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TAXATION OF TREASURY STOCK

By W Lewis Roberts

In recent years courts have had to solve problems relative to the taxation of "treasury stock." These problems have been varied and have given rise to conflicting opinions as to their solution. There has even been a lack of unanimity as to just what should be included under the term "treasury stock."

Probably the simplest and most commonly accepted definition of the term is that given by the late Professor Glenn, that "Treasury stock, of course, is stock that has been issued, and later reacquired by the same company." The Circuit Court has cited with approval the statement given in Cook's work on Corporations. That writer, the court observes, in speaking of treasury stock says: "Such stock having once been legally issued as fully-paid stock, and then donated back into the corporate treasury, can be legally sold for cash at less than par." The Missouri court, in Maynard v Doe Runhead Co. says: "Treasury stock is stock belonging to the corporation and subject to sale by it." And Fletcher defines it as follows:

"Treasury stock, as its name implies, is stock held by the corporation in its treasury to be used or disposed of by the company in the furtherance of corporate purposes, but the courts are not in accord as to how or by what procedure shares of stock acquire or take on the status of treasury stock the courts are agreed that such stock is the personal property of the corporation, to be disposed of by the company on such terms as it chooses."

A difference of opinion arises as to whether treasury stock is "property" or an "asset" of the corporation. Professor Glenn states that he could find but one case where a creditor of an insolvent corporation sought to get at treasury stock as an "asset." In computing the capital employed in the state, he says it has been held not an asset. In Amelia H. Cohen Trust v Commissioner of Internal Revenue, the court said that "treasury stock is an asset in the cor-

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3 305 Mo. 355, 265 S. W. 94 (1924).
4 Cyc-Corporations, Vol. 11, p. 44, sec. 5088.
5 Supra n. 1, citing Coit v. Freed, 15 Utah 426, 49 Pac. 533 (1897).
7 121 F. 2d 689 (1941).
poration's treasury and may be resold at any time as suits the corporate owners' purpose, while retired stock ceases to exist as an evidence of interest or ownership in corporate property."

Judge Hand in *Kirschenbaum v Commissioner of Internal Revenue* has recently said in regard to this question:

"The status of 'treasury shares' is in general not made perfectly clear in the books. Some courts treat them as though they were, so to say, in suspended animation—existing, but existing only in a kind of Limbo; other courts treat them as though they were retired."

Ballantine took the position that the shares when acquired by the corporation were really retired and when sold by the company, they constituted a new stock issue. To quote:

"When so-called treasury shares are sold by the corporation it is regarded as if the shares issued to the purchaser were the old shares and as if the corporation had merely been an intermediate transferee. In reality the old contract was extinguished and the new shares are new units of interest created in their place. The principal use of this fiction of already issued shares has been to get around the wooden requirement that par value shares must be issued at par at all times, which is an arbitrary and unreasonable rule."

Finally, it has been said by a learned writer on corporations, that treasury stock cannot be voted, cannot draw dividends, and is lifeless, without rights and powers."

Confusion has often arisen by the treatment treasury stock has received at the hands of accountants. A district court judge has referred to this fact in *Winkelman v General Motors Corporation*. To use his words:

"The fact that the annual statement contained a figure showing a total of Treasury stock, would not make the Treasury stock 'issued and outstanding.' Even if the accountants incorrectly included the Treasury stock in the total of issued stock that would not make the treasury stock in fact 'issued and outstanding. The corporation's own stock, purchased in the market and held in its treasury for further use, was not 'issued and outstanding and under the bonus plans was not capital employed' on which 7% had to be deducted in calculating the bonus base."

Treasury stock, however, has generally been regarded as "outstanding capital stock" within the meaning of franchise tax statutes and subject to the franchise tax. In *State v Stewart Bros. Cotton*

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8 155 F 2d 23, 25 (1940).
10 COOK, CORPORATIONS (7th Ed.) Vol. 1, p. 900.
the court said that this is due to the fact that as long as the corporation owns the shares, "they represent the price in cash, services or assets paid by the shareholders to the corporation in consideration therefor and the corporation continues to use this capital in the operation of its business after acquiring the "Treasury Shares," because they were paid for out of its surplus."

