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NOTES

FEDERAL TAXATION OF TREASURY STOCK TRANSACTIONS

The Revenue Act of 1938[1] provides that " 'Gross income' includes gains, profits and income derived from .... sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from .... the transaction of any business carried on for gain or profits, or gains or profits and income derived from any source whatsoever." Since it has been well-settled that American corporations can deal in their own stock,[2] the question has frequently arisen as to whether the difference between

[1] 52 Stat. 447 (1938); 26 U.S.C. § 22a (Supp. 1938).

[2] Green v. Bissell, 79 Conn. 547, 65 Atl. 1056 (1907); Leland v. Hayden, 102 Mass. 542 (1869); for a discussion on the protection of creditors in such transactions see 47 Harv. L. Rev. 693 (1934); for reasons underlying the acquisition of treasury stock consult Montgomery, Financial Handbook 621 (2d ed. 1933).

the purchase and sales price of the corporation's stock is a "gain, profit, or income" within the meaning of the Revenue Acts.

The first Treasury Regulation in 1918 stated that "if the corporation purchases any of its stock and holds it as treasury stock, the sale of such stock will be considered a capital transaction and the proceeds of such sale will be treated as capital and will not constitute income of the corporation. A corporation realizes no gain or loss from the purchase or sale of its own stock."[3] In line with this regulation, the Board of Tax Appeals in 1925 ruled that there was no deductible loss where a corporation purchased its own stock at $223 per share and sold it at $110.[4] The nontaxability of the difference between the purchase and resale price of a corporation's own stock continued to be followed consistently[5] until *Commissioner of Internal Revenue v. S. A. Woods Machine Co.*[6] in 1932.

In the *Woods* case, the corporation accepted shares of its own stock in satisfaction of its judgment. The stock was then retired. The corporation, following the Treasury Regulation, did not report the value of these shares of its stock as taxable income. The corporation's position was overruled by the Circuit Court of Appeals on the grounds that the transaction was equivalent to payment of the debt in cash and investment of the proceeds by the corporation in its own stock, and that a contrary rule would open a wide door to tax evasion.[7] Although the case did not involve the purchase and resale of treasury stock, this situation was covered by the broad language of the court which stated that "Whether the acquisition or sale by a corporation of shares of its own capital stock gives rise to taxable gain or deductible loss depends upon the real nature of the transaction involved," and that "where . . . . a corporation has legally dealt in its own stock as it might in the shares of another corporation, and in so doing has made a gain or suffered a loss, we perceive no sufficient reason why the gain or loss should not be taken into account in computing taxable income."

[3] U.S. Treas. Reg. 45, art. 542 (1918). Identical provisions appear until 1934 in U.S. Treas. Reg. 62, art. 543 (1922); Reg. 65 art. 543 (1924); Reg. 69 art. 543 (1926), Reg. 74, art. 66 (1928); Reg. 77 art. 66 (1932).

[4] Simmons and Hammond Manufacturing Co., 1 B.T.A. 803 (1925).

[5] Cooperative Furniture Co., 2 B.T.A. 165 (1925); Atlantic Nat'l Bank, 5 B.T.A. 520 (1926); United Drug Co. v. Nichols, 21 F. (2d) 160 (Mass. 1927); for sale of stock to employees Haskell & Barker Car Co., 9 B.T.A. 1087 (1928); Curtis v. Comm'r of Internal Revenue, 89 F. (2d) 736 (C.C.A. 8th 1937).

[6] 57 F. (2d) 635 (C.C.A. 1st 1932), *cert. denied* 287 U.S. 613 (1932).

[7] This reasoning is unnecessary, the question being one of realization of profit on the asset not the stock. The Revenue Act provides "the amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. 49 Stat. 1678 (1936), 26 U.S.C.A. § 111(b) (Supp. 1937)." See Allyne Zerk Co. v. Comm'r of Internal Revenue, 83 F. (2d) 525 (C.C.A. 6th 1936); Houghton and Dutton Co., 26 B.T.A. 52 (1932). For a case where this confusion resulted in the non-taxability of a legitimate gain, see Houston Brothers Co., 21 B.T.A. 804 (1930).

In 1934 the Treasury Department amended its regulation pertaining to dealings by a corporation in its own stock by making its regulation conform to the language quoted above from the *Woods* case.[8] In accordance with the new regulation, the Board of Tax Appeals ruled in three cases that a taxable income resulted when a corporation bought its own stock and resold it at a higher figure.[9] These rulings were appealed to the Circuit Court of Appeals.

