, p. 320.
Comm. v. Smith (1945) 324 U.S. 177.
T. D. 5507.

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Tyler, op. cit., p. 614.
Dohr, op. cit., p. 441.
Dillavou, op. cit., p. 321.
Smith decision, as reviewed by Dohr, Journal of Accountancy, April 1945, p. 343.

the end of the period was much closer, the price of the stock fell below $20 per share, and yet the warrants continued to sell (on the Curb) for prices ranging from $3 to $5.[36]

This is not an isolated instance. The put-and-call market, which is discussed in a later part of this section, can and does make such offers for every leading security on the New York Stock Exchange. The interesting fact is that short-term calls set the option price at or above the present market price, and yet investors pay considerable sums for the privilege of acquiring such options.

The calculation of the value of put-and-call options is obviously a very uncertain affair. Yet it is done daily. There seems to be no reason why a similar calculation cannot be made for the value of an option when it is acquired by an employee.

The present tax rules differ considerably from the above conclusions. It is not the purpose of this dissertation to present all the multitude of implications of the Internal Revenue Code. Yet it is worthy of note that the Treasury Department's insistance that all the difference between the market value and the option price at the time of exercise is compensation may have resulted in depriving the government of a considerable amount of

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[36] Moody's Manual of Investments, Industrial Securities, 1947, Moody's Investor's Service, New York, p. 1641.

revenue in the past few years. Since the difference is "compensation" it is deductible on the corporation's tax return as a business expense. During the period of the excess profits tax the potential net result is obvious. Even now, suppose the employee is paid a salary of about $40,000 a year, is married, and has exemptions, etc., which make the tax rate on any extra compensation about 50 per cent.[37] Suppose he is given an option worth $200 at acquisition, but $1,000 when exercised.

Then,

Treasury Department Method

Value of "Compensation"	$1,000	
Tax on Individual @ 50%		$500
Reduction of tax on Corporation @ 38%		380
Net Revenue to Government		$120

If option were valued at acquisition

Value at acquisition	$200	
Tax on Individual @ 50%		$100
Reduction of Tax on Corporation @ 38%		76
Net Revenue to Government		$ 24
Later Sale by Individual at $1,000 Capital Gain of $800, considered long term (short term would be more) @ 25%		200
Total Net Revenue to Government		$224

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[37] Under the 1948 laws this income can be shown jointly with his wife. An increase of $1,000 would actually be shown as $500 on each return. The net effect would be as shown in the above illustration.

Thus the Treasury's efforts may have a somewhat negative result, unless the tax rate on the employee exceeds the current corporation rate by more than 25 per cent.

If the treatment recommended here is followed, it makes little difference whether the stock involved is that of the employer or of any other corporation whose securities it may own or control indirectly.

Puts and Calls

Puts and calls are options which are dealt in regularly by a special group of New York brokers. When a person buys a put, he receives the right to sell the broker a certain number of shares of a named stock at a special price, anytime within a given period (usually six months or less, frequently thirty days). In the case of a call, the buyer receives the right to buy from the broker a certain number of shares of a named stock at a specified price, anytime within a given period (same as puts). These options are popular with speculators who wish to protect themselves against extended movements in uncertain periods.

If a put is purchased to protect the owner against a sudden drop in the market price of a security already held and is not used, for his purpose this represents a

short-term expense and should not be capitalized.[38] If the period extends past a fiscal closing date, some apportionment to the two periods should be made. If the put is exercised, the cost represents a reduction in the amount of return realized from the sale.

If a call is purchased and used, the cost should be added to the basis of the security, which includes the call price and any commissions and taxes. Puts can be purchased as speculations by persons who do not own the stocks named; these and calls not exercised should be considered as securities which on a certain date become worthless and are capital losses.[39]

Use of Puts and Calls

For example, suppose a corporation wishes to acquire some New York Central stock but is afraid that some impending news event, such as a possible strike, might make the market price drop precipitously. On the other hand, the purchaser does not wish to wait too long, for, if the strike does not occur, the price might show a sudden rise. If otherwise satisfied with the current market price,

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[38] This expense is much like insurance, which Gilman would call a loss. Cf. Stephen Gilman, Accounting Concepts of Profit, The Ronald Press Company, New York, 1939, p. 311.

[39] For tax treatment, see Leslie Mills, "Tax Problems in the Purchase and Sale of Securities, (Second Annual Conference on Federal Taxation), Taxes, June 1947, p. 555.

e.g., \$20 a share, the corporation might purchase a thirty-day call for 100 shares, paying \$200. Then, if the price of New York Central goes above \$20, it will be worthwhile to exercise the call, unless the rise is only equivalent to brokerage fees. If the stock rises to 21½ within the thirty days, and the corporation makes the purchase, it has lost about \$50 by not waiting and buying without use of a call. On the other hand, if the price rises above \$22, it has saved the difference; if the price falls below \$20, the most it can lose is \$2 per share.

Puts are similar except that these options are ordinarily purchased by owners who are not convinced that they wish to sell their securities, but who fear a possible market decline. Given a stock price of \$20 and a put for 100 shares costing \$200, any drop below \$20 will return part of the cost (after brokerage), while a drop below \$18 will mean the owners have been safeguarded from a loss equivalent to the difference. If the price rises, the put is useless and becomes an expense, since it is a form of insurance and not an addition to the investment.

Acquisition from Prior Security Holdings: Stock Rights and Warrants

Stock rights and warrants are closely allied in meaning. Both are options to buy a named security at a certain price or prices within a given period. In

financial circles "rights" are usually considered to be shorter in term and as fixing a price below the market price so that they will be exercised; they are customarily used for financing. "Warrants," on the other hand, may run for considerable periods, name prices higher than the market price at issue and therefore are not so likely to be part of an immediate financing plan, but these distinctions are not invariably followed. In addition there is not full agreement as to whether one right (or one warrant) is to be considered to be the right attaching to one old share or the right to buy one new share; the investor should be careful to ascertain exactly which is referred to in any prospective transaction.[40]

The question of income upon the receipt of rights or warrants is treated in Chapter IV, along with stock dividends. A general conclusion in the case of common stock is that they are best considered as an implicit division of the investment account, and therefore part of the original value of the security should be allocated to them. The allocation should be made on the basis of respective market values.

For example, if a stock is selling at $100 a share, and one right is issued for each two old shares, to buy

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[40] Graham and Dodd, _op. cit._, pp. 636, 638.

one new share at $80, then the value of the right attached to each old share is $100 — 80) ÷ (2+1) = $6-2/3 (the market price less the subscription price divided by the total of old and new shares).

If the stock originally cost $60 a share, the cost assignable to the right would be $\frac{6\text{-}2/3}{100}$ x $60 = $4. This amount should be set up in a separate account:

Stock Right (X Co.)	$4.00	
X Co. Common Stock		$4.00

If the stock has been acquired in a number of lots, it is necessary to make such entries for each lot for tax purposes, although it is somewhat more logical to consider the holding as a whole, using an average cost per share.

If no market value is available, the allocation might be made on the basis sustained by the Supreme Court for rights issued before 1925; the cost of the old shares plus the consideration needed to acquire the new shares was divided by the total number of shares, the subscription price of the new shares subtracted, and the difference divided by the number of rights.[41]

If the stockholder receives a right to subscribe for a fraction of a share, he may either purchase a

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[41] Miles v. Safe Deposit & Trust Co. 259 U.S. 247. Cf. George T. Altman, Federal Tax Course, Commerce Clearing House, Chicago, 1946, Para. 841.

further fraction, sell his fraction, or allow it to lapse. If proper allocation has been made to the fractional right, this forms the basis for either computing part of the cost of the security, or gain or loss on sale or lapse.

In many cases warrants received may name a price so much above present market that they are virtually worthless. The stockholder is then justified in allocating all the basis to the stock and none to the warrants.

Acquisition from Prior Security Holdings--Conversions, Exchanges, and Reorganizations

Since the important factor in conversions, exchanges, and reorganizations is the continuity of interest rather than the acquisition of new securities, a discussion of these situations is deferred to Chapter VI.

Acquisition from Prior Security Holdings--Wash Sales

The concept of wash sales has been developed by the Internal Revenue Code as a variant of the "continuity of interest" concept. Briefly, if an investor sells a security, and in a period extending thirty days before or after that date buys a "substantially identical" security, then no loss is allowed for the sale. Gains are taxed as usual. The rule does not apply to dealers, traders, gifts, inheritances, or tax-free organizations.[42]

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[42] I. R. C., Sec. 113(a).

This rule has no logical basis. It arbitrarily limits the deduction of capital losses for persons whose economic position has been impaired but who do not happen to fall into the category of those exempted. The rule also makes an exception to the generally accepted accounting practice of recognizing an arm's length sale as the most trustworthy evidence of valuation. It is an extension of the Treasury Department's belief that no loss has occurred when securities drop in value until they become completely worthless, at which time the loss is considered instantaneous.

Acquisition from Prior Security Holdings--"Dividends"

When an investor receives a dividend in the form of securities, there is a question as to whether the action should be viewed as the receipt of income or a readjustment of his capital investment. A full discussion of this problem is therefore deferred to Chapter IV.

Mortgages and Other Installment Contracts

A problem of cost measurement sometimes arises in connection with mortgages. In the typical situation, the amount loaned is the face of the mortgage, which offers no difficulties. However, the mortgage may be a "cash equivalent" in a sale of property. Suppose A sells a

piece of real estate to B for the nominal price of $80,000, B paying $20,000 in cash and giving his ten year, six per cent note, secured by a mortgage of like terms, for the balance. The actual cost of the mortgage to A in this situation is not $60,000 but probably somewhat less, as would be shown if the mortgage were immediately transferred at a discount. For tax purposes it need only be set up at this fair market value. Even more definite is the case where a loan is made in which the cash given is less than the face of the mortgage. Here the cash cost should be shown, either net or by setting up a contra to the face amount.

Long-term installment contracts, such as the type often used for the sale of land, offer some of the aspects of a single payment annuity. The payments usually combine interest and reduction of principal, as in the case of F.H.A. mortgages. However, since the payments are not underwritten by the government, there is more danger of default. As the balance is reduced by successive collections and the danger of default is minimized, the earning rate required by the investor should fall. Paton suggests that there is a "possibility of periodic revaluation on the investor's books in terms of market values, in lieu of the use of a calculated yield rate as just explained. Aside from the general objections to such valuations, however, the narrowness of the market and the lack of reliable

quotations make such a procedure impracticable."[43]

As in the case of the mortgages, the "cost" of such contracts may be different from the face amount recorded, which will be indicated if the contracts are traded. When they have been recorded at face, any loss sustained through discounting of such contracts should be considered as an offset or addition to the gain or loss recorded on the sale of the land.

For example, if a piece of land costing $50,000 has been sold under contract for $60,000, the seller might show:

Land Contract	$60,000	
Land		$50,000
Gain on Sale of Land		$10,000

If the contract were then transferred for $55,000, the proper entry would be

Cash	$55,000	
Loss on Sale of Contract	5,000	
Land Contract		$60,000

The Loss on Sale of Contract is best considered an offset to the Gain on Sale of Land.

When a contract is discounted, the purchaser should accumulate the difference by the effective yield rate method. Since the investment balance is decreasing, straight line accumulation will distort the picture to

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[43] Paton, Advanced Accounting, p. 208.

an excessive degree. For an illustration of the method for finding the rate when it must be determined by the investors, see Paton, Advanced Accounting, pages 206-7.

It sometimes happens that the contract to purchase a security is transferred to another party before completion. In such cases the cost to the new party is the sum of the payment made to the original holder and the balance of the payments which must be made on the contract. It would appear that the principle as to the capitalization of interest would apply -- if title to the securities is received and any interest or dividends will accrue to the new owner, then such interest payments are expense. Otherwise, they may be capitalized. In the case of a life insurance contract so transferred to another individual (not the insured), it is necessary to keep a record of the original payment and subsequent premiums, as any return above these accounts is considered income by the Treasury Department.[44]

Partial Gifts

The question of partial gifts has arisen mainly in connection with tax matters. An effort may be made to disguise gifts by selling property, including securities, to a related interest at a price which is considerably

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[44] Regulations 111, Sec. 29, 22 (b) (2) 3.

above or below its fair market value. Presumably the parties are aware of the actual situation and can separate such transactions into their true elements, which should always be done. It is advisable that careful and complete records be kept, together with independent support for valuations used, if the investor wishes to avoid difficulties with the Collector of Internal Revenue.

Special situations may arise where such estimates are difficult. For example, it is the practice of some institutions to encourage people to grant them endowments by agreeing to pay annuities on the sum during the life of the grantor. These annuities are usually considerably less than could be purchased for the same sum from an insurance company. The balance is a gift, and is considered such by both parties. However, often no particular allocation is made; the principal is added to the general fund of the institution, and payments are made from the general receipts, with no attention given as to any connection between the donation and income earned on it. Application of the Treasury Department's rule that three per cent of the principal is income would obviously be inequitable in such situations unless the true purchase price is determined and recorded by the donor.

Apportionment of Cost in Blanket Acquisition

Where more than one type of security is acquired for a single purchase price an allocation should be made so that each security can be recorded at its separate value. Frequently the amounts can be established by reference to market quotations for the securities. If no such values can be determined at the time of acquisition, it is necessary either to postpone the apportionment or to make it on an arbitrary basis.[45] It should be noted that postponing an apportionment is not the same as postponing recognition of value. In previous sections (options, etc.) it was argued that postponement of recognition is inadvisable, but in this case a total value is shown for the controlled assets immediately; only the segregation is delayed.

Par values are unreliable as a basis for such allocations, even when one of the securities is a preferred stock or a bond. When no fair apportionment can be made, courts have held that all the securities must be sold before any loss can be recognized.[46] Holzman concludes,

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[45] Paton, Advanced Accounting, p. 174.

[46] Spreckels- Rosekrans Investment Company v. Lewis (44-1 USTC Para. 9142).

"There is no satisfactory formula for apportioning basis among several parcels acquired in a block."[47] For tax purposes, the Regulations permit any basis to be used if the Commissioner agrees.[48]

The problem of valuation can be approached in the same manner as when a single security is involved (see Appendix I). After a total value for the group has been obtained apportionment can be made on the basis of the relative values which together made up the estimate.

For example, suppose two securities are acquired at a cost of $1,000. Independent appraisal gives security A a value of $600 and security B, $360. Then A should be shown at $\$1,000 \times \frac{600}{960}$ or $625; B at $\$1,000 \times \frac{360}{960}$ or $375.

Non-Cost Acquisition of Securities--Gifts and Inheritances

There are a variety of ways in which securities can be acquired without cost. For many of these situations the government has developed special methods for computing the basis of the securities.[49] For purposes of economic

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[47] Robert S. Holzman, "Basis in Tax-Free Reorganization," Taxes, August 1946, p. 713. Cf. Stock Yards National Bank of South St. Paul v. Comm. 153 F (2d) 708 (1946).

[48] Regulations 111, Sec 29.113 (b) (1)-3.

[49] For summary, cf. Accountants' Handbook, p. 615.

control every such recipient should ascertain the value of the securities at acquisition, even if the circumstances are such that it can only be an estimate. Since there is no consideration, the valuation will have to depend solely upon an appraisal of the securities, but this is better than making no estimate at all. The date of valuation need not be the exact date of acquisition if the valuation can be made with more accuracy at a date reasonably proximate.

Securities are frequently transferred as gifts. It would appear, logically, that this should be one of the simplest of all possible transactions -- a mere transfer of value from one party to another. Nevertheless there are few economic events which cause the courts and the government (and, therefore, the investor) more trouble. In spite of the fact that the Treasury Department has developed the concept of separate entity to a high degree, gifts between individuals are considered as though there were some type of continuity of interest and a substituted basis is used.[50] This in spite of the fact that the break in ownership must be absolute, or the gift is considered

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[50] IRC Sec 113 (a) (2); Regulations 111, Sec 21.113 (a) (2)-1.
Cf. Regulations 108, Sec. 86.2 (1) where it is held that a gift by a corporation is indirectly a gift by the stockholders, who are therefore subject to gift tax.

colorable.[51] It might be thought that the law recognizes that it may be difficult to value a gift at the time of transfer, but the law also states that fair market value must be used if the gift is sold at a loss. Since future sales prices cannot be foretold, this means that the fair market value at the time of gift should always be estimated and recorded. Moreover, the fair market value at the time of the gift is the amount used for purposes of the gift tax. The Supreme Court has even ruled that the value of fully paid life insurance policies is not their cash surrender value but the cost of replacement at the date of the gift, regardless of the time

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[51] Adolph Weil, 31 BTA 899 (aff'd CCA-5) 82 F (2d) 561 (cert. denied October 12, 1936). The board stated the essential elements of a gift as:

1. Donor competent to make the gift,
2. Donee capable of taking the gift,
3. A clear and unmistak able intention on the part of the donor to absolutely and irrevocably divest himself of the title, dominion and control of the subject matter of the gift, in praesenti,
4. The irrevocable transfer of the present legal title and of the dominion and control of the entire gift of the donee, so that the donor can exercise no further act of dominion or control over it,
5. A delivery by the donor to the donee of the subject of the gift or of the most effective means of commanding the dominion of it,
6. The acceptance of the gift by the donee.

--If all essential elements are present the motives are immaterial.

elapsed between issue and assignment.[52] Since the investor is required to make an estimate of the fair market value of gifts for the above purposes, he has little excuse for neglecting to use this valuation for his personal accounting.

In the case of another large group of non-cost acquisitions -- inheritances -- the logic of the courts and government is exactly reversed. Death is not a transaction; as a result, no gain or loss is realized by the transmission of property at death.[53] Nevertheless, a substituted basis is not applicable. Since 1942, the value to the recipient is that used for estate tax purposes, even when it is temporarily held in trust for others. Usually the net result is that the securities will be recorded by the new owner at their fair market value, though exceptions may exist when the property is in trust with the income payable to others during their lifetime. In such situations the basis is still deter-

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[52] Guggenheim v. Rasquin 312 U.S. 254.
Cf. Powers v. Comm. 312 U.S. 259; U. S. v. Ryerson 312 U.S. 260.
The board has applied this even to policies on which only the first annual premium had been paid, so there was no cash surrender value. Phipps v. Comm. Dec. 11, 686, 43 BTA 790 (1940).

[53] George T. Altman, op. cit., Para. 454.

mined as of the date of death, although it can hardly be claimed that the securities are under the final recipient's economic control at that date.

As noted in Chapter I, when the law requires accounting methods which do not properly reflect the economic situation, the owner of securities is often justified in resorting to a double set of books.

Securities Held by Custodians

Securities are frequently held by parties other than the beneficial owner. The accounting requirements differ considerably with the facts of the situation.

When securities are held as collateral for loans, they are still included in the assets of the depositor.[54] Nevertheless, it may be advisable to show them on the books of the holder for purposes of control. In a specific case, where bonds were held by a real estate company as a tenant's security, two accountants suggested that they be shown on the books as a debit, e.g. "U. S. Government Bonds Deposited" or "Securities held to guarantee lease," with a contra credit, "Tenant's security" or "Lease Guarantee deposit." One suggested that the items be shown as current, the other as non-current.[55]

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[54] Accountants' Handbook, p. 493.

[55] "Accounting Questions," Journal of Accountancy, November 1944, p. 517.

If the holder is acting as guardian, e.g., a bank or a trust company acting for a minor, it seems certain that the guardian should follow all the accounting procedures which a capable owner would employ. The same is true of anyone acting in a fiduciary capacity. "The essence of fiduciary accounting is the ascertaining to what extent the person holding these delegated powers has fulfilled his duties and to what extent he is still accountable. He is charged with all property coming under his control, and he is discharged by any lawful disposal of it for the good of the estate."[56]

Agents, such as Nominees, Voting Trusts, Dummy Stockholders, Brokers, Investment Dealers, Trustees, and specific agents (such as a husband acting for a wife) may or may not keep complete records for the owner. Frequently their records are satisfactory so far as the agency is concerned, but they may not provide all the details which an investor should know. This is particularly true if the investor is on the accrual basis, since the agent usually distributes income as received, not as earned.[57] An investment trust, on the other hand,

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[56] Accountants' Handbook, p. 1368, citing Sprague, The Philosophy of Accounts.

[57] H. Arnold Strangman, "Tax Accounting for Bank Agency Accounts," Taxes, August 1946, p. 764.

may have a bank acting as trustee, buying and selling for it on instructions and keeping an independent set of records which are complete in every detail -- to such an extent that an auditor may feel justified in shortening the audit-time spent on the investor's books.[58]

In general, the investor should not rely too heavily on the accounting of the custodian, merely as a matter of personal protection.

Disputed Ownership

As a rule an investor may consider any costs necessary to prove title at the time of acquisition as part of the capital investment. But if the stock was acquired at the regular market price, and, for some reason, perhaps neglect by the broker, the transaction leads to litigation, such costs might better be considered as expenses. Similarly, if the suit is instituted at a much later date, the expenditures seldom can be considered as adding to the asset which the investor has shown on his books, since the accounting presumably was made on the basis of complete ownership.

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[58] "Examination of Security Transactions in an Investment Trust Audit," Accounting Questions, Journal of Accountancy, June 1946, p. 515.

Treasury Stock and Bonds

Neither Treasury Stock nor Treasury Bonds are an asset.[59] Any acquisition by a corporation of its own securities represents a contraction; the process may be reversed by re-issue, but while the securities are held they should be considered as deductions from the equity accounts. Unfortunately corporations have bought and sold their own shares on the market and have listed them as assets; as a result courts have considered the transactions as if they were ordinary purchases and sales.[60]

The Treasury Department has attempted to treat such transactions as resulting in gains and losses as though the securities were those of another corporation.[61] Subsequently the Supreme Court ruled that such transactions do not result in income.[62] A corporation should govern its transactions and keep its records in such a way that there can be no doubt that it is not treating its own securities as assets.[63]

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[59] Accountants' Handbook, pp. 961, 1008.

[60] First Chrold Corporation v. Comm. 97 Fed (2d) 22 (but cf. below).
Cf. Accountants' Handbook, p. 1007.

[61] Regulations 111, Sec. 29.22 (a)-15.
Comm. v. S. A. Woods Machine Company (CCA-1) 57 Fed (2d) 635, cert. denied, 287 U.S. 613.

[62] Helvering v. R. J. Reynolds 306 U.S. 110.
First Chrold Corporation v. Comm. 306 U.S. 117.

[63] There are a variety of other methods of acquisition which are of minor importance and are not treated

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63 (continued)
here in detail. The interested reader is referred to the following cases and other sources:

Securities exchanged for a promise to marry: Doris-Es-Sultaneh v. Comm. (CCA-2, April 11, 1947); 47-1 USTC, Para. 9218 (S. S. Kresge).

Judgments and Condemnation Awards: Kieselbach v. Comm. 317 U. S. 399.

Forgotten securities become property of custodian: Commerce Clearing House, Federal Tax Service, 1948, Para. 51.7395.

Replacement of lost securities: Prentice-Hall, op. cit., Para. 10,456.

Securities acquired illegally: George T. Altman, _op. cit._, Para. 239: "It was an early principle of English law that the King's conscience need have no commerce with his purse. So it was held by the Supreme Court...."

Embezzlement: Comm. v. Wilcox, 66 S. Ct. 546.

Void and Voidable Issue: Lusk, _op. cit._, p. 765-6.

"When and How To Be a Dealer Rather Than an Investor for Tax Purposes," an article by John P. Allison, _Journal of Accountancy,_ July 1948, p. 38.

Summary

This chapter has endeavored to survey the various ways in which securities are acquired. In spite of the variety of such transactions, it contends that for the purposes of economic control the most satisfactory basis at which the investor can record the acquisition is at fair value as of the date of the transfer (or reasonably close to it). The best measure of this value is usually cost. When that is unascertainable, an appraisal may have to be made, preferably based on contemporary prices for the same security. If, due to restrictions, there can be no market for the security, an honest attempt should be made to obtain a valuation of economic significance to the investor.

Subsequent accounting for the security will be considered in the following chapters.

Chapter III

PERIODIC INCOME: SECURITIES EVIDENCING INDEBTEDNESS

From the standpoint of the investor, if the issuer of a security promises to return a definite sum of money on or before a certain date, it is considered a certificate of indebtedness. This chapter will consider the problems of periodic receipt and measurement of interest income on bonds and other types of debt securities. Specifically, "A corporate bond is a written promise, under seal, to pay a sum of money, called the par value, at a fixed time in the future, called the date of maturity, and carrying interest at a fixed rate, payable periodically."[1] Bonds form one of the favored mediums of investment, and

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[1] Accountants' Handbook, p. 1457. It should be noted that a debtor-creditor arrangement may be used in most states as a method of contributing funds to be used by the borrower in a specific business in return for a share of the profits. If the lender does not have any voice in the management, this does not involve personal liability to creditors. Crane suggests that in many jurisdictions this arrangement is superior to a limited partnership. "Are Limited Partnerships Necessary?" 17 Minnesota Law Review, pp. 351, 360.

as such deserve special consideration in and of themselves, but they are also interesting because they illustrate most of the problems usually encountered in dealing with securities evidencing indebtedness. In this chapter these common features will be stressed first, leaving special considerations arising from particular forms of contracts to the later sections.

Bonds -- Legal Aspects[2]

Transactions concerning bonds are governed by state laws. As a general rule the law of the place where a bond is executed governs its validity, construction and negotiability, unless it is to be performed elsewhere, when the latter will govern. The parties may stipulate by which state laws they wish to be governed. In most respects the laws concerning bonds are in substantial agreement, and if the general requirements have been met the accountant or investor will not experience much difficulty unless there is a default. Strict compliance with statutory forms is unnecessary if the essential elements are present.

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[2] Adapted from Corpus Juris Secundum, "Bonds."

The Periodic Measurement of Interest Income --

Receipt of Interest

There are two principal ways in which interest on bonds are paid: periodically, or in a lump sum on retirement. Periodic interest is paid in the form of detachable coupons which are honored on specific dates, or payments are made directly to the owner if the bond is registered. In either case the most frequent practice is to make such payments semi-annually.

The issuer of the other type of bonds makes only one interest payment, at maturity or at any other time that the capital amount is returned to the investor. Discount bonds have become familiar to the public in recent years because of the wide use of this type of security by the national government.

Because the interest payments made by the issuer are so definitely fixed there are few accounting problems which arise in connection with the time of receipt of the income, unless payments are defaulted. Investors who keep books on the "cash basis" merely record the amount when the coupon becomes payable or a check is received. Those on the accrual basis must make an estimate of the amount accrued at the end of their fiscal period, but since the interest dates are usually the first of the month, the calculation is seldom difficult. For example, if the coupon date is four months away at the time books are closed, 2/6 of the

amount is considered to have accrued. The treatment is based on the presumption that when the return is assured, the owner has a right to accrue. If the security were sold, the purchaser would pay the amount of the accrual in addition to the quoted price. The Supreme Court has held, "Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the right to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrues."[3]

It should be noted that the right to receive does not become "fixed" by the mere holding of the security. If there is reason to believe that the issuer will default on payment of the next coupon, there is no need to accrue.[4] Moreover, this right has not definitely accrued in the eyes of tax law until the interest date is reached. A taxpayer who sells a bond between interest dates can include the payment for accrued interest as part of his capital return,

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[3] Spring City Foundry Co. v. Comm. 292 U.S. 182, 184; cf. U.S. v. Anderson, 269 U.S. 422.

[4] Great Northern Railway, 8 BTA 225 (N.A., C.B. Dec. 1928, p. 47).

if he wishes, and is liable only for capital gains tax thereon.[5]

For tax purposes, the investor on the cash basis has the right to defer all interest on discount bonds to the year of actual receipt. However, without relinquishing his right to return other income on the cash basis, he may treat the increment in redemption value on discount bonds as received each year. In the first year that he elects to do so he must include as if received in that year all the unreported increments of prior years, and in that and subsequent years he must use the same method for all such obligations he owns (unless granted permission to change by the Commissioner).[6]

The increment in redemption value of Series "E" government bonds in the first few years is considerably

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[5] L. A. Thompson Scenic Ry. Co. 9 BTA 1203, Sol. Op. 46, C.B. Dec. 1920, p. 90.

"The burden is on the taxpayer to show what part of the monies paid or received by him on account of a transaction involving the sale or purchase between interest dates of interest bearing obligations should be allocated to capital investment and what part to interest. In the absence of such showing the construction most favorable to the government should be adopted."

Prentice-Hall, Par.8008: "Because of the percentage limitations on capital gains and losses, it will usually be to the advantage of the seller to treat the interest as part of the sales price if the transaction results in a gain, but if the transaction results in a loss, reporting interest separately will usually produce a more favorable result."

[6] I.R.C. Sec. 42(b).

less than the effective rate if held to maturity. An investor who holds a large amount of such bonds and intends to keep them until maturity might wish to accrue the interest at the effective rate. Although this is not the most conservative practice, it is little different from the accruing of discount on a coupon bond purchased below par and due in about ten years.

The accrual of interest implies that the amount is definitely under the control of the recipient. Therefore, if the securities are the subject of litigation and the payments are impounded, there is no income to be recognized until the case has been settled. It is preferable to interpret this rule rather strictly; even though a judgment has been rendered in the lower courts, if the loser signifies his intention of appealing the decision, the other party would be wiser to defer the "income" until such time as he can be reasonably certain that he is going to receive it.

The Periodic Measurement of Interest Income -- Adjustments Due to Purchase of the Security at a Premium or Discount

When an interest bearing security is purchased at a premium or discount, the periodic payments received are not the sole measure of the income derived from the ownership of the security. The economic significance of such investments is not always understood. Many investors amortize

any premium as quickly as possible, but do not accumulate discount -- both acts in the interests of "conservatism."[7]

Whether a security is purchased at a premium or a discount an investor acquires the same bundle of rights. Strictly speaking, he acquires a group of promises to pay: each semi-annual coupon being considered a separate promise. (The same reasoning holds if the bond is of the registered variety.) In the case of coupon bonds this separateness is not theoretical, but literally true, since the coupons may be detached and dealt with as securities.[8] The value of the bond at any date before maturity is the total value of all the separate promises as discounted. The discount rate used should be the "effective rate" of interest to the holder. From this viewpoint, when a coupon matures and is cashed, only a part of amount received is interest; the remainder is return of capital. Each coupon is, in this respect, exactly the same as a small discount bond.

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[7] Cf. H. T. Scovill, "Investments and Funds," Contemporary Accounting, Editor, Thomas W. Leland, American Institute of Accountants, New York, 1945, p. 2.

[8] H. Gates Lloyd, 4TC 829, affirmed (CCA-3,1946) 154 F (2d) 643. Unmatured coupons on municipal bonds detached and sold, the amount received treated as proceeds of sale, not tax-exempt interest.
Helvering v. Horst, 311 U.S. 112.
Cf. Corpus Juris Secundum, Bonds, Section 65, pp. 437-438.

This fraction of the coupon is not the only interest which has been earned during the period. Each of the other uncashed coupons and the principal sum are accruing interest. Since each of these obligations has a separate maturity date, the amount earned on each during the period is somewhat different. It is obvious that the calculation of each of these amounts would be a tedious task. Moreover, it can be argued that each obligation should be discounted at a slightly different interest rate, the average of which would be the "effective rate."

Therefore it seems more reasonable to consider the bundle of promises as a group, rather than as separate obligations. As an illustration, suppose a company buys a block of $100,000 of 5% bonds, interest payable semi-annually, due in ten years. It then holds promises totalling $150,000. If the purchase is made to earn 6%, compounded semi-annually, the bonds will cost $92,561.26, and the income, spread over the ten years, will be $57,438.74. Of this $50,000 is collected prior to maturity, while the $7,438.74 accumulates as a sound receivable as part of a growing security account. "Instead of collecting each period the full amount of interest earned the investor permits the issuing corporation to retain a portion of such interest, with the understanding that it be included in the amount payable on the final interest date."[9]

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[9] Paton, Advanced Accounting, pp. 196-197.

The amount of discount or premium can be spread throughout the term of the bond in two ways, by the "straight-line" method, or by the "interest" method. Under the first, the discount or premium is divided equally; $7,438.74 divided by 20 equals $371.94 per period. This amount is either added to (discount) or subtracted from (premium) the amount of the coupon or check, the result being considered income. Under the interest method the effective yield rate is determined and applied to the book value of the investment at the beginning of each accounting period to determine the amount of interest earned; the difference between this amount and the nominal interest for the same time is the accumulation or the amortization.[10] On $92,561.26 this amount would be $276.84 (applying the yield rate per half year of 3% gives $2,776.84, less $2,500 equals $276.84).

A comparison of what might be called the "over-all" method with the separate obligation concept gives the following results:

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[10] *Ibid.*, p. 198.

Table I

"OVER-ALL" METHOD

Cost of bonds	$92,561.26	
Yield Rate per half year	.03	
Total Interest, first period	2,776.8378	(Compare with Table II)
Interest Collectible	2,500.00	
Interest Reinvested	276.85	
Book value at start	92,561.26	
New Book Value	92,838.10	
Yield rate	.03	
Total Interest, second period	2,785.1430	(Compare with Table II)
Interest Collectible	2,500.00	
Interest Reinvested	$ 285.14	
etc.		

Table II

SEPARATE OBLIGATIONS

Present worth of $2,500 at 3% due in:

1 Periods	2 Discounted Amount	3 3% of 2	Total 3 & 2
1	$ 2,427.184	$ 72.816	$2,500.000
2	2,356.490	70.694	2,427.184
3	2,287.854	68.636	2,356.490
4	2,221.218	66.636	2,287.854
5	2,156.522	64.696	2,221.218
6	2,093.711	62.811	2,156.522
7	2,032.729	60.982	2,093.711
8	1,973.523	59.206	2,032.729
9	1,916,042	57.481	1,973.523
10	1,860.235	55.807	1,916.042
11	1,806.053	54.182	1,860.235
12	1,753.450	52.603	1,806.053
13	1,702.378	51.072	1,753.450
14	1,652.795	49.583	1,702.378
15	1,604.655	48.140	1,652.795
16	1,557.917	46.738	1,604.655
17	1,512.541	45.376	1,557.917
18	1,468.487	44.054	1,512.541
19	1,425.715	42.772	1,468.487
20	1,384.189	41.526	1,425.715

Total Interest on Coupons: $1,115.811

$100,000-20 periods away:

$55,367.575 + $1,661.027* = $57,028.602

Total Investment $92,561.263

Total Interest First Period: $2,776.838 (Compare with Table I)

The second period will be the same with only 19 periods of coupons, or ($1,115.811 – $41.526) = $1,074.285
Plus 3% of $57,028.602 = 1,710.858
Total Interest Second Period $2,785.143 (Compare with Table I)

Change in Interest Income:
Second period is greater by 3% of $1,661.027 = $49.831
and less by 20th period coupon interest = 41.526
Increase in interest ($2785.143 - $2776.838) = $ 8.305

*3% of $55,367.575

The two tables will show identical results so long as the rate applied to each "obligation" remains the same. However, it is not true that investors evaluate short-term obligations at the same rate as they do longer term. Nevertheless, the rates must be such that the summation of the separate amounts will give the total interest as in the over-all method, and therefore the over-all method, which uses what may be thought of as an average of the rates, is by far the best approximation of the separate obligation concept.