Our next and most important problem under taxation of treasury stock is whether a corporation that buys its own stock and later sells it at an increased price must include this increase over cost in computing its federal income tax. Of course, that problem raises the question whether a corporation has the right to buy and sell its own stock. There are two views on this question, the so-called English doctrine and the American doctrine. The English courts have held to the proposition that corporations do not have this right. They regard the purchase by a corporation of its own stock as ultra-vires. They make an exception, however, where a corporation takes its own stock as collateral or in settlement of a prior claim to avoid loss.\footnote{Id. at 183.} The English view is followed by a minority of the courts in this country. The great majority of courts hold that a corporation has an implied power to buy its own stock provided it does so in good faith.\footnote{Id. at 183.} In a few states, statutes make such purchases illegal.\footnote{Id. at 183.} National banks are also restricted by statutes in this respect.\footnote{Id. at 183.} Of course, the certificate of incorporation may restrict the exercise of this power and statutes sometimes require such purchases to be made out of surplus funds.

The Board of Tax Appeals at its start took the position that gains and losses from the purchase and sale of a corporation's own stock were not to be included in computing the federal income tax for the corporation. In the case before it, Simmons & Hammond Manufacturing Co.,\footnote{193 La. 16, 190 So. 317 (1939).} the company purchased all of its stock held by three stockholders and resold it to two other stockholders for less than half the price it had paid. It sought to deduct this loss from its income. The Board held that it was a capital transaction and did not result in a realized loss to the corporation. The Board's explanation is interesting. It said:

\begin{quote}
193 La. 16, 190 So. 317 (1939).
\footnote{The Power of a Corporation to Acquire Its Own Stock by I. Maurice Wormser, 21 Yale L. J. 178 (1915).}
\footnote{Id. at 183.}
\footnote{11 Harv. L. Rev. 658 (1928).}
\footnote{Rev. Stat. U. S. sec. 5201.}
\footnote{1 BTA 803 (1925).}
\end{quote}
"To the extent the price paid for these 94 shares exceeded par, there was a reduction in the surplus account of the taxpayer, and a distribution of surplus to the seller of the stock resulted. While it may be true that the purchase of this stock by the corporation did not in fact constitute a retirement of the stock, yet, in so far as such treasury stock was treated by the corporation as an asset, it could have an asset value per share equal only to the remaining assets of the corporation divided by the shares outstanding. Since there had been a diminution of surplus in acquiring this stock, the stock had a relatively less value in the hands of the corporation."

The same year the Board disallowed the loss where the corporation bought its own stock and resold it to an employee at a lower price upon his reemployment by the company 19

The Treasury Regulation 74, Art. 66 (1928) conformed to the Board's ruling in the Simmons & Hammond Manufacturing Co. case, and provided, among other things, that if a corporation purchases its own stock and holds it as treasury stock, the sale of it will be considered a capital transaction and will not constitute income of the corporation. This regulation was later challenged by the Circuit Court in the cases of R. J. Reynolds Tobacco Co. v Commissioner of Internal Revenue 20 and E. R. Squibb & Sons v Helvering. 21 In the first, the court said the Board's broad statement that a corporation realizes no gain or loss from the purchase and sale of its own stock was not in keeping with section 22(a) of the Act of 1928, which defines gross income as including "gains, profits and income derived from sales or dealings in property, or from any source whatsoever; and that the amended regulation was a correct interpretation of the statute." 22 In the Squibb case the difference between what the tax-

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19 Cooperative Furniture Co., 1 BTA 165 (1925).
20 97 F. 2d 302 (1938).
21 98 F. 2d 69 (1938).
22 As amended May 2, 1934, the regulation reads as follows:
"Acquisition or disposition by a corporation of its own capital stock. 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. The receipt by a corporation of the subscription price of shares of its capital stock upon their original issuance gives rise to neither taxable gain nor deductible loss, whether the subscription or issue price be in excess of, or less than, the par or stated value of such stock."
"But where 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 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 transaction is subject to tax, and any loss sustained is allowable as a deduction where permitted by the provision of applicable statutes."
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payer sold the shares for and what it paid for them was held "taxable income" rather than "capital gain."