In the first case, *First Chrold Corp. v. Comm'r of Internal Revenue*,[10] the Board ruling was upheld on the practical ground that the corporation without affecting its "capital structure" had increased its cash account in the same manner as if it had made a profit in the stock of another corporation. This may have been the typical "in-and-out" transaction. But if the rise in the market value was in large measure due to a rise in the book value of the stock, the analogy breaks down when it is seen that a corporation is taxed as a unit but once upon its profit from the purchase and sale of another corporation's stock, while a tax on the "gain" from the purchase and sale of its own stock is a second tax upon the same corporation and the same "gain." For example, if the X corporation buys its own stock at $100 and sells it at $200, its net worth having doubled in the meantime, a tax on the $100 difference between purchase and sale price would in effect be a second tax on the surplus built up while the stock was being held, a surplus which has been taxed already as income. However, when the X corporation buys the stock of the Y corporation for $100 and sells it for $200, the net worth of the Y corporation having doubled, the X corporation as a unit pays but one tax on this gain.

Ignoring this distinction as to the unit paying the tax, however, the analogy is very close. In both situations, the original gain (the income of the corporation) is taxed three times. Thus, when the X corporation buys and sells its own stock as described above, one tax is paid by the corporation on its income, which, when retained, resulted in an increased net worth of the corporation, and increased book value of the stock. Another tax is paid on the $100 differ-

[8] U.S. Treas. Reg. 77, art. 66 (1932) as amended by Treas. Dec. 4430 (May 2, 1934), "Whether the acquisition or disposition by a corporation of shares of its own capital stock gives rise to taxable gain or deductible loss depends upon the real nature of the transaction, which is to be ascertained from all its facts and circumstances .... but if a corporation deals in its own shares as it might in the shares of another corporation, the resulting gain or loss is to be computed in the same manner as though the corporation were dealing in the shares of another. So also if the corporation receives its own stock as consideration upon the sale of the property by it, or in satisfaction of indebtedness to it, the gain or loss resulting is to be computed in the same manner as though the payment had been made in any other property. Any gain derived from such transactions is subject to tax, and any loss sustained is allowable as a deduction where permitted by the provisions of the Act." The identical provision is repeated in art. 22 (a)-16 Reg. 94 (1936).

[9] First Chrold Corporation, 36 B.T.A. 1330 (1937); R. J. Reynolds Tobacco Co., 35 B.T.A. 949 (1937); E. R. Squibb & Sons, 36 B.T.A. 260 (1937). For a consideration of these cases and a different analysis of the problem, see 47 Yale L. J. 111 (1937).

[10] 97 F. (2d) 22 (C.C.A. 3d 1938).

ence between the purchase and sale price of its stock (if the *Chrold* case is followed). Then a third tax is paid by the individual stockholders on this original income when the dividends are declared. Similarly, when the X corporation buys and sells the stock of the Y corporation as stated above, the Y corporation has paid a tax on the increase in its net worth. The X corporation pays a tax on the profit realized from the sale of the stock, and a third tax is paid on the original income of the Y corporation by the individual stockholders of X corporation when dividends are declared. However, since the Revenue Act in its terms taxes the corporation as a unit,[11] the fact that the X corporation pays but one tax on profits from transactions in the Y corporation's stock, while paying twice on "gains" in its own stock is a sufficient basis for distinguishing the two transactions.

In *R. J. Reynolds Tobacco Co. v. Comm'r of Internal Revenue*[12] the court rejected the new interpretation of the Revenue Act on the technical ground that since the definition of gross income in the Revenue Act was reasonably susceptible of two constructions, its reenactment after an authoritative interpretation amounts to legislative sanction of that interpretation.[13] However convincing the doctrine may be in that case, the two reenactments of the definition of gross income in the Revenue Acts of 1936[14] and 1938[15] after the 1934 change in the Treasury Regulation[16] makes such reasoning inconclusive in future cases.

In *E. R. Squibb and Sons v. Helvering*[17] the court held that taxable "income or gain" from the sale of treasury stock was not the difference between the purchase and sale price, but the difference, if any, between sales price and market price. This result was arrived at through the use of a general concept of "true" or "real" value, the court unconsciously assuming that book value and market value were the same or else changed proportionately. On this assumption, the difference between the purchase price and the market price for which it was sold is not a taxable gain, as is hereinafter explained, and makes possible also the novel distinction between a sale at the market price and a sale at a higher than market price. This assumption, usually does not conform to the facts. Moreover, the court reaches its conclusion by reasoning that if the corporation paid the "true value" for the stock, and sold it for its "true value," the corporation received no more than the stock was worth, and made no profit unless by some arrangment it managed to sell it for more than its "value." This reasoning ignores the obvious fact that a tax is paid upon a rise in value of an asset when that rise in value (profit) is realized, and that need

[11] 52 Stat. 455 (1938), 26 U.S.C.A. § 13 (Supp. 1938).

[12] 97 F. (2d) 302 (C.C.A. 4th 1938).

[13] See National Lead Co. v. United States, 252 U.S. 140, 146 (1920); McCaughn v. Hershey Chocolate Co., 283 U.S. 488, 492 (1930).