Straight-line apportionment gives no recognition to the fact that the investment account is growing as a result of discount accumulation, or decreasing as a result of the amortization of premium. This means that the rate of return changes from period to period, since the interest reported as income remains the same and the book value of the security is changing. In addition, the rate is higher for the early years and lower for the later years in the case of accumulation of discount, while the reverse is true for amortization of premium -- a decidedly inconsistent result.

In spite of these disadvantages, the difficulty of calculation of the adjustments by the interest methods may be reason for use of the straight-line apportionment for small holdings, where the differences would be immaterial.

Under any of the methods the actual entries are similar in form. Each period, the adjustment is shown as

increasing or decreasing the net book value of the investment. Under the individual obligation concept the addition or deduction is equivalent to showing the accrued interest as added to the net book value followed by retirement of one obligation (the interest coupon), which gives the same net adjustment as under the over-all concept.

The use of any of these methods can be extended to include an adjustment for bonds purchased between interest dates. In such cases the additional amount involved is usually small, and the adjustment can be calculated by straight-line interpolation between the interest dates.[11] If several blocks of the same issue are acquired at different times for different prices, a schedule must be arranged for each block. The same is also true for purchases of serial bonds with varying maturities, although in the latter case a single schedule can be arranged if the prices are such that the yield rate is the same throughout. The latter situation is only a variation of the individual obligation concept, with several large amounts to be discounted.

When the bond price has not been settled in advance, the buyer must make calculations to determine the bid price

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[11]For a discussion of short terminal bonds, cf. Charles E. Sprague with Leroy L. Perrine, Accountancy of Investments, Ronald Press, New York, 1914, p. 207.

which will yield the desired effective rate. This subject has been extensively explored, especially by the large investment brokers, and will not be treated here. Tables are available which can be used either to calculate the bid price, given an effective rate, or the effective rate, given a certain price.[12] The latter case would be that of the investor who purchases the bonds on the market after issue. Those who purchase from the investment houses which underwrite a new issue are usually notified as to the effective rate at which the bonds are being offered.

When bonds are purchased at a substantial discount, consideration should be given to the possibility that the discount indicates such a substantial risk that it is not logical to treat the security as a group of obligations which are likely to be fulfilled. In such cases the discount should not be accumulated, at least until such time as conditions make payment seem more probable.

Because certain types of bonds are tax-exempt, the Treasury has evolved special rules regarding accumulation of discount and amortization of premium on such securities. In general, adjustments are required so that on retirement there will be no gain or loss to affect taxable income.

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[12] Cf. Edward Kircher, David Johnson, Milton C. Cross, Caleb Stone, Yields of Bonds and Stocks, Prentice-Hall, Inc., New York, 1928. For an illustration of accumulation and amortization schedules, cf. Paton, Advanced Accounting, pp. 626-7.

The Periodic Measurement of Interest Income -- Significance of Call Premiums and Convertibility

Most bond issues are redeemable by the issuer prior to maturity. In return for this privilege the redemption price is usually above par; the call premium may vary, being lower as the date of maturity nears. Since the investor has no option, but is obliged to relinquish the security if the issuer desires it, the net book value of the security should not exceed a call price which has become operative. The amortization schedule should be readjusted if it would give a value for the security which is above the call price on that date; if the schedule gives values below the call price the latter can be ignored. It need not be considered if the bond is purchased at a discount.

If the bond is called, the investor realizes a special profit if the amount received is above the current net book value. This "profit" should be interpreted with care. It is true that a profit has been made in comparison with the adjusted purchase price, but if the bond is called because of a drop in interest rates, the investor may find it impossible to reinvest the larger amount at a rate which will give him as much income with equal security.

Sometimes a bond will sell at a figure substantially above its current call price because investors believe that the issuer does not intend to call within the near future.

The Accountants' Handbook gives an interesting example of such a situation. On November 1, 1940, the Home Telephone and Telegraph Company 6% bonds due July 2, 1943, were selling at 106 plus accrued interest of $200. At this time the bonds were callable at 103 on sixty days' notice. The Handbook recommends that any purchaser at that date immediately transfer $300 of the premium paid to the debit side of an Income Account, or a reserve account, which results in a zero yield for the first period. The only sure return is sixty days' interest, or $100; if the bonds are not called after being held six months, then the procedure would be as though the bonds had been purchased at that date for $103.[13]

Any securities which have been called but not redeemed at the time of closing the books should be valued at the call price, or perhaps at a slight discount if the date is more than a few weeks away.

Bonds have been issued under the terms of which a certain number are to be retired each year. The specific bands are unknown, being selected yearly by lot. In such cases the investor has no way of knowing the exact maturity

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[13] Accountants' Handbook, p. 490.

of his holding. A possible suggestion would be that the average maturity date be selected for amortization or accumulation purposes, but admittedly this is not too satisfactory.

Although the courts have attempted to keep the concepts of debt and ownership separate, there are securities for which it is difficult to keep accounting records because they may be converted from one type to the other on short notice. In the case of bonds which are convertible into stock at the request of the owner, the Accountants' Handbook suggests that if the price of the stock is such that conversion seems probable, "it would seem necessary at least to make some supplementary adjustment in the balance sheet to show the change in the value of the investment."[14] It cites an unusual case (American Airlines 4½% of 1941) which in the fall of 1940 were convertible into stock with a market value of $4,800 per bond. In such cases the purchaser of the bond has acquired two inseparable securities:

1. A bond, with the usual attributes of such a security.
2. An option to buy stock at a given price, exerciseable only if the bond is used as payment.

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[14]Accountants' Handbook, p. 469.

Although the securities are infrequently encountered, stock may be convertible into bonds. The Kentucky laws specifically permit the issue of such preferred stock. (Ky. Revised Statutes, 1942, Sec. 271.140(1); but the federal court has held that the stockholders could not be placed on a par with creditors -- In Re Phoenix Hotel Co. of Lexington, Ky., 83 F(2d) 724 (CCA) cert.den. 299 U.S. 568.

The purchaser of such a combination should make an attempt to allocate his cost between the two elements. Then it would seem advisable for the accounting to proceed as it would if two securities were held instead of one. If the option is exercised, the cost of the shares would be the original amount assigned to the option plus the bond value as adjusted by amortization of premium or accumulation of discount. If this method of allocating the cost to the bond and option elements is not followed, any such security purchased at a time when conversion is profitable (which means at a price considerably above par for the bond) should not be treated as an ordinary bond. The premium should not be subjected to amortization even though tax rules apparently permit a complete writeoff.

It is possible to issue securities convertible at the option of the issuer.[15] The proper treatment of such securities is difficult to determine. Probably it would be best to regard them as accruing income with only the same degree of certainty that is implicit in ownership of the stock; i.e., only when declared or paid. This is a case when the amortization of premium but not the accumulation of discount seems justified, since the bonds might be converted into stock of considerably less value.

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[15] Cf. Graham & Dodd, op. cit., p. 314, for a discussion of such an issue by the Associated Gas and Electric Company. The authors recommend treating the bond as a preferred stock.

The Periodic Measurement of Interest Income --

Constructive Receipt

In certain situations the owner of a security may not receive the income directly. It may be paid to someone else, at his direction, or it may be paid to some agent or controlled interest who holds it for the owner. In such situations there is said to be "constructive receipt" of the income. In a leading case the Supreme Court defined this control: "Command may be exercised through specific retention of legal title or the creation of a new equitable but controlled interest or the maintenance of effective benefits, through the interposition of a subservient agency."[16] Moreover, if the right to receive the income is given to someone else -- for example by detaching bond coupons -- the result is income to the donor.[17] In a review of Helvering v. Horst, the Tax Court has said,

> As we construe the Supreme Court's opinion in the Horst case, it is this, that all the fruit of the tree that had grown on the tree at the time of the gift and was plucked by the donee in the same year as the gift was as effectively gathered by the owner of the tree as if he had plucked the fruit himself. Also if he remains the owner of the tree, he is also taxable on the fruit that grows on it, even after the date of assignment. We do not interpret the Horst case, however, as holding that when a gift is made by the owner of not only the fruit but the tree as well, that the former owner is taxable on any of the fruit which grows on the tree after the date of the gift."[18]

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[16]Griffiths v. Helvering, 308 U.S. 355 (1939).

[17]Helvering v. Horst, 311 U.S. 112.

[18]Estate of Bertha May Holmes 1 TC 508, dismissed (CCA-2, 1-25-44).

These interpretations would appear to be largely in line with the logic of the economic situation. When the interest has accrued, the owner should record it as income, regardless of whether the collection is made by his agent or someone to whom he has relinquished title. On the other hand, if the interest is being collected for the owner and yet he cannot exercise control over it, due to unusual circumstances, then he may be justified in refusing to consider it as income. A purchaser of bonds held in Germany in 1915 and 1916 was unable to collect the interest until 1921; it was held to be income of the later year.[19] But where a controlling stockholder did not order interest to be paid on promissory notes which she held, though the corporate assets (not cash) were sufficient to enable such payments to be made, there was no constructive receipt.[20]

An even more complicated situation arises when the gift is made or collected in a period other than that in which it was "earned" by the holder of the security. Because of the wording of the decision -- "plucked by the donee in the same year as the gift" -- the courts have held that if the accrued income on a note was not collected by the donee in the year of the gift, the donor was not taxable in that year.[21] Nor was the donor taxable in a later year

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[19] Charles L. Suhr, 4 BTA 1198.

[20] Marion Otis Chandler, 16 BTA 1248.

[21] Annie A. Colby, 45 BTA 536.

when interest was collected.[22] This conflict is obviously unjustified. It is based on a failure to recognize the promise to pay interest as a separable right, whether or not it is represented by a coupon. As such, the owner can be said constructively to receive a certain amount of return at any time he parts with the right. The true measure of his income for any period is the amount of interest which is accruing on all the other promises which he still holds. When the coupon is held, it is customary to measure the income on the bond by adjusting the value of the matured promise, as explained in the early part of this chapter. The same method of measurement is still accurate, even though the promise is not collected by the owner of the security; the only difference is the interest earned on the coupon during the period from the gift to maturity. Therefore a gift of a detached coupon a year or two before it becomes collectible has little effect on the amount of interest actually earned by the owner of the security in the later period. A slight adjustment can be made for the discount on the coupon which accumulated while in the hands of the donee.

There are various situations in which the beneficial owner of the security does not receive payments. If the

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[22] Estate of H. H. Timken, 47 BTA 494, affirmed (CCA-6, 1944) 141 F. (2d) 625, 32 AFTR 445.

bonds are pledged as collateral, held by an agent, or in any such circumstance in which the holder of the securities is not the owner, the owner should still keep his accounting records as though the securities were in his possession. The accumulation of discount and amortization of premium should proceed as usual. A notation as to the location of the specific securities is all that is necessary.

One type of income constructively received by the owner of bonds is excluded from the taxpayer's gross income. By special statutory exception he is permitted to exclude any tax paid for him by a corporation issuing "tax-free covenant bonds."[23] These bonds are issued by corporations with a covenant which states that they will pay a certain amount of tax for the investor by withholding it at the source. The amount is deductible on the taxpayer's report as though paid by himself, but although he receives this benefit, he is not required to include it in gross income. The owner of such bonds should make some notation as to the benefit thus derived. The amount of the tax which has been saved is as valid an income as any other financial event which relieves a liability for the taxpayer without expenditure on his part.

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[23] I.R.C. Sec 14 3 (a) 3; (d).

Perhaps the most difficult problems of constructive receipt of income arise out of sales subject to repurchase agreements. Since the same difficulties arise in connection with income from stocks, further discussion is deferred to Chapter IV.

This concludes the section on the general aspects of the periodic measurement of interest income. The remainder of this chapter is devoted to bonds which are in special circumstances, such as those in default, and to other types of indebtedness.

Bonds in Default

Bonds may be in default as to interest, principal, or both. Bonds in default as to interest are quoted "flat" on the market and the interest is not accrued. In Chapter II it was suggested that it is better not to regard as income any payments on such bonds for coupons past due at acquisition.[24] Nor should the interest on current coupons be accrued. The default signifies that the issuing corporation is not meeting its obligations, and therefore the owner cannot be sure of receiving payments. The investor might even go so far as to regard payments made on the

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[24]Cf. Chapter II, Accruals and Arrears. May objects to this interpretation if the interest is earned while the bonds are held. Cf. George O. May, Financial Accounting, Macmillan Company, New York, 1946, pp. 219-221.

coupons maturing after purchase as being a return of capital if payment of the principal sum is extremely doubtful. (For tax purposes such receipts are income.)

The position of the owner of a bond issued by a corporation which gets into difficulties is often like that of a preferred stockholder. Unless property under mortgage has a substantial value if separated from the business, the bondholder must rely entirely on the earnings. In fact, he may find himself actually to be a stockholder if there is a reorganization, since large companies are seldom liquidated in order to pay off bondholders. The Accountants' Handbook recommends that "bonds on which interest or principal or both have been defaulted should be closed from the regular investment amount into a special account pending final settlement. If a considerable time is involved in effecting settlement, it may be advisable to appraise the bonds and accrue the loss, at least in the form of a special contra to the investment account."[25]

When a debtor issues interest-bearing scrip as payment for accrued interest, the Board of Tax Appeals has held that the owner of the security received income to the extent of the fair market value of the scrip.[26] This

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[25] Accountants' Handbook, p. 490.

[26] Charlotte L. Andrews et al, 46 BTA 607.

interpretation does not appear to be justified. Certainly a creditor has not received income when he receives a note formalizing overdue interest.[27] The mere fact that the scrip received was interest-bearing does not add to the owner's purchasing power until the interest is paid or the scrip is sold. It is true that the owner may be able to realize immediate benefits by borrowing money on the scrip, but that is equally true of the bond itself.

Lost or Stolen Coupons

Individual bond coupons are negotiable securities; if they are lost or stolen the rightful owner has no remedies against a holder in due course who has acquired them for value.[28] Therefore, the owner of securities should accrue interest only on the obligations which are under his control.

The owner of non-negotiable (registered) bonds may follow them or their proceeds and recover wherever found.[29] He may be able to prove loss and have them replaced by the corporation. However, although he will probably be able to obtain the payments eventually, it may require considerable time and effort. It might be more conservative not to accrue income during the waiting period, especially since there will probably be some offsetting expenses.

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[27]Mellinger et al, Trustees, v. U.S. 86 Ct.Cl.272., 21F. Supp 964.

[28]*Corpus Juris Secundum*, "Bonds," Sec.82, pp.452-453.

[29]*Ibid*., p. 453.

<u>Certificates Evidencing Indebtedness Other Than Bonds</u>

There are a variety of certificates evidencing indebtedness. It is not the purpose of this dissertation to explore the various characteristics which distinguish one from the other, except insofar as they affect the accounting which must be made for each. In many cases the unique features have to do with the collateral which supports the securities; these are of interest to accountants primarily at the time of disposal (e.g., the foreclosure of a mortgage). Some of the other features which are the result of unusual circumstances at the time of an acquisition have already been discussed. The remainder of this chapter is devoted to those aspects which are concerned primarily with interest-bearing characteristics.

<u>Notes Receivable</u>

The distinction between a note and a bond is not important for the purposes of the accountant. Any security which promises to pay sums at intervals before maturity can be treated as suggested in the early part of this chapter. Frequently short-term notes call for one interest payment, at maturity; sometimes the matter of interest may not be mentioned in the contract. However, there is little difference between an agreement which calls for the payment of $1,030 in six months and one which calls for the return of $1,000 in half a year with interest at 6 per cent per annum, if the same amount was paid for

both contracts. Unfortunately the tax authorities do not accede to this point of view; they have held that unless a contract specifies part of the payment as interest it cannot be so regarded.[30]

The determination of the interest portion of the repayment may be difficult when the note is accepted for consideration other than cash: for instance, if the note represents payment for an overdue account receivable. Such a note is far from being a voluntary investment. The fair market value may be difficult to determine, since one of the most compelling reasons for payment may be the desire of the buyer to maintain favorable trade relations with a supplier. He would therefore view it differently than if the note were held by a third party. Similarly, the supplier might not press for payment as he would if the debtor were not also a customer. For this reason it is advisable to segregate trade notes receivable; in many ways they are more closely akin to accounts receivable. Correctly considered, the latter also contain an element of interest, which is usually implicit.

Mortgages

To a large extent the accounting for income from mortgages follows the same pattern as that from bonds.

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[30] I.T. 2674, C.B. June 1933, p. 96. Special treatment of Tax Notes is considered in a later section of this chapter.

When the amount involved is not of sufficient size to justify a bond issue, the certificate of indebtedness is usually called a "note, with a real estate mortgage as security." Since such mortgages often arise from personal contacts between the parties and are likely to be held to maturity by original investor, they are much less marketable than most bonds. There is less basis for any revaluation unless the danger of default is very evident. When the mortgage arises from a sale of real estate and there is reason to believe a substantial discount exists, the discount should be recorded and accumulated as for any bond purchased at a discount.

Mortgages guaranteed by the Federal Housing Administration provide for monthly payments which are a composite of mortgage insurance, fire and windstorm insurance, taxes, interest income and principal reduction. The payments remain fixed in amount, with the result that the portion allocated to interest declines and that to reduction of principal increases.

These mortgages are frequently sold, since they are in effect insured by the federal government and have a ready market. The institution which made the original loan continues to service it, charging the purchaser a portion of the return. The purchaser frequently pays a premium, which should be amortized as usual.[31]

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[31] For a more complete discussion of the treatment of F.H.A. mortgages, cf. <u>Accountants' Handbook</u>, pp.494-496.

Annuities

The term "annuity" can apply to any series of equal periodic payments, but in Investments it is usually restricted to contracts which call for a series of payments terminating at a certain date or upon the occurrence of a specified event -- usually the death of the recipient -- with no principal return at that time. A provision may be added to the "life annuity" specifying that if death occurs within a given time there will be nevertheless a certain minimum number of payments.

Annuities may either be purchased outright in one transaction, or they may call for a series of annual payments. In either case, if the annuity does not start immediately, there will be additional investment through interest earned and reinvested. At present recognition is seldom taken of this factor, perhaps due to the uncertainties of repayment and the difficulties of calculation.

For one type of annuity, which represents probably the greatest investment operation in the history of the world, there is not even a recognition of the annual payment as investment by many of the individuals concerned. Technically, the Employees' Old Age Benefit Tax is capital expenditure for the individual, not current expense.[32] (As to employers, the old-age benefit tax is a deductible

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[32] I.T. 3194, 1938-1 C.B. 114; I.T. 3447, I.R. Bulletin No. 6, Feb. 10, 1941.

expense, as tax.[33] From the over-all economic point of view this employer contribution might also be considered an investment.) Since the income benefits are not taxable income when received,[34] there is no legal necessity for the individual to keep records and make calculations of the type necessary for ordinary annuities. Nevertheless, many individuals have a substantial investment in Social Security, and in any accounting which is designed to show their economic position it would seem desirable that it be given more than token recognition.

If an annuity is payable for a minimum number of years "certain", then it is possible to calculate the amount necessary to yield that number of payments at a given rate of interest. Since the investor is assured of an asset of at least that much value as a minimum, he should accumulate his premium payments at compound interest until he reached that figure. Further calculations would require the use of life expectancy tables.

When payment begins, the investment is amortized at the effective rate and part of each payment is treated as a return of principal, the balance being interest. As the investment balance declines, the interest portion of the regular periodic payment decreases. At the

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[33] I.T. 3154, 1938-1 C.B. 113.

[34] I.T. 3447: CB 1941-1, p. 191.

termination of the contract, the investment should be entirely written off the books.

Because of the uncertainties involved in life annuities, there has been a great deal of difficulty in making proper evaluations, especially in connection with the income tax, where the rules laid down by the authorities have resulted in obvious inequities. The amount received each year as annuity must be included in gross income to the extent of 3 per cent of the consideration paid. The excess over 3 per cent is excluded until the total of such excess amounts equals the consideration, at which point the capital is assumed to have been returned.[35] If the annuitant dies before the total capital has been refunded, there is no loss allowed.[36] The inequity in such a rule is illustrated by Freyburger, who has calculated that at present a female aged 55 must live to 105 to recover her capital free of tax, although her life expectancy is about 25 years.[37]

The fairest solution to the problem seems to require a bold stand in regards to the element of uncertainty -- the length of payments. Either the insurance companies who usually underwrite such contracts should

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[35]I.R.C. Sec. 22(b) (2), Regulation 111, Sec.29. 22(b)(2)-2.

[36]I.T. 2915, C.B. Dec. 1935, p. 98.

[37]Walter D. Freyburger, "Income Tax on Annuity Payments," Taxes, September 1946, p. 860.

make a definite separation of each installment into capital and interest, or the individual should be allowed to do it with the aid of a standard life-expectancy table. This approach has recently been approved in Canada, where it is provided that income is taxable from

> "annuities received under a contract (other than payments described in paragraph (c) of this Subsection) except a portion of each amount received thereunder that bears the same relation to the whole amount as the amount the annuitant could, under the contract, have chosen to receive in lieu of the annuity, or, if no such choice is provided by the contract, the present value (computed in such manner as the Minister by regulation may prescribe) of the annuity at the time of the commencement thereof, bears to the aggregate (computed in the case of an annuity for life on the assumption that the annuitant will live during the period of his normal expectation of life calculated in accordance with mortality tables approved by the Minister) of the annuity for which the contract provides."[38]

The use of the 1937 Standard Annuity Table for life expectancy is recommended.

In addition, regardless of the method that is approved, there seems to be no economic or moral justification for the rule that the portion of capital unreturned is not a loss. Since all payments after capital is returned are considered to be and taxed as income, the fact that a person may receive more than the original investment is not an offsetting factor.

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[38] Statutes of 1945, Income War Tax Act, Chapter 23, Section 3, Subsection (1) (b) (Canada).

The provisions of the Internal Revenue Code regarding Employees' Trusts and Annuities are extremely complicated, but from the viewpoint of the beneficiary they are at least consistent with the general annuity provisions. The benefits are treated as an annuity, the cost of which is the amount contributed by the employees. If the plan is not "exempt," this includes payments made by the employers which are compensation at the time made.[39]

If an annuity has been set up by a will or a trust, then the payments are income to the recipient to the extent they are paid from the income of the estate or trust; to the extent that payments are made from corpus they are excluded from gross income. If there is more than one such annuity payable, then the amount of income available is prorated.[40] (This rule was set up by the 1942 Act, prior to which time the entire amount of payments which were made out of corpus when necessary were excluded from the gross income of the recipient.)

An exception to the usual tax doctrine is found in the case of payments based on the marital obligation to support, as required by a decree of divorce or a written instrument incident to divorce or separation. In general such payments are deductions from the income

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[39] I.R.C. Sec 165.

[40] I.R.C. Sec 162 (d).

of the husband and income to wife, unless a fixed sum is paid in lieu of alimony; if the sum is payable in installments ending more than ten years from the date of the decree, then the deduction by the husband and income to the wife is limited to ten per cent of the principal sum.

An unusual type of annuity is the perpetuity, which is supposedly continuous. It has been issued by a few governmental entities; the British "Consols" being the outstanding example. In such cases no amortization is advisable, and the entire amount received is income. If the market value changes radically, some adjustment to book value might be made in an accessory account.

Insurance Contracts

There is at present approximately $180,000,000,000 of life insurance in force in the United States.[41] When this amount (less lapses) is eventually paid to the beneficiaries of the insured, an important part will represent interest earned on the capital contributions of the policy holders. Yet it is safe to say that only a very small fraction will have been accrued by the owners. The interest represents a definite investment, along with that part of the annual premium in excess of the amount

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[41] The Economic Almanac for 1948, National Industrial Conference Board, New York, 1947, p. 317.

needed to purchase "pure" or term insurance. On some contracts this interest element becomes so large that the cash surrender value eventually increases more than the annual premium payment. The fact that such accrual of interest is ignored is especially interesting because most of the larger life insurance companies are "mutual", furnishing protection as profitless cooperatives. Nevertheless, individual members of such groups often do not receive sufficient information to determine the net earnings on their investment. In spite of their size and importance such companies seldom send Income Statements to their members. If such net earnings were available, the individual policy holder might consider the investment portion of his premiums as accumulating interest at a proportionately equivalent rate.

Whitney suggests the use of the loan discount rate on the policy to determine the true income and expense. This rate fixes the day-to-day cash value of the policy, since usually the issuer will loan up to the cash surrender value at the end of the policy year as discounted to the present at the rate specified in the policy.[42]

For example, suppose a policy has a cash surrender value of $4,050 just before the premium payment, a premium

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[42] W. H. Whitney, Accounting for Investments in Life Insurance, Accounting Review, December 1939, p. 381.

of $1,351.50, and a cash surrender value of $5,070 at the end of the next premium year. If the loan rate is 5%, then the cash surrender value immediately after the premium payment is $4,816.50 ($5,070 discounted at 5%), the interest being $253.50.

The annual insurance expense would then be:

Premium		$1,351.50	
Cash Surrender Value, next year	$5,070		
Cash Surrender Value, present	4,050		
Increase		1,020.00	
Net Premium Cost			$331.50
Interest (also Interest Income)			253.50
Total Expense			$585.00

The value of the policy immediately after the payment of the premium could be shown on a Balance Sheet as follows:

Cash Surrender Value ($5,070 discounted)	$4,816.50	
Prepaid Expense	585.00	
Total		$5,401.50

This total of $5,401.50 is equivalent to the cash surrender value before payment, and the premium:

Cash Surrender Value	$4,050.00	
Premium	1,351.50	
Total		$5,401.50

Therefore, in accounting for the policy, Whitney suggests that the Prepaid Expense be calculated as above; then if the policy dates and balance sheet dates are not the same, a correct portion of insurance expense and interest income may be accrued at the latter date. As he demonstrates, the initial period bears the heaviest portion of the net insurance expense if this interest factor is ignored.

The reasoning in the above paragraphs appears to be sound with the possible exception of the method of calculating the interest amount. Whitney uses the loan rate demanded by the company. However, since the insurance companies ordinarily make a profit on such loans, it seems probable that the economic cost of the insurance is somewhat overstated by this method. Use of the average net earnings on the company's assets might perhaps be a closer approximation in the ordinary case when no loan on the policy is contemplated. If this were done, both the Prepaid Expense and later the Interest Income would be correspondingly lower; since Interest Income and the interest element in prepaid expense are the same, there would be no effect on the net income for the year. The Balance Sheet showing would be more difficult to determine, because, if the prepaid expense were calculated with interest at 3 per cent on the total of the present cash surrender value and the premium, _e.g._, $5,401.50, it would be:

Net Premium Cost (as before)	$ 331.50
Interest (3% of $5,401.50)	162.05
Total Expense	$ 493.55

A Balance Sheet immediately after the premium payment would then show:

Cash Surrender Value	$ 4,816.50	
Prepaid Expense	493.55	
		$5,310.05

Under Whitney's method, the total was $5,401.50 so there has apparently been a loss of $91.45 merely as a result of payment of the premium. Actually, there is no economic loss but rather a refusal to consider the $91.45 as interest income, which is required to offset the higher expense shown by the Whitney method. Although using any interest rate other than the loan rate has this disadvantage of showing unequal amounts of periodic cost if the year is divided into parts, because the cash surrender value and the interest element in Prepaid Expense are calculated with different rates, nevertheless calculation of the Prepaid Expense by use of the earning rate on the insurance company assets seems more accurate for reflecting economic cost and revenue for the year as a whole.

Using a different approach to isolate the expense element in the premium payment, Paton suggests that the amount be compared with the premium required on a term

policy for the same amount. The cost of term insurance presumably represents the cost of bare protection. He notes the objection that the cost of short-term insurance is not the same as for the more permanent type, and offers as an alternative the possibility of attempting to find the amount of the annual installment necessary to accumulate a fund equal to the face of the policy during a term equal to the normal life expectancy of the individual whose life is being insured, and to treat a corresponding portion of each year's premium as an investment.[43]

Participating Policies

In order to safeguard their interests, mutual companies charge rates considerably in excess of the amount which they think will actually be necessary. Therefore, Whitney states, "The payment of a dividend by a strong, well-managed participating company is as certain, a year in advance, as the collection of the highest grade of accounts receivable, or bonds."[44] The prospective dividend is an asset and should be recognized.

Suppose, given the policy used for illustration in the previous section, that the current dividend is $135.15.

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[43] Paton, Advanced Accounting, p. 210.

[44] Whitney, op. cit., p. 389.

This amount can be used as an estimate for the next year. The net premium will be \$1,351.50 — \$135.15 = \$1,216.35, which amount should be used in place of \$1,351.50. The showing immediately after payment would be:

Cash Surrender Value	\$4,816.50	
Prepaid Expense (Whitney)	449.85	
Participation Rights	135.15	
		\$5,401.50

The above shows Prepaid Expense as computed by the Whitney method; under the alternative procedure proposed it would of course be lower. A possible further refinement would be to discount the asset, Participation Rights, since the receivable is not due for one year. The discount rate to be used is open to question; it is probable that resulting amounts would usually be small enough so that the problem can be ignored.

Cash Surrender Value in Early Years

Sometimes it is suggested that if there is no cash surrender value until the end of the third year, nevertheless a portion of the third year amount be allocated to the first two years. Finney would use a surplus adjustment to accomplish this, rather than show the rather large asset increase as a reduction of the premium expense for the third year only.[45] It seems better to avoid such

[45] H. A. Finney, Principles of Accounting, Advanced, Prentice-Hall, Inc., New York, 1946, p. 107.

surplus adjustments wherever possible, and therefore either to recognize that the increase in asset value decreases premium expense for the third year, or, emphasizing the going-concern concept, to accrue one-third of the amount in each of the first two years.[46]

Endowments

Endowment plans are usually handled in much the same way as ordinary life insurance, the principal difference being that the cash surrender value grows much more rapidly, and eventually the premium payments cease. The tax doctrine has been to consider all the excess of the value at that point over the total of the premium payments as income of the year of maturity,[47] a point of view which is completely unrealistic for the individual investor and emphasizes the need for a better solution of the problem of annual evaluation. Since the individual investor is not competent to make the calculations, insurance company actuaries could make a definite contribution if they would give their clients a schedule with each policy which would show a definite amount as being the investment element of each yearly payment.

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[46] Paton, Advanced Accounting, p. 210.

[47] I.R.C. Sec. 22 (b)(2).

Tax Notes, Post-War Refunds

Short term securities (often called "tax notes") issued by government units without interest on a discount basis and maturing in one year or less, are not considered to accrue interest for tax purposes until paid or sold.[48] However, the investor might better ignore this legal provision and accrue as usual; an exception might be made if the amount involved is trifling. There has been some question as to whether on some occasions these notes may not be regarded as prepaid taxes, since the purpose of the holder customarily is to use them for tax payments. They form a convenient way of investing cash for a small return until the taxes are due. For this reason some accountants have been willing to consider them as an offset to taxes payable on the balance sheet.[49] However, it appears preferable to treat them as assets.

Post-War Refunds were established under section 250 of the Revenue Act of 1942 (adding sections 780-783 to the Internal Revenue Code). The Secretary of the Treasury was authorized and directed to establish a credit to the

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[48] I.R.C. Sec. 42 (c) I.T. 3588, 1942-11-11023.

[49] Committee on Accounting Procedure, Accounting Research Bulletin No.14, "Accounting for United States Treasury Tax Notes," American Institute of Accountants, January 1942. Cf. discussion by Scovill, Investments, Contemporary Accounting, Chapter 6, pp. 5-6.

account of each taxpayer in an amount usually equal to ten per cent of the taxpayer's excess profits tax. The credit was applied to the purchase of bonds issued under the authority of the Second Liberty Bond Act. The bonds bore no interest; they were not negotiable or transferable by sale, exchange or pledge. The bonds matured on January 1, 1946, but at the time of acquisition the maturity was indefinite, being nominally set at from two to five years after the termination of the war. Shortly after the authorization of the bonds, the American Institute of Accountants issued a Bulletin, in which they recommended that "the amount of such post-war credit, representing the right to receive government bonds or the par value of government bonds received therefor, should be shown, at least as long as they remain non-negotiable, as a non-current asset."[50]

Although the bonds are now history, they presented some unusual problems which it is still instructive to consider. They were non-interest bearing, had no definite maturity,[51] and were non-transferable. It is difficult to

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[50]Committee on Accounting Procedure, Accounting Research Bulletin No.17, "Post-War Refund of Excess Profits Tax," American Institute of Accountants, December 1942, p. 147.

[51]It must be remembered that "after the termination of the war" has a different connotation than "when the fighting stops." Several times in history the "war" has not been officially over until long after hostilities have ceased.

imagine a debt-security issued by a responsible party which would be of more dubious value.

> The Bulletin recognized that "it may be urged that the full amount of the excess-profits tax must be paid now, that no funds will be or can in any way be made available until the post-war period; and that the time when the bonds will become negotiable or mature is uncertain and the amount of the credit should not, therefore, be treated as an asset in its full amount if at all."[52]
>
> The Bulletin then continues: "It is recognized that the last mentioned argument has some theoretical validity. However, the same argument might be applied to other assets which it is not customary to discount; and since the discount in this case would be relatively small, the committee does not believe that a meticulous insistance on this point is desirable. The committee does not believe that the uncertainties of the post-war period warrant deferment. These uncertainties should as far as possible be taken care of under the rules of Accounting Research Bulletin No. 13.[53,54]

Under the specifications, most of the securities were designed to have a life of at least five years, since their maturity was to be "two to five years after the termination of the war, depending upon the taxable year in which they were acquired."[55] Taking five years as

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[52]<u>Accounting Research Bulletin No. 17</u>, p. 148.

[53]Committee on Accounting Procedure, <u>Accounting Research Bulletin No. 13</u>, "Accounting for Special Reserves Arising Out of the War," American Institute of Accountants, January 1942.

[54]<u>Accounting Research Bulletin No. 17</u>, p. 149.

[55]<u>Ibid</u>., p. 148.

the expected life, we have the following discounted values for a refund of $1,000,000, due in five periods:

Annual Discount Rate	Discounted Amount
2%	$905,730.81
2½%	883,854.29
3%	862,608.78
3½%	841,973.17
4%	821,927.11
5%	783,526.17

The choice of yearly discount rate on a non-interest bearing, non-transferable security with no certain maturity date is left to the reader to determine.

The securities actually did not have a life of five years. They were redeemed at par on January 1, 1946. The maximum life was thus only 3½ years, since the credits were first due on taxes paid for taxable years ending after June 30, 1942.[56] If we suppose a hypothetical company with fiscal year ending on January 1, 1943, the refund of $1,000,000 would have a value at that date of the following amounts:

[56] George T. Altman, *op. cit.*, p. 855.