In the case of Allen, Collector v National Manufacturing & Stores Corporation, the corporation purchased its own stock on "fifty per cent margin" and carried it for six years as treasury stock. It then sold it at a profit. The gain was held to be income and not a capital transaction under Section 22(a) of the 1936 Revenue Act. The majority of the court in Commissioner of Internal Revenue v Air Reduction Co. held that where the company employed its own stock as an ordinary asset to pay for stock in another corporation and also sold treasury stock, as an ordinary asset, to its own officers pursuant to an option agreement, it was taxable on the gain received. Judge Hand dissented on the ground that the taxpayer was not dealing with its shares "in the same manner as though" they were "the shares of another." He said the regulation was meant primarily to cover buying and selling "treasury shares" for profit.

The fact that the corporation designated the stock on its books as assets and carried the same on its balance sheet as investments in stock of domestic corporations, did not prevent the gain when the stock was sold from being taxable income. Nor did the fact that the corporation bought stock at the holder’s demand, as provided by its charter, and later sold it at a profit, crediting the excess to surplus; relieve the corporation from including the gain in its gross income. The court observed that the fact the company carried the stock on its books differently than it did shares of other corporations did not change the result. The phrase "deals in its own shares" related to the acquisition and disposal of the stock at the beginning and the end of the holding period and not the method of bookkeeping concerning them.

The method of acquiring its own stock is not necessarily determinative of whether there is a taxable gain or loss. In 1926, the Board of Tax Appeals did hold that where a company purchased its own stock, giving in part payment stock and bonds of another corporation for less than the cost of the same, there was not a capital transaction.

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24 Art. 22 (a)-15 provides: "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."
26 130 F. 2d 145 (1942), cert. denied 317 U. S. 681.
27 Dow Chemical Co. v. Kavanagh, 139 F. 2d 42 (1943).
which gave rise to either a gain or loss. A year later, however, the same Board held that a transaction may result in gain or loss where capital assets were used as part of the consideration to acquire the corporation's own stock. Such gain or loss must be ascertained by determining the fair market value of the property other than cash used in the transaction. In Houston Brothers Co., the corporation received its own stock in part payment of assets sold. This was regarded as a receipt of property within the provisions of the Revenue Act of 1924 and the corporation was required to take the gain into account in computing net income.

This question of whether a taxable gain or loss occurs in a transaction where a corporation's own stock is taken or given in the purchase or sale of property or settlement of a claim, received a careful consideration by the Circuit Court in the case of Commissioner of Internal Revenue v. S. A. Woods Machine Co. in 1932. In that case the Woods company in settling a judgment for patent infringement received 1022 shares of its own stock. This stock was retired by reducing the capital stock. The commissioner ruled this constituted taxable income. The Board of Tax Appeals ruled against the Commissioner and the Government appealed. The Circuit Court held such an acquisition gave rise to a taxable gain. A note writer made an interesting comment on the decision. He says:

"From an accounting viewpoint, the corporation received income to the amount of the judgment, since the entry, upon the judgment being rendered, would be a debit to a receivable, and a credit to some account such as income from patent infringement. From an economic standpoint, perhaps, the corporation received an income to the extent that it is left with a larger surplus and thus in a stronger financial position."

Since the Woods case, the Circuit Court has repeatedly held that where a corporation receives its own stock in payment or part payment for real estate or other assets, the gain must be included in the gross income.