[14] 49 Stat. 1657 (1936), 26 U.S.C.A. § 1 (Supp. 1937).

[15] 52 Stat. 447 (1938), 26 U.S.C.A. § 1 (Supp. 1938).

[16] *Supra*, note 8.

[17] 98 F. (2d) 69 (C.C.A. 2d 1938).

not be at the time of such rise in value or gain.[18] Thus the decision in this case, like its predecessors, does not satisfactorily solve the problem.

In cases involving the taxability of transactions in a corporation's own stock, it is essential to treat the corporation as a group of stockholders rather than as an entity. Taxes on corporate income are, in their effect, generally regarded as a second tax on the dividends paid stockholders.[19] Moreover, if the corporation is strictly regarded as an entity, it would profit every time it issued stock, for its assets would be increased without correspondingly increased liabilities. Conversely, the corporation would sustain a loss when it repurchased its own stock.

If the corporation sells its treasury stock above the purchase price, the taxability of the gain should depend on whether the increased price has been matched by a proportionately increased book value, *i.e.*, the number of dollars of income retained by the corporation as surplus and upon which an income tax has already been paid. For example, the X corporation, with 100 shares of outstanding stock and assets of $10,000 purchases ten shares of its stock for $1,000. Five years later, its assets having risen to $18,000, the corporation sells these shares for $2,000. Whether or not this $1,000 difference between the purchase and sale price is a profit or gain in some sense, it should not be considered a profit within the meaning of the Revenue Act. The increase in the value of the stock has been due to the increased surplus account upon which an income tax has presumably been paid by the corporation. This distinguishes the transaction from that involving the sale of an ordinary asset in that in such a case no tax has been paid upon its increased value before its sale, and from the case of the sale of stock of another corporation in that in that case, as previously explained, the tax on the income has been paid by that other corporation.

If, however, there is no proportionate increase in the book value, the resulting "gain" has not been taxed twice.[20] The income tax, therefore, should be assessed upon the "gain" from the sale of the stock less the difference between the book value at the time of purchase and of sale. For example, the X corporation buys one share of its stock at $100, the book value being $200. It later sells the same share for $500, the book value having increased to $300. The taxable gross income should then be $300 ($400, the difference between purchase and sale price, less $100, the increase in book value). Of course, if the transaction is the typical "in-and-out" one, the book value remains unchanged and the entire difference between the purchase and sale is taxable income. The same formula is applicable if the corporation wishes to take a deductible

[18] 49 Stat. 1678 (1936), 26 U.S.C.A. § 111 (a) (Supp. 1937).

[19] See Tennessee v. Whitworth, 117 U.S. 129, 136 (1886).

[20] Even if the increased surplus results in part from a non-taxable income, the same solution is applicable since it is as theoretically undesirable to tax non-taxable income once as to tax taxable income twice.

loss. The deductible loss should be allowed on the difference between the sale of the stock less the difference between the book value at the time of purchase and sale. For example the X corporation buys one share of stock at $300, the book value being $200. It later sells this share for $50, the book value having decreased to $100. The deductible loss would be $150 ($250, the difference between the purchase and sale price, less $100, the decreased book value).

One difficulty with this approach is that it is expensive and difficult to ascertain the book value of a share of stock at any given time.[21] Partially to eliminate this objection the Statute should provide that the purchase price is presumed to be the book value unless otherwise shown by a preponderance of the evidence. If the taxpayer sells a share of stock at a higher price than he paid for it and believes the gain should not be included as income, the burden of proving that this gain is represented by a corresponding increase in book value should be upon the taxpayer. Likewise, if the taxpayer sells a share of stock at a lower price than was paid for it, and desires to decrease his income tax assessment, he should have the burden of proving that the book value of the stock has not decreased while the company was holding it. The general policy of not favoring this type of transaction and the greater ease of proof by the corporation is a justifiable basis for imposing this rule.[22]

It is submitted that because of the undesirable nature of such transactions,[23] the federal government might also impose an excise tax on treasury stock transactions.

[21] See H. S. Crocker Co., 5 B.T.A. 538 (1926), the findings of fact included as one item "accumulated profits." Since this finding was only incidentally used in the opinion, it must have been obtained without very great difficulty.

[22] Nusbaum, Acquisition by a Corporation of Its Own Stock, 35 Col. L. R. 971 (1935); note, 47 Harv. L. Rev. 693 (1934); *cf.* Wormser, The Power of a Corporation to Acquire Its Own Stock, 24 Yale L. J. 177 (1915).

[23] Note 22, *Supra.* The English rule completely prohibits these transactions. Trevor v. Whitworth, 12 A. C. 409 (1887); Companies Act, 1928, 19 & 20 Geo. V, c. 23, § 45; Levy, Purchase by an English Company of Its Own Shares, 79 U. of Pa. L. Rev. 45 (1930).