Annual Discount Rate	Discounted Amount (3 periods)
2%	$942,322.33
2½%	928,599.41
3%	915,141.66
3½%	901,942.71
4%	888,996.36
5%	863,837.60

In any case, the discounts would seem to be substantial and provide a good illustration of the distortion which can result from ignoring the interest factor on a security which is nominally non-interest bearing.

Income Bonds, Revenue Bonds

Income bonds are securities with a fixed maturity but on which interest payments are either wholly or in part conditional. The condition is usually based upon the earnings of the issuer. Such securities are obviously less desirable than ordinary bonds from the standpoint of certainty of return. As a rule they are issued as part of a reorganization scheme rather than as original financing.

Since the interest payments are not certain it is not desirable to treat them as separate obligations. The owner is in much the same position as the possessor of cumulative preferred stock, with exception that the latter has no maturity. Because of the circumstances under which they were issued income bonds frequently sell at substantial

discounts. It is usually inadvisable to accumulate this discount in the customary manner, at least until the maturity date is close enough so that there can be a high degree of probability that the principal sum will be paid. If part of the interest is unconditional, that part might be accrued, but the remainder should not be considered as income until payment has been definitely assured.

Revenue Bonds are somewhat similar to Income Bonds. The conditions are based upon gross revenue less certain expenses, but frequently before depreciation. There is usually less room for argument as to whether the conditions have been fulfilled. Such bonds are frequently issued by governmental enterprises and institutions and may be of a very high grade. The investor must decide whether the circumstances justify a treatment similar to bonds containing unconditional promises.

Usurious Interest

Although it will seldom concern an investor who holds securities, he should be aware of the fact that many states set a maximum rate which can legally be charged as interest for loans.

> "The usury laws apply to corporations, in the absence of special legislation, to the same extent as to natural persons, and the corporations cannot, any more than individuals, legally sell their bonds, bearing the highest rate of interest, at a discount, for the purpose of borrowing money."

> However, "A special clause in a charter, authorizing a company to borrow on such terms as may be agreed upon by the parties, overrides an existing general law on the subject, and enables it to borrow at any rate of interest."[57]

A few typical maximum legal rates are:

New York	6%
Pennsylvania	6%
Michigan	7%
California	10%

The legal treatment of usurious payments is not uniform. In some states the creditor may be liable for damages. Just what effect this will have on tax returns already filed by the creditor and debtor seems to be uncertain.[58] In Texas and Mississippi local courts have held such usurious interest to be return of principal, not income.[59] The Board of Tax Appeals, on the other hand, considers it all income.[60] The investor should become acquainted with the regulations for the jurisdiction in which the corporation resides.

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[57] Leonard A. Jones, The Law of Bonds and Bond Securities, Bobbs Merrill Company, Indianapolis, 1935, p.823.

[58] Cf. Taxes, June 1946, p. 595, regarding California Supreme Court Decision in Rose Milana v. Credit Discount Co., 1946.

[59] Commerce Clearing House, op.cit., Para.51.20. S.M. 4591 C.B. Dec. 1925, p. 160.

[60] Edgar B. Terrell 7 BTA 773.

Other Interest Income

Interest may be earned in a number of ways other than on bonds, notes, or deposits with banks, trust companies and other financial institutions. Dividends left with the declaring company may be considered as equivalent to a loan, and bear interest. Where the distribution of an estate was delayed, payments made were held to be interest.[61] Banks frequently make arrangements for a "line" of funds to be available to a company. The rate which must be paid on all borrowings is set, but in addition the company pays about ¼% on the unborrowed portion of the "line," for the privilege of being able to increase the loan up to that amount on short notice.

In some situations interest may accrue even though no rate has been set, where it is to be determined later by an arbiter.[62] On the other hand, interest does not accrue for tax purposes when due to a cash basis taxpayer if it is not paid by a related interest within 2½ months of the end of the year though the payor is on the accrual basis.[63] Although interest is almost invariably payable in cash there have been instances where bonds gave the

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[61] Estate of Anna M. B. Foster et al v. Comm. (CCA-5, 1942), 131F (2d) 405.

[62] Missouri Pacific Railroad Co., 22 BTA 267.

[63] George T. Altman, op. cit., p. 574.

owner the option of taking payment in common stock at a fixed price per share.[64]

The legal doctrine holds that when payments are made by a debtor, he has the right to specify whether they are interest or return of principal. If he gives no indication as to which the payment is, the creditor can specify.[65]

<u>Summary</u>

As far as the investor is concerned, the essential element of bonds and notes is the unconditional promise to pay. The promise may be either for a single payment or a series. In any case the value at acquisition of the security is the total of the discounted amounts of each of the promised payments. The interest earned during any subsequent period is the amount accruing on each of the promises, provided that there is no likelihood of default.

When it becomes doubtful that all of the promises will be fulfilled, or if any of them are conditional, the investor should not accrue income until the current payment has been received. In extreme cases he may consider the

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64 Graham and Dodd, <u>op</u>. <u>cit</u>., p. 285.

65 G.C.M. 2861, CB June 1928, p. 255.

payment as return of capital.

When other types of certificates of indebtedness are involved, the main problem is the correct segregation of the elements of principal and interest in each receipt. Each situation must be carefully analyzed to ascertain the number and amount of future payments; these, together with the capital investment, form the basis for the determination of periodic income.

The interpretation of interest income will be discussed in Chapter V.

Chapter IV

PERIODIC INCOME FROM SECURITIES EVIDENCING OWNERSHIP

The investor, whether corporation or individual, has many factors to consider in deciding how to account for income from investment in corporate shares. Whereas a debt security is basically a rather simple agreement between two parties, a share of stock involves a very complex bundle of rights, privileges and duties. In this chapter an effort is made to develop an approach to problems of income recognition and measurement which is consistent with the realities of the investment world. To support this it is necessary to examine briefly the position of a stockholder as regards the degree of control he is able to exercise and the legal and contractual rights which he possesses. The conclusion reached is that the separate entity concept is justified in most cases, but in a few special circumstances income may be accrued by the investor as it is earned by the corporation.

When the separate entity concept is controlling, income should not be accrued until dividends have been

legally declared. Even then the proper time to recognize income is open to debate; a summary is given of the various possible dates and the authorities who have supported each. Theoretically the date of declaration seems to have the most justification, but for practical purposes the date of receipt is considered acceptable.

The chapter concludes with an examination of the various methods by which corporations may effect the distribution of assets to stockholders. In order to determine the proper measurement of such income it is necessary to value the distribution correctly and then to deduct any portion which is a return of capital. For tax and general accounting purposes the viewpoint apparently has been that the investor should reconcile his basis with that of the corporation; here it is suggested that he should make an independent calculation to determine capital and income.

The problem of measuring the return of capital is discussed further in Chapter V.

Degree of Control by the Investor

Accounting methods which should be used by the investor are partly dependent upon the degree of control which the individual or investing corporation exercises over the company issuing the shares. The number of shares outstanding varies greatly from company to company, and the shares of each therefore represent varying fractions

of ownership. An investor's position may range from that of a sole stockholder to that of an owner of a single share of a large corporation (for instance, less than one forty-millionth of General Motors). In either case there is a definite separation of entities which always should be recognized; only after this has been done should the owner of a substantial portion of outstanding shares give consideration to the advantages of consolidation of income for purposes of investment control. The earnings of the corporation are not earnings to the stockholder, according to the authoritative view of the Committee on Accounting Procedure of the American Institute of Accountants:

> "In applying the principles of income determination to the stockholder of a corporation, it is generally agreed that the problem of determining his income is distinct from the problem of income determination by the corporation itself. The income of the corporation is determined as that of a separate entity without regard to the equity of the respective stockholders in such income. Under conventional accounting procedure, the stockholder has no income solely as a result of the fact that the corporation has income; the increase in his equity through undistributed earnings is no more than potential income to him. It is true that income earned by the corporation may result in an enhancement in the market value of the shares, but until there is a distribution, division, or severance of corporate assets in the form of cash or its equivalent, the stockholder has no income."[1]

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[1]Committee on Accounting Procedure, Accounting Research Bulletin No. 11, "Corporate Accounting for Ordinary Stock Dividends," American Institute of Accoun- New York, September 1941, pp. 103-4.

This does not mean that it is inadvisable for investors to keep memorandum accounts which show the full record of earnings and losses as well as dividends since acquisition of the stock. Such accounts may be helpful for separating income from capital returns, as will be shown later. They are also necessary for proper supervision of the investment. But they are subordinate to the regular accounts, which should be used to show those assets over which the investor has more complete control. Although it would be convenient to keep one set of books for all records, the economic facts are such that there are many gradations of control over property. Exclusion from the formal records does not mean that such control does not exist, only that it is better shown in other ways. When a stockholder owns a controlling interest in a corporation, the preferable method of showing the situation is by means of consolidated statements.

When companies are linked by complete or a high degree of stock ownership, accountants often authorize the use of this consolidated statement device. In a recent survey (by the writer) of 130 large industrial corporations, all reports certified, it was found that over 100 presented a consolidated statement only. Tax authorities also permit returns to be made on a consolidated basis, the income being taxed to the group much as though it had been earned by a single company.

When complete control exists, some accountants favor the further step of accruing the income to the parent as it is earned. Moonitz states:[2]

> "The contention here is that income accrues when the investments increase in value; the investments increase in value when the equities they represent grow; the equities of which they are a reflection grow when bona fide increases in subsidiaries' proprietary equities occur. In brief, income accrues to the parent at the same time that it accrues to the subsidiary and in an amount determined by the proportion of a subsidiary's capital owned by the parent."

He would authorize this procedure only if the control were indisputable.

The change which occurs in the stockholder's position as his percentage of ownership increases is well illustrated by the attitude of the Treasury Department, which endeavors to tax income to corporations as separate entities and then tax it again when distributed. Yet where a larger tax would result by ignoring corporate lines, it seeks to tax large stock holdings as though they constituted a partnership or single entity.[3] Inequities resulting from this attitude have led to

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[2] Maurice Moonitz, The Entity Theory of Consolidated Statements, American Accounting Association, 1944, p. 59. Cf. Chapter III, pp. 22-44, for the degree of control necessary. Moonitz requires additional standards; "controlling interest" alone is not enough (p. 32).

[3] George T. Altman, op. cit., Para. 635.

suggestions that for tax purposes the investor should be allowed to accrue income as it is earned by the corporation and thus pay only one tax on it.[4]

Preinreich maintains that the "soak-up" method of accruing income is proper in any case. In discussing stock dividends, he states:

> "In all cases, the measure of income-realization is given by that portion of the book equity transferred to the new symbol which accrued since the acquisition of the old symbol and was, therefore, never recorded by the investor. This method still falls considerably short of picturing the true state of affairs, but it represents the highest development of all theories based upon the convenient fallacy that corporate action is a prerequisite of realization and thus lends itself more readily to the logical development of all its details than any of the other hybrid methods in use.
>
> The next step forward will be that of discarding the concept that distributions are indispensable vehicles of income realization. It will then be possible to base the computation of income from investments in corporate assets upon the gradual increase in the book value of the investor's holdings. This will place stockholders and partners on equal footing. There are no serious obstacles to the adoption of the accrual method in this manner."[5]

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[4]Cf. William A. Paton, "Simplification of Federal Tax Administration," Accounting Review, January 1944, pp. 12-13; Russell Bowers, "The Income Tax and the Natural Person," Accounting Review, December 1941, p.373.

[5]Gabriel A. D. Preinreich, The Nature of Dividends, Lancaster Press, New York, 1935, pp. iv-v (a thesis at Columbia University).

It might also be noted that investment counselors sometimes advise a similar approach in appraising securities. Cf. Edward Sherwood Mead and Julius Grodinsky,

As a practical matter it would appear important to investigate these suggestions to see whether they would aid the investor in maintaining proper control of a portfolio. Unfortunately it is difficult to test the value of the consolidated concept where a high degree of control exists. At first glance it would appear obvious that a corporation which controlled 100 per cent of another should be able to withdraw the earnings at any time that it wished to do so. Yet it is conceivable that many other considerations influence management in addition to the desire to reinvest the earnings. Presumably such subsidiaries remain as separate legal entities for practical reasons, which also might affect the availability of the profits. It seems certain, for instance, that the top holding company, American Telephone and Telegraph, would not be allowed to withdraw all the surplus of its operating subsidiaries unless the services required should contract proportionately. In such a situation it seems doubtful that the total profits can be said to have been fully realized by the parent company.

Nevertheless the general position taken by Moonitz appears to be sound. Where there is substantial control,

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5 (continued)
The Ebb and Flow of Investment Values, D. Appleton-Century, New York, 1939. "The investment value of securities is the capitalization at current money rates of the income of the issuing corporations" (p. 65).

the investor should consider carefully the advisability of taking up the income as it is earned. General Electric (1946) and DuPont furnish illustrations of this practice. Neither presents a consolidated statement; instead, they take up their share of changes in the book value of subsidiaries. DuPont does this for General Motors, although it owns less than one quarter of the stock. It appears to be justified, for DuPont certainly exercises a large measure of control over General Motors' dividend policies in spite of the fact that it controls less than a majority of the shares outstanding. The increases and decreases are shown separately on the Income Statements and the unrealized incomes are segregated as special surpluses on the Balance Sheets.[6] This gives the reader an understanding of the economic position of the investing corporations without submerging the investment as in an ordinary consolidated statement.

Income Realization: Dividends

Where control does not exist, the proposition of Preinreich seems considerably more dubious. Fortunately the experience of the last twenty-five years is available to test his statement that we can discard distributions

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[6] Cf. Annual reports of General Electric and DuPont for 1946. In its 1947 report General Electric presented a consolidated balance sheet.

as indispensable vehicles of income realization. There is an excellent study by Curry, which investigates the earnings of corporations over a fifteen-year period, 1922-36. He omits transportation, public utility, finance, mining and oil companies because "these industries are subject to varying degrees of governmental control and regulation or have peculiar problems of depletion accounting."[7]

Except for these limitations the survey makes a determined attempt to be representative of large corporations, subject to the obvious limitations that "Any company which remained in business from 1921 through 1936 . . . must have been profitable or else very strong at the beginning of the period."[8] Seventy-two companies are examined.

One of the first difficulties which would confront an investor who attempted to keep a record of his equity based on reported earnings is the discrepancy between balance sheet stock equity changes and a summa-

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[7] Othel Jackson Curry, The Utilization of Corporate Earnings, 1922-36, Doctoral Thesis, University of Michigan, Ann Arbor, 1938, Chapter 3, p. 2.

[8] Ibid., Chapter 3, pp. 4-5.

tion of yearly additions or deductions to surplus reported from the income sheets. Curry devotes one of his longest chapters (Chapter IV) to a discussion of this difficulty and the adjustments he was compelled to make in order to complete his study.

Curry's work is primarily an attempt to determine whether companies that retained earnings in prosperous periods used them to pay dividends in depression periods. He demonstrates that during the prosperous period, 1922-1930, the companies earned $8,627,044,000 of which 83.39 per cent was available to common stockholders, who received $4,202,973,000, leaving $2,989,441,000 as retained earnings. "Dividends paid in excess of reported income available to common stockholders during the three or four poorest years (following) total $438,344,000, which was 14.7 per cent of the amount withheld in the good years."[9]

Further,

> "Based upon the well diversified sample of manufacturing enterprises examined in this research, it is apparent that the only companies which paid extensive dividends during the depression are those which had no depression. A general proposition can be made that if fifty per cent or more of profitable years' earnings are retained for a period of years, the common stockholders may hope to receive during poor years not more than one third of amounts once withheld and not more than the earnings retained in the two profitable years immediately preceding the lean year or years."[10]

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[9] *Ibid.*, Chapter 6, p. 4.

[10] *Ibid.*, Chapter 6, p. 5.

A similar survey of 150 corporations, shown as a chart by Mead, Jeremiah and Warrington, discloses that in the years 1922-1936 approximately one-eighth of the retained earnings were redistributed, a result which agrees closely with Curry's findings.[11] A more recent study, reported in Business Week, came to the conclusion:

"Stockholders haven't been getting as fat a share of corporate earnings as they used to get -- even though total annual dividends are up. In 1929, dividends accounted for some 69% of earnings. In 1939, they took about 75%. In 1940, 63% went to stockholders. Since then, the stockholders' share has slimmed down a lot. In 1946 their cut was down to less than 45%. Last year, the trend continued."[12]

Income Realization: Increase in Market Value

It is frequently argued that the retention of earnings does not injure the common stockholder. For example, in his work on the legal aspects of dividend distributions, Kehl says:

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[11] Edward Sherwood Mead, David Bowen Jeremiah, William Edward Warrington, The Business Corporation, D. Appleton-Century Company, New York, 1941, p. 385.

[12] Business Week, February 14, 1948, p. 95.

> "The injustice to the common stockholder from non-distribution of corporate profits may be more apparent than real. The undistributed profit is not lost to him. Although not realized in the form of dividends, his stock appreciates on the market, often nearly in proportion to the increase in assets and surplus. If he is in need of cash, even that may be met by a sale of some of his stock. To this there is only the objection that he is forced _pro tanto_ to give up valuable voting rights."[13]

Curry did not make any comparison of the prices of the securities of his companies. However, it is probable that the experience would not be particularly favorable for many of the possible purchases between 1923 and 1930, compared with prices for 1936, 1937 and 1938. For instance, despite retained earnings, U. S. Steel at 65-112 (adjusted for 40 per cent stock dividend) in 1936 was not greatly changed from the 82-111½ range of 1922. Many shares were no doubt considerably higher in 1936, but it might be argued that this was as much the result of devaluation of the gold dollar as a reflection of the accumulated earnings.

In order to investigate further this belief that market prices reflect the increase in equity, and to extend Curry's work, the writer offers the following study. The earnings and dividends record of 65 representative companies was examined for the years 1937-1946, making a total of

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13 Donald Kehl, _Corporate Dividends_, Ronald Press Company, New York, 1941, p. 159.

650 annual reports.[14] The companies chosen were those which made up the well-known Dow-Jones Industrial, Utility and Railroad averages.[15] If there is any bias in the choice, it would seem probable that these companies have a better record of paying dividends than the average, since they are all large, important, and except for certain rails and utilities, paid dividends in most of the years in question.

The Dow-Jones averages for the start and finish of this period, and two months later, were as follows:

	January 2 1937	December 31 1946	March 1 1947
Industrials	178.52	177.20	179.29
Rails	53.28	51.13	50.54
Utilities	34.66	37.27	36.78

March first was chosen as approximately the date when most of the prior year's earnings would be generally known to investors.

If it is true that stock prices in general will reflect undistributed profits, the above price averages would lead one to suppose that the companies paid out an amount roughly equivalent to net earnings during the ten-year period. That they did not should be apparent from the following:

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[14] As reported by Moody's Investors' Service.

[15] As of November 1, 1943.

Table III

Number of Reports

	Total	Industrials	Rails	Utilities
Total Investigated	650	300	200	150
Reports showing less than 4/5 of earnings paid in dividends	466	214	149	103
Reports showing deficits	40[16]	2	32	6
Reports showing more paid than earned	33	22	9	2

It may seem as though there were a fairly large number of payments exceeding earnings. But of these 33, only the following payments exceeded earnings by more than one dollar a share:

Industrials	1
Rails	5
Utilities	0
Total	6

Incidentally, the earnings per share retained by one company in one year (Goodyear in 1946) exceeded all the per share surplus distributions of all the companies in all the years. The rails showed a large number of deficits, it is true, but this was offset by an even larger amount of retained earnings (*e.g.*, Atchison retained over $70 net per share) and, as shown in the footnote, only two companies showed a net loss for the entire period. The stock of both companies

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[16] Only two companies showed a net loss for the whole period.

was selling at a low price and so had negligible effect on the averages.

These were unusual years, and it is not maintained that the above study necessarily proves that over a longer period the market will not reflect the undistributed profits. In fact it would be surprising if that were not the case to a greater degree than the study shows. However, it does seem apparent that it would be dangerous for any investor to rely upon this in accounting for a specific investment.

Income Realization: United States Steel

As an illustration of the difficulties which would be encountered, and the unpredictable results, a study has been made of the United States Steel Corporation. This company has been important in America for almost half a century. Its stock has been actively traded on the stock exchanges throughout that period. Since 1902, when it was formed, U. S. Steel has shown a deficit in only four years. It has never failed to make some payment on its preferred stock, and failed to make full payment in only three years, the deficit being promptly made up in the following years. It has paid common dividends in 36 of the 45 years, from 1902-1946, including the last seven years.

What would be the experience of a common stockholder who accrued income as it was earned and took up the losses throughout that period? On Friday,

December 27, 1901, the price of U. S. Steel Common varied from $42-3/4 to $43-1/8. Suppose an investor had purchased 1/10 of 1% of the business on that date, at an average price of $43 per share, or approximately 5,083 plus shares for about $218,570. (The fact that U. S. Steel shares may have contained a large amount of "water" at that time is considered in a later paragraph of this section.)

The average price available during the year 1947 was about $70 per share. On the enlarged holding of 8,703 shares this would give a value of $609,210. The total investment for a 1/10% interest would be $444,170 (see footnote), showing a capital appreciation of less than $170,000 as against the "reinvested earnings,"[17] totaling over $1,100,000. Even if the investment were not maintained at 1/10% by the high-priced purchases 1929-31, the capital gain would be considerably less than the reinvestment. It must also be remembered that if the reinvested earnings had been distributed to investors and placed in bonds, even at a small rate of interest they would have amounted to a much larger figure in the 45-year period involved.

The above computations do not include the effect of the $232,000,000 surplus adjustments in the 1920's and

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[17] Cf. 1946 report of the U. S. Steel Corporation, p. 27. "Reinvested earnings" is the phrase used in the report.

Table IV

UNITED STATES STEEL INVESTMENT

Based on 1/10% of Reported Earnings and Dividends

1902 - 1946

	Earnings to Common	Dividends	Reinvested	Investment	N.Y.S.E. Price Range per Share
1901				$218,570	
1902	$54,600	$20,300	$34,300	252,870	$29 3/4 - $46 3/4
1903	25,000	12,700	12,300	265,170	10 - 39 7/8
1904	5,000	--	5,000	270,170	8 3/8 - 33 1/8
1905	43,400	--	43,400	313,570	24 7/8 - 42 1/2
1906	72,900	10,200	62,700	376,270	32 5/8 - 50 1/4
1907	79,400	10,200	69,200	445,470	21 7/8 - 50 3/8
1908	20,500	10,200	10,300	455,770	25 3/4 - 58 3/4
1909	53,800	20,300	33,500	489,270	41 1/4 - 91 7/8
1910	62,200	25,400	36,800	526,070	61 1/8 - 91
1911	30,100	25,400	4,700	530,770	50 - 82 1/8
1912	29,000	25,400	3,600	534,370	58 1/4 - 80 3/4
1913	56,000	25,400	30,600	564,970	49 7/8 - 69 1/8
1914	(1,800)	15,200	(17,000)	547,970	48 - 67 1/4
1915	50,700	6,400	44,300	592,270	38 - 89 1/2
1916	246,300	44,500	201,800	794,070	79 3/4 -129 3/4
1917	199,000	91,500	107,500	901,570	79 1/2 -136 5/8
1918	100,100	71,200	28,900	930,470	86 1/2 -116 1/2
1919	51,600	25,400	26,200	956,670	88 1/4 -115 1/2
1920	84,500	25,400	59,100	1,015,770	76 1/4 -109
1921	11,400	25,400	(14,000)	1,001,770	70 1/4 - 86 1/2
1922	14,400	25,400	(11,000)	990,770	82 -111 1/2
1923	83,500	29,200	54,300	1,045,070	85 1/2 -109 5/8
1924	59,900	35,600	24,300	1,069,370	94 1/4 -121
1925	65,400	35,600	29,800	1,099,170	112 3/8 -139 1/4
1926	91,500	35,600	55,900	1,155,070	117 -160 1/2*
1927	62,700	49,800	12,900	1,167,970	111 3/8 -160 1/2
1928	88,900	49,800	39,100	1,207,070	132 3/8 -172 1/2
1929	172,300	63,800	108,500	1,315,570	150 -261 3/4
1930	79,200	60,400	18,800	1,334,370	134 3/8 -198 3/4
1931	(12,200)	37,000	(49,200)	1,285,170	94 -150
1932	(91,900)	--	(91,900)	1,193,270	51 1/2 -113
1933	(43,700)	--	(43,700)	1,149,570	53 -105 1/2
1934	(28,900)	--	(28,900)	1,120,670	67 1/4 - 99 1/2
1935	(6,100)	--	(6,100)	1,114,570	73 5/8 -119 1/4

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*In 1927 there was a 40% stock dividend, increasing holding to approximately 7,116 shares. In 1929 this was increased to 8,133 shares; 1930 and 1931, to 8,703 shares. To maintain

UNITED STATES STEEL INVESTMENT

(Continued)

	Earnings to Common	Dividends	Reinvested	Investment	Price Range per Share
1936	100	--	100	1,114,670	46 3/8 - 79 7/8
1937	36,400	8,700	27,700	1,142,370	48 1/2 -126 1/2
1938	(32,900)	--	(32,900)	1,109,470	38 -71 1/4
1939	15,900	--	15,900	1,125,370	41 5/8 - 82 3/4
1940	77,000	34,800	42,200	1,167,570	42 - 76 1/2
1941	91,000	34,800	56,200	1,223,770	47 - 70 3/4
1942	46,000	34,800	11,200	1,234,970	44 1/4 - 55 3/4
1943	37,400	34,800	2,600	1,237,570	47 3/8 - 59 3/8
1944	35,600	34,800	800	1,238,370	50 1/4 - 63 7/8
1945	32,800	34,800	(2,000)	1,236,370	58 5/8 - 85 3/4
1946	63,400	34,800	28,600	1,264,970	65 1/8 - 97 3/8
1947	101,900	45,700	56,200	1,321,170	61 5/8 - 79 3/8
	Totals		$1,102,600	$1,102,600 (net)	

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a 1/10% interest, this would require the following additional investments:

	Average Price	Investment
1929, approx. 1,017 shares	$140 (18)	$142,380
1930 plus 1931 570 shares[19]	146	83,220
Total required to maintain proportionate interest		$225,600
Original investment		218,570
Total Investment		$444,170

[18] Offered at $140, one new share for each seven held, May 1, 1929.

[19] Most of these shares would have been acquired in 1930, if the 1/10% interest was maintained as the company increased its issue -- to 8,687 in 1930, to 8,703 in 1931.

the $270,000,000 surplus adjustment made by U. S. Steel in 1935. It is difficult to interpret such surplus adjustments in their true light, since to some extent at least they do not represent losses but merely adjustments to compensate for previous bookkeeping practices, and were so labelled. U. S. Steel showed its common at $100 par during this period, but as shown by the market prices, it was never worth that much until the first World War. If the 5,083,000 shares had been shown approximately at the purchase price of $43 on December 27, 1901, as used in the schedule, this would have meant a surplus adjustment of almost $300,000,000 -- about 3/5 of the writedowns.

To make the point even more clear, suppose that the investor was given the common stock on Friday, December 27, 1901. Suppose no further investment was made, so that in 1947 the holding was 7,116 shares worth about $500,000, with a cost of $0. The reinvested earnings applicable to these shares would total over $900,000. Again, if these earnings had been distributed and invested in government securities, they would amount to a much larger sum. It is clear that even if the shares had cost nothing, the economic benefit derived from market appreciation was still considerably less than that which would have been enjoyed if the profits had been distributed.

It is not claimed that the record of U. S. Steel is typical of American industrial firms; in fact there

are grounds for belief that it is somewhat unusual. Nevertheless any accounting formula which is advocated for general use should surely give informative results when applied to a company which has so consistently been an investment favorite.

The record of other companies examined by the writer appears to show similar divergences, but there seems to be little point in extending the discussion. To be convinced of the discrepancies between stock prices and reinvested earnings, it is only necessary to spend a few minutes with one of the publications which charts stocks for an extended period, showing also reported earnings and dividends.[20]

Income Realization: Liquidating Value

There is still one more possibility -- that the stockholder may receive the earnings if the company is liquidated. But this appears to be too unusual an event for the stockholder to place much reliance on it.

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[20] Cf. F. W. Stephens, Graphic Stocks, 15 William St., New York 5, N. Y. Shows ten-year record of over 900 stocks, published bi-monthly.

Other companies studied by the writer: Firestone, Goldblatt Dept. Stores (several stock dividends), Illinois Central (drop in price despite large retained earnings), Minnesota Mining and Manufacturing (increase in price greatly exceeded retained earnings).

Prosperous corporations almost never liquidate; indeed, there is reason to believe that most of them could not do so if they tried. In addition to the certain objection by regulatory bodies if any utility, railroad or other "public" corporation tried to disband, Ballantine states: "The general rule in the absence of statute has been declared to be that such a disposition of assets or a dissolution may be restrained on the objection of a single shareholder."[21]

In conclusion it may be said that any attempt to revalue the investor's equity on the basis of the retained earnings by the company should be made with extreme caution. Only if there is ample justification as a result of control, or unusual circumstances (such as a share in a company whose total earnings are regularly distributed), the investor might consider such a course. For most ordinary situations the statement from Bulletin 11 should be taken as a guide.

The Legal Nature of Dividends -- State Laws

In the preceding section an attempt was made to show why the investor, in most instances, should wait until dividends are declared before accruing income. If this position is accepted, it means that a knowledge

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[21] Henry Winthrop Ballantine, Ballantine on Corporations, Callaghan and Co., Chicago, 1946, p. 666, citing Geddes v. Anaconda Copper Mining Company, 254 U.S. 590.

of the nature of dividends is very important to the investor. Unfortunately, a dividend is not a simple matter in the eyes of the law.

Corporations are creatures of the state and therefore particularly subject to the laws of the state of incorporation. To a certain degree they are also subject to the laws of each state in which they operate. As Kehl has said, concerning the aspect of corporate practice which forms the subject of this chapter:

> "With the exception of such limited common law concepts as have been discussed, there is no general body of American dividend law. The rules for determining the fund from which dividends may be paid depend upon the particular statutes of the state of incorporation, which must be consulted every time a dividend problem is considered. The law of no two states is exactly the same."[22]

It is beyond the scope of this paper to examine the various state regulations concerning corporate distributions. For most purposes the investor may rely on summaries in the <u>Corpus Juris Secundum</u>[23] or Fletcher's <u>Cyclopedia of the Law of Private Corporations</u>.[24]

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[22] Donald Kehl, <u>Corporate Dividends</u>, Ronald Press Company, New York, 1941, p. 26.

[23] <u>Corpus Juris Secundum</u>, William Mach, Editor-in-Chief, American Law Book Co., New York (various dates).

[24] William Meade Fletcher, <u>Cyclopedia of the Law of Private Corporations</u>, Callaghan and Company, Chicago (various dates).

At least two authors have dealt specifically with the subject, Reiter (1926)[25] and Kehl (1941).[26]

A brief description of the historical background of corporate distributions will reveal the way in which various concepts were evolved and changed in the course of time. It is believed that the first corporations were trading ventures which dissolved after the accomplishment of a single mission, such as a voyage. The profits did not have to be calculated before the completion of the venture. Some time later the obvious advantages of continuing a successful relationship led to the practice of expanding the purpose to include several ventures. Some of the profits might be distributed before dissolution, but it was generally accepted that the process would not continue indefinitely. With the advent of profitable trading opportunities developed in the wake of Columbus' and DaGama's voyages, groups obtained monopolies which they wished to perpetuate. The best known of the English companies which resulted were the East India Company (1600), the Russia Company (the earliest, chartered in 1555), the Hudson Bay Company (1670), the

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[25] Prosper Reiter, Profits, Dividends and the Law, Ronald Press Company, New York, 1926.

[26] Donald Kehl, op. cit.

the Bank of England (1674) and the South Sea Company (1711). These and other early corporations laid the ground work for our present dividend concepts. The charter of the New River Company, from James I in 1620, required that dividends be paid from profits.[27] In 1697, when Parliament authorized an increase in the capital of the Bank of England, it provided that stockholders would be liable to creditors for dividends paid from capital. The original Bank Act (1694) had made stockholders individually liable in the event that debt was created in excess of capital, and when Alexander Hamilton copied this provision in drafting the important charter of the first Bank of United States, he made the directors liable rather than the stockholders on the ground that they would be responsible for incurring the indebtedness.[28] This was the model for the later provision in American charters that directors were liable for the declaration of illegal dividends. In 1811 New York enacted a general corporation law open to all applicants for certain specified manufacturing industries. In 1825 New York passed

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[27] The first American case on this point is considered to be Wood v. Dummer 3 Mason 308, Fed. Case No.17,944 (cc. Me. 1824).

[28] Hamilton's Report to the House of Representatives on a National Bank, Dec. 13, 1790, I U. S. Reports on Finances 1790-1814-, 54, 76; Bank of United States Charter, 1 Stat. 191. Section 7, subs. IX.

"An Act to prevent fraudulent Bankruptcies by Incorporated Companies" which "exerted wider influence on the development of American dividend legislation than any other enactment."[29] It provided:

> "That it shall not be lawful for the directors or managers of any incorporated company in this state to make dividends, excepting from the surplus profits arising from the business of such corporations; and it shall not be lawful for the directors of any such company to divide, withdraw, or in any way pay to the stockholders or any of them, any part of the capital stock, without the consent of the legislature,"

and the directors who voted for the distribution were to be jointly and severally liable.[30]

To the profits rule and capital impairment rule, Massachusetts added the insolvency rule in the Massachusetts Manufacturing Regulation Act of 1830, which provided that directors voting for a dividend when the company was insolvent or which would render it insolvent were liable to the extent of the dividend.[31]

By then the concept of limited stockholder liability was firmly established in America. Kehl states that "The principle had for the most part been accepted

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[29] Kehl, _op_. _cit_., p. 12.

[30] N. Y. Laws 1825, c.325 Section 2.

[31] Mass. Laws Jan. Sess. 1830, c.53 Section 9.

by the time American corporations were receiving their first special charters. This is indicated by a marked dearth of early cases where attempt was made to hold a stockholder personally liable."[32]

Modern corporation laws have altered these original concepts in many instances. Delaware, a state which has often led the way toward liberal corporate practices, permits a reduction of stated capital and payment of dividends from the reduction surplus; several other states have copied this provision.[33] Delaware also permits dividends to be paid from current year's earnings in the absence of a balance sheet surplus, a practice which, as Paton demonstrates, can easily lead to the dissipation of capital.[34]

From the lawyer's viewpoint, the maintenance of capital is largely for the protection of the creditor, or at least that was the dominant point during the nineteenth century. Kehl indicates that there has been

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[32] Kehl, _op. cit._, p. 14. Citing Commonwealth v. Blue Hill Turnpike Corp. 5 Mass. 420 (1809) and several other cases dating before 1825.