In several of the cases already considered, the courts have referred to "capital transactions" as not resulting in taxable gains or deductible losses. The Board of Tax Appeals in Farmers Deposit National Bank,
held that where one member of an affiliated group of corporations sells shares of its stock to other members of the group, it is a capital transaction and does not result in either a taxable gain or a deductible loss. The transaction, in other words, amounts only to a re-adjustment in the capitalization of the affiliated organization. The Circuit Court, in dealing with a similar situation in United Drug Co. v. Nichols[35] the next year, observed:

“It seems clear that the sale of the capital stock of the Seamless Rubber Company was nothing more than a sale by the affiliated group of its own capital stock. The entire proceeds from the sale of this stock represented additional capital to the affiliated group—the investment of the new stockholders who purchased the stock. The sale was a capital transaction, which could not give rise to a taxable gain or deductible loss.”

Again in First Chrold Corporation v. Commissioner of Internal Revenue,[36] where a corporation purchased its own stock for less than the price at which it was issued, and retired it, the Circuit Court said the result was a taxable gain and not a mere change in the capital structure of the corporation. The court laid down a test as to whether a transaction by a corporation is a capital or an income transaction. It said.

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

Where, then, the purchase or sale by a corporation of its own stock is for the purpose of effecting a change in its capital structure, there is not a taxable gain or deductible loss. The Board of Tax Appeals, however, in one of its last decisions held there was a taxable gain where the company purchased and sold some of its own common stock with the object in view of purchasing its outstanding preferred stock. It did purchase the preferred and held it is treasury stock. With one exception the common was sold to holders of the preferred stock.[37] The same year, the newly organized Tax Court ruled that the purchase of a corporation’s own stock pursuant to an agreement to effect a permanent equal division of stock control, and the resale of the same stock two years later at an increased price, was a capital transaction and not one resulting in a taxable gain. The court said the operation was not one that could have been effected by dealing in the stock of another corporation; that the purchase of other cor-

[37] 21 F 2d 160 (1927).
porate securities would not have equalized the stockholders' interests in the company. In *Cluett, Peabody & Co.*, treasury stock was sold to shareholders in readjustment of capital. This treasury stock had been acquired a year earlier for use in a profit-sharing plan with its employees. The plan was given up. The court said the real nature of the transaction was not the same as a sale of the shares of another corporation and the company did not realize a taxable gain. In *The M. Conley Co.* case, the corporation purchased its own shares from some of its own stockholders in carrying out its policy of keeping ownership in the hands of persons interested in the company, namely, officers and employees. It sold to its officers and employees at a profit. The Court here said it was dealing in its own shares as it might deal in the shares of another corporation and it realized a taxable profit on the sales. The court, in distinguishing the case from the *Dr Pepper* and *Cluett, Peabody* cases, said the real nature of the transaction here was not one of capital adjustment.

That the purpose of the transaction is determinative in these cases is further emphasized by the court in *Rollins Burdick Hunter Co.* There, pursuant to an agreement with its shareholders, the company purchased its own stock to keep it in the hands of officers and those rendering personal services to the corporation. Stock was to be held in proportion to the relative abilities of those contributing services to the company. The purchases and sales were for the purpose of readjusting the stock ownership to conform to this agreement. The court held it did not give rise to a taxable gain under section 22(a) and Treasury regulations.

Closely related to the subject of stock purchases and sales for capital readjustments is the matter of purchases and sales for carrying out profit-sharing agreements with company employees. The Chrysler Corporation, in compliance with a plan to distribute stock to its employees, sold 60,000 shares of its stock to a trust set up to carry out the distribution. The sale was made for eight points below the market price in order to protect the trust against future depreciation in market value. The company was allowed to deduct the difference between the market value and the price the stock was sold for to the trust in 1929. This difference was additional compensation to the

