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Stock Dividends

An Analysis of Some of the Major Obstacles

By BENJAMIN GRAHAM

IN our previous article we have indicated some of the obvious tax advantages that might accrue to the investor if more corporations paid dividends in stock instead or as well as in cash, provided that this policy were thoroughly explained—to the public and accepted as normal by the financial community.

Corporations which need large sums for capital development, as most do today, are caught on the horns of a dilemma with respect to dividends. If they conserve cash, and make small dividend payments, the investor obviously suffers as regards return. If, on the other hand, they pay generous cash dividends, and then come back into the market for capital the shareholder may be scarcely better off. He will pay a high income tax on the dividend received, and if he then subscribes to the new capital issue he will be just where he was before, *minus* the tax. In the case of many utilities, and in the dramatic case of A. T. & T. in particular, we showed that this needless shuffling of funds back and forth between company and shareholder has been enormously expensive over the years.

There is, therefore, a prima facie case for the use of stock dividends which avoid giving this unnecessary hostage to the Federal Treasury. But, if this practice is to spread, it will have to receive much more general public acceptance than is the case today. In this concluding article we will examine some of the obstacles to stock dividend policy, first from the point of view of the law and, secondly, from the point of view of the corporation and its owners.

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As to the law, it is well-known that dividends paid in stock (on a basis which does not change the relative position of each shareholder) are not subject to income tax. This was the ruling of the U. S. Supreme Court in the famous case of Eisner versus Macomber in 1920. The Court found that an ordinary stock dividend is not income within the meaning of the Constitution as amended, because it neither gives to the shareholders anything that they did not already have nor takes anything from the corporation. It merely re-divides stockholders' equity into more parts than before, in the same manner as is done by a reduction in par value or other stock splits.

The non-taxability of the *ordinary* stock dividend is thus firmly established in law, logic and practice. However, one may properly ask whether a program of stock dividends adopted in place of a previous combination of cash dividends, plus stock offerings, would be regarded as a device to avoid the second or personal tax on corporate earnings. When the philosophy of the present tax law is examined the answer is found to run quite the other way. The present practice of paying cash dividends and then selling stock is in fact a *device to subject earnings to double taxation when they should be taxed only once.*

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The present scheme of taxation—good or bad—imposes three kinds of taxes on corporate profits, viz: 1. Corporate earnings are first subject to the corporate income tax. 2. Earnings paid out to stockholders are then subject to the personal income tax. 3. Earnings improperly accumulated—i.e., retained by the corporation for the purpose of evading the payment of personal income tax by shareholders—are subject to a penalty tax under Section 102 of the Internal Revenue Code.

The purpose of these provisions should be clear. Earnings properly retainable by a corporation, and so retained, are subject only to corporate tax; earnings not properly retainable by a corporation are subject to a double tax, whether or not actually paid out in dividends. The courts have held that earnings are properly retainable if they are used to expand the business.

It is an evasion of the tax law to retain earnings not needed in the business in order that stockholders may be spared personal income tax thereon. But, conversely, the purpose and provisions of the tax law are complied with when earnings are retained for expansion. If an expanding business pays out cash dividends and then takes the equivalent money back from its stockholders for new stock, it is going out of its way to subject the profits to double taxation. Furthermore, it is thereby reducing its own ability and that of the American economy to finance the expansion needed to maintain full employment. Thus we are led to conclude that one of the most vital tax reforms from the standpoint of encouraging business expansion does not require governmental action or change in the tax laws, but can be initiated by business itself by a change in its dividend and financing policies.

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Turning from government to management we find that the latter should clearly favor the payment of stock dividends rather than cash dividends when their corporate financing needs are large. The problem of paying adequate dividends and financing plant expansion has become increasingly serious, in view of the sharp increase in the sum total of corporate indebtedness and the accompanying rise in the cost of borrowing. Moreover, as we indicated in our previous article, a regular stock dividend policy is certainly no more burdensome to administer than the policy of cash dividends, plus regular offerings of subscription rights.

Management, of course, plays the key role in establishing a successful stock dividend program. The plan should call for systematic distributions representing current or recently accumulated earnings. As a corollary to the above, the market value of the stock should be taken into account when declaring a stock dividend. In the 'twenties, when stock dividends were popular, distributions tended to be much too high relative to earnings. (In 1929, for example, the regular quarterly stock dividends of 2½% paid by North American Co. had an aggregate market value of $12.70 per share, while the year's earnings were only $5.03 per share.) Excessive liberality discredited the stock dividend concept in the past and must be avoided in the future. Finally, large stock dividends, purporting to represent the "distribution" of accumulated surplus, have no sound place in financial practise. An increase in the number of shares and the reduction of their market level should be accomplished by *split-ups* having no connotation of a dividend.

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Above all, however, managements must be clear as to what they are doing and explain matters thoroughly to their shareholders. For as investors view the matter today a stock dividend is not an adequate substitute for cash dividends. They are willing enough to take a stock dividend *in addition to* the regular cash payment, but in most cases the typical 5% extra declared in stock has much less of an effect on the market—i.e., on stockholders' thinking—than is produced by a more modest increase in the regular rate of distribution.

The chief reason for this is that stock dividends are *not* recognized by the market as part of the dividend yield. The example of Caterpillar Tractor Co., examined in our previous article, clearly illustrates this point. When Caterpillar Tractor sold at $60 and paid $3 in cash, its dividend yield was universally figured at 5%. When the rate was changed to $2 in cash, plus 4% in stock, the financial community had no adequate method of recognizing and evaluating the new policy. The newspapers and services cut the stated dividend rate down from $3 to $2, with a

VOICE OF THE MARKET

Members of the New York Stock Exchange proved last week that they can do some independent thinking. By a margin of 41 votes, out of over 1,100 cast, they turned down a raise in commission rates recommended by their Board of Governors. Some