[33] For these and following points, cf. _Corpus Juris Secundum_, "Corporations"; Revised Code of Delaware, 1935, Chapter 65, sec. 28. Delaware even permits directors to sell an interest in the corporation by issuing options for shares without the knowledge or consent of shareholders and without filing a report in any public office. Cf. Ballantine, _op. cit._, p. 516.

[34] Paton, _Advanced Accounting_, pp. 570-571.

a constant trend toward minimization of this creditor protection, with a correlative increase in the right of stockholders to receive previously restricted corporate assets.

> "The line of cleavage which separated the early corporate creditor from the stockholder is slowly disappearing. In modern corporate reorganizations, the creditor is able to stand less and less upon a vested right to insist upon payment of his claim; while, in contrast, the stockholder of a far-flung enterprise comes to resemble more and more an investor with interests resembling those of a creditor."[35]

Recently the attention of the investing public has been centered on the legislation passed by the Federal Government to regulate the securities business, the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company and Advisers Acts of 1940. It is sometimes forgotten that these laws deal primarily with the type of information which must be given to investors, and certain selling practices. Congress has no express authority to create or authorize the creation of corporations and those which it creates must therefore be an extension of its power to regulate

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[35] Kehl, op. cit., p. 19, citing also Bonbright, Valuation of Property, Vol. 2 (1937), p. 915; Dodd, "American Business Association Law a Hundred Years Ago and Today," Law, A Century of Progress, Vol. 3, pp. 254, 277-278; Littleton, "The Dividend Base," Accounting Review, 1934, pp. 140, 144-145.

interstate and foreign commerce, the war power, the fiscal power, the spending power, and the power to govern territories.[36] "Proposals of federal incorporation as a method of controlling interstate commerce have been so far rejected in every instance in favor of some other mode of regulation."[37]

The principal federal attempt to control general corporate distributions has been through its income-tax policies. Of these the most important is probably Section 102 of the Internal Revenue Code (now that the undistributed profits tax of 1936-1939 and the confiscatory war-time excess profits tax are not operative). Concerning this, Regulations 111 says:

> "Section 102 imposes (in addition to other taxes imposed by chapter 1) a graduated income tax or surtax upon any domestic or foreign corporation formed or availed of to avoid the imposition of the individual surtax upon its shareholders or the shareholders of any other corporation through the medium of permitting earnings or profits to accumulate instead of dividing or distributing them."[38]

And,

> "An accumulation of earnings or profits (including the undistributed earnings or profits of prior years) is unreasonable if it is not required for the purposes of the business, considering all the circumstances of the case."[39]

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[36] Robbins, "Federal Licensing and Business Corporations," 13 Tulane Law Review, 214, 215.

[37] Ballantine, op. cit., p. 49. Cf. Stevens, "Uniform Corporation Law Through Interstate Compacts and Federal Legislation," 34 Michigan Law Review, 1063, 1064-66.

[38] Regulations 111 Sec 29.102-1.

[39] Ibid., 29.102-2

This surtax has been sustained by the Supreme Court,[40] but as yet has not been applied by the Treasury to the extent which the law apparently permits.

Because of the nature of the income tax act, and the fact that it could only impose taxes on incomes after February 28, 1913, there has been an elaborate series of laws, regulations and court decisions to determine exactly what is capital and what is income. A detailed description of these will not be attempted here, but salient points will be introduced later in the chapter. However, it should be noted that for tax matters, if there is a conflict between state law and federal law, the latter is controlling.[41]

Dividend Rights and Preferences

In addition to purely legal aspects, dividend payments are also subject to any agreements made by and between the stockholders. A share of stock is a legal contract for a unit of interest in a corporation, based on a contribution to the corporate capital. One of its major provisions is a definition of the manner in which

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[40] Helvering v. National Grocery Co. 304. U.S. 282.

[41] Ella P. Burdick, Trustee, Estate of J.W.Burdick v. Comm.; 29 BTA 731, (cca-3) 76 F(2d) 672. For an example of a situation in which the state laws are in direct controversy with the federal, see the discussion of dividend dates, infra.

profits shall be shared. Common stock entitles the owner to pro rata dividends without any preference or priority over any other class of shareholders, and variations usually have to do with other matters, such as voting rights.

There are several important types of preference which the contract may give to a certain class of stockholders. Usually the preference is in connection with priority in the distribution of profits, although it may take various forms. The share contract itself does not express all these rights; in many states they must be set forth in the articles or certificate of incorporation and cannot be added to or changed by the by-laws, stock certificates or corporate resolutions. However, this policy is not uniform. Baker says,

> "Some results under statutes of the class of Art. 1538a seem unjust and one is put to the question whether the policy of all knowledge of terms from one source is sound at the expense of possible misleading of investors. Yet one is appalled by the breadth of the sources from which some of the older cases gathered the terms of preferred and by the uncertainties the practice engendered."[42]

He continues concerning

> ". . . recent statutes of many states that carry specialized provisions as to the dividends on preferred shares. These take various forms

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[42]Ralph J. Baker (Professor of Law, Harvard Law School), "Hildebrand on Texas Corporations -- A Review," Texas Law Review, December 1942, p. 198; citing Gaskill v. Gladys Belle Oil Co., 146 Atl. 337 (1929), Continental Ins. Co. v. Reading Co. 259 U.S. 156 (1922), Scott v. B&O R. 49 Atl. 327 (1901).

> including: even though capital is impaired, dividends from current profits can be paid on both preferred and common, unless the impairment reaches capital applicable to the preferred, when dividends from such source are cut off either on both classes or on the common; limitation of the use of paid-in and sometimes other capital surplus to dividends on preferred....[43]

In spite of these varying degrees of preference, a corporation cannot issue shares which guarantee payment of dividends in excess of its earnings unless it is given express legislative authority to do so. In other words, preferred stockholders cannot be placed in a position equal or superior to that of the creditors. Shareholders, both common and preferred, are risk takers. For example, bonds secured by a trust mortgage cannot be made convertible into preferred shares which will be equally secured by mortgage as to dividends with the bonds not converted.[44] Even where the stock "bears interest," as issues often did during the period of railroad construction in this country, the security is either an evidence of indebtedness or of ownership, and in the latter case the so-called "interest" is dependent on earnings unless there is specific legislative permission to pay from capital.[45]

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[43] Ibid., pp. 198-199.

[44] Elbert R. Gilliom, "Corporations -- Unorthodox Preferred Stock Provisions in Priority Litigation," Michigan Law Review, November 1937, p. 100. Gilliom notes a few cases in which such rights have been upheld, but they have been "denied by the majority," p. 106.

[45] Richardson v. Vermont R. Co. 44 Vt. 613.

The importance of this distinction lies in the fact that the owners, as stockholders, are not entitled to receive a dividend until it has been declared by the board of directors.[46] Although the dividends are cumulative (and in some cases where they are non-cumulative[47]) this only gives the shareholder a priority and in no way guarantees that he will receive payment. The historical record shows that such dividends, though earned, have frequently been withheld and thus subjected to the risks of future business. Large preferred arrearages are often refunded and though the stockholder may receive the nominal amount due, it may be years later, thus including a large amount of implicit interest if viewed from the original dividend period. But there is no guarantee that the owner will be that fortunate, for as Ballantine says, "the concept of certain vested rights under the charter contract protected against the reserved power (to amend) is illusory," including the supposed "rights to arrears of accrued dividends on cumulative preferred shares."[48]

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[46]There are few exceptions to this rule, but in the main they are unimportant; it may be mandatory that profits be distributed: Wood v. Lary, 26 N.E. 338, Lydia E. Pinkham Medicine Co. v. Gove, 20 N.E. (2d) 482.

[47]Cintas v. American Car and Foundry, 25A(2d)418. However, the leading case has been opposed: Wabash Railway Co. v. Barclay, 280 U.S. 197 (1930).

[48]Ballantine, op. cit., p. 649. Cf. Havender v. Federal United Corp., Del. Supreme Court, Jan. 16, 1940, discussed in 53 Harvard Law Review, 877. The court

Even the dissolution preference may be of little protection; there is seldom a surplus and in some jurisdictions preferred stockholders cannot claim a liquidation preference if the dividends must be paid out of common capital.[49]

A general conclusion would seem to be that legal history, though somewhat confused and unsettled, shows that preferential agreements do not give the investor sufficient protection to justify the accrual of dividends in advance of declaration. The investor should not place much reliance upon the quick enforcement of any preferred dividend rights.

On the other hand, many companies have a long history of regular payment of preferred dividends. If the company has a record of such preferred payments, there may be pragmatic justification for accrual between dividend dates. Even though the dividend is missed for a year or two, where there is reason to believe that it will soon be paid the investor might better consider the income as

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48 (continued)
allowed the complete elimination of preferred arrearages despite the protest of a minority shareholder. For a contrary view, cf. Lusk, op. cit., p. 776; Cintas v. American Car and Foundry Co., cit. supra, but the effect of this case has apparently been largely limited to New Jersey.

[49] Michael v. Cayey Caguas Tobacco Co., 190 App. Div. 618; 180 N.Y.S. 532 (1st Dept. 120); Johnson v. Johnson Briggs, 138 Va. 487, 122 S.E. 100 (1924). Cf. Kehl, op. cit., p. 166; Dewing, op. cit., Bk. 1, pp. 146-148.

accruing rather than as being recognized in a lump sum on some later date. U. S. Steel preferred is a good example of this. Preferred dividends were paid in full for thirty years; then only partial payments were made in 1932 to early 1936. Arrearages were completely made up in the next two years and payments have continued since. An investor might obtain a truer economic picture by considering a portion of the large payments in 1936 and 1937 as having been earned by the ownership of the stock in 1932-1935. But if a dividend record is at all erratic, such as that of American Woolen preferred, even though the arrearages were eventually paid, an investor would be ill advised to anticipate the income, since a sudden change in the business picture might easily have led to the deferment of the payment for many years.

Dates on Which Dividends May Be Recognized as Income

Although the investor (individual or corporation) may be convinced that it is wiser to wait until a company has definitely declared a dividend before accruing income, there still remains the decision as to when the income is realized. All of the following dates have been suggested:

1. The date of declaration
2. The date "of record"
3. The date checks are placed in the mail
4. The date checks are received
5. The date on which the stockholder makes a choice of alternate methods of payment

Some investors have also attempted to wait until the check was cashed, but this seems unreasonable if the check is good.[50]

Which of the dates the investor should employ depends upon the purpose or the situation involved. As will be noted, in certain jurisdictions certain dates must be used. The tax authorities have rules of their own, which must be followed if the investor is to avoid difficulties. Each of the possible dates therefore requires some discussion, following which an attempt will be made to indicate the viewpoint an investor might take if he were permitted to base his choice on logic.

1. The date of declaration

After a cash or property dividend has been lawfully declared by the directors and their action has been announced, the corporation becomes indebted to the shareholders. They may recover the debt against the corporation; the directors cannot revoke it. However, state laws are conflicting as to whether the income is received by the shareholders at this date. Fletcher says:

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[50] Income was held to have been received even though checks could not be cashed because recipient was incompetent and no one else was authorized to sign -- I.T. 2072 C.B. Dec. 1924, p. 76.

> "As a general rule, dividends declared before a transfer of stock belong to the transferor, and those declared after a transfer belong to the transferee, unless the parties have agreed otherwise or there is some statutory or other controlling provision to the contrary."[51]

Altman declared that this has been held the proper date for tax purposes if the stock is sold.[52]

2. The date "of record"

Since shares of stock are readily transferable, it is necessary to set a certain date when the corporation's stockholder records will be temporarily closed. All shareholders "of record" at that time will be sent the dividend. Brokers on the New York Stock Exchange make a list, about three days before the record date, of holders of a stock which is paying a dividend; the stock sells "ex-dividend." A stockholder who sells his stock after the declaration date, but before this "ex-dividend" date, will not receive the dividend except constructively as part of the sales price. If he receives the dividend because the corporation

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[51] Fletcher, Cyc. Corp. p. 928, citing cases in California, Connecticut, Georgia, Indiana, Iowa, Kansas, Kentucky, Maine, Maryland, Massachusetts, Missouri, Nebraska, New Hampshire, New York, North Carolina, Oregon, Pennsylvania, Tennessee, Utah, Vermont, and Virginia.

[52] Altman, op. cit. paragraph 850, citing Silberman, E., and Sons v. Comm. (cca-7) 76 Fed (2d) 360, 35-1 USTC 9254. Cf. Helvering v. Estate of McGlue 119 F (2nd) 167,171.

was not notified, he is usually liable to the broker.[53] The Prentice-Hall Federal Tax Service states that he will not be taxed on it; the tax will be paid by the purchaser, who is considered to have stepped in the shoes of the seller.[54] The Supreme Court has declared "Mere declaration of a dividend does not alter the stockholder's interest in the corporation as such.... The stockholder can acquire no interest in a dividend amounting to an accrual under Section 42 (I.R.C.) before the amount of the dividend and distributee is determined."[55] The Corpus Juris Secundum cites cases showing that the following states have supported the record date: North Carolina, California, Connecticut, Illinois, Massachusetts, and the District of

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[53] Cf. Birl S. Shultz, The Securities Market, Harper & Brothers, New York, 1942, p. 338. But a seller of stock who did not know of this practice was not liable to the broker in Ford v. Snook, 205 App. Div. 194, 199 N. Y. Supp. 630, Aff'd 240 N.Y. 624, 148 N.E. 732.

[54] Op. cit. Paragraph 9009. Cf. U.S. v. Phellis 257 U.S. 156 at p. 171. "Presumably the prospect of a dividend influenced the price paid and was discounted by the prospect of an income tax thereon. In short, the question whether a dividend made out of company profits constitutes income to the stockholder is not affected by antecedent transfers from hand to hand."

[55] Putnam Estate v. Comm. U.S. 65. Sup. Ct. 811. Cf. George G. Tyler, "When Does a Dividend Become Income?" Journal of Accountancy, November 1945, p. 355.

Columbia.[56] The New York law has now "probably" been changed by statute to mean the record date.[57] In at least one case where dividends in stock of a third corporation were declared, the date the corporation recorded the transfer was used, and not the date of receipt.[58]

3. The date checks are put in the mail

Until checks have been put in the mail, the payment is still uncertain, for the corporation might decide not to send them and thus delay payment for a considerable period. At the least, it would seem to avoid the possibility that a dividend mailed from New York late in December would be taxable to a New Yorker in 1948 and a Californian in 1949. Nevertheless this date is usually ignored by investors. Regulations 111 specifically declares that it shall not be used.[59]

4. The date of receipt

The date of receipt by the shareholder is also frequently considered to be the date on which income is realized. It is the day on which brokers credit their

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[56] Corpus Juris Secundum, Vol. 18, Corporations, Section 470.

[57] Ballantine, op. cit., p. 568, citing In re Estate of Bashford 178 Misc. 951, 36 N.Y.S. (2d) 651, 654 construing Section 62 of the Stock Corporation Law, as amended 1938.

[58] Elvira Scatena, 32 BTA 675, affirmed (CCA-9), 85 F (2d) 729 followed in John M. Perata 33 BTA 843 (reversed on another point (CCA-9), 89 F (2d) 550) rehearing denied 90 F (2d) 498.

[59] Regulations 111, Sec. 29, 42-3.

customers' accounts. When the dividend is credited to a stockholder's account, the date the entry is made rather than of official payment is the day of constructive receipt.[60] For tax purposes it is used by parties on the accrual basis as well as those on the cash basis. The Internal Revenue Code says a dividend is a distribution "made", so the rulings have always been in favor of the date when payment is received. This in spite of the Supreme Court dictum previously quoted:

> "Keeping accounts and making returns on the accrual basis, as distinquished from the cash basis, import that it is the right to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrues."[61]

However, Tyler points out that if a single rule were not adopted for both accrual and cash basis taxpayers, a property dividend might be valued and taxed at different amounts by different taxpayers. Moreover, if a seller on the accrual basis sold the stock just after the record date to a taxpayer on the cash basis, both would be taxed on the dividend, while in the reverse situation neither would be.[62]

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[60] Leon S. Herbert, 32 BTA 372, Aff'd (CCA-3) 81 F (2d) 912.

[61] Chapter III, footnote 3.

[62] Tyler, _op_. _cit_., p. 356.

5. The date the stockholder makes a choice of alternative methods of payment

If the stockholder has a choice, such as an option to receive stock or cash, there is no constructive receipt until the option is exercised by the stockholder and communicated to the corporation.[63]

In addition to the above, Polisher believes that on occasion a stockholder may be taxed for dividends before declaration, which would add another possible date to the list. "Even if the transfer of stock is made shortly before, the dividends will be taxed to the original owner of the stock."[64] However, this seems unlikely. Polisher cites Hyman v. Comm., but in this case it was specifically stated by the court that its decision was based on the fact that "petitioner at all times here material remained the owner of the stock upon which dividends were declared."[65]

It appears obvious that there is no set rule which can be given to the investor. The states are divided between two dates, while the tax authorities are determined

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63 A.R.R. 375, C.B. June 1921, p. 102.

64 Edward N. Polisher, "Assignment of Income--An Ineffective Attempt to Reduce Income Taxes," Journal of Accountancy, September 1944, p. 229.

65 Florence S. Hyman v. Comm. 1.T.C. 911 (1943) aff'd (CCA-2 June 30, 1944) at 911. Cf. Prentice Hall, op. cit., paragraph 7103.

to use a third. In situations likely to lead to legal controversy apparently all the investor can do is to avoid selling his stock (or dying) at any time between the date of declaration and the date of receipt.[66]

The logic of the situation would seem to favor the declaration date. It is fixed for all and widely publicized for important companies. On that date the share of stock becomes, for practical purposes, two securities -- a share of ownership and a non-interest bearing note. Any purchaser so regards it in estimating the price, as the Supreme Court apparently admits: "In buying at a price that reflected the accumulated profits, he of course acquired as a part of the valuable rights purchased the prospect of a dividend from the accumulations -- bought dividend on as the phrase goes."[67] (However, the court went on to enunciate its "stepped into the shoes of the seller" doctrine, under which the purchaser was taxable). Also, the dividend may be treated as a separate security and traded or given away without relinquishing title to

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[66] For a discussion of the difficulties faced by those who must manage an estate, cf. John J. Traynor, "The Nature of Principal and Income in Fiduciary Accounting and Notes on Current Developments," New York Certified Public Accountant, November 1945, p. 589.

[67] U. S. v. Phellis 257 U.S. 156 at 171.

the share of stock.[68] If both cash and accrual basis taxpayers are to use the same date, this would seem economically more sound than the date of receipt, since it is almost invariably more representative of the period in which the distributed profits were earned.

Nevertheless, it is probably more convenient to use the date of receipt. As Paton says, it is "the most conservative procedure for the investor."[69]

The Measurement of Income from Dividends

To this point the main problem has been the determination of the time at which income from the ownership of securities accrues. The pragmatic conclusion is that in situations where the separate entity concept is controlling it does not accrue until a distribution is declared, at the earliest, a possible exception being preferred dividends with a good record.

This problem has usually concerned the relations between the corporation and the stockholder, or one group of stockholders and another -- as such, it was largely the realm of state legislatures and the lawyers. The next question is the proper measurement of the amount of income

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[68] Cf. Hyman v. Comm., supra. First National Bank & Trust Co. v. Glenn, 36 F. Supp. 552.

[69] Paton, Advanced Accounting, p. 193.

received as a dividend, which is of major interest to Congress and the Treasury Department. Their decisions have occasioned frequent protests from accountants and businessmen; disputes concerning the income tax have multiplied to such an extent that a separate Tax Court has been established. (Of course, the purpose of the Court is to hear all types of tax cases, but a large number involve securities evidencing ownership, as a glance at the published cases will quickly demonstrate.) Considerable attention will therefore be paid to tax doctrines throughout the remainder of this chapter.

When an investor receives a dividend he should make two calculations:

1. The amount of value he has received
2. The portion of that amount, if any, which is a return of capital.

It should be noted that corporations have sometimes made distributions or changes in their capital structure which they have called dividends but which are similar to regular dividends in name only. The investor should understand the significance of such transactions and treat them accordingly.

The Measurement of Income from Dividends --

The Value Received

The simplest and most frequent type of distribution to securities evidencing ownership is a dividend in cash.[70] If there are no restrictions on the payment, the stockholder usually has no problem of measurement.

However, dividends can and have been paid in almost every way in which economic benefit can be transferred from one party to another. In many of these cases the problems of valuation are virtually identical with the circumstances discussed in Chapter II, in connection with the acquisition of securities. The important point is that the investor should measure the value of the property, securities, or services received as of the date on which he accrues the income. The result will frequently be different than the basis in the hands of the company, but the latter is of secondary significance to the investor.

The following sections will discuss in more detail those methods of dividend payment which have been used most frequently.

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[70] In fact, the word "dividend," when used without qualification or explanation ordinarily signified dividends paid in money. Cf. Powell v. Maryland Trust Co. 125 F (2d) 260.

The Measurement of Income from Dividends --

Cash Dividends

Although the measurement of cash dividends is usually quite simple, there are a few circumstances which have led to disputes. For example, if a stockholder does not wish to receive the dividend and voluntarily repays it to the company, he nevertheless must include it in his gross income for tax purposes.[71] Although this may seem unimportant, it can form the basis for a great injustice, because in certain circumstances the receipt of such income may make the shareholder liable for taxes almost equal to or even more than the total amount received.

On the corporation side, it is well established that a legal cash or property dividend cannot be revoked after it has been announced. If the declaration is illegal according to the laws of the state of incorporation, the directors are primarily liable, but the stockholders also may be. Ballantine states:

> "By the federal and majority view an unauthorized dividend out of capital can be recovered only against shareholders who received the dividend with knowledge of its illegality, or if an innocent shareholder received a dividend from a corporation insolvent at time of payment. There has also been a conflict as to the right of recovery by subsequent creditors and as to the right of reimbursement of directors who paid damages against shareholders who received an unlawful dividend with knowledge."[72]

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[71] The Shield Co. Inc., 2 TC 763.

[72] Ballantine, op. cit., p. 598. Cf. Fletcher, Cyc. Corp., Vol. 12, "Unlawful Dividends," Sections 5419-5442 (pp. 122-168).

The Advisory Tax Board has ruled that a repayment of dividends by the stockholder under such conditions reduces his income, but only if the corporation had "a legal right" to force rescission and repayment of the dividend. Even if there is a contractual obligation to return the dividends when received, they are still "unqualifiedly" subject to the stockholders' demands and taxable as income.[73] Fletcher (cit. supra) devotes twenty-three sections to a summary of the situations in which a corporation, its creditors, or other stockholders have this "legal right," and it is evident that individual investors cannot hope to handle the problem without legal counsel.

Where the stockholder immediately reinvests a cash dividend in the stock of the company, or has an option to take stock or cash, he still is taxed on the full cash amount. On the other hand, it has been held that the distribution was non-taxable stock dividend where such was the major purpose, although eight per cent of the stockholders took cash; or if the dividend was by check which was only to be used for the stock.[74]

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[73] T.B.M. 77 C.B. 1919, p. 25. Cf. Edgar M. Soreng v. Comm. (CCA-7) 46-2 USTC paragraph 9400. Although the payment violated a private contract and was refunded, the dividends were taxed: St. Regis Paper Co. v. Higgins (CCA-2, 1946) 46-2 USTC paragraph 9383.

[74] Theresa Zellerbach et al. 2 BTA 1076. B.R.Norvell 3 BTA 56. I.T. 1605 C.B.June 1923, p. 18.

If the dividends are received from an investment in foreign securities, the rate of exchange at the time of receipt governs. The payments must be subject to the control of the taxpayer; if blocked there is usually no income, but, if they are allowed to remain in the foreign country when they could be removed and subsequently become blocked, the income accrues. The courts may require that such blocked amounts be valued and tax paid on the estimate if there is reason to believe they represent a benefit. If some exchange is permitted, the "official" (though artificial) rate must be used for tax purposes, but this should not compel the investor to use it for private purposes where there is reason to believe it will not be continued, or the market rate of transfer is substantially different.[75]

The Measurement of Income from Dividends --

Non-Cash Dividends

A declaration of dividends does not necessarily mean that any specific fund or group of assets is set aside

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[75] Cases supporting the above:
F. W. Rose 44 BTA 1, vacated and remanded pursuant to stipulation (CCA-4; 1943) 32 AFTR 1729.
International Mortgage and Investment Corp. 36 BTA 187. Followed in United Artists Corp. of Japan, Memo TC 6-13-44.
P. J. Eder et al 47 BTA 235, remanded by (CCA-2, 1943), 138 F (2d) 27 for revaluation of blocked "pesos." Valuation = 50%, P. J. Eder, Memo TC 5-16-44.
Bank of England rate: Mim. 5297 CB 1942-1 p. 84.

to be distributed among the stockholders. The declaration merely creates an immediate right in the shareholder as a creditor. The liabilities are increased and the surplus is decreased an equivalent amount.

The directors are permitted to authorize distributions in bonds, stock, or property. Only if a dividend is to be paid in cash, such as preferred dividends in the usual case, can the shareholder compel the corporation to discharge its debt "as it is bound to discharge all its other debts, in lawful currency."[76] The value placed on the assets at distribution by the corporation may be influenced by tax advantages, and should not govern the investor.

Concerning the receipt of such non-cash distributions, Gilman raises the question as to whether they represent realized income when received, as is held by the Treasury. He approves Sanders' test for realization:

> "that profit is considered to be realized when a sale is effected, unless collection of the sale price is in doubt, and that unrealized profit, or profit not properly includable on an accrual basis, should not be credited to income either directly or indirectly."[77]

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[76] Williams v. Western Union Tel. Co. 93 N.Y. 162.

[77] T. H. Sanders, "Reports to Stockholders," Accounting Review, September 1934, pp. 216, 217.

Therefore,

> "It is the cash aspect of the exchange that represents the primary test of realization, whereas the period of time elapsing between the receipt of a good claim to cash and the actual receipt of the cash itself really has no theoretical significance although admittedly important from the practical financial viewpoint."[78]

Adhering consistently to this standard of realization, Gilman would admit only bonds and notes as being realized income at the time of receipt as a dividend. Dividends paid in merchandise and shares of stock, including stocks of other companies, are not claims to cash and therefore do not represent realized income.

This treatment is somewhat similar to the 1941 Statement of Principles (American Accounting Association),[79] but the Committee on Revision of the Statement has broadened the concept.

"There is no denial of the recognition of revenue because the consideration received takes a form other than cash. It is necessary that the consideration received be 'valued' or 'priced' in order that a measure of revenue will be accomplished. The basis adopted should provide the most objective basis available." The committee is

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[78] Stephen Gilman, Accounting Concepts of Profit, Ronald Press Company, New York, 1939, p. 102. Cf. pp.109-111.

[79] Accounting Review, January 1942, p. 63. Revenue--"cash or cash equivalent."

apparently ready to include property acquisitions, as it adds "the measurement of consideration received from customers is perhaps best indicated in most cases by the established selling prices of the goods or services exchanged."[80]

Former tests for realization of income arose partly as a result of the accountants' conservative practice of refusing to recognize income until there has been an increase in assets which is objectively verifiable, which means in cash or cash equivalent.[81] For trading operations this rule is usually justifiable; normally, a trade is made because the parties involved believe that the property acquired is of more value than the property released. When no limit is placed on the valuation by insisting that each party wait until the asset is valued by an exchange for the universal medium, cash, there is always a danger that each will tend to overvalue his new acquisition and thus overstate the income.

Presumably no one would dispute the fact that the investor has enjoyed an increase in the assets under his

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[80]Thomas W. Leland, "Revenue, Expense and Income," Accounting Review, January 1948, p. 18. Reporting for Committee on Revision of the Statement of Principles, Herbert E. Miller, Chairman.

[81]Accountants' Handbook, p. 175.

control, viewed from the separate entity "minority position"; (from the other point of view the shareholder receives no income from a dividend since it is merely a transfer of income already realized.) If Gilman's approach is applied strictly, it is impossible to value such a dividend issued in property until it is sold, at which time there is neither gain nor loss, although there may be a considerable change in value while it is held. If merchandise dividends are consumed by the shareholder (as, for instance, Park & Tilford's wartime dividend in whiskey),[82] the liquid asset test is difficult to apply. Most important of all, there is a considerable period during which the investor has economic control of an asset which does not formally appear on the books, unless it is assigned part of the value of the capital investment, which seems an undesirable alternative when the separate entity concept is used.

In the case of a trading transaction, the increase in value of the assets may be small or non-existent, but in the case of a dividend it is presumably from zero to a substantial figure (keeping the capital element separate). If a choice must be made between the two evils of possible misvaluation and of non-recognition, the first would seem the lesser.

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[82]Moody's Industrials, 1946, p. 1157. Warrants issued for purchase of six cases of whiskey, below market price, for each share held -- June 23, 1944, to May 15,1946.

A few specific types of non-cash dividends require special consideration. Notes or bonds of the company have been used as dividends in an effort to distribute assets at a later date, whether dividends are earned then or not. If they result in capital impairment such dividends have been successfully contested.[83] Of course the fair value of such bonds is not necessarily par; in one case the bonds were valued as low as 78 per cent of par.[84]

Scrip dividends also entitle the shareholder to a benefit at some future time. Scrip is "an interim or provisional document or certificate, to be exchanged, when certain payments have been made or conditions complied with, for a more formal certificate, as of shares or bonds, or entitling the holder to the payment of interest, a dividend, or the like."[85] Unless the scrip is an unconditional obligation it is difficult to see how the stockholder has received any economic benefit, since he already had an equitable right to share in the corporate assets if and when distributed. The stockholder should await performance.

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[83] Jorguson v. Apex Gold Miners Co., 74 Wash. 243, 133 Pac. 465 (1913); Strickland v. National Salt Co., 79 N.J.Eq. 182, 81 Atl. 828.

[84] U.S. v. Fuller (D.C.Pa.) 42 F (2d) 471.

[85] Century Dictionary and Cyclopedia. "Scrip," quoted by Ballantine, op. cit., p. 565. Cf. Barnes v. Spencer & Barnes Co., 162 Mich. 509, 127 N.W. 752. Brown v. Lehigh Coal (etc.) Co., 49 Pa. 270.

Kehl is opposed to this reasoning. He appears to agree with the view of the dissent in Merz v. Interior Conduit & Insulation Company: "That discharge of an outstanding obligation on the scrip constitutes a thing of value sufficient to be classified as property seems sound."[86]

The problem of scrip is further complicated by the question as to the time to accrue the income for tax. The Prentice-Hall Federal Tax Service holds, at paragraph 9084, that scrip dividends are taxable in the year warrants are received and, at paragraph 9262, in the year in which the warrants are issued.[87]

"Certificates of profit" have been issued, maturing in several years and subject to the future losses and expenses of the company until redeemed, with interest payable on the face amount. They were held taxable when issued, with a subsequent gain or loss to be reckoned on maturity, although such certificates seem to be a far cry from regular dividends.[88]

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[86] 87 Hun 430 (1st Dept.,1895), app.dism. 151 N.Y. 638 (1896); Kehl, op. cit., p. 172.

[87] Prentice-Hall, op. cit., paragraph 9084, paragraph 9262 citing Patterson v. Anderson, 18 AFTR 1319; Paragraph 9262, citing Regulations 111 Sec. 29, 115-10.

[88] O.D. 589, C.B. Dec. 1920, p. 37.

Dividends in stock of other companies are to be treated as ordinary property distributions. For convenience, a dividend in real estate or other fixed assets may be converted into a stock distribution by the payor by forming a subsidiary to take over the property and then distributing the shares of the subsidiary. Other interesting situations can arise in connection with controlled subsidiaries: it has been held that when a corporation receives its own stock from a wholly-owned subsidiary, the transfer is a taxable dividend -- certainly an extreme application of the separate entity concept.[89] The ultimate in such circumstances would seem to be a case in which a shareholder received a dividend from one corporation in shares of two others of which he was also a shareholder, and his percentage interest in the shares of each was the same before and after the transactions. Yet this situation has been considered as giving rise to taxable income at least twice.[90]

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[89] Golden State Theatre & Realty Corp. v. Comm. (CCA-9, 1942) 125 F (2d) 641.

[90] W. J. Cheley, et al, 45 BTA 707, affirmed (CCA-10,1942) 131 F (2d) 1018. Warren J. Bleeker Est. et al v. Comm. 136 F (2d) 683. The stock of the other corporations was purchased by the first, which distributed it to its own stockholders. Since the individual in question received only a portion of this distribution, he had the same proportionate interest in each corporation as he did before the transaction began. The net result was a transfer of assets from the first corporation (purchasing and distributing the stock) to the other two corporations, and an increase in the stock issued and outstanding by the other two.

The Measurement of Income from Dividends --

Stock Dividends

Dividends in stock of the same company have caused trouble almost since the inception of the income tax. The history of this dispute highlights an interesting human characteristic: the ability to deal with symbols for years without firmly establishing their characteristics. A share of stock is a conventional symbol for a certain kind of proportionate ownership; an investor owning one share of stock in a corporation with five shares outstanding is in exactly the same position with regard to ownership as he is if he owns two shares in the same corporation with ten shares outstanding. Although he, along with the other owners, has been given more symbols (another share of stock) each symbol now represents one half what it did before and there has been no distribution of profits under any conceivable interpretation of the phrase.

The fact that the corporation has capitalized some of its surplus, as in a stock dividend, does not mean that profits have been made available. In fact, the reverse is true; the profits are now locked in the corporation's capital structure and are unavailable as dividends. Of course, some states permit the corporation to formally reduce its capital and return the amount to surplus available for dividends. If stock dividends were income,

this round could be repeated endlessly, with nothing transferred to the investor but a handful of symbolic paper, from which he would be expected to derive an increasing glow of satisfaction.

Considering the difficulties it has recently caused, one might suppose that the practice of issuing dividend stock was relatively new. Actually it has been carried on for more than a quarter of a millenium. The Hudson Bay Company declared such a dividend in 1690, and the African Company followed suit in the next year.[91]

Eisner v. Macomber, which gave rise to a widely accepted definition of income, was based on a suit concerning stock dividends.[92] Numerous articles have been written on the subject, especially after the Koshland v. Helvering decision, which held that stock dividends were taxable if the owners' proportionate interests were changed by issue of a different security than the one held.[93]

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[91] William Robert Scott, <u>The Constitution and Finance of English Scottish and Irish Joint Stock Companies to 1720</u>, Cambridge, University Press, 1910-12, Volume 1, pp.317-318; Volume 2, pp. 232,235. The directors of the South Sea Company used a 10 per cent stock dividend as part of their scheme to boost the market price of the shares just before the collapse in 1720 (Volume 3, p.321).

[92] 25 2 U.S. 189.

[93] 298 U.S. 441. Cf. William L. Ashbaugh, "Legislation and Litigation Re Stock Dividends," <u>Journal of Accountancy</u>, July 1943, p. 11. Thomas York, "Stock and Other Dividends as Income," <u>Accounting Review</u>, September 1940, p. 380. Harry D. Kerrigan, series in <u>Accounting Review</u>, 1936-1938.

Thomas York (cit. supra) in a well reasoned article came to the conclusion that since preferred stockholders are more closely akin to creditors, and common stockholders are the residual risk-takers, stock dividends in any kind of stock declared on preferred stock are income to the preferred shareholders under all circumstances. A dividend on preferred stock, like interest on bonds or any other form of corporate obligation, is essentially compensation for the use of money loaned.

As for common stock, York believes the common stockholders are the beneficiaries of a sort of trust fund, with the corporation the trustee. "The gain which common stockholders acquire individually when they receive a dividend is completely cancelled by the loss they sustain in consequence of the reduced value of their respective interests in the corporation."[94] Therefore, "all kinds of dividends, including all kinds of stock dividends, are not income when declared on common stock."[95]

Acceptance of this latter view requires the stockholder to accrue income as it is earned by the corporation.

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[94] York, op. cit., pp. 388-9.

[95] Ibid., p. 392. Cf. Godfrey N. Nelson, New York Times, January 25, 1948, Financial Section, p.1, "New Ruling Made in Stock Dividend," describing a commissioner's ruling that preferred issued to common stockholders was not income to them.

In spite of the theoretical appeal of this approach, it involves serious practical difficulties because of the long delay in realization by the investor of re-invested corporate earnings, as demonstrated in the early part of this chapter. It was concluded there that the investor had best wait until corporate assets are actually distributed to him. But this does not impair the validity of York's objection to stock dividends on common stock as income.

The problem was finally made the subject of a special Accounting Research Bulletin (No. 11), "Corporate Accounting for Ordinary Stock Dividends." The considered conclusion:

> "1. An ordinary stock dividend is not income from the corporation to the recipient in any amount.
>
> 2. Upon receipt of such a dividend, the cost of the shares previously held should be allocated equitably to such shares and to the shares received as a dividend."[96]

In spite of this attitude on the part of accountants, the belief still persists that stock dividends represent something valuable above the original capital

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[96] Committee on Accounting Procedure, Accounting Research Bulletin No. 11, "Corporate Accounting for Ordinary Stock Dividends," American Institute of Accountants, September 1941, p. 103.

investment. State income tax laws may tax them.[97] Speaking as a lawyer, Kehl supports the basic contradiction without seeming to realize that he has done so: "The stock dividend performs valuable functions in corporate finance. It permits the actual retention of assets for use in the business, while at the same time enabling a distribution to the stockholder which may be retained or disposed of by the latter."[98] Graham and Dodd, Security Analysis, list four supposed advantages to the stockholder of periodic stock dividends.[99]

These views have been strongly opposed by financial writers as well as by accountants. Dewing has made a survey of studies in this field and comes to the conclusion that the results do not justify the belief that stock dividends are an important market influence. He refers to Siegel, who says:

"The belief that stock dividends have been responsible for increased value marketwise, or that they exaggerate price movements, is apparently fallacious. The

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[97] Benjamin Harrow, "Contemporary Accounting--New York State Taxes," New York Certified Public Accountant, September 1945, p. 475 (taxable if not new issue).

[98] Kehl, op. cit., p. 173.

[99] Graham & Dodd, op. cit., p. 393.

degree of variation shown between stock-dividend-paying stocks and cash-dividend-paying stocks is so infinitesimal that it deserves very little further consideration."[100]

One actual example might emphasize this point of view. Preinreich, who defends the practice of considering stock dividends as income, gives considerable attention to an unnamed company whose dividend policies and market quotations, as he gives them, correspond exactly to those of the North American Company.[101] This company is an outstanding example of one which made a practice of issuing stock dividends. North American began its policy of paying a ten per cent stock dividend in 1924.[102] At that time there were approximately 3,000,000 shares of common outstanding. During the following years there was a ten per cent stock dividend each year, until 1931. In 1932 there was an 8½ per cent stock dividend, and in 1933 a 5 per cent stock dividend as well as a 37½¢ cash dividend. By this time there were over 8,188,000 shares outstanding. During this period the company reported earnings in every

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[100]S. N. Siegel, "Stock Dividends," <u>Harvard Business Review</u>, October 1932, p. 87. Cf. Dewing, <u>op. cit.</u>, pp. 831-836. S. Livermore, "The Value of Stock Dividends," <u>American Economic Review</u>, December 1930, p. 688.

[101]Preinreich, <u>op</u>. <u>cit</u>., p. 18, pp. 38-39.

[102]All data from Moody's Investors Service, <u>op</u>. <u>cit</u>., Utilities.

year, which remained with the company (with the 37½c exception). The total of this reinvestment came to over $180,000,000, or about $60 per share on the original amount outstanding. In 1924 the price of North American fluctuated between $22 and $45 a share, an average of $33½. Adding $60 to this figure gives a total of $93½, which may be compared with the following prices:

	Actual Quotation Range	Adjusted for New Number of Shares Outstanding[103]	Average
1934	$10 - $25	$27 1/3 - $68¼	47 3/4
1935	9 - 28	24½ - 76 1/3	50½

In other words, the average price at the end of the ten year stock dividend period was less than the per share total of the retained earnings.

North American Company suffered under the same disadvantages during the period referred to as did all utilities during the Roosevelt administration. It may certainly be argued that the stock price was unduly depressed and the example is a-typical. Nevertheless, the fact remains that any investor who considered his stock dividends as income during this period was not reflecting the actual economic situation. Incidentally, the price of the stock continued to react unfavorably, reaching a low of 6½ in 1942.

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[103] 8.188 for each previous three.

Stock rights are usually treated on the same basis as stock dividends. They do not represent income, but rather a separation of part of the capital investment. Nor do such rights represent income if they give the right to subscribe to stock of another company, so long as the price asked is fair, and if the transaction is not "essentially equivalent" to a dividend under I.R.C. Sec. 115. Rights to subscribe to convertible bonds are substantially the same as stock rights, and are non-taxable unless the circumstances are unusual.

A corporation may find itself in circumstances which make the payment of cash dividends impracticable, yet for various reasons (such as the undistributed profits tax) may wish to declare dividends. Section 28 of the Internal Revenue Code permits the corporation to obtain a credit without actually paying out dividends, if the shareholders consent to include the amounts in their gross income as "consent dividends." The practical effect is the same as if the dividends had been paid in cash and then reinvested in the corporation. The reinvestment is capital to the corporation and is added to the base of his stock by the investor, who is thus relieved of tax later if a distribution is made as a dividend from the capital.

The Measurement of Income from Dividends --

Constructive Dividends

A distribution of profits by consent of the shareholders and directors in an informal manner is generally held to be in effect a dividend and valid if the creditors are not injured.[104] There is no objection if stockholders owning a majority of the stock sanction payment to the minority without any payment being made to themselves. Moreover dividends need not be pro rata if there is general agreement.

Since dividends are not deductible expenses for tax purposes the Treasury Department wages a constant struggle to prevent corporate distributions to stockholders from being disguised in ways other than by the declaration of dividends, -- such as compensation to stockholder employees in proportion to stock holdings, so-called commissions, royalties, rents, gifts, "interest" on unpaid dividends, permission to buy corporate assets below market price, and so on. The general term used to describe such distributions is "constructive dividends."

As far as the investor is concerned, a payment is income whether received as compensation or a dividend;

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[104] Corpus Juris Secundum, Vol. 18, Sec. 464, pp. 1104-5. Cf. Harvard Law Review, February 1913, p. 370.

the only reason to differentiate between them is to keep a proper record for investment control. The Treasury must frequently base its opinion on appearances, but the investor is presumably aware of the true situation and is only deceiving himself if he fails to keep accurate records.

The simplest of such "constructive dividends" are mere withdrawals by the stockholder in the guise of non-interest bearing loans. The loans may be bona fide, but they become dividends if the corporation cancels the indebtedness.[105] An interesting variation is the withdrawal of sums by partners during the period of incorporation -- these also have been held to dividends.[106]

Assessments are usually considered to be an addition to the investment, but advances may or may not. Levy and Simonds consider this problem, and agree with the conclusion, as stated by the Board of Tax Appeals, that there is no general rule that a payment by a stockholder to his corporation "is per se a contribution to its capital which augments the cost of his share. The question is controlled by the circumstances in which the

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[105]Prentice-Hall, paragraph 9062-B, C. It is interesting to note that the reverse situation has been held a gift, in a case which has apparently caused the Treasury Department much concern -- Helvering v. American Dental Co., 318 U.S. 322.

[106]I.T. 1299, C.B. June 1922, p. 251. Cf. I.T. 1532, C.B. Dec. 1922, p. 10, for withdrawals by an individual for payment of federal income taxes.

payment is made. If there is intent that the payment shall enlarge the stock investment, the shareholder may not treat it otherwise to support a loss or bad debt deduction. Whether there is such intent, actual or implied, is determinable by evidence which may vary in different cases."[107] Where the assessment or advance is considered an investment any so-called repayment by the corporation will be considered a dividend for tax purposes unless there are no earnings to distribute. Where there is a potential assessment, stock having been issued at a discount, if the corporation debits its profit and loss account and credits the capital stock, the transfer has been taxed as a cash dividend.[108] On the other hand, a similar transfer from surplus has been held to be essentially equivalent to a stock dividend and non-taxable;[109]

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[107] T.B.M. 82, C.B. 1919, p. 275. Arnold Levy and Jerome H. Simonds, "Stockholder Advances to Corporations," Taxes, February 1947, p. 128, citing Daniel Gimbel, 36 BTA 539 at 542.

[108] A.R.R. 1127 C.B. Dec. 1922, p. 8. In both this and the Michaels case (cf. footnote 109) the stock was 80 per cent paid up.

The transfer of surplus to the Capital account has been held a dividend under New York Franchise Tax law, even though stockholders were not enriched thereby: People ex. rel. Adams Electric Light Co. v. Graves, 247 App. Div. 237, 288 N.Y. Supp. 137.

[109] Michaels v. McLaughlin and C. F. Michaels, Executor v. McLaughlin (D.C. Calif. 1927), 20 F (2d) 959, 6 AFTR. Cf. I.T. 2455, C.B. June 1929, p. 218; J.F.Carlson 22 BTA 217.

The liability to creditors is apparently not relieved: Fletcher, Cyc. Corp., Sec. 6136, p. 577.

which perhaps may be taken as an illustration of the way in which legal bodies are often governed by form and not substance.

A more difficult problem arises in connection with pro rata stock redemptions, which distribute corporate assets to the stockholders and yet leave them with the same proportionate control of the company as existed before. This has been viewed as essentially equivalent to a taxable dividend in many instances. The cases on this subject are at odds; Gutkin and Beck say that the "whole area needs the Supreme Court touch."[110] They list tests used by the Board of Tax Appeals substantially as follows:

1. Whether the issuance and redemption is part of a continuing plan.
2. Nature of the distribution -- pro rata being especially suspect, but not necessarily so.
3. Who has control of the corporation and dividend policy.
4. Is it for a legitimate business purpose or for the benefit of the stockholders.[111]

But each of these tests has many exceptions. Crown humorously notes the baffled comment of the judge in

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[110] Sydney A. Gutkin and David Beck, "Stock Redemptions as Taxable Events under Section 115(g): The Impressionistic Test," Journal of Accountancy, October 1945, p.285.

[111] Ibid., pp. 287-288, citing many cases.

Kirschenbaum v. Commissioner: "Perhaps the section (115(g) of the I.R.C.) covers all cancellations or redemptions which result in the distribution of accumulated earnings; perhaps there are some purposes for which a corporation may reduce its shares and distribute such earnings, and yet the distribution will not be 'essentially equivalent' to a taxable dividend."[112]

Tax doctrine, with its emphasis on the corporation rather than the investor, has inevitably reached an impasse on this issue. But there is less difficulty for the investor who thinks independently; for him a distribution of corporate assets which does not alter his proportionate holding is income unless the circumstances are such that any type of distribution is best regarded as a return of his personal capital investment.

Besides direct payment to stockholders, a company may perform a great variety of acts which indirectly result in a benefit to them and should be considered income. A few examples will suffice: payment of taxes or debts for stockholders, gifts to relatives of stockholders, valuable rights assigned to stockholders, etc. Perhaps

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[112] Leo W. Crown, "Essentially Equivalent to a Taxable Dividend," Taxes, February 1947, p. 147, quoting Kirschenbaum v. Comm. 155 F (2d) 23.

the following case will illustrate the lengths to which the Treasury Department is prepared to go in taxing such benefits: a corporation, at the suggestion of its controlling stockholder, transferred some of its assets so that art objects were purchased which the stockholder desired to purchase. The objects were then subject to his dominion. It was ruled that the stockholder had received taxable income.[113]

The Measurement of Income from Dividends -- Constructive Receipt

It is a general rule that income accrues to the owner of a security whenever the payment is unqualifiedly available to him. This has been extended to mean that any payments to an agent or a broker give rise to realized income since the latter are supposed to obey the orders of the owner. In addition, dividends which have merely been credited to an account of the stockholder are considered as realized.[114]

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[113] Security First National Bank of Los Angeles, et al, Executors (Estate of Huntington) 28 BTA 289.

[114] This has been held to be true even though the stockholder must surrender his stock in order to receive the dividends if there is no restriction on the purchase of new shares. I.T. 3103, C.B. 1937 -2, p. 114.

For tax purposes there is a so-called "doctrine of constructive receipt" based on Regulations 111, Section 29.42-2 and 29.42-3. This is a strict rule which gives the Treasury Department the right to levy taxes on the owner of securities though payments are made to other parties or are held by the corporation. It has been stated that this doctrine is perhaps never applied to the recipient's advantage because to do so would be contrary to the purpose of the rule.[115] The rule seldom causes much difficulty except in cases where someone other than the owner is holding the stock.

Dividends on borrowed stock are usually income to the lender, but on margin stock to the buyer. Court cases are divided as to whether dividends on stock placed in escrow are taxable to a purchaser who has assumed the responsibility for completing payments on a contract. Recently opposing decisions were handed down in two cases involving the same transaction.[116] Otherwise, income from escrowed securities is usually taxable to the person who deposited them. If the securities are in escrow during a suit, the income accrues when the suit is settled.

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[115] Sanford Corp. 38 BTA 139, aff'd (CCA-3) 106 F (2d) 882, cert. den. Feb. 5, 1940.

[116] Moore v. Comm. (CCA-7), 124 F (2d) 991. Deguire v. Higgins (D.C.N.Y.: 1946) 65 F. Supp. 445.

Concerning securities pledged as collateral, Fletcher says: "The general property in the dividends is in the pledgor, but in the absence of agreement to the contrary the pledgee is entitled to receive dividends subsequently declared, to be applied on the debt or held in trust subject thereto for the pledgor."[117] If the pledgor collects the dividends, he may be required to account to the pledgee. The pledgee is supposed to collect the dividends, but it has been held that if he fails he does not have to credit the dividends on the debt.[118]

When securities are sold subject to repurchase agreement the buyer and seller should be careful to make certain that treatment of the dividends is mutually understood. Tax authorities have successfully attacked such agreements, holding that the transfer of ownership was in form but not in substance and therefore only a loan with the securities as collateral.[119] Nevertheless, the evidence can establish the transactions as genuine purchases

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[117] Fletcher, Cyc. Corp., Sec. 5382.

[118] McAulay v. Moody, 128 Cal 202, 60 Pac. 778.

[119] First National Bank in Wichita v. Comm., 19 BTA 744, (CCA-10), 57 F (2d) 7, cert. den. Oct. 17, 1932.

although repurchase agreements were entered into at the same time.[120]

A large number of court cases have been based on the difficulty of determining the recipient of income from securities in trust. Concerning the leading case, Helvering v. Clifford (309 U.S. 331), it has been said that:

> "Income of a trust is taxable to the grantor under section 22(a) although not payable to the grantor himself and not to be applied in satisfaction of his legal obligations if he has retained control of the trust so complete that he is still in practical effect the owner of its income. In the absence of precise guides supplied by an appropriate regulation, the application of this principle to varying and diversified factual situations has led to considerable uncertainty and confusion."[121]

In borderline cases the investor had best seek competent legal counsel; literally hundreds of cases testify to the danger of inadequate determination.

When funds for the payment of declared dividends have been provided in a special bank deposit, the deposit becomes a trust fund, and the right of the shareholders to receive it is not impaired by subsequent insolvency of the corporation. However, this does not mean that if the depository fails there has been constructive receipt

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[120]The Bank of California, National Association, 30 BTA 556, aff'd (CCA-9), 80 F (2d) 389.

[121]Commerce Clearing House, op. cit., 1948 ed. paragraph 86 A.

and the corporation is released, for it still must pay the debt to the shareholders.[122] (The trust doctrine does not hold for the payment of interest coupons; in such cases the depository is the mere paying agent of the corporation and no trust on the part of the corporation or depository is inferred.)

The Measurement of Income from Dividends -- Exclusion from Income

In Chapter I it was seen that investors are vitally interested in making a distinction between income and returns of capital. This problem will be discussed in more detail in the next chapter from the point of view of the investor, but here it should be noted that many distributions are labelled dividends which are unmistakably returns of capital. Liquidating dividends will frequently fall into this category, unless the investor has acquired his stock at such a low price that a part of the payment can be considered income. The same is true of "dividends from depreciation or depletion reserves," (a term used by tax authorities). There is no income from dividends on stock illegally issued or other payments to

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[122] King v. Paterson & H.R.R. Co. 29 N.J.L. 504.

non-stockholders, if they must be repaid, or on treasury stock, or dividends paid in apparently worthless securities (even though they later become valuable).

Voting Trust Certificates

Under many voting trust agreements the beneficial owners of stock cease to be shareholders of record and ordinarily are stripped of all collateral rights, such as voting for directors, inspecting the books, voice in fundamental changes (e.g., sale of all assets). The owners become tenants in common in the mass of shares transferred to the trustees, with a contract right to receive dividends and a return of a certain number of shares when the trust is terminated. Legally, therefore, each owner is then a "stranger to the corporation." The transfer of the new shares, the voting trust certificates, can give rise to taxable gain or loss.[123]

Nevertheless, although the status of the owner has changed considerably, for accounting purposes the new security may usually be treated as a continuation of the old, and dividends recorded as when the stock was owned directly.

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[123] Cf. Ballantine, op. cit., p. 431-432.
State ex rel. Crowder v. Sperry Corp. (Del.) 15 A (2d) 661.

<u>Summary</u>

In this chapter an effort was made to bring together the most important factors which determine the nature of a share of stock and therefore the methods of accounting which should be used to record income from it. It was shown that an individual investor's position is partly dependent upon the degree of control which he (or a corporation) can exercise over dividend distributions; unless he has substantial control he should usually wait for the declaration of dividends before accruing income. The investor is also governed by legal requirements, which vary from jurisdiction to jurisdiction, and by tax law, which has its own set of rules. The chapter concluded with a discussion of the time dividends become income and of the various ways in which dividends may be paid. The valuation of such dividends is the first step in the determination of income from stock; the next is the segregation of capital return, which is treated in Chapter V.

Chapter V

INVESTOR'S EXPENSES, RETURN OF CAPITAL

Although the investor has correctly measured the periodic return derived from the securities, before he can determine his income he must deduct current expenses and separate any returns of capital. Often both of these quantities can only be estimates. Expenses are frequently applicable to the revenue from the portfolio as a whole and an investor can never know for certain the final amount of income and/or capital return until he disposes of the security. If a security becomes worthless, payments which were considered income will prove to have been capital return, using the term "income" to mean excess received over and above the capital investment.

It can be seen that this view regards the holding period as a unit; yearly periods are given less emphasis than in ordinary corporate accounting. It is also suggested that the investor might go a step further and regard his experience with a group of securities or even the entire portfolio as a unit, in line with the concept of diversification of risk to preserve a general capital sum.

The chapter concludes with a statement of the advantages of segregating the report of investment performance from other financial activities, and of giving the current position full disclosure.

Investor's Expenses

Before arriving at net income an investor must deduct all applicable expenses. Some of these are quite obvious, such as the cost of a safety deposit box at the bank, but many of them are often merged with the investor's other affairs in such a way that separation may not be attempted. Even companies which hold a substantial portfolio of securities frequently give no indication in their reporting that, for instance, a part of the salary of an executive who spends an appreciable amount of his time controlling the investments is segregated from the general administrative expenses. It may be believed that such expenditures are insignificant and do not merit separate recognition, but certainly it is impossible to measure investment performance accurately until all such costs are considered. In this period of low percentage returns and high service costs, together with the always-present possibility of capital loss, the net gain from corporate investment in securities is probably close to an all-time low, and therefore requires special attention if the investment program is to be successful.

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data[1] perhaps the best indication of the amount of these costs comes from the statements of companies which make a business of investment -- the investment trusts. Their reports show a relation of investment expense to income which may surprise investors, both corporate and individual, who have never bothered to make a separate study of the items, tending to rely on statements like that of Loftus concerning investment trusts:

"Expenses are assumed to require annually one-fifth of one per cent of the average net worth of the Fund.... ... the assumption was made only after consultation with officers of trust companies, investment trusts and investment counsel houses. The rate is probably somewhat too high."[2]

Whether or not this statement was true at the time and for the companies investigated by Loftus, it does not appear to be true today, as the following table shows:

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[1] This and similar general observations are based on a study by the writer of the reports of 130 corporations.

[2] John A. Loftus, Investment Management, Johns Hopkins Press, Baltimore, 1941, pp. 32-33.

Table V

INVESTMENT COMPANY EXPENSE[3]

	Portfolio (millions)	Expenses (thousands)	Expense as Per Cent of Portfolio
Adams Express	$45	$225	.5
Amer. Cities Power & Light	30	96	.3
American General Corp.	35	161	.5
Atlas Corp.	59	900	1.5
Carriers and General	8	70	.9
Equity Corporation	24	90	.4
First York Corporation	17	148	.9
Lehman Corporation	61	520	.9
Selected Industries	35	180	.5

The expenses do not include the costs of buying and selling the shares of the investment trust, since these are handled separately as "loading charge."[4] Expenses consist of costs of supervision, collection and distribution of income. An ordinary corporation making substantial investments will not have equivalent expenditures; it does not trade in the market as often, and it may consider the additional costs of distribution to be unimportant because it is already making dividend distributions. Presumably, however, it would not claim that it should spend any less

[3]Moody's Manual of Investments, Banks, Insurance, Real Estate, Investment Trusts, 1947 Edition, data year end 1946.

[4]Cf. Marshall D. Ketchum, The Fixed Investment Trust, University of Chicago Press, Chicago, 1937, pp. 66-69.

than an adequate amount for supervision, for if it did it could expect to suffer more than an equivalent amount through capital loss. Whether these investment trust figures are an indication of the exact size of an "adequate amount for supervision" may be doubted, but surely they demonstrate that such amounts are not likely to be insignificant.

The following companies showed their supervision costs separately:

	Total Expenses	Management Only
American General Corp.	$161,000	$110,000
Carriers and General	70,000	45,000
Equity Corporation	90,000	52,000

In each case the cost of supervision was well over half the total cost of operation of the trust. In view of these figures, the burden of proof would appear to be rather on those who believe that segregation of such expenses can be ignored.

Investor's Expenses: Direct and Indirect

One of the difficulties confronting the investor who wishes to arrive at net figures for his records is the fact that while the incomes derive from individual securities, most expenses are general, applicable to the entire portfolio. A tentative solution to this problem is suggested by the techniques already developed in the field of cost accounting.

Costs of security management may be divided into two general categories, direct and indirect. Direct costs are those which are connected with a specific security; the cost of selling a dividend paid in property would be an example. Indirect expenses are such matters as the salary of the official in charge of the investments (or a portion corresponding to the time he spent on that work), the bookkeeping necessary, the safety deposit boxes, financial services, legal counsel, and taxes. The last item, taxes, is especially important. For most investors investment income is perhaps best thought of as being in addition to that from regular operations or from an individual's occupation, i.e., marginal income. This is especially true because the investor has a choice of returns ranging from low, but secure and tax-free, to large but risky. Or, the investor may decide to hold cash and receive no return at all.

The tax deductible is usually considered when comparing various securities to determine which should be purchased, or whether it is wiser to hold cash. As for allocation of tax to the investments as a group, Bailey, in his presidential address to the American Institute of Accountants, summarized Accounting Research Bulletin No. 23: "Briefly, it was the position of the bulletin that for unusual items the tax should follow

the item."[5] The concept seems particularly applicable to the investment account. Though the item may not be large enough to deserve separate attention in published statements, it should always be significant for internal control.[6]

Investor's Expenses: Allocation to Individual Securities

Direct costs are easily traced, and some indirect costs, such as taxes, may suggest a proper basis by their nature. For income taxes a division can be made among the taxable securities on the basis of the amount each earns net of its share of expenses deductible on a tax return.

After capital losses have been offset against capital gains the tax on net gains should be shown separately. If there is a net capital loss, resulting in tax

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[5]George D. Bailey, "The Increasing Significance of the Income Statement," Journal of Accountancy, January 1948, p. 13.

[6]Allocation of taxes is only possible if some basic concept of investment income is adopted. (Here it is considered to be "marginal.") Vatter states: "What part of a dividend arises from the assets in particular funds is another question which cannot be answered. The allocation of income tax charges is a problem of the same nature; income-tax allocation, however, is even further complicated by the existence of graduated tax rates on brackets of income, the offsetting of losses against gains from other sources, and the effects of timing transactions (as they must be reported for tax purposes) differently from the way in which these items would be treated for other purposes." W. J. Vatter, The Fund Theory of Accounting and Its Implications for Financial Reports, University of Chicago Press, July 1947, p. 107.

saving, there will be a smaller tax to be allocated among the various securities.

For intangible taxes the division may be as a percentage of revenues or as a percentage of face or paid in values, depending upon the state law applicable: banks, trust companies or building and loan companies may pay this tax directly for their shareholders and the payments should be noted by investors for comparative purposes. Such matters as the cost of lawyer's services may apply to a group of securities, if advice has been sought as to whether they are a legal investment. Record keeping, safety deposit boxes, and supervision would ordinarily apply to all securities. The simplest method would be to allocate such expenses on the basis of income, and to a large extent this should be justifiable. Of two investments of equal size, the one with the larger returns is apt to be somewhat more risky and to require more supervision. It may be objected that this could apply a large share of the expense to a very safe investment in government bonds, if that were the major portion of the portfolio; in such a case some adjustment might be justified. However, it must be remembered that under any kind of supervision worthy of the name the investment represents a careful choice of a certain issue of government bonds from the many available; also it results from a careful survey of other potential investments with a resulting decision in

favor of the bonds. The decision must be continually reviewed; recent changes in the value of the dollar have certainly disabused any ideas that a person who purchased government bonds is secure against any and all contingencies.

Investor's Expenses: Non-recurring

So far the major emphasis has been upon expenses which are of a recurring nature. An investor may also have unusual costs and expenditures which in a sense only protect the capital investment with no production of income. Should these be deducted from income, be capitalized, or perhaps "charged to surplus" as suggested by Accounting Research Bulletin No. 32?[7]

For example, suppose the owner of stock joins in an attempt to oust the management of the company. He is likely to incur substantial expense which certainly bears little relation to past incomes and affects the corporate income of the present year only to a minor degree. Is it an addition to the capital investment? Nothing has been contributed to the company except perhaps a new management of unproved quality; not even that if the attempt fails. Yet it seems unjustifiable to call any such situation a loss, chargeable to surplus, when it is entered upon willingly and with a business purpose.

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[7]Committee on Accounting Procedure, Accounting Research Bulletin No. 32, "Income and Earned Surplus," American Institute of Accountants, New York, December,1947.

For federal income tax such expenses are apparently deductible in the year made (although a transfer of stock by the principal stockholder to an employee to induce him to remain was not, and expenditures defending title are considered capital expense).[8] In view of the uncertainties of the situation current deduction would seem to be the best treatment. It is difficult to offer a general rule for this type of unusual expenditure, but perhaps the following will be of some help: deduct as expenses of the year all such payments except those which add to the capital of the corporation (such as assessments), or which confer or protect the right of ownership. The latter may also be deducted if they do not add to rights which already were believed to exist -- such as defense of title long after the investor considered title to be clear.

This rule would admittedly be somewhat arbitrary if the investor were primarily concerned with the performance for each year as a separate unit. It would appear more advisable to take a long range point of view and to keep books in such a way that the figures can be accumulated. Perhaps the expenses of a stockholder's suit may be applicable to an increase of revenue during the next

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[8] Prentice-Hall, _op. cit._, Para. 11, 166 - 11,175, also Para. 11,141.

decade; if the period is viewed as a unit it makes little difference whether they are deducted in one year or spread over several.

Investor's Expenses: Conditional Payments

Another type of expenditure is that which recurs, but only for a specified period. In a leading tax case it was decided that if expenses are for the management, conservation or maintenance of property held for the production of income, deduction is allowable even if the particular expense does not produce income.[9] Does this include payments which the security-holder agreed to make at the time the securities were acquired, as part of the purchase agreement? The Tax Court has decided that in a case where such payments were not conditional upon their being earned through income from the securities, the payments were not expenses.[10] But if the payments are so conditional, there still seems to be a question as to whether they are an expense or part of the purchase price. Viewed from one aspect the payments merely reduce the income during the specified period and the expectation of such a reduction is presumably reflected in a lower

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[9] Bingham's Trust v. Comm. 325 U.S. 365 (1945).

[10] Edgar W. Leonard, Memo T.C. 3-2-44.

purchase price. Viewed from another the income is realized by the new owner and then reinvested in the security as a sort of installment plan purchase which brings the total investment up to the fair value at acquisition of a similar but unencumbered security. The difficulty with this plan lies in its contingent nature: to a certain extent it is only a partial sale, since the seller is still receiving income subject to the risks of an owner. Since the choice of method will determine the amount of income during the interval and the eventual "capital investment," it is important that an answer be given, but the writer can see no infallible solution to this problem.

The Segregation of Capital Return: Bonds

Once expenses have been established the security owner must make a further adjustment to determine his income: all capital returns must be segregated. The proper way to do this will be discussed in two sections, first for income from bonds, then for income from shares of ownership.

Separation of interest and dividends requires some justification. As May has said, in discussing the narrowing of the gap between the legal position of the creditor and owner: "There would seem,therefore, to be strong arguments for assimilating the treatment of dividends and

interest in the accounting for investment income."[11]
But though the investor may in practice be equally distant from management in either case and have rights in dissolution or bankruptcy more nearly equal than old-time bond contracts required, there is still a fundamental difference which is of importance in discussing the capital investment. In the usual case the bond has a maturity date and the stock contract does not; there is an upper limit on the capital return only for the bond. With the exception of a few special types, a bond never returns more than par value at maturity and at best a few per cent more if called earlier. As a result a bond investor can only preserve his capital, viewing his portfolio as a whole, if:

1. He never suffers a default, or
2. He replenishes his capital by purchases below par or by saving a portion of his income.

The first may be dismissed briefly. The only bonds which approximate the safety implicit in the expectation that there will never be a dollar default are those of our national government. State and local governments have defaulted, and the corporate record during the 1930's, while remarkably good for high grade bonds, was far from certainty. Even our national record is none too good when

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[11] George O. May, Financial Accounting, Macmillan Company, New York, 1946, p. 223.

we recall the treatment of gold and subsequent inflationary practices. The investor has retained his capital fund in name only.[12]

As for purchases made at a discount, the market rate of interest may be higher than the coupon rate on the bond; such discount is merely a way of paying extra interest, as described in Chapter II, and should not be considered as a means of replenishing capital. Or, the bond may be selling at a substantial discount because of the risk that it might default. The purchase of such a bond is a speculation and should not be used by an investor to restore his capital account solely because the security in question is a bond. Many stocks may be of equal or better investment quality. The Accountants' Handbook states that "if the amount of the discount is large primarily as a result of the impaired credit position of the issuing company, and there is serious doubt as to the payment of the remaining interest and principal obligations in full, there is some question as to the reasonableness of any accrual of discount as income."[13]

Based on the foregoing, it would appear that the only method whereby a bond investor can be reasonably certain to maintain his capital account intact is to set

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[12] For a review of the poor record of the bonds of various governments through history, cf. Harry Scherman, The Promises Men Live By, Random House, New York, 1938.

[13] Accountants' Handbook, p. 483.

aside a certain portion of the interest and view it as though it were a return of capital. To many accountants this suggestion will sound like anticipating a loss, a practice similar to so-called "reserves for self-insurance." Admittedly there is a good deal of resemblance. The Accountants' Handbook points out the danger: "Fire damage and other casualties do not accrue. Regardless of average experience the particular concern suffers no loss until the fire or other casualty occurs." It adds, "On the other hand reserves for workmen's compensation, pensions, etc., which reflect a reasonable estimate of an actually accruing obligation, based on accidents which have occurred or on any other decisive evidence of accrual, may be well built up by charges to current operations and the credit balances reported as estimated liabilities."[14]

This statement of the conservative approach to the anticipation of losses seems to be strongly justified and any similar treatment by the investor requires "decisive evidence" of the need to accrue, which would ordinarily mean the actual experience of a loss before deduction would be allowed. If this strict interpretation is applied to investments it would at least seem advisable to remind the investor that a certain part of the income should be reserved, if the purpose is to maintain a given

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[14] Accountants' Handbook, p. 1,037.

capital amount. Theoretically this reservation would be roughly equivalent to the "premium for uncertainty" which the investor has received over and above the "pure rate of interest." The premium is demanded by the investor because he believes the security in question runs some risk of default; the greater such risk the larger the premium demanded.

This idea is not of recent origin. J. B. Say entered into a discussion of the "pure rate of interest" at the beginning of the nineteenth century.[15] Böhm von Bawerk also investigated the idea.[16] As developed by economists, the concept simply states that there is a certain theoretical interest rate which would be demanded for a long-term riskless investment; any excess in the actual market is "premium for uncertainty and a payment for the trouble and expense incident to investment."[17]

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[15] J. B. Say, Traite d'Economique Politique, Paris, 1826, (5th Ed.), Livre Seconde, Chapitre VIII, "Du Revenu des Capiteaux."

[16] Eugen Böhm von Bawerk, Kapital und Kapitalzins, Innsbruck, 1884, 1st part, p. 8. "Risikoprämien" is term used. In a general way the idea is probably as old as financial history. For example, Juvenal in Satire IX, says: "Why! Creperius Pollio had not a more woe-begone face than yours; he that went about ready to pay three times the ordinary interest, and could find none fools enough to trust him." (Tr. by Rev. Lewis Evans, Harper and Brothers, New York, 1861, p. 94.)

[17] George H. Evans, Jr., and George E. Barnett, Principles of Investment, Houghton Mifflin Company, 1940, p. 26.

It is not easy to estimate the premium for uncertainty (or, "premium for risk"). Of the net periodic payment after deducting expenses, part is "pure interest," part is premium for uncertainty, and part can also be regarded as reward for superior judgment in selecting bonds which yield more than the minimum of pure interest. Past experience has shown that the extra payment made on bonds rated as low grade frequently has not been sufficient to compensate the investor for the extra risks involved, to say nothing of a reward for superior judgment.[18] On the other hand, certain investors no doubt can consistently better the market average, and it would not be helpful to label the excess return above the pure interest rate as premium for risk in their cases. To do so would reduce computations of income to a dead level at the pure interest rate, something like the proposals to include goodwill in the listing of corporate assets so that companies with superior earning power would end up with the same rate of return as others with more average capabilities.

For these reasons investors who purchase bonds which have a greater yield rate than that on the highest grade securities may accept the extra return as income,

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[18] Gilbert Harold, Bond Ratings as an Investment Guide, Ronald Press Company, New York, 1938, p. 238.

since our techniques of market judgment are not accurate enough to enable them to do otherwise in their accounting. But they might well make some mental reservations as to the certainty and reliability of such income and be somewhat reluctant to spend all of it if their purpose is to keep a portfolio intact.

In actual practice various schemes are used to preserve the capital amount of an investment fund placed primarily in bonds. It has long been recognized that trustees or administrators of an estate must amortize premium on bonds purchased above par; if they pay out the entire coupon they are dissipating capital. Banks usually follow this practice. Fischer discusses the fact that bank purchases are usually made at market prices, plus commission charges, at other than interest due dates. Moreover, bonds are frequently sold before maturity, so "For the reason set forth a straight-line aliquot method of writing down bond premium is the only practical method for use in a banking institution and this is the method generally used under income tax accounting."[19]

That this is primarily a capital protection device rather than an attempt to determine the true interest income is shown by the fact that trustees and banks rarely accumulate discount except on non-interest bearing obliga-

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[19] O. E. Fischer, "Amortization of Bond Premium in Tax Returns of Banks," Journal of Accountancy, June 1946, p. 477. Cf. Max Rolnik, "Tax Accounting for Banks," New York Certified Public Accountant, April 1947, p. 245.

tions covered by Section 42(b) of the Internal Revenue Code. Perhaps the best expression of this conservative attitude is given in the answers to a question sent to the Journal of Accountancy: Is it acceptable to amortize premium bonds over a ten-year period, or remaining life, or to the first call date, whichever is the lesser, without offsetting by amortizing discount bonds in the same investment fund? The answers were agreed that this was acceptable, with a qualification by one respondent that short-term, high-rating discount bonds should probably be accumulated.[20]

In addition to this protective device banks also frequently inventory their securities on a "cost or market" basis. Unlike industrial corporations, they are allowed to take deductions for partial worthlessness on their tax returns. They also can treat worthless bonds as bad debts, thus escaping the long-term capital loss limitations. Other institutions may follow a similar practice, often with interesting variations. For example, the Rockefeller Foundation, in its annual report for 1941, showed

> "Other Bonds--Ledger Value* $26,051,738
> (Market Value Dec. 31, 1941, $13,894,400)
>
> *The ledger value has been written down $1,026,143 in 1938, 1939, 1940, and 1941."[21]

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[20] Journal of Accountancy, February 1941, p. 172.

[21] As reported in Your Investments, October 1942, p. 51.

The subject of periodic revaluation is interesting in connection with bonds, but more important for stocks, so a discussion in greater detail is deferred to the next section which is devoted to income from securities evidencing ownership.

<u>The Segregation of Capital Return</u>:

<u>Shares of Ownership</u>

The problem of segregating dividend income from capital returns is probably as difficult as any which faces the investor. In Chapter IV an effort was made to describe the complications which surround the position of the stockholder; any attempt to summarize them runs a danger of over-simplification. However, it is possible to trace many of the difficulties to a single concept: that the corporation is unaffected by changes in its ownership. From this it follows that an incoming stockholder "steps in the shoes" of the one departing; the chain is complete, back to the original group who paid in the capital; any dividends paid are income so long as they leave this original capital intact.

This concept was adopted as the basis of federal income tax policy, which merely added the notion that all undistributed earnings as of March 1, 1913, were reinvested and also part of the capital. The original capital was frequently $100 per share; subsequent owners might invest $10 or $1,000 per share through market purchases, but

their "income " or "capital return" was controlled by the action of the man at the head of the chain. As has been noted in Chapter IV, corporations are permitted to change their capital accounts, so even if the "stepped into the shoes" doctrine had logical significance the original position is frequently lost in history, capable of being reconstructed only through difficult research. Many of our corporations are now approaching their centennial and it is conceivable that some of them may survive for another hundred years. With each added year it becomes more preposterous to tie new stockholders to measurement of income based on acts in the far past.

Accountants have not been unaware of the problem. May has said: "Each stockholder can and a corporate stockholder, at least, should deal with dividends in its own accounts according to the special circumstances of its own investment." As a start, he suggested: "A sound general rule is that, in order to justify a credit to income in respect of dividends, it must appear that the paying corporation has both earned and paid during the investing corporation's ownership of the stock sums equal to the rate of dividend for which the credit is proposed to be taken."[22]

This proposal has considerable merit, especially

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[22] George O. May, Financial Accounting, Macmillan Company, New York, 1946, p. 217.

in the years immediately following the purchase. As time goes on, however, it has less and less significance because of the accumulation of reinvested earnings. It is of no protection to the capital account when the market price of the security is less than the total of such earnings reinvested since the stock was purchased, as may be the case with many companies, especially the railroads, in recent years.

There are at least two major difficulties with methods of record-keeping by the investor which rely on reports of the issuing company to designate income and capital return:

1. The accounting procedures of the company are not set up for that purpose.
2. Such methods usually wait for the company to furnish notice of liquidating dividends.

The first of these is discussed by the recent Accounting Research Bulletin No. 32, "Income and Earned Surplus."[23] This bulletin deliberately emphasizes the point that public accountants are not primarily concerned with providing the investor with cumulative figures.

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[23] Committee on Accounting Procedure, Accounting Bulletin No. 32, "Income and Surplus," The American Institute of Accountants, December 1947. Cf. George D. Bailey, "The Increasing Significance of the Income Statement," Journal of Accountancy, January 1948, pp. 18-19.

Emphasis is rather on the operations of the annual period. Net surplus changes are also to be shown if differing from the appointed "net income," but the major purpose of the accounting is to give an indication of the "normal" earning power of the company rather than the overall experience. This gives the investor a better figure to capitalize but a worse one to accumulate. Surplus adjustments must be made, which always involve difficult problems of interpretation. As shown in Chapter IV, over a long period the total of such "earnings" when reinvested may come to bear little relation to the actual value of the stock as assessed by the market. It is not maintained here that accountants should therefore change their methods; the purpose is merely to warn the investor not to use data in ways for which they were not intended.

In addition, accounting procedures are more conservative in regards to unearned income than the investor might wish to be. This means, for instance, that an investor who adopted May's suggestion might be forced to keep a set of records for the company to show the changes in value since acquisition of the stock. Otherwise a situation such as the following could arise: The company has inventory which recently has appreciated, a change which it has not recorded. It pays a dividend, ostensibly from earnings created prior to the acquisition of the securities by the investor, but less than the

amount of inventory appreciation. The investor does not expect to hold the securities until the inventory is sold. Is the dividend income or return of capital? Other examples could easily be supplied -- cases where the company had made use of reserves to absorb expenses, or neglected to provide for adequate depreciation.

The second situation, waiting for the company to declare liquidating dividends, is the method approved by tax accounting and much investment advice. Certain aspects of the tax view have already been commented upon at the beginning of this section. As for investment advice, consider the following from a textbook: "The measurement of the current income from common stocks involves no difficulties. Like preferred shares, common stocks have no maturity date; hence it is impossible to accumulate discount or amortize premiums on shares bought at prices other than par. The total current income received from an investment in common stocks is simply the sum of all the cash dividends received, less any amounts such as are in the nature of liquidating dividends."

To which is later added: "Liquidating dividends are not easy to distinguish. Except in the case of investments in corporations engaged in exploiting wasting assets, where one would act wisely to consider all early cash dividends as a return of capital, it is necessary for the investor to rely on his corporation for the identification

of liquidating dividends. Until quite recently it was rare for a corporation (other than a mining concern) to designate a particular dividend as liquidating, but the trend now appears to be in the other direction."[24]

The fact that such a treatment ignores the amount paid (capital investment) by the shareholder has already been noted. But there is a more subtle danger in relying upon the company to warn the investor that his capital is being returned or dissipated. The shareholder is supposed to wait until the company starts to liquidate before taking alarm. As May has pointed out in a trenchant passage: "The antithesis to 'profit' is 'loss.' There is no similar antithesis to 'dividend.'"[25] Like soldiers in the old song, many corporations never seem to die; they simply fade away, or reorganize. Even when their company is sold stockholders frequently receive stock of the purchaser in payment.

A private investor should not wait for liquidating dividends to reduce his capital investment, because in the normal course of events he will die or sell his stock before such liquidating dividends are received. In either

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[24] James C. Dolley, Principles of Investment, Harper and Brothers, New York, 1940, p. 172, pp. 200-201.

[25] George O. May, "Distribution of Profits," New York Certified Public Accountant, May 1945, p. 223.

case the stock is then valued at the market price, which not only is often below the stated capital or par, plus earnings since acquisition, but may even be below the per-share value of the net current assets. Under application of the liquidation concept such a market situation is ridiculous, but it has occurred in too many cases to be a novelty.

A general conclusion would appear to be that complete reliance on company accounting and reports is inadequate as a means of ensuring the investor that his capital amount is intact and that current receipts may be considered income.

The Segregation of Capital Return:

Anticipation of Value at Disposal

If the above concept is abandoned, what alternatives exist? The objective must be to anticipate the value of the security on that future date when it will be sold or otherwise disposed of; only then can the investor know for certain whether he has retained his capital amount and earned some income with it. But what is the best current estimate of that future price? Several methods have been advocated, variations of which suggest themselves as possibilities.

Of these the most strongly supported is present market price. Insurance companies, security dealers, and investment trusts use this method; the latter may

even revalue their portfolios as often as several times a day. But these groups are somewhat exceptional in their effort to be fair to the "interim owner." For ordinary corporations it is more frequently suggested that some sort of cost or market rule be followed, which accepts losses as evidenced by the market and thus by offsetting turns any current dividends into a sort of capital return. Unrealized appreciation is avoided, although there is some question as to whether previous write-downs may not be restored if the market recovers. Recently Accounting Research Bulletin No. 30, "Current Assets and Current Liabilities--Working Capital," declared:

> However, practice varies with respect to the carrying basis for current assets such as marketable securities and inventories. In the case of marketable securities where market value is less than cost by a substantial amount and it is evident that the decline in market value is not due to a mere temporary condition, the amount to be included as a current asset should not exceed the market value.... Accordingly it is important that the amounts at which current assets are stated be supplemented by information which reveals, for temporary investments, their market value at the balance sheet date,...[26]

Emphasis on the word "temporary" does not exclude the advisability of disclosing the market value of long-term investments. But no mention is made of appreciation, even for securities which are highly marketable, although

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[26]Committee on Accounting Procedure, Accounting Research Bulletin No. 30, "Current Assets and Current Liabilities--Working Capital," The American Institute of Accountants, August 1947, p. 251. For a discussion of appreciation, cf. Accountants' Handbook, pp. 157-158.

such a policy seems logically consistent with the willingness to revalue downwards. In any case the Bulletin's suggestion is a haphazard way of maintaining the capital investment, ignoring an essential characteristic of shares of ownership as opposed to bonds: the fact that they have no limiting maturity value. Diversification of risk therefore enables the investor to offset losses in one security by gains in another.

Theoretical support for current market valuation comes from certain independent accountants and investment counsel. MacNeal, for example, says in Truth in Accounting: "Conclusion: The subject of acceptable market prices may be left with the reassertion that they, not original costs, are present economic values and that they should be used in financial statements in all cases where they are available, unmodified, save by way of comment, by any subsequent event, or supposition of an event."[27]

A special group is composed of "Dow theorists," whose numbers are sufficient so that they are considered to be a market influence of at least a temporary nature. Robert Rhea, one of their leading exponents, stated their belief that the market is the best forecaster of its

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[27] Kenneth MacNeal, Truth in Accounting, University of Pennsylvania Press, Philadelphia, 1939, p. 150.

own prices: "The fluctuations of the daily closing prices of the Dow-Jones rail and industrial averages afford a composite index of all the hopes, disappointments, and knowledge of everyone who knows anything of financial matters, and for that reason the effects of coming events (excluding acts of God) are always properly discounted in their movement. The averages quickly appraise such calamities as fires and earthquakes."[28]

Opposed to these groups are those who believe that today's market is always wrong -- tomorrow. Williams begins his effort "to outline a new sub-science that shall be known as the Theory of Investment Value," with the sentence: "Separate and distinct things not to be confused, as every thoughtful investor knows, are real worth and market price."[29] Williams is interested in the former: "Let us define the investment value of a stock as the present worth of all the dividends to be paid on it," and he develops a calculus of discounted dividends leading to the "real worth." His method has great theoretical appeal. It also has practical significance, for if the long-term investor could make a

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[28] Robert Rhea, The Dow Theory, Barron's, New York, 1932, p. 19.

[29] John Burr Williams, The Theory of Investment Value, Harvard University Press, Cambridge, Massachusetts, 1938, p. 3. The descriptive quote is from the Preface.

reasonably accurate estimate of the market price at some future date, however distant, he could then proceed to treat his common stock portfolio much like a similar investment in bonds.

The general stock market may actually approximate such a position. For example, the following are yearly yields, based on separate computations for each year's prices and dividends, of fifty industrial stocks:[30]

Table VI

Year	High	Low	Average
1946	4.7%	3.6%	4.15%
1945	4.7	3.6	4.15
1944	5.2	4.5	4.85
1943	5.4	4.3	4.85
1942	7.2	5.5	6.35
1941	8.0	6.4	7.2
1940	7.2	5.0	6.1
1939	5.3	4.0	4.65
1938	4.9	3.0	3.95
1937	7.4	4.1	5.75
1929	5.4	3.1	4.25

These percentage returns show a rather remarkable stability, considering the uncertain nature of stock

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[30] Standard and Poor's Industry Surveys, 1948 ed., p. A1-13.

market prices. Since each year has a different base, it is not advisable to average the yearly averages, but the median of these averages, 4.85 per cent, is a fairly representative figure. With the interest rate on governments at 2 to 2½ per cent during the period, this apparently gives a surprisingly low "premium for uncertainty" on stock investments. It seems investors were not demanding a high price for risk-taking in these fifty stocks, despite the unusual nature of the period. It might also indicate that investors were discounting future dividends with a fair degree of accuracy. (As noted in Chapter IV, price changes averaged about even during this period as measured by the Dow-Jones averages.)

But this average return does not justify the presumption that forecasts can be made concerning a single stock or small group of stocks. The record of individual forecasts is notoriously bad. Williams devotes fifty-four pages, about one-tenth of his book, to an illustrative study of United States Steel, and comes to an estimate of approximately $119 a share.[31] In the ten years following publication United States Steel never sold over 90 except for a few months in 1946, and is currently in the 70's.[32] The point is not that Mr. Williams was a poor prophet,

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[31] Williams, *op. cit.*, p. 451.

[32] Fall of 1948.

but that the calculation proved unreliable in spite of the fact that many of the criteria he used to make his estimate were in general fulfilled -- the company has had much larger sales than he expected, the general price level has risen tremendously, interest rates for capitalization of earnings have been lower -- all of which should have raised the price. However, other factors such as government control, costs, and taxes have more than negated these favorable influences.

A great many studies have been made testing the reliability of forecasting devices. A survey of them was recently made by A. W. May, with the conclusion that: "A specific reason for the abortiveness of predictions about 'the market' is the persistent divergence of its behavior from expectations warranted by the economic factors -- resulting in rightness in guessing events, wrongness on the market. This has been perfectly demonstrated during the past two years."[33] As for the difficulty of estimating the price of individual issues: "A recent compilation shows that despite the intervening reduction of the Dow-Jones Industrial Average by more than 50 per cent since the 1929 all-time peak; nevertheless 185 stocks are selling above their 1929 highs. Furthermore

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[33]A. Wilfred May, "Observations--The Perils of Prediction," Commercial and Financial Chronicle, November 27, 1947, p. 5. This article was one of a series of eight dealing with forecasting, published in the Commercial and Financial Chronicle between October 23 and December 4, 1947.

147 are higher than both 1937 and 1929, and 38 issues are higher than 1929 but lower than 1937. For the period since VJ Day we have witnessed a virtual crazy-quilt of simultaneous net advances and declines; showing the great double difficulty of correctly appraising individual industries, even if, for one reason or another, one manages to predict the trend of the general market average."[34]

The shortcomings of both present market value and of market forecasts are summed in a work by late British economist Keynes.[35] In discussing the "state of confidence" which governs the yield rate, when combined with the rate of interest, he says: "The outstanding fact is the extreme precariousness of the basis of knowledge on which our estimates of prospective yield have to be made.... If we speak frankly, we have to admit that our basis of knowledge for estimating the yield ten years hence of a railway, a copper mine, a textile factory, the goodwill of a patent medicine, an Atlantic liner, a building in the City of London amounts to little and sometimes to nothing; or even five years hence. In fact,

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[34] Ibid., December 4, 1947, p. 5.

[35] The quotations used in this section are from Chapter 12, "The State of Long-Term Expectations," John Maynard Keynes, The General Theory of Employment, Interest and Money, Harcourt, Brace and Company, New York, 1935, pp. 146-164.

those who seriously attempt to make any such estimate are often so much in the minority that their behavior does not govern the market." In a striking simile, Keynes describes the way the market provides liquidity for the individual: "It is as though a farmer, having tapped his barometer after breakfast, could remove his capital from the farming business between ten and eleven in the morning and reconsider whether he should return to it later in the week." Anyone with capital is free to enter the market, and "thus certain classes of investment are governed by the average expectation of those who deal on the Stock Exchange as revealed in the price of shares, rather than by the genuine expectations of the professional enterpreneur." This expectation is liable to violent fluctuations because:

1. A large proportion of the aggregate investment is owned by people who do not manage and have no special knowledge of the circumstances of the business.

2. Short-term fluctuations in profits have undue market influence.

3. There are no roots of strong conviction to hold the market steady, since it is based on the convention that the existing state of affairs will continue indefinitely, except insofar as there is specific reason to expect a change. But we know from extensive experience that the existing state of affairs will not continue.

4. The most important factor in setting prices is the battle of wits between speculators who are attempting to guess what the basis of conventional valuation -- not of "real worth" -- will be a few months hence. Keynes compares this to a newspaper contest in which the competitors have to pick the six prettiest faces from a hundred photographs, the winner not being the one who picks the prettiest but he who comes nearest to guessing which faces the majority will pick. The majority are also doing the same, so "We have reached the third degree where we devote our intelligences to anticipating what average opinion expects average opinion to be. And there are some, I believe, who practice the fourth, fifth, and higher degrees."

Keynes then attacks the question as to whether a skilled individual can make long-term investments based on genuine expectations, unperturbed by current "players." His conclusion: "Investment based on long-term expectation is so difficult today as to be scarcely practicable.... It needs more intelligence to defeat the forces of time and our ignorance of the future than to beat the gun."

The major purpose of the foregoing discussion was to show that neither investment counsellors nor economists have developed any methods of estimating stockholders' capital return which the accountant can use with confidence. The current market price is perhaps the best estimate, but

it is a poor best. On the other hand, if current market values are unreliable as estimates, original cost is usually of still less significance for that purpose.

Thus we have a dilemma, with no satisfactory solution in sight as long as we attempt to measure current income from securities periodically. The greater the risk, the more unreliable such estimates will be. Yet something must be done in order to report to the owners of a corporation which has made an investment; there is a similar need for the private investor to make periodic reviews for purposes of control. A suggestion which seems to meet these needs with the fewest practical objections will be discussed in the next section.

Separate Reporting of Investment Performance

In the preceding section the conclusion was reached that it is usually impossible to make an accurate measurement of the income from a stock investment before the security is sold. The principal exceptions would be those controlled situations, discussed in Chapter IV, where the income can be considered as earned when realized by the subsidiary. For most others there will be a considerable doubt, even where the control of such investment is substantial but where there are economic and social reasons which prevent some of the earnings from being available to the parent company.

Because any reports concerning the latter type of

income must be considered tentative, it is suggested that all receipts from securities be reported separately on the Income Statement, together with a clear declaration of all the expenses which are applicable. Gains and losses from the sale of securities should be shown. The original cost and, so far as is known, the market value of all securities at both the beginning and end of the period should be given on schedules, in sufficient detail so that unrealized gains and losses on securities held at the close of the period can be computed if they are not already noted.[36] It is not necessary that unrealized gains and losses be considered on the Income Statement itself if they are available elsewhere. This suggestion does not limit the company to any type of statement; the "single step" Income Statement is acceptable if the various items are distinguished sufficiently.

As for the Balance Sheet, it is necessary that the investment section be separate and distinct from the other assets, and that any securities included in the Current Assets be labelled with especial care. The figures used probably had best be governed by the conventional expectation that the existing state of affairs will continue

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[36] Cf. Part 1 of First Schedule, English Companies Act of 1947, especially A, 2, (c), "in the case of investments not having a market value, their value as estimated by the directors" should be shown.

indefinitely, except insofar as there is specific reason to expect a change. This would mean acceptance of cost figures unless the market was decisively different in either direction. Of course, it is the phrase "decisively different" which causes difficulty, but the problem is minimized if both cost and the current market price are available so the dubious owner can make his own readjustments. Any net adjustments upward should be shown as a distinct credit "unrealized market appreciation," those downward as a reserve deducted from the Investment Account. When such adjustments are made they should also be included on the Income Statement as unrealized income or loss.

There is a natural reluctance among accountants to add to the number of schedules, or to detail on statements which are sometimes attacked as being too complicated already. Accountants may feel that the results can be thrown into "Other Income" or "Other Expense" with no particular loss to the reader.

It is also true that there is pressure from various interests asking that this or the other section of statements be amplified. Nevertheless there is an unusual degree of justification for the belief that results of the investment performance be segregated as completely as possible. Unless the corporation is specifically of a financial nature, investing is an act which is somewhat

alien to the stated purpose of the corporation. Even when the security purchased is that of another company in an allied line of business there may be a large degree of truth in that assertion. A recent report of the National Industrial Conference Board made the flat statement: "The security of the corporation as an economic unit appears frequently to be a motive of management more compelling than profits for distribution to stockholders."[37] Since the logical place to hold such profits for security is often in the investment account, it is not surprising that, as Paton says, "Securities held represent a major element in a great many corporate balance sheets at the present time."[38]

But this major element is one of the most poorly defined sections of the accounting statements. Men who must study reports are becoming increasingly critical of the manner in which investments are presented. For example:

"Investment is a mystery item" on the corporate Balance Sheet, -- Roy A. Foulke, Vice President of Dun and Bradstreet, in his recent work on financial analysis.[39]

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[37] National Industrial Conference Board, Effects of Taxation upon Corporate Policy, 1943, p. 9.

[38] W. A. Paton, "The Balance Sheet," Contemporary Accounting, Editor, Thomas W. Leland, American Institute of Accountants, New York, 1945, Chapter 2, p. 12.

[39] Roy A. Foulke, Practical Financial Statement Analysis, McGraw Hill Book Company, New York, 1945, p. 88.

Even more specific was a Texas banker, Fred L. Florence: "Too frequently reports are unsatisfactory as to 'other asset' items. This is particularly true of investments in, and advances to affiliates. In many cases the captions used do not satisfactorily reveal the true nature of the items which are included therein or the basis of valuations."[40]

In addition to this demand from those who study the statements, there is also the theoretical basis for a more complete showing of the investment performance. As May has pointed out, "There is a vital distinction between primary income, such as that which is derived from trade, manufacture or services, and investment income, such as interest and dividends, which represents a transfer of income from one corporation to another. The growth of intercorporate security holdings has increased the practical importance of this distinction."[41]

Vatter declares that "to recognize that investment in other companies and agencies is separate from general operations follows logically from the related managerial activities. When economic capital is invested in other

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[40]Fred L. Florence, "What the Banker Expects of the Certified Public Accountants," an address to the Dallas chapter, Texas Society of Certified Public Accountants, as quoted by Victor Z. Brink, Journal of Accountancy, June 1947, p. 527.

[41]George O. May, Financial Accounting, pp.215-216.

companies, it passes beyond the immediate control of the operating management, and it is therefore segregated from the capital employed in directly controlled activities."[42] He therefore advocates showing the Investment Fund as a separate unit, with a Balance Sheet and Report of Operations of its own. The concept of diversification of risk, leading to treatment of the investments as a group, lends support to this suggestion.

It is not necessary for accountants to adopt the fund concept in order to make a showing of investment performance which will be a considerable improvement over present practice. It does not seem too much to hope that the trend will be toward disclosure of figures which will enable the investor to make a calculation of the ability of a management to invest funds as well as to operate the business.

As for the individual who is accounting for his own interests, his records should show the year-by-year history of his investment performance completely and separately from his other financial activities. Adequate records are of vital importance if he is to succeed in

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[42] W. J. Vatter, The Fund Theory of Accounting and Its Implications for Financial Reports, University of Chicago Press, July 1947, p. 107.

the difficult task of preserving the estate on which so much of his personal independence is based.

Consolidated Statements

The problem of presenting investments in subsidiaries on consolidated statements has not been investigated in this dissertation for two reasons:

1. The field has already received considerable attention,[43] and

2. "The acquisition by one company of the controlling stock interest in another constitutes, in effect, the acquisition of the assets of the acquired company subject to its liabilities and the interests of minority stockholders."[44]

The best method of disclosure of the investment in a controlled company would appear to be publication of a separate statement for the parent and subsidiaries, but this practice is extremely rare at the present time.

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[43] E.g. in advanced texts by Paton, Finney, etc.; Moonitz, op. cit.; dissertation by Floyd Morrison, University of Michigan, 1948. Cf. Carman G. Blough, "Current Accounting Problems," Journal of Accountancy, June 1948, p. 486.

[44] Carman G. Blough, as Chief Accountant of the Securities and Exchange Commission, S. E. C. Accounting Release No. 3, September 13, 1937 (Treatment of investments in subsidiaries in consolidated statements).

Summary

In order to determine income from securities, it is first necessary to deduct from receipts all expenses and return of capital. Expenses can be allocated to such income on a cost accounting basis. Return of capital must be determined by the investor, since announcements of liquidating dividends are not necessarily the criterion. A definite decline in market value below cost also may make it advisable to consider current receipts as capital return. The investor might also consider the advisability of interpreting a portion of the periodic return equivalent to "premium for risk" on debt securities as being return of capital in the overall, maintenance of a fund sense.

Because investment income is so difficult to analyze, it is suggested that investors should keep records of both cost and market values of all securities, and reports to others should disclose both of these figures so that independent judgments can be made concerning unrealized depreciation or appreciation.

Chapter VI

MAJOR CAPITAL ADJUSTMENTS, DISPOSAL OF SECURITIES, INTERPRETATION OF GAIN OR LOSS

The preceding chapter discussed measurement of return of capital before a security is sold or disposed of otherwise. Adjustments may also be made to the capital account for various other reasons, including recapitalization or reorganization; these problems are treated in the first part of this chapter. The mechanics of a sale are then investigated in order to determine the best accounting treatment. Short sales and gifts are considered.

Some capital gain or loss usually results from investments in securities. The proper interpretation of this capital change is more involved than appears to be generally recognized. Several suggestions are offered, based on recent contributions to thought on this subject. Special emphasis is given to a method of common-dollar reporting designed to offset the influence of changes in the purchasing power of the dollar. Included is further

consideration of the benefits to be derived from treating all investments as a group or fund.

Adjustments during Ownership

In Chapter V several situations were described in which it was suggested that the investor might revalue his securities or at least treat part of the current receipts as capital return. To a certain extent these are interconnected with other situations which require adjustments, so in part the following will briefly recapitulate former material.

One such adjustment is that which should be made when the company is definitely in the process of liquidation. The investor should still decide whether he is likely to receive more than his capital investment, but unless the company's assets have a definite market value, such proceedings are so uncertain that it seems advisable to adopt the tax device of considering all liquidating dividends as capital return until the basis is received. If the liquidation is only partial, however, it may be better to consider it as a recapitalization (discussed in the following section).

Chapter V suggested that the investor should not wait until securities become completely worthless before writing them down. However, for tax purposes it should be noted that a record must be kept showing the precise date of complete worthlessness as nearly as possible.

Otherwise considerable difficulty may result. For example, in a recent case the court decided that the taxpayer should have considered his stock to be worthless in the year the corporation executed an agreement disposing of all its assets to pay its liabilities, and not in a later year when worthlessness was established by sale of the securities for a trifling amount.[1]

In some circumstances the investor should consider unusual receipts as a reduction in the cost of stock and not as income. An instance would be a case where the corporation made certain agreements in selling its stock, and later was forced to refund part of the payments because of breach of the agreements.[2]

There are a variety of circumstances in which the investor is justified in making an upward adjustment. Pro rata assessments and contributions should usually be so treated. However, tax authorities have disallowed such payments as bad debt deductions or losses where they were made without compulsion to a corporation already insolvent.[3]

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[1] Franklin R. Chesley v. Comm. C.C.H. Dec. 15498(M), memo. On the other hand, the government has unsuccessfully attempted to claim that loss was not established on a bank stock, when sales were still being made at 12½¢ to 62½ a share. Wesch v. Helburg, 5 F. Supp. 581.

[2] Henri Chouteau, 22 BTA 850.

[3] Lemuel S. McLeod, 19 BTA 134, (dismissed CCA-1).

The adjustment may be allowed if the assessment is not pro rata, even if one stockholder alone makes advances to a corporation in which he is interested.[4] Consent dividends are also in this category. If a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction usually amounts to a contribution to capital to the extent of the principal of the debt.

For tax purposes, losses on wash sales are added to the basis of the new securities, but this rule appears to have little justification for the investor insofar as the accounting is for purposes of economic control. Nor should costs of stockholder suits be capitalized unless there is a definite contribution to the corporation.

When stock is contributed to the corporation, the tax rule is that the cost of the surrendered stock should be added to the cost of the stock retained. In situations where the stock has been recorded at its true value and the contribution is made by all the owners, this is the correct interpretation and is much more enlightened than the Treasury's attempts to tax the opposing circumstance -- the issuance of stock dividends. However, as Paton has pointed out: "It was formerly common -- particularly in jurisdictions in which it was presumably illegal to issue stock at a discount -- for mining corporations and other

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[4]Cf. G.C.M. 4015, C.B. June 1928, p. 120.

speculative enterprises to issue a large block of stock in exchange for property with the understanding that a portion of such block was to be returned to the corporate treasury as a 'donation' for the purpose of facilitating the raising of working capital. By this device the stock was made nominally 'fully paid and non-assessable,' with consequent increase in marketability, and was then sold at whatever price it would bring."[5] Obviously it would be incorrect to add the "price" of shares donated to that of those retained in such circumstances. The recorded value of the shares ultimately retained should be no more than the value of the property originally exchanged for the shares.

Capitalization of donations has been approved even when they were not exactly pro rata.[6] However, if the donation is not made directly to the corporation, it may better be treated as a gift. In a case where there were indirect benefits, the president of a corporation was not allowed to add the cost of shares of the corporation's stock, which he gave to its employees, to the basis of his remaining shares -- a decision which seems justified.[7]

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[5] W. A. Paton, Advanced Accounting, pp. 518-519.

[6] Edgar G. Murphy, Para. 45, 259, P.H. Memo TC.

[7] Cecil P. Stewart et al, Para. 46,077 P.H. Memo TC.

Situations may arise in which more is involved than a mere adjustment. Securities which have been written off as worthless may later prove to have regained considerable value, as has frequently been the case when foreign investments were written down during war periods.

For tax purposes, recoveries "result from the receipt of amounts in respect of previously deducted of credited section 22 (b)(12) items."[8] The rule reflects the finding in Dobson v. Commissioner, holding that recoveries in 1939 on stock as to which losses had been claimed by the taxpayer in prior years did not constitute taxable income when no benefit resulted from the deduction in the prior years.[9]

It does not appear advisable for the investor to wait until a previously "worthless" security is sold or redeemed before recognizing that value has returned. Yet it is not easy to say when this recognition should take place. Recovery is ordinarily slow and highly uncertain, with a possibility of relapse into worthlessness at any moment. The fact that market values are available is not necessarily a decisive factor: optimists are still

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[8] Reg. 111, Sec. 29.22(b)(12)(a)(1) (as amended by T.D. 5307, November 29, 1943, and T.D. 5454, May 10, 1945).

[9] Dobson v. Comm. 320 U.S. 489.

trading in Czarist Russian bonds.[10] Nor should the new position be considered a revision of the action in the previous year when the securities were written off. If the securities were demonstrably worthless or nearly so at that time, recognition of the fact is not altered by the possibility of a lucky recurrence of value at a later date.

The timing of recognition that value has reappeared is important because it will govern the amount. No hard and fast rule can be laid down. One point seems certain: although the tax authorities may be justified in reverting to original cost as the basis (adjusted for any tax savings resulting from the deduction for worthlessness) such a showing is unrealistic for purposes of economic control. About the best the investor can do is to make several revisions of the carrying value, until the price of security reaches a relatively stable position. When reporting the investment, the date of the last revision should be shown.

There is a temptation to call any gains from this source a special kind of revaluation surplus, or to show the changes as surplus adjustments rather than on the

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[10] Cf. Moody's Governments, 1948, p. 1905. These bonds were repudiated in 1919.

the Income Statement. If the securities have demonstrably regained value, they are of as much economic importance as many other non-cash items and there is little point in half-hearted recognition; an Income Statement showing is preferable.

Adjustments During Ownership -- Recapitalization and Reorganization

Dewing devotes a complete book (Book V) to "Financial Readjustments." As he says:

> The conditions that may require a readjustment of the capital structure of a corporation are many and varied. Some of these conditions result from a great success. Some result from a long-continued failure or a sudden loss. In some instances the failure precipitates bankruptcy and the resulting capital readjustment is carried out under the supervision of the courts; in some cases the failure does not jeopardize the solvency of the corporation and capital readjustment is carried out by the stockholders alone and the interests of the creditors are unaffected. Because of the great variety of the antecedent conditions and the even greater variety among the changes brought about in the stock and debt liabilities, it is extremely difficult to suggest a classification of capital readjustments which fits every case. There are, at most, types, not classes.[11]

He suggests the following types:

A. Slight, but nevertheless, real changes in the contract between the corporation and its preference security-holders.

B. Important, perhaps radical, changes in the charter provisions pertaining to stock issues.

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11 Arthur Stone Dewing, Financial Policy of Corporations, p. 1228, Ronald Press, New York, 1941.

C. Readjustments of balance sheet valuations resulting in the revision of the stated value of the capital stock and of the surplus.

D. Comprehensive readjustments affecting the whole capital structure.[12]

Where, in this hierarchy of possible changes, is the point at which the convulsion is sufficiently violent so that the investor should revise the carrying value of the security? No definite answer can be given but, in keeping with the general tenor of this dissertation, it is suggested that the investor should lean toward a willingness to revalue with less provocation than has been generally recommended in the past. If the change in rights is accompanied by a substantial increase or decrease in market value, the investor should always give the circumstance serious consideration. If new securities are issued to or for the old, they should be shown at current values and not at the antiquated cost price of the original securities. It is fully recognized that this new valuation may be highly uncertain and subject to revision in the light of later knowledge, but to record the new securities at the old cost price is to give them the same name and not a valuation.

It is impossible to examine all the possible situations, or even the major ones, within the scope of

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[12] Ibid., pp. 1228-1230.

this work. A few important examples will have to suffice.

For the bondholder, there are several possible changes:

(a) Revision of the security terms

(b) Revision of the interest rate

(c) Extension of the period

(d) Exchange for other securities.

As a rule changes (a), (b), and (c) will not necessarily require a revaluation.[13] The amortization or accumulation schedule should be changed for (b) or (c). As for (a), only if the change in underlying security agreements is so drastic that there is evidently an increased danger of default should the investor make an adjustment.

Exchanges for other securities usually are the result of an attempt to cancel accrued interest. They may or may not be accompanied by statutory reorganization. In either case the position of the investor is difficult to interpret. The Prentice-Hall Service says: "Despite the decision in Claridge Apartments Co. v. Comm. (1944) 323 U.S. 141,... some doubt still exists as to whether issuance of stock for bonds of a predecessor, pursuant

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[13] Cf. G.C.M. 22056, CB 1940-2, p. 89:--Each case of this nature must be governed by its own facts.

to a 77-B reorganization, effects a cancellation or reduction of indebtedness."[14]

The Tax Court has recently stated, "The question which really evolves is: Did the substitution of shares of common stock for bonds of the debtor effect a cancellation or reduction of the indebtedness? We think this question, with all due deference to the Circuit Court of Appeals for the Seventh Circuit, which expressed a contrary view in the Claridge Apartments v. Commissioner, 138F (2d) 962, must be answered in the negative."[15]

General Tax doctrine on this matter is expressed thus in the Regulations 111: "The purpose of the reorganization provisions of the Internal Revenue Code is to except from the general rule certain specifically described exchanges incident to such readjustments of corporate structures, made in one of the particular ways specified in the Code, as are required by business exigencies, and which effect only a readjustment of continuing interests in property under modified corporate forms."[16] The word "reorganization" is defined carefully in the Internal

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[14] Prentice-Hall Federal Tax Service, Para.10,699-C.

[15] Motor Mart Trust (Lowe et al, Trustees) 4 TC 931, 936; NA, 1RB, 1945-12, affirmed, (CCA-1, 1946), 156 F (2d) 122, followed in Tower Bldg. Corp., 6 TC 125, (NA, 1RB, 1946-10). Woodmont Corp., Para. 46,085 PH Memo TC.

[16] Regulations 111, Sec 29.112 (g)-1.

Revenue Code;[17] but as Holzman says: "Sixteen of the words and phrases in this definition have had further clarification in court decisions or regulations."[18]

Bonds are securities but, in many decisions, notes are not, for the purposes of effecting tax-free reorganizations, if of less than five year maturity.[19] For many years the Commissioner has held that an exchange of bonds for other bonds of the same corporation (no capital stock being involved) is a "refinancing" rather than a "recapitalization" under the reorganization provisions of the income tax law. Accordingly, such exchanges have been held to result in taxable gain or deductible loss. Recently the Tax Board and Tax Court have shifted from this view. Where new bonds and cash were received in exchange for old bonds and accrued interest (the face amount of the bonds and cash received equalled the face of the old bonds plus accrued interest) it was held that the gain was taxable only to the extent of the cash received.[20] An exchange of bonds for shares of preferred stock was held to be in connection with a recapitalization by the Board of Tax

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[17]I.R.C. Section 112 (g).

[18]Robert S. Holzman, "Basis in Tax-Free Reorganizations," Taxes, August 1946, p. 716.

[19]Prentice-Hall, Paragraph 10,254.

[20]Koppers United Co. Memo TC, 5-13-43. Cf. discussion in Will of Sigmund Neustadt, et al, 43 BTA 848, affirmed (CCA-2, 1942) 131F (2d) 528.

Appeals.[21] On the other hand, a taxpayer exchanged notes costing $1,500,000 for second mortgage bonds of the value of $900,000 and was allowed a $600,000 loss.[22]

Such exchanges are not to be confused with the exercise of a conversion privilege in a bond or preferred stock. Article 1563 of Regulations 45 (1920 edition) states: "Where the owner of a bond exercises the right, provided for in the bond, of converting the bond into stock in the obligor corporation, such transaction does not result in a realization of profit or loss, the transaction not being closed for purposes of income taxation until such stock is sold." This rule is still in force, though not where the conversion is into stock of another, though allied, corporation.[23] Although the exchange does not result in taxable income, it appears advisable to record the new securities at market value when acquired. Presumably the exchange would only be effected when that amount is substantially above the adjusted cost of the former security, and the new situation deserves adequate

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[21] Capento Securities Corp., 47 BTA 691, affirmed (CCA-1, 1944) 140F (2d) 382.

[22] The Chemical National Bank of N.Y. 30 BTA 178, (NA, CB Dec. 1934, p. 23).

[23] *E.g.*, Chesapeake Corporation bonds into Chesapeake and Ohio Railway Stock, I.T. 3056, CB 1937 - 1, p.101.

description for purposes of economic control. The decision to exchange the original security for another instead of selling it may later prove to have been unwise and the extent of the loss will be concealed if the original cost is maintained as the recorded value of the new securities. If no fair values are available, the original book value may have to be carried over as an expedient.

For the preferred stockholder:

(a) He may receive additional securities without relinquishing his stock, or

(b) He may exchange it for new securities.

The tax view has been that in (a) the investor has received a property dividend, taxable at fair market value. In Chapter IV this position was investigated, the conclusion being that it was usually justified.

When the preferred stock is exchanged for new securities there is usually no gain or loss, unless other property is also transferred. In the reorganization of the General Baking Company, holders of preferred shares of a corporation in which dividends were accrued but not paid received common stock of a new corporation in exchange for the preferred and also received debentures of the new corporation for the arrearages in dividends. The exchange was held non-taxable.[24] Where cash was received with the

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[24] H. B. Leary, Sr., 34 BTA 1206 affirmed (CCA-4) 93F (2d) 826.

new securities, the gain was taxable to that extent.[25]

For the common stockholder:

In Chapter V it was concluded that revaluation might be advisable whenever the fair value was decisively different than the original cost. This is likely to be the case in the majority of reorganizations, regardless of the type of securities received, and any such event may be taken as a warning that the investor should consider the advisability of restatement.

The taxability of exchanges of common stock is governed by the general provisions of the Internal Revenue Code, Section 112. The exact terms of the act must be followed in order to make the exchange tax-free. This allows astute lawyers an opportunity for manipulation, since, as Edelmann points out, if it is advantageous for other reasons an exchange can be taken out of the tax-free class by deliberate avoidance of one of the requirements.[26]

A determined attempt was recently made to use Sections 112(b) 3 and 112(g) 1(E) of the Code to avoid the effect of the surplus profits tax levied under Section 102. A reorganization was planned in which bonds and stock would

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[25] South Atlantic Steamship Lines, 42 BTA 705.

[26] Chester M. Edelmann, "Tax Minimization," New York Certified Public Accountant, January 1946, p.40. Cf. Day and Zimmerman, Inc. (CCA-3; 9-2-45) 151F (2d) 517.

be issued for common stock, the bonds to be redeemed later for cash.

If this had been permitted to be tax-free, as Schlosser demonstrates: "Distribution of taxable dividends would have become a thing of the past."[27] But the Supreme Court ruled otherwise in a case which was recently decided.[28] It is difficult to see how the ruling could have been different if our present tax structure was to be maintained, but this does not prevent the investor from making an independent analysis of such situations and endeavouring to record the true economic picture, with taxes as a necessary deduction where the reorganization is not technically tax-free.

As Hills has put it: "During the past decade practically every voluntary corporate reorganization has been accomplished by a sale of assets of one or more corporations to another, the sale being for shares or securities of the purchasing corporation which are distributed to the shareholders of the selling corporation as part of the same transaction."[29] If underlying assets have been sold,

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[27] Jack Schlosser, "Income Tax Decisions of 1947," New York Certified Public Accountant, February 1948, p. 118.

[28] J. Robert Bazley and Adam A. Adams v. Comm. 331 U.S. 737.

[29] Hills, "Consolidation of Corporations by Sale of Assets," 19 California Law Review 349.

the investor would certainly appear to be justified in considering the event to be of sufficient importance to warrant a restatement of the investment account.

Another difficult problem arises when a merger is effected. This may take the form of the liquidation of a subsidiary or the consolidation of two independent organizations. Both moves are considered tax-free, with use of the substituted basis, provided there is a continuity of interest and certain other technical requirements are met. Should the stockholder in the surviving corporation make any adjustment in his private bookkeeping? Where the merger represents the liquidation of a minor subsidiary or the acquisition of a small organization, probably not. But as the addition grows in size and importance, the answer becomes more dubious. When several companies are merged, though the combination adopts the name of one of them, it may actually be a minority interest in the new set-up. Such a major change may be recognized by the investor as an occasion when revaluation is frequently justified. There need not even be a statutory merger for such a condition to arise. For instance, in 1902 the Atlantic Coast Line Railroad, with a net capital of $114,000,000, acquired control of the Louisville and Nashville Railway, with a net capital of $161,000,000. This was accomplished in a few days by purchasing a bare majority of the stock in

one block, and paying for the shares by the issue of collateral trust bonds secured by a pledge of the Louisville and Nashville shares. Thus the Atlantic Coast Line more than doubled in size almost overnight.[30] It is stretching the imagination to suppose that a share of Atlantic Coast Line was the same sort of asset before and after such an event. As Ballantine says: "Often a purchase of the assets or of a large majority of the shares of stock in exchange for the securities of the purchasing corporation may be a more convenient method of combination than a statutory consolidation or merger."[31]

Whenever there is a merger or consolidation, if new securities are issued the old shareholders have two choices:

(a) They can accept the new securities, or

(b) They can withdraw from the enterprise and obtain payment in money for the appraised value of their shares by following the strict procedure prescribed by appraisal statutes.

Dissenters cannot simply retain the old securities and assert any rights under them. If they fail to demand

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[30] Dewing, op. cit., Volume 2, p. 918.

[31] Ballantine, op. cit., p. 664. He tabulates the resemblances and differences, concluding that the methods are much alike.

appraisal, they are bound by the lawful action of the majority, unless the plan of recapitalization gives them the right of non-acceptance ("voluntary plan"). If the action of the majority is fraudulent, then the shareholder can obtain an injunction.

Appraisal statutes have been enacted in about thirty-three states, under which dissenting shareholders are given a right to demand payment of the fair value of their shares. The statutes seem to be drawn in a way which is really an aid to the majority, to avoid interference by racketeers. It is difficult to comply with all the provisions of the law; it is even more difficult to obtain an appraisal which greatly exceeds current market value and the investor is justified in demanding one only if there is such an excess. As a practical matter, a shareholder should seldom rely on provisions of the law to support a valuation for his records.[32]

Disposal of Securities -- Sale

The most frequent method of disposing of securities is by outright sale. An active market is maintained for most of the securities issued by large corporations, the

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[32] Cf. "Remedies of Dissenting Stockholders under Appraisal Statutes," 45 Harvard Law Review, pp. 233-248. Lattin, "Reappraisal of Appraisal Statutes," 38 Michigan Law Review, pp. 1165-81.

principal exception being bonds and preferred stock placed with large investors such as insurance companies. Transferability of the shares is one of the great advantages of the corporate form over partnership.[33] In fact, the ease with which such securities can be marketed is one of the principal justifications for frequent revaluation, as urged in this dissertation. For most other assets value is always rather difficult to ascertain, since it may be largely dependent on adjunctive matters such as location of the asset, adaptability, etc., to say nothing of the sales ability of the owner. Many securities, on the other hand, can be sold at any time on a moment's notice, and even large blocks can be handled with surprising speed unless the market is temporarily upset.

The securities of smaller corporations may be listed on local exchanges, or traded "over the counter" by brokers. The market for such securities is considerably more uncertain, and sales may take on the aspects of transactions for other types of assets, involving a certain amount of negotiation. However, the general effect of the transfer will be the same as if the sale were made on a larger exchange; the principal difference being in the type and amount of

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[33] In the absence of a valid reason to refuse, a corporation must accept and record the transfer on its books and issue the transferee a new certificate. Cf. 54 ALR 1157. The Uniform Stock Transfer Act, now adopted by almost all states, including the centers -- New York, Illinois, and California -- has as its object to make share certificates freely negotiable, not to codify rules as to registration of transfers.

expense involved.[34]

There are two main problems in connection with a sale:

(a) The determination of the security sold, and

(b) The calculation of the net selling price.

Determination of the Security Sold

Since securities of a certain class are usually identical as far as rights are concerned, they are often dealt with in lots. When several lots of the same class are held for tax purposes, it is necessary to determine which securities are disposed of in a sale, if only part of the holding is sold.

The problem is complicated by the fact that different lots are often acquired at different prices and the number or type of securities may change after the original acquisition, as the result of stock dividends, splits, subscriptions, exchanges, or conversions. The general tax rule is that sales are on a first-in, first-out basis unless the taxpayer can identify the specific securities he wishes to sell. To find the basis for a given lot, it is necessary to keep a record of the original price

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[34] As for the valuation of such securities, cf. Paton, Advanced Accounting, pp. 180-181.

paid for the stock and all the changes, such as stock dividends, which affect it specifically.[35]

It is expedient for the investor to follow the tax rules, but the result is not a true picture. Securities are much like fungible goods and the method which has most logical support is average cost.[36] It makes no difference to an investor whether he owns certificate No. 12,000 or No. 12,001. The situation might be summed by saying that this is another reflection of the tendency in government circles to treat a share of stock as a tangible thing, like a chair, instead of as a symbol indicating a percentage of ownership. (As, indeed, the word "share" implies.) Our government carries this insistence to such lengths that the Supreme Court has ruled that even if certificates actually delivered by an agent are not those which he was instructed to deliver, and though the taxpayer had no intention of selling that particular lot, the delivered certificates determine the accounting.[37]

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[35]For a discussion of methods required, cf. Prentice-Hall, op. cit., Paragraphs 10, 119 -- 10, 128, or Paton, Advanced Accounting, pp. 184-190. Tax authorities permit the use of average cost when shares of a new corporation are received in a tax-free exchange for shares of another corporation.

[36]Lynch supports average cost as "soundest in theory." However, he points out the difficulty in explaining to stockholders if two methods are used: average cost for the company records and fifo or "identified" for tax purposes. John F. Lynch, "Investment Company Accounts," Journal of Accountancy, September 1943, p. 247.

[37]Davidson v. Comm. (1938) 305 U.S. 44.

In the case of a mixed aggregate of securities acquired as a unit purchase, the total purchase price should be fairly apportioned among the classes, but if such apportionment is impractical, then no gain may be reported until the original investment is recovered. The Tax Court has supported this view.[38] Sometimes this means that an original lump sum must be traced through several exchanges, if it is at no time apportionable.[39]

Calculation of the Net Selling Price

After determination of the specific securities, the next step in ascertaining gain or loss is to find the net selling price. This requires:

(a) The value received

(b) Applicable expenses

If the sale is for cash, there is usually little difficulty in determining the gross selling price, unless there are certain restrictions or installment provisions. If there are such additional factors to consider, e.g., if other forms of property are received, the sale is best viewed as a double transaction -- an agreement on a certain amount of value, which is then accepted in a form other than ready cash. The agreed present value is the important consideration as far as the security is concerned;

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[38]William T. Piper, 5 TC 1104.

[39]Cf. Kirkland v. Burnet 57 F (2d) 608.

it is the amount which determines gain or loss during the time the security was held. Acceptance of various means of payment constitutes a new financial operation which should be considered as far as possible on its own merits. The rules for the determination of the present value of the various possible arrangements are the same as in the case of purchase of securities by similar methods (Chapter II), and will not be repeated here.

A few types of sale require special attention. If a share of stock is redeemed by the corporation, and payment is made in property, has there been a gain or loss in the economic sense? The stockholder presumably is given the same value-portion of the corporate assets which he already controlled. In theory the symbol has merely been replaced by the actuality. However, just as with undistributed earnings of the corporation (Chapter IV) this view seems to carry the share of ownership concept farther than is justified by reality. The symbol-share does not have the right to withdraw its percentage of the net assets at any time it wishes, and the performance of such a withdrawal is an event which changes the economic position of the investor to a degree sufficient to justify a recognition of gain or loss in most instances. However, if the degree of control is such that the investor is justified in accruing income as it is earned by the corporation, there also seems to be sufficient economic

identity so that transfer of assets for shares is not a decisive event.

Where securities are transferred for a consideration which is in excess of their fair market value, the elements of the transaction should be carefully distinguished. There may be a gift involved or a cancellation of debt. So far as the securities are concerned, they should be recorded as having been sold at their fair market value; any excess or deficiency should be treated separately. For example, a stockholder settled a debt due one controlled corporation by transfering to it securities of another controlled corporation worth less than the amount of the debt. The Tax Court held there was realized income to the extent of the excess of the debt over the fair market value of the securities.[40] But the income was from the debt cancellation, not the security sale.

All expenses directly connected with the sale, such as commissions and cost of delivery of the certificates, should be deducted from the gross selling price. In addition, there may be some indirect expenses which should not be ignored. For example, if the securities are not sold on a regular exchange, it may be advisable to go to considerable expense, involving the time of

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[40] F. W. Leadbetter et al, Memo, TC 8-13-43.

high-salaried executives, to formulate the proper asking price. Such costs are definitely allocable to the securities involved. Lawyers' fees, services of outside appraisal agencies and like expenses must all be deducted if investment performance is to be measured accurately.

There is one deduction which may be kept separate--the tax on capital gains. Whereas in Chapter V it was maintained that part of the income tax might be allocated to interest or dividends from each security, this procedure is not as feasible for the tax on capital gains. Because of the nature of the tax, it takes a part of any net increase due to all securities disposed of during a specified period, and is therefore primarily related to the performance of the investment fund as a whole.

The question as to the time title passes is usually of minor importance. Even if a transferee of a certificate fails to have the corporation record or register the transfer, the transferor is divested of ownership of the shares except so far as is necessary to protect the corporation in its dealings with its shareholders. Courts have differed as to whether an unregistered transfer passes legal title or merely an equitable title, but the net result is about the same.[41]

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[41]William Wilson Cook, Corporations, 8th Ed. Section 444, Baker Voorhees & Company, New York, 1923.

Delivery of sales on the exchanges is usually delayed, although there is an alternative offered. If the seller wishes to be paid immediately, he can request a "cash" sale (marked "C" on the ticker tape). For tax purposes this distinction may sometimes be important, since a taxpayer on the cash basis is taxed on losses in the year the contract was entered into, even though delivery of the stock is not made till the following year. But for gains such a taxpayer must wait until cash or its equivalent has been received.

Disposal of Securities -- Involuntary Sale, Repurchase Agreements

Section 371 of the Internal Revenue Code provides that under certain specified conditions, if exchanges and sales of stock and securities are in obedience to an order of the Securities and Exchange Commission, no gain or loss shall be recognized. Similarly, Section 112(m), taxpayers may elect not to recognize gain on sale of stock in a radio broadcasting company, where such sale is certified by the Federal Communication Commission to be necessary or appropriate to effectuate the policies of the Commission. The Merchant Marine Act of 1936, as amended, also provides for non-recognition of gain from certain sources.

In all these instances, and any similar provisions which may be enacted, the general purpose is the same:

to relieve the investor of taxes as a partial acknowledgment of possible injury caused by the involuntary nature of the transaction, or to encourage reinvestment in similar property (Merchant Marine). This partial recompense should not blind the investor to the realities of the situation; he has a certain amount of economic goods or cash under his control as a result of the disposal of the securities, regardless of the circumstances which led to that position. Dollar gain or loss should be recorded in the usual manner, based on the fair value of the new holdings.

When a sale is made, subject to a repurchase agreement, there may be some difficulty in determining whether the transaction is a bona fide sale, or merely a loan arrangement. Since the securities need not be repurchased, the transaction usually can be considered as setting a minimum value for the securities; if that amount is under current market values, the propriety of the "sale" may be seriously questioned. Otherwise it may usually be accepted as a completed transaction -- the option to repurchase being considered separately. It may be appropriate to consider the option as part of the payment received for the securities, with a value separate from that of the other property or cash received. There would then either be a loss when the option expired,

a gain or loss if it were sold or traded, or an addition to the other consideration paid if it were exercised.

Disposal of Securities -- Foreclosure and Dissolution

The subject of mortgages and foreclosure is too complicated for a detailed investigation here. Braunfeld lists three situations:

(1) The owner and the mortgage debtor are identical and personally liable.

(2) The mortgage debtor is personally liable but the owner is not. (A buyer did not accept liability.)

(3) The owner, either the original mortgagor or one of his grantees, is liable with the property only, according to a special agreement with the mortgagee.

Three events may occur:

(1) Foreclosure

(2) Voluntary Surrender

(3) Abandonment

Braunfeld adds that the rules concerning the treatment for each of these, or a combination, vary in different jurisdictions.[42]

Tax doctrine recognizes each of the three events, and also distinguishes between sales in which the title was transferred, (gain or loss on repossession is the same

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[42] Fritz L. Braunfeld, "Subject to a Mortgage," Taxes, May--June 1946, pp. 424, 446.

as where sale was reported on an installment basis), and sales in which the title was not immediately transferred (wholly different, treated somewhat as if the sale had not been made at all).

Concerning the latter Altman comments:

> "This method takes into consideration the fact that the repossession is not a separate transaction but is an enforcement of the right arising from the original sale. But it does not take into consideration, as does the method available where the sale was reported on the installment basis, the fluctuation in value between sale and repossession while the property was in the hands of the purchaser beyond the taxpayer's power to sell.[43]

Altman recommends treating the second method as a limitation on gains realized by the first.[44]

In spite of the tax and legal technicalities, the investor had best make as close an estimate as possible of the value of his rights under the mortgage, at the time of foreclosure. That value marks the disposal value of the security; from that point further gains and losses may be realized as a result of the sale of the property or other transactions, but the results can be separated from the experience with the security. Deficiency judgments are to be considered as one of the above-mentioned valuable rights. Gain or loss may result from subsequent collection

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[43]George T. Altman, op. cit., Paragraph 483.

[44]Ibid., Paragraph 483.

of more or less than the amount estimated collectible. (For tax purposes such a loss can be treated as a bad debt, up to its cost.[45])

Writers on this subject warn the investor that if he bids in property at a price which includes the mortgage price and also accrued but unpaid interest, he is held to have constructively received the interest and will be taxed on it as income.[46]

The treatment of stock in dissolution and complete liquidation of a company differs little from that previously discussed under sale of stock to the company for property. There is an additional point of interest, however, which usually arises only in dissolution. Stockholders are so accustomed to ignoring any question of liability that they may be inclined to forget that their liability is not non-existent, but only limited. It has been stated in a leading case:

> "Where the assets of a dissolved corporation have been distributed among the stockholders, a creditor of the dissolved corporation may follow such assets as in the nature of a trust fund into the hands of stockholders. The creditors have the right to subject such assets to their debts and for that purpose the stockholders hold them as

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[45] I.R.C. 23 (k).

[46] Helvering v. Missouri State Life Insurance Company, 78F (2d) 778, (CCA-8, 1934).

> though they were trustees.... A stockholder who receives only a portion of the assets is liable to respond only for that portion.... Where the trust property has been used by the stockholder for his own purpose, or disposed of by him, he may be held personally liable for the full value thereof."[47]

Taxes form an important claim under this rule. Former stockholders have even been held liable for taxes under a retroactive Income Tax law, though imposed after the corporation had dissolved and distributed its assets.[48]

Short Sales

Because of the active market maintained for the securities of large corporations, it is possible for an individual or trading concern to sell a security which he does not own (*i.e.*, "short"), with the assurance that at some future time he will be able to buy the security and "cover" the sale. Meanwhile the trader borrows the security from a broker in order to make delivery. The broker may charge a rental, but frequently merely requires a deposit large enough to protect the account from price fluctuations.

Paton suggests the use of self-balancing memo accounts at the time the sale is made, to be reversed

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[47]Koch v. United States, 138 F (2d) 850, 852.

[48]U. S. v. McHatton, 266 Fed 602. Cf. Internal Revenue Code, Section 311, "Transferred Assets." There are literally hundreds of cases involving this section.

later when it is covered.[49] If financial statements are prepared before the transaction is completed, some mention should be made of any reduction in the trader's equity due to adverse price change. The Tax Court holds that dividends declared on the stock during this period constitute expenses, and are deductible for tax purposes.[50] They should be charged to an expense account, with a credit to the broker. Rentals should also be charged as they are billed by the broker. In this way the purchase cost will be only the market price (including brokerage, etc.), a desirable objective whenever possible. However, this interpretation is presently being disputed in some jurisdictions, and Schlosser believes that the issue will be taken to the Supreme Court.[51] Because of the peculiar ideas of taxing authorities concerning long and short term gains and losses, a short sale may be used to convert a short term gain (fully taxed) into a long term gain (tax limited to 25 per cent).[52]

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[49] W. A. Paton, _Advanced Accounting_, p. 177.

[50] Comm. v. Norbert H. Wiesler, (CCA-6) 6 TC 1148. Cf. I.R.C. Sec. 23(a)(2).

[51] Jack Schlosser, "Income Tax Decisions of 1947," _New York Certified Public Accountant_, February 1948, p.127. Cf. Prentice-Hall, _op. cit._, Paragraph 11,133.

[52] Cf. Benjamin Grund, "Tax Accounting for Security Brokers," _New York Certified Public Accountant_, October 1947, p. 679.

Gifts and Trusts

The investor should make a careful estimate of the fair value of any securities which are given away. Not only is it important to have the figure to use in evaluating the investment performance, but it is necessary for purposes of the gift tax.

No estimate of the investor's ability to choose securities can be made if certain of the investments are disposed of without calculating the gain or loss from holding them exactly as if they were sold or traded. Otherwise there will always be a temptation to think of the gift in terms of the best showing of the securities--cost for those whose price has fallen, fair market for those whose price has risen.

The necessity for accurate estimate is especially pressing in cases where a sale is made at a price other than fair market value. If this condition is known to the parties, the element of gift should be recognized in the accounts, so that true investment performance can be preserved. Such situations are perhaps unusual, even between related interests; the fact that a transfer directly between two parties was not made at the same price as that established on some market does not mean that the valuation was inaccurate for the conditions under which it was made.[53]

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[53] Reg. 108, Sec. 86.8. Cf. George T. Altman, *op. cit.*, Paragraph 2002.

The situation of securities placed in trust may be extremely difficult to analyze. Eisenstein speaks of

> "the trust device, one of the superb masterpieces of the law. It enables us to open that substantial bundle of rights which we call 'ownership' and to rearrange the contents within and without the bundle.... Innumerable trusts are no more than technically elegant schemes for distorting tax liabilities."[54]

A recent example may serve to illustrate the possible complexity of such situations. A trust was set up by a Mexican holding company, which controlled the company employing a Mr. Jones. Jones did not work for the company that set up the trust and received no compensation from it. The trust held shares of stock of the company employing Jones, in trust for him and other key employees.

The stock was supposedly conveyed to the trust in consideration for services rendered earlier by the beneficiaries. Jones received an assignable certificate evidencing his trust interest, that interest being to receive a pro rata part of the dividend from the trust stock for twenty years, after which the stock was to be delivered to the certificate holders. His salary was lowered to a degree somewhat proportionate to the dividends.[55]

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[54] Louis Eisenstein, "Modernizing Estate and Gift Taxes," Taxes, September 1946, p. 872 (address at National Tax Association, 39th Annual Conference).

[55] Harold F. Jones et al, 6 TC 412.

How should Jones record the receipt and disposal of such a "certificate"?

In general the law has sought to distinguish between two types of trust, those revocable by the grantor and those non-revocable. Since 1924 income from revocable trusts has been, by statute, taxable to the grantor. The Supreme Court has upheld the provision stating:

> "The income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income whether he sees fit to enjoy it or not."[56]

There is still considerable debate about borderline cases where the revocability can only be exercised through a substantial adverse interest.[57] The average investor should not attempt to set up such trusts without the aid of competent counsel.

For our purposes a clear cut distinction is required, and acceptance of the general tax view seems justified. If the transfer to the trust can be revoked

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[56] Corliss v. Bowers 281 U.S. 376, 2 U.S.J.C. 525. Cf. Reinecke v. Smith 289 U.S. 172.

[57] Cf. George T. Altman, op. cit., Paragraph 1015. J. S. Seidman, "The Income Tax Regulations of Trusts," Taxes, June 1946, p. 549. Philip Balitzer, "The Intra Family Tax Saving Device," Accounting Review, October 1944, p.432. Samual J. Foosaner, "The Tax Technique in the Preparation of Wills and Trusts," Taxes, June 1946, p. 568.

at will, the investor should continue to account for the securities as though they were part of his portfolio, with the income being a gift to other parties. If the trust is non-revocable, the transfer is like any other gift, and should be treated as suggested previously. Even where there is a chance that the trust may be revoked by action of the beneficiary, this is no more than the similar chance that any gift may be returned.

There are two types of trust dealing with securities which deserve special notice. Edelmann suggests that persons owning large amounts of life insurance should set the policies in irrevocable charitable insurance trusts. Then the policies are not part of their estate, thus escaping estate tax; moreover, the premiums are deductible as contributions, for the income tax.[58]

The other type is the pension trust which usually holds securities. Lauritzen points out that many employees' pension trusts now in operation are of a continuous nature, drawn so they will benefit others than persons born within twenty-one years after the origin of the plan. They therefore violate the laws against perpetuities and are void. In such cases the corpus of the trust reverts to

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[58] Chester M. Edelmann, "Tax Minimization," New York Certified Public Accountant, January 1946, p. 45.

the grantor -- a rather disturbing situation to say the least. Lauritzen lists eight states which have passed statutes in an attempt to remedy the problem by exempting such trusts from the general rule.[59]

The Interpretation of Gain or Loss from Securities

There are a bewildering number of types and variations of types of securities, so many that although this work has dealt with a large number, still it has been forced to talk mainly in generalities. Under some systems of accounting the methods differ for handling various types of securities, and differ again for the type of holder and the length of the period held. This is especially true of the tax regulations.

Here, however, an attempt has been made to develop an approach which will lead to a result similar for all types of securities and for all situations. Exceptions have been made, but only where there are special factors, such as a degree of control which allows the investor quickly to bridge the gap to the underlying assets. Otherwise the basic formula is simple:

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[59] Christian Marius Lauritzen, "Perpetuities and Pension Trusts," Taxes, June 1946, p. 519. Cf. Lovering v. Worthington, 106 Mass. 86 (1870) (Perpetuities). W. Barton Leach, "Perpetuities in a Nutshell," Harvard Law Review, Vol. 51, 1938, pp. 638-656.

The security is acquired with a certain amount of value; then value is derived from it during ownership and at disposal. The difference between the value given up and the value received, considered together with the dates at which these events occurred, should constitute the entire measure of the performance of the security. The investor is thereby provided with a record of dated payments and receipts which can be accumulated, compared, and analyzed on an equal basis regardless of the types of security which provided the experience. He can determine the amounts transferred from other sources into his investments in securities, and the net result of such actions, with only a listing of present holdings at present values required to give a complete picture.

There is an actuarial basis for this point of view. Aside from subjective factors, such as possible preference for regular yearly payments of interest or dividends rather than a lump sum after several years, there is no difference between the following types of returns, given an interest rate of 4% per annum:

Table VII

SECURITIES

	A	B	C	D	E
Original Cost	$100.00	$100.00	$100.00	$100.00	$100.00
Receipts 1st year	4.00	--	54.00	20.00	1.00
Receipts 2nd year	4.00	--	52.00	37.36	1.00
Final Receipt 2nd year (Maturity of Bond or Sale of Stock)	100.00	108.16	--	50.00	106.12
Total Value, End of Holding (Compounded)	$108.16	$108.16	$108.16	$108.16	$108.16

In other words, given an interest rate of 4% per annum, there is no actuarial reason to prefer any of the above securities -- whether there is no capital gain or loss, as in A; or all the return is "Capital Gain," as in B (which could be either a discount bond or non-dividend paying stock); or where there are large interim returns but eventual worthlessness, as in C; or fairly large periodic returns but "capital loss," as in D; or low returns combined with capital gains, as in E. An investor who held all five of the securities should evaluate his experience with each as equally satisfactory, unless he had personal reasons for preferring any of them.

From this it can be seen that the interpretation of capital gain or loss should not be considered apart from the periodic returns on the security. This is the reason for the recommendation that a record of each return

be valued at the time of receipt, and for the attempt to forecast eventual selling or maturity price and thereby to adjust periodic "income," as described in Chapter V. In that chapter the results were always tentative, since the final price could never be known in advance. But after the security has been disposed of, the record is complete, and a review of the entire holding period can be made.

It is advisable that such a review be made for the investment fund as a whole as well as for individual securities. Operating with the concept of "diversification of risk," investors do not expect to achieve identical results with each security, but attempt to handle their portfolio so that the total performance will be an optimum.

Common Dollar Investment Accounting

In addition to the dollar performance of the investment fund it is advisable for the investor to give some thought to the effects of the changing value of the dollar. Investment funds are established for a purpose, and that purpose is seldom accomplished by the mere holding of securities or cash. Periodic income and the capital fund may be used to pay off dollar liabilities, but more frequently the purpose is the eventual purchase of goods or services.

Just how important are variations in the purchasing power of our monetary measuring unit? Sweeney has a

discussion of the effect of the changes in purchasing power, and declares, "One prominent economist considers that a fluctuation of only ten per cent in the general price level over a period of twenty-six months is liable to have serious effects on economic life. Hence, he believes that a change of such magnitude is too large to be neglected. Yet such a change is less than five per cent a year."[60] But the Industrial Raw Material Index of the United States Bureau of Labor Statistics varied from 100 in August 1939 to over 275 in July 1948, a period of less than ten years.[61] In less than twenty years Moody's Spot Commodity Index varied from 100 to over 430.[62]

The Cost of Living Index of the United States Bureau of Labor Statistics was less than 100 in August 1939 and over 170 in June 1948.[63] Dislocations and hardships which have resulted indicate the verity of Cassel's observation.

With these fluctuations in purchasing power becoming more rather than less violent, it seems too much to expect any considerable improvement in the

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[60] H. W. Sweeney, Stabilized Accounting, Harper and Brothers, 1936, p. 13, citing G. Cassel, Post-War Monetary Stabilization, p. 88.

[61] Business Week, July 31, 1948, p. 13.

[62] Ibid., p. 13.

[63] Ibid., p. 70.

foreseeable future. We can hope that control of the monetary system will improve as we extend our knowledge, but meanwhile corporations and individuals must carry on as best they can.

The objective of most users of accounting is to exercise intelligent economic control of their assets with the help of the data which accounting processes provide. Recently there have been a number of suggestions that the use of index numbers would provide the best method of making conventional figures more meaningful.[64] The major American prophet of these ideas was H. W. Sweeney, who in 1936 published a comprehensive system for the use of index numbers under the title of Stabilized Accounting, after making an intensive survey of the practices of German firms during their drastic post-war inflation.[65]

In spite of widespread interest in the problem and the fact that common dollar accounting is not designed to replace conventional procedures, but rather to extend their usefulness by showing what is happening in real as well as financial terms, the complexity of stabilizing all the accounts has apparently so far prevented the use of

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[64] E.g., Samual J. Broad, "The Impact of Rising Prices upon Accounting Procedures," Journal of Accountancy, July 1948, p. 10.

[65] Sweeney, op. cit.

techniques supported by Sweeney. This writer knows of no firm which has attempted to stabilize its records.

If common dollar accounting is ever to become popular, it seems probable that the technique will first be applied in the field of investments, for several reasons:

1. The number of transactions is less than in regular corporate operations, and can be further reduced by grouping.

2. Investments are usually made for long periods and therefore are especially subject to the effect of changes in the value of the dollar.

3. The dollar amount of investments is of secondary importance to most corporations, which are more concerned with the use to which the funds will be put in furthering regular operations.

4. The relative degree of forebearance involved in saving and investing as compared with immediate expenditure can best be interpreted in the light of the purchasing power of the fund at a later date.

Since the processes of common dollar accounting are not widely understood, it seems advisable to demonstrate its usefulness by means of an illustration. The situation given is hypothetical, but fairly complete, so that most of the elements of the method will be discussed.

First it should be understood that the purpose is to eliminate the distortion caused by the fact that ordinary accounting employs an elastic measuring unit. We need a unit which is both stable and meaningful. Economists have

devoted considerable attention to this problem, developing such concepts as the commodity dollar, or advocating a return to a rigid gold standard. Unfortunately, even if such units became generally popular, they would not answer the purpose of many investors. Unless money is accumulated for pure miserliness, the investor usually has some future, though perhaps ill-defined, purchases in view. These desired purchases will vary from investor to investor, from buildings and equipment for the corporation to living expenses for the individual. Since the cost of such items may vary in opposite directions, no single measuring unit seems likely to be satisfactory for all. Under present conditions it seems preferable for each investor to develop its own measuring unit. If the probable use of the fund is known, an index can be constructed from price changes of the objects in question. If no single use has been determined, one of the general indices published by trade magazines or the government may be satisfactory.

The hypothetical example covers five years, from 1946 to 1950. Index numbers for these years are assumed to be as follows:

Year	Index
1946	160
1947	200
1948	240
1949	200
1950	120

The given fluctuations will enable us to examine the effects of a fall and then a rise in the purchasing power of the dollar for the article or commodities in question. To make the situation more realistic, suppose the investor is a large corporation and the index given shows the cost in dollars of building a warehouse with a fixed number of cubic feet of storage space. The fluctuations shown for the index, ranging from 120 to 240, are more violent than usually experienced in the building industry, but will serve to make the changes distinct.

If actual fluctuations were as substantial as those given in the example, it might pay a large investor to make a stabilization readjustment as often as each quarter. The technique would be exactly the same as in the illustration, with the operations repeated more often.

The index number is an average and stands for the entire year; therefore there is an unrealistically sudden change between December 31st and January 1st. If actual index fluctuations are less, if investment transactions are scattered evenly throughout the year or occur mostly at the time the price index is near its average, the effect of this abrupt change is minimized. Otherwise, as suggested above, the stabilization should be carried out more frequently than once a year.

Data for the illustration are as follows: In 1946 the X Company decided to set aside $100,000, which amount

would otherwise have been available for dividends. The fund would probably be used to build a warehouse. In 1946 the building index stood at 160, meaning that it required approximately $1.60 to build a certain fraction of a standard type of warehouse used in their business, as estimated by company engineers. The fund was partially invested -- $40,000 in high grade bonds, $40,000 in stocks, leaving $20,000 in cash.

In 1947 the company bought $10,000 bonds, $20,000 stocks; it sold stocks costing $24,000 for $20,000.

In 1948 it bought $22,000 stocks; it sold $18,000 bonds at par and stock costing $10,000 for $14,000.

In 1949 it bought $4,000 bonds and $32,000 stocks; it sold stock costing $20,000 for $30,000.

In 1950 it bought $4,000 bonds; stock costing $10,000 became worthless.

During these years the company received dividends and interest totalling $3,200 in 1947, $4,000 in 1948, $4,800 in 1949, and $3,200 in 1950. The market value of the bond portfolio remained close to par, but that of the stock portfolio varied considerably, to $30,000 in 1947, $60,000 in 1938, $90,000 in 1949, and $60,000 in 1950.

These facts may be summarized as follows:

Table VIII

INVESTMENT RECORD

Year	Index	Fund in '000 dollars Cash	Bonds	Stocks	Market of Stocks	Income Receipts	Gain or (Loss)
1946	160	20	40	40	40	--	--
1947	200	10	50	36	30	$3,200	($4,000)
1948	240	20	32	48	60	$4,000	$4,000
1949	200	14	36	60	90	$4,800	$10,000
1950	120	10	40	50	60	$3,200	($10,000)

Table IX

THE STOCK RECORD

		Sold		Holdings--Bought in									
				1946		1947		1948		1949		1950	
Year	Bought	Cost	Sold at	C*	M*	C	M	C	M	C	M	C	M
1946	40			40	40								
1947	20	24	20	16	10	20	20						
1948	22	10	14	6	10	20	28	22	22				
1949	32	20	30	6	20	0	0	22	38	32	32		
1950	--	10**	0	6	10	0	0	12	20	32	30	-	-

*C, Cost; M, Market

**Worthless

All figures in '000 of dollars

With conventional accounting procedures, the following schedules would be developed, if each year the interest and dividends were removed from the fund:

Table X

Fund Assets	1946	1947	1948	1949	1950
Cash	20*	10	20	14	10
Bonds	40	50	32	36	40
Stocks	40	36	48	60	50
	100	96	100	110	100

*All figures in '000 of dollars

The investor who keeps an ordinary record of his portfolio, together with market prices when they are substantially different from cost, needs only an index to complete the picture. In this case the accounts will be stabilized to the purchasing power of the dollar in the original year of the fund, 1946. All holdings will be valued in dollars of that period. To transform the figures into dollars of the base period, all that need be done is to multiply the actual dollar figures by a fraction, the base year's index being the numerator and the given year's index the denominator. To show the purchasing power in 1946 dollars of $1,000 in 1947, we multiply $1,000 by 160/200 = $800. (Given the index numbers used in

this illustration. This means that $1,000 in 1947 would build approximately the same amount of warehouse space as $800 would have built in 1946.)

The 1946 Balance Sheet Schedule of the Investment Fund is the same for both ordinary and common dollar accounting, since 1946 dollars are those which were set aside and are the measure of the forebearance of the owners. In this illustration the market value of the stocks is always assumed to be equal to cost in the year of purchase, then to fluctuate later.

The 1947 Balance Sheet Schedule would appear as follows:

X COMPANY

SCHEDULE OF INVESTMENT FUND

December 31, 1947

	Conventional	Common Dollar (Market for Stocks)
Assets		
Cash	$10*	$ 8
Bonds	50	40
Stocks	36	24
Total Fund	$96	$72

*All figures in '000 of dollars

Common dollar figures were computed by multiplying each figure on the conventional form by 160/200, except in the

case of the stocks. The market value of the stocks was given as $30,000, this multiplied by 160/200 gives a purchasing power in 1946 dollars of $24,000.

The computation is simple and can be made by most investors. The common dollar statement shows a capital loss of $28,000, as compared with the $4,000 loss on the conventional form. The explanation of this loss requires a somewhat unusual type of Income Statement.

The $28,000 loss in purchasing power arose in this way:

X COMPANY

INCOME STATEMENT FOR INVESTMENT FUND

YEAR ENDING DECEMBER 31, 1947#

		Loss*
Purchasing power loss from holding $20,000 cash from 1946 into 1947		
Purchasing power in 1946	$20,000	
ditto in 1947 ($20,000 x 160/200)	16,000	
		$4,000*
Purchasing power loss from holding $40,000 bonds from 1946 into 1947		
Purchasing power in 1946	$40,000	
ditto in 1947 ($40,000 x 160/200)	32,000	
		8,000*
Purchasing power loss on stock held from 1946 through 1947		
Cost (1946 dollars)	$16,000	
Market (1947 dollars) $10,000		
(1946 dollars) $10,000 x 160/200	8,000	
		8,000*
Purchasing power loss on stock sold		
Cost (1946 dollars)	$24,000	
Selling price (1947 dollars)$20,000		
(1946 dollars) $20,000 x 160/200	16,000	
		8,000*
Total Purchasing Power Loss		$28,000*

#The dividend income was $3,200 in 1947 dollars, or $3,200 x 160/200 or $2,560 in 1946 dollars, which can also be shown on the statement. Here it is kept separate in order to show clearly the $28,000 capital loss.

There is no purchasing power gain or loss to be computed on the stocks and bonds which were bought. The computation of any purchasing power gains and losses following the purchase of assets forms the greater part of the difficulty encountered in common dollar accounting. Under the method suggested above, the problem is somewhat simplified, first by taking all the investments which do not fluctuate in market value as a group and those which do fluctuate as a group, and secondly by computing purchasing power changes before new purchases are made.

The new bond holdings were acquired with $10,000 of cash which has already been stabilized, making further treatment unnecessary. Similarly, the $20,000 cash received from the stock sale is stabilized at $16,000 and is thus represented in the $24,000 shown for the stock value, which is made up of $8,000 in purchasing power from 1946 stock purchases and $16,000 from 1946 purchases.

The schedule for the following year, 1948, is computed in the same manner as before, but with a different fraction, because the purchasing power of the dollar is assumed to have declined still further. Two hundred and forty dollars were required to build in 1948 the same space that one hundred sixty could in 1946.

X COMPANY

SCHEDULE OF INVESTMENT FUND

December 31, 1948

Assets	Conventional	Common Dollar
Cash	$20*	$13 1/3
Bonds	32	21 1/3
Stocks	48	40
Total Fund	$100	$74 2/3

*All figures in '000 of dollars

The market value of the stocks rose to $60,000, which is multiplied by 160/240 in 1946 purchasing power.

The explanation of the $2,666.67 purchasing power gain over 1947 is as follows:

X COMPANY

INCOME STATEMENT FOR INVESTMENT FUND

YEAR ENDING DECEMBER 31, 1948

		Gain Loss*
Purchasing power loss on $10,000 cash held from 1947 into 1948		
Purchasing power in 1947 (1946 dollars) $10,000 x 160/200 =	$8,000.00	
Purchasing power in 1948 (1946 dollars) $10,000 x 160/240 =	6,666.67	
Loss		$1,333.33*
Purchasing power loss on $50,000 bonds held from 1947 into 1948		
Purchasing power in 1947 (1946 dollars) $50,000 x 160/200 =	$40,000.00	
Purchasing power in 1948 (1946 dollars) $50,000 x 160/240 =	33,333.33	
Loss		6,666.67*
Purchasing power gain on stock held from 1947 through 1948 (shown in 1946 dollars)		
Market value, 1948, $38,000 x 160/240 =	25,333.33	
Market value, 1947, $23,750 (a) x 160/200 =	19,000.00	
Gain		6,333.33
Purchasing power gain from stock sold in 1948		
Selling price (1946 dollars) $14,000 x 160/240 =	$9,333.33	
Market price of this stock in 1947 (1946 dollars) $6,250 (b) x 160/200 =	5,000.00	
Gain		4,333.33
Net Gain		$2,666.66

Interest and Dividend income, $4,000, or $2,666.67 in 1946 dollars

(a) It was assumed that the records showed a market value for stocks as follows, in 1947:

Stock bought in 1946, cost $16,000; market	$10,000 in 1947
Portion sold in 1948, cost $10,000, market $10,000 x 10/16 =	6,250 in 1947 (b)
Portion held through 1948, cost $6,000, market $10,000 x 6/16 =	$ 3,750 in 1947
Stock purchase in 1947, cost and market	20,000
Market value in 1947 of stock held in 1948	$23,750 (a)

In 1949 the schedule would be:

X COMPANY

SCHEDULE OF INVESTMENT FUND

December 31, 1949

Assets	Conventional	Common Dollar
Cash	$ 14*	$ 11 1/5
Bonds	36	28 4/5
Stocks	60	72
Total Fund	$110	$112

*All figures in '000 of dollars

The market value of the stock was $90,000 , and the index 200, so the fraction used was 160/200 and the common dollar value $72,000.

The gain of $37,333.33 in purchasing power over 1948 is explained as follows:

X COMPANY

INCOME STATEMENT FOR INVESTMENT FUND

YEAR ENDING DECEMBER 31, 1949

		Gain Loss*
Purchasing power gain from holding $20,000 of cash from 1948 into 1949:		
Purchasing power in 1949, $20,000x160/200=	$16,000.00	
Purchasing power in 1948, $20,000x160/240=	13,333.33	
Gain		$2,666.67
Purchasing power gain from holding $32,000 of bonds from 1948 into 1949:		
Purchasing power in 1949, $32,000x160/200=	$25,600.00	
Purchasing power in 1948, $32,000x160/240=	21,333.33	
		4,266.67
Purchasing power gain from holding stock which cost $6,000 in 1946, from 1948 through 1949:		
Purchasing power in 1949, market $20,000, $20,000 x 160/200	$16,000.00	
Purchasing power in 1948, market $10,000, $10,000 x 160/240	6,666.67	
		9,333.33
Purchasing power gain from holding stock which cost $22,000 in 1948, from 1948 to 1949:		
Purchasing power in 1949, market $38,000, $38,000 x 160/200	$30,400.00	
Purchasing power in 1948, cost and market $22,000, $22,000 x 160/240	14,666.67	
Gain		15,733.33
Purchasing power gain from stock sold in 1949, over value in 1948 (cost $20,000 in 1947):		
Selling price $30,000, $30,000x160/200 -	$24,000.00	
Purchasing power in 1948, market $28,000, $28,000 x 160/240	18,666.67	
Gain		5,333.33
Total Gain		$37,333.33

Interest and Dividend Income, $4,800, in 1946 dollars, $4,800 x 160/200 = $3,840

Finally, in 1950:

X COMPANY

SCHEDULE OF INVESTMENT FUND

December 31, 1950

	Conventional	Common Dollar
Assets		
Cash	$10*	$13 1/3
Bonds	40	53 1/3
Stocks	50	80
Total Fund	$100	$146 2/3

*All figures in '000 of dollars

The index has dropped to 120, the fraction used is 160/120. The market value of the stocks is $60,000, equal to $60,000 x 160/120 - $80,000 in common dollars.

The explanation of the gain in purchasing power from 1949, amounting to $34,666.67, is as follows:

X COMPANY

INCOME STATEMENT FOR INVESTMENT FUND

YEAR ENDING DECEMBER 31, 1950

		Gain Loss*
Purchasing power gain from holding $14,000 of cash from 1949 into 1950:		
Purchasing power, 1950, $14,000x160/120 =	$18,666.67	
Purchasing power, 1949, $14,000x160/200 =	11,200.00	
Gain		$ 7,466.67
Purchasing power gain from holding $36,000 of bonds from 1949 into 1950:		
Purchasing power, 1950, $36,000x160/120 =	$48,000	
Purchasing power, 1949, $36,000x160/200 =	28,800	
Gain		19,200.00
Purchasing power gain from stock held from 1949 through 1950:		
Purchasing power, 1950, market $60,000, $60,000 x 160/120 =	$80,000	
Purchasing power, 1949, market $76,000(a) $76,000 x 160/200 =	60,800	
Gain		19,200.00
Purchasing power loss from stock worthless in 1950:		
Purchasing power in 1949, market $14,000(a), $14,000 x 160/200 =	$11,200	
Purchasing power in 1950	--	
Loss		11,200.00*
Net Gain		$34,666.67

Dividend and interest income $3,200, or
$3,200 x 160/120 = $4,800 in common dollars

(a) It was assumed that stock costing $10,000 in 1948, with a market value of $14,000 in 1949, was worthless in 1950. Since the total market value of stocks in 1949 was $90,000, the value of the stocks which later did not become worthless must have been $90,000 less $14,000 or $76,000.

No capital additions or withdrawals were made in the illustration; in practice these would probably occur, but there would be little added difficulty. The cash fund was always at least $10,000; it could have been decreased to $ 0 by withdrawals and the only effect would be that there would be no further gain or loss to compute from holding the cash. If additional investment were made, the purchasing power of those dollars should be computed, *e.g.*:

Addition to fund in 1948 -- $10,000
Index in 1948 -- 240
Purchasing power of addition
$10,000 x 160/240 = $6,666.67.

The total cash fund at the end of 1948 would then be $30,000, with a purchasing power of $20,000 in 1946 dollars. The accounting would then proceed as before. There is no gain or loss from the mere process of moving dollars into or out of the fund.

Dividends and interest were shown at their conventional amount and at their common dollar equivalent, but there is justification for eliminating this computation if they are removed from the fund. If they are used for other corporate purposes, another index might be more appropriate to show their purchasing power.

The five-year record of the fund may now be examined as a whole, both as shown by conventional and by common dollar accounting:

Year	Recorded Fund	Common Dollar
1946	$100,000	$100,000
1947	96,000	72,000
1948	100,000	74,666.67
1949	110,000	112,000
1950	100,000	146,666.67

Cash dividends and interest totalled $15,200. If this were added to the fund, the total purchasing power of the fund would be increased $15,200 x 160/120 = $20,266.67 to $166,933.33.

In other terms, if the warehouse were to be built in 1950, it could be half again as large as it would have been had it been constructed in 1946. If the earnings on the fund were accumulated, it could be one and two-thirds as large.

A valid criticism of any index method, such as that used in this illustration, is that the physical objects whose purchase price is used to form the index may change in quality from one year to the next. Presumably, for instance, changes in building techniques would occur which would alter the type of warehouse which would be built. Or the investor's business situation might change, the line of products and methods of distribution, so that an entirely different building might be more useful.

The best answer to this criticism is that such changes are usually evident and for managerial purposes should be considered apart from the concept embodied in the index.

One of the most obvious of such changes is that in the standard of living in this country. New products, such as television, have no counterpart in history. Nevertheless, when we find that the Cost of Living Index of the United States Bureau of Labor Statistics has increased more than 75 per cent in recent years, it means that a private investor whose capital fund did not increase proportionately was probably poorer in 1948 than he was in 1939, although his records may show a substantial profit. Meanwhile he has been forced to pay income taxes on any realized gains and, insofar as any price rises in his securities are due to the devaluation of the dollar, the investor has been subjected to a capital levy on purchasing power.

Such a levy seems unjust unless the purpose of the income tax law has changed from that which was originally intended. The government is responsible for our currency; by increasing the currency in circulation and other inflationary measures the government in effect developed a new method of taxation, the results of which can only be accurately analyzed by investors if they

employ a system of common dollar accounting such as that illustrated.[66]

In general, the benefits of showing a long range record of the changes in purchasing power seem to outweigh any disadvantages involved. It appears certain that the legal owners of many investment funds -- the stockholders of corporations which make large investments -- would get a much more revealing picture if reports were made to them which showed changes in purchasing power as well as dollar amounts. The public is educated as never before to an understanding of the fact that the dollar is an elastic yardstick; large organizations should not find it too difficult to explain a common dollar Balance Sheet to persons who read their reports. A common dollar Income Statement might be more difficult to portray, but if the changes were grouped as in the illustration a large degree of understanding does not seem improbable.

While the method proposed here may not be the optimum, should prices continue to fluctuate as in the recent past, adoption of some system which will enable investors to study the effects of the changing value of

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[66] Cf. Sir Geoffrey Heyworth, "Essential Maintenance of Capital," London Times, August 27, 1948 (Remarks of Chairman of Lever Brothers and Unilever Limited at Annual Meeting).

the dollar seems to be inevitable if proper economic control is to be maintained.

Common Dollar Accounting for Individual Securities

In addition to the performance of the fund, the investor may wish to trace the experience with one particular security. Conventional figures and index numbers are required for the dates on which the security was acquired and disposed of. The figures may then be stabilized either in dollars of the year the fund was established, in dollars of the year of acquisition of the security, or year of disposal, whichever seems best to the investor. It makes little difference which base is chosen, since the relation of the two figures, the percentage difference, is of more importance for analysis than the absolute amounts.

For example, if a security had been acquired in 1948 at $300 a share and sold in 1950 at $240, the purchasing power record would be as follows:

	Conventional	1946 Dollars	1948 Dollars	1950 Dollars
Cost (1948)	$300	$200	$300	$150
Selling Price (1950)	240	320	480	240
Gain (or Loss)	($ 60)	$120	$180	$ 90

The conventional accounting shows a dollar loss, but since dollars will buy more in 1950 than they did in 1948 (in fact, using indices of 120 and 240, they buy

twice as much), there is a purchasing power gain. It can be seen that this gain is 60 per cent of the cost price, regardless of the base year employed. This gain, considered together with any dividend or interest returns, stabilized, is the true measure of the purchasing power change as a result of making the investment.

It should also be noted that holding cash is a form of investment which gains or loses in purchasing power as the index fluctuates. One thousand dollars placed in a safety deposit box in 1900 is the same as $1,000 today in name only. Even the type of promise represented and the appearance of the bills has been changed in the interval.

<u>Summary</u>

There are several situations in which adjustment of the capital account should be made, although ownership of the security continues. Liquidating dividends, assessments, donations of securities, reorganizations, recapitalizations, and mergers may require such treatment.

When securities are disposed of, it is important to determine the specific securities and the net value received (if sold). Special consideration is necessary for repurchase agreements, foreclosures, short sales, gifts, securities placed in trust, and other circumstances where the procedure varies from an ordinary sale, but the

primary requirement is always an adequate determination of the value at the time of disposal.

The gain or loss from holding the security should be established. The investment performance can then be evaluated and a decision reached as to how well the desires of the investor have been met.

Elimination of the effects of the changing value of the dollar are of considerable assistance in making a proper evaluation. The elimination of these effects is best accomplished by some method of common dollar accounting which uses an index showing the purchasing power of the dollar for the uses for which the fund is intended. If no definite use has been determined, adjustment with a general index will usually provide reports of more value than if no attempt at all is made to compensate for the unstable nature of our measuring unit.

Chapter VII

SUMMARY AND CONCLUSIONS

The primary function of the accounting system used by an investor is to provide a basis for economic control of the investment fund. In controlling a portfolio, an investor usually can best evaluate the results of ownership of a particular security and management of the whole fund by comparing the value or values at acquisition of securities with subsequent amounts received during ownership and at time of disposal.

There are many ways in which an investment can be made; in Chapter II an investigation was made into problems which arise at acquisition of types which enter into the majority of investment transactions. Cost to the buyer is usually considered the best measure of the value which should be recorded. It may require careful analysis to determine this cost when payment is made in ways other than outright cash purchase. When cost does not reflect the fair value, other methods of determining the amount should be employed. The original amount of value is usually considered to be the "capital investment."

Subsequent receipts are either income or return of capital. Since dollar income is considered to be the excess received above the capital amount, it can never be finally determined until the security has been disposed of and the complete history is available. In practice, however, it is customary to assume that the capital will be recovered at time of disposal unless there is good reason to believe otherwise, and to that extent current receipts are usually considered to be income. The most frequent adjustment required to measure current income from debt securities is the amortization of premium or accumulation of discount. The amount of premium or discount is usually apparent when bonds are acquired, but may require careful analysis when other types of debt security are involved. In other types of debt securities there also may be an important element of capital return in current receipts, which should be segregated.

Theoretically the earnings allocable to a share of stock are an immediate benefit to the stockholder, but in practice it seems preferable for investors in stocks to wait until dividends are declared before accruing income. Non-cash dividends should be recorded at fair value; stock dividends on common stock are not income. The date of declaration has strong theoretical support as the proper time to accrue income, but there are practical advantages in using the date of receipt.

Expenses at acquisition should usually be

capitalized; subsequently they may be deducted from current income. All costs of managing an investment portfolio should be considered in order to determine the net income. Expenses may be allocated to individual securities on a direct or indirect basis, depending upon the nature of the expense. Additional investments, such as assessments, may be capitalized. Capital returns should be deducted from the capital account. When the market price of a security is substantially different from cost, the investor may be wise to anticipate the probable gain or loss as compared with the original capital investment. Since it is difficult to decide when the price is substantially different and likely to remain so, managers of investment funds, whether the fund is a primary or a secondary interest of the corporation, have an obligation to notify interested parties of current values for investments held.

When a major change occurs in the organization which issued the security, such as a merger, recapitalization, or reorganization, again it may be advisable for the owner to consider revaluation.

The final values received, directly through sale or liquidating dividends, or constructively through gift, etc., should be recorded in order to complete the picture of the investment performance. Interpretation of this performance is a subjective matter which was not dealt with in this dissertation, except to point out that

by common dollar accounting it is possible to remove some of the distortion caused by fluctuations in the purchasing power of the dollar.

Viewing the economic situation with regard to investments as a whole, an accounting system may be considered as an objective bridge between the original subjective desires of investors and subsequent evaluations of the investment performance. Accounting methods should be judged by the degree of success with which they design that bridge.

Appendix I, on Valuation of Securities

As discussed in Chapters II and VI, it may be necessary to appraise securities whenever the cost outlay does not constitute an adequate measure of the fair value of the securities. Such occasions arise most frequently in the case of partial cash or non-cash payments, gifts and inheritances. Appraisal may also be helpful in allocating the cost of a blanket acquisition, or determining present value when revaluation seems advisable (such as after a reorganization.)

The theoretical problems involved in the process of appraisal are too complicated to be covered fully in this brief survey. However, since this dissertation has advocated the use of appraisals somewhat more frequently than is customary in conventional accounting, it seems advisable to include a short section describing some of the available procedures.

The usual method of appraising securities acquired in circumstances where the amount of value (such as property) given up is not easily determinable is to say that the securities are equal in value to other similar securities being traded on the open market. If there is some fluctuation in price, the mean of the highest and lowest prices or

the closing price may be used. If there are no sales on the valuation date, a mean of bid and asked may be used or the most recent sales price. If the security is listed on more than one exchange, the records of the exchange where most sales are made should be employed.

Courts have held the above to be better evidence than the book value of the assets or opinion evidence.[1] In some cases the market price is considered abnormal, and testimony has been accepted.[2] "Blockage" is said to exist if the number of shares is much larger than could normally be handled in a few days on the exchange; some adjustment can be made for the difficulty of distribution.[3]

If no satisfactory market price is available, the problem becomes considerably more complicated. Many formulae have been suggested for the proper valuation of securities, but when their results are compared with the impartial verdict of the market place the general conclusion has been

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[1] May Rogers v. Helvering (CCA-2) 107F(2d) 394. The Metropolitan Life Insurance Co. v. U.S., 65 Ct Cls. 149.

[2] E.g. in Rogers v. Strong (CCA-3) 72 F(2d) 455, cert. denied 293 US 621

[3] Sensenbrenner, BTA memo op. Dec. 9215A. Helvering v. Maytag, 125 F(2d) 55. "As well as any controverted question of administrative law may be settled without declaration by the Supreme Court, it is established that the size of a block of listed stock may be a factor to be considered in its valuation for gift or estate tax purposes. Cf. Allin H. Pierce, "The Preparation of Valuation Cases," Taxes, January, 1947, p. 53.

that one should not place too much reliance on any of them. The Accountants' Handbook lists the following factors which should be considered:

1. Earning power
2. Dividend policy
3. Book value
4. Value of underlying properties
5. Capital structure and size of company
6. Competitive position of company
7. Character of management.[4]

In actual cases the Commissioner's value, based on earnings, corporate assets, surplus and prospects has been accepted in numerous cases, but there has been considerable discussion of the propriety of methods used by the Commissioner. Criticism has centered about the fact that frequently he has not been compelled to explain the basis he uses for making valuations, except in general terms.[5]

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[4]Accountants' Handbook, p. 464; cf. 464-470. Cf. Bonbright, op. cit.

[5]Douglas Van Dyke, "Commissioner Unfair to Fair Market Value," Taxes, September, 1945, p. 788.
Commerce Clearing House, 697. 27 citing 12 cases, 697. 2716 citing 5 cases, (1948 ed.)
Cases where Commissioner's value differed substantially from that accepted by court.
Laird v. Comm. (on rehearing) 85 F(2d) 598, 601.
Russell v. Comm. 45 F(2d) 100.
Worcester County Trust Co. v. Comm. 134 F(2d) 578, 581.

In an unusual case the Court fixed a value of $14.00 for estate purposes although the value quoted on the exchange was $10.50. The $14.00 figure was based on negotiations under way at the time of death but unconsummated until six months later, when the shares were exchanged for those of another corporation on that basis. The $14.00 also represented a capitalization of dividends paid @ 8%.[6] Other cases can be cited where prior year's earnings, dividend payments and book values adjusted for proper reserves have been used.[7]

As an example of the difficulties which may be encountered, the following case might be considered. Stock of the corporation was distributed as compensation to a person already the principal stockholder of the corporation. The Commissioner called the distribution taxable income to the extent of the "value" of the shares. The Board of Tax Appeals upheld this interpretation, dismissing contentions that the issuance merely diluted the value of the shares previously held and that the stockholder received as income only the difference between his interest in the assets prior

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[6] Telling, TC Memo op. 3 TCM 652 Dec. 14018 (m)

[7] Alfred C. Thompson 18 BTA 843, and 16 other cases cited at CCH (1948) op. cit. 697.2686.

to and after issuance of the additional shares.[8]

Difficulties are also encountered where unusual agreements form part of the contract of sale. An instance is the matter of restrictive or repurchase agreements. In several cases the courts have held that the repurchase figure constituted fair market value.[9] Where part of the stock was subject to repurchase, that part was valued at the option price and the remainder at market.[10] But if the owner, though restricted as to the persons to whom he can sell, nevertheless has the right to will the securities to his heirs, then he has a valuable right of retention.[11]

The problem of valuation in such cases is demonstrated in the solution offered by Cohen. He estimates the value of the right of retention briefly as follows:

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[8]Cornacchia, BTA Memo, op. Dec. 12521-F.

[9]Wilson v. Bowers, 57 F(2d) 768 affirming 51 F(2d) 261 (S.D.N.Y, 1931)
Lomb v. Sugden 82 F(2d) 166, reversing 11 F. Supp. 472 (W.D.N.Y. 1935.)

[10]Helvering v. Salvage 297 US 106 (an agreement not to compete).

[11]Worcester County Trust Co. v. Comm, (CCA-1, 1943) 134 F(2d) 578 reversing 46, BTA 337. The option price was $15.46, and the Commissioner estimated the value at $35.00 per share. He was not upheld by the court, but the Court agreed that while the option had a depressing effect, the value was not reduced to the option price.

Establish (a) an appropriate average rate of return,

(b) the option price

(c) the anticipated annual dividends on the stock, and

(d) the period before the option will be exercised.

Then the value of the excess of (c) over (a) times (b) for a period equal to (d), is the retention value, to be added to the option price.

The option price is the only certain element in the above formula, and interest factors are ignored; it is obvious that difficulties might be encountered in persuading interested parties that the result was a fair value. Cohen gives an example in which a corporation was obliged to buy at book value, at which price the seller had to sell unless he could arrange a transaction with other employees and obtain the Director's consent. The book value price was $90,000, the Commissioner's original valuation was $219,000 (apparently based on the fact that dividends had averaged $10,800 for nine years), and the final valuation was $117,500.[12]

The value of anything is a subjective matter and there may be as many opinions about it as there are persons

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[12] Edwin S. Cohen, "Restrictive Agreements for Purchase of Stock: Effect on Estate and Gift Tax Valuations," The New York Certified Public Accountant, March 1947, p. 162.

involved. Accountants have been reluctant to incorporate appraisals in the books. In some of the more difficult situations described above such reluctance seems obviously justified. But where there is a valuation from the records on an active market for a security, the situation seems different from that where fixed assets are involved. In the latter case the potential buyers may be few or non-existent. For this reason, it is felt that consideration might be given more frequently to the possibility of revaluing securities more frequently than would be advisable for other assets.[13]

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[13]As an example of the extent to which a balance sheet may depart from a showing of value if the historical cost is shown, see Exhibit One, ff.

CHRISTIANA SECURITIES COMPANY

Balance Sheet, December 31, 1948

Assets

Cash		$407,658.80
Investments in Common Stocks:		
E.I. du Pont de Nemours & Company, 3,049,800 shares		44,659,257.46
(Closing sale price on the New York Stock Exchange at December 31, 1948, was $184.50 a share, which, if multiplied by 3,049,800 would produce a figure of $562,688,100; this amount, however, is not represented to be either the aggregate quoted market value or realizable value of 3,049,800 shares of the common stock of E. I. du Pont de Nemours & Company)		
Other companies (at cost):		
General Motors Corporation, 85,000 shares	$4,187,653.85	
Wilmington Trust Company, 7,210 shares	903,592.06	
The News-Journal Company (wholly-owned subsidiary) 7,460 shares	846,106.26	
		5,937,352.17
Total		$51,004,268.43

Liabilities

Dividend on Preferred Stock,		
Payable January 3, 1949		$ 262,500.00
1948 Federal Income Tax	$1,720,010.66	
Less: U.S. Treasury Tax Notes		
(at cost)	1,600,000.00	120,010.66
Capital Stock		
7% cumulative non-voting preferred	15,000,000.00	
Common, par value $100 a share	15,000,000.00	30,000,000.00
Surplus (earned)		20,621,757.77
Total		$ 51,004,268.43

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E. Abbreviations

General Legal and Services

AFTR American Federal Tax Reports published by Prentice Hall.

BTA Board of Tax Appeals

CCH Commerce Clearing House

Ct.Cl. Court of Claims

Cyc. Corp. Fletcher's Cyclopedia of Corporations

F or F(2d) Federal Reporter, West Publishing Co., St. Paul, Minn.

F. Supp. Federal Supplement, West Publishing Co., St. Paul, Minn.

IRC Internal Revenue Code, West Publishing Co., St. Paul, Minn.

S. Ct. Supreme Court Reporter, West Publishing Co., St. Paul, Minn.

T.C. Tax Court (succeeded BTA)

U.S. Official U.S. Supreme Court

U.S.T.C. United States Tax Cases, (Commerce Clearing House).

States abbreviated -- state cases. Usually also reported in regional reporters, NE -- North East, Pac -- Pacific, etc. Some early cases are reported in volumes bearing an abbreviation of the name of the man who collected them.

Cf. also abbreviations shown for Federal Regulations and Reports, supra.