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38 *Dr. Pepper Bottling Co. of Miss.*, 1 TC 80 (1942).
39 3 TC 169 (1944).
40 5 TC 250 (1946).
41 9 TC 169 (1947).
42 42 BTA 795 (1940).
employees and deductible as such. The same view of a similar situation was taken by the Board of Tax Appeals in 1928. It allowed a deduction of the difference between the price paid for stock and the price it was sold to employees, as a wage deduction.\textsuperscript{43}

In a fairly recent case, \textit{Commissioner of Internal Revenue v Batten, Barton, Durstine & Osborn, Inc.},\textsuperscript{44} an advertising company issued all its stock to its officers and employees. The purchasers, as part of the agreement, donated one-fifth of the shares bought to the company to hold in the treasury for sale to other employees who should demonstrate their worth to the corporation. The purpose was to bind the employees as firmly as possible to the company. The company retained the right to repurchase the stock when an employee left its employment. Stock held by the company was not carried on its books or balance sheets as an asset and no dividends were declared on it. The Circuit Court sustained the commissioner’s position that the company was dealing in its own stock as it might deal in stock of another corporation and held it for a deficiency assessment on the difference between the buying and the selling price. Judge Swan dissented on the ground that the taxpayer was not dealing in its own stock here as it might deal in the stock of another corporation.

\textbf{Summary}

We have seen that there are different views as to just what the status of treasury stock is. Some have regarded it as property, an asset of the corporation; some as Judge Hand pointed out, treat it as held in suspense and some as though retired. One authority says that upon the purchase of the stock by the company, the contract is extinguished and when treasury stock is sold a new contract is made, a new interest in the company created. He says that the fiction that there is a sale of shares already issued is used to get around the “wooden requirement that par value shares must be issued at par at all times.” It has also been said that treasury stock cannot be voted, nor draw dividends, and that it is in fact “lifeless, without rights and powers.” Accountants frequently treat treasury stock as “issued and outstanding” and include it in the corporate balance sheet.

Such stock is generally considered as outstanding within the meaning of franchise tax statutes and included in computing franchise taxes.

\textsuperscript{43} Haskell & Barker Car Co., 9 BTA 1037 (1928).
\textsuperscript{44} 19-1 USTC Par. 9117, reversing 9 TC 448 (1947).
When it comes to the question whether a corporation must pay a federal income tax on gains derived from the purchase and sale of its own stock, the corporation's right to deal in its own stock demands attention. England and a minority of states in this country regard such a transaction as *ultra vires* but do recognize the right of a corporation to take its own stock as collateral or in settlement of a prior, bona fide claim, to prevent loss. The great majority of American jurisdictions do recognize the right of a corporation to deal in its own stock. The Board of Tax Appeals first took the view that a gain from such a transaction was not taxable and a treasury regulation followed the holding of that decision. The transaction in that case was really a capital transaction and the taxpayer was seeking a deduction for the loss it suffered in the deal. A few years later the courts refused to follow this early decision and held that where a corporation bought and sold its own stock, gains were taxable and losses deductible. The treasury regulation had in the meantime been amended to include such transactions. Where, however, the purpose of the purchase and sale is for capital readjustment, no tax is due. The method of acquiring the stock is not necessarily determinative. The corporation may take its own stock in payment or part payment in the purchase of property or give it in settlement of a claim against it. Such transactions give rise to a taxable gain or a deductible loss. The Circuit Court has repeatedly so held.

The courts have said that "capital transactions" are not taxable. Such a transaction is for the purpose of making a readjustment in the capital of the corporation. An instance of this is where one member of an affiliated group sells its shares to another member of the same group. It also might be that purchases and sales are made for the purpose of keeping the company's stock in the hands of its officers and employees. Such would be a capital transaction. However, in profit-sharing schemes with employees, the corporation might be allowed a deduction for its loss in such a case on the ground that it was a payment of wages. In a recent case the court has held that the purchase and sale of its own stock from and to its employees was a dealing in its own stock as it might deal in the stock of another corporation and therefore subject to a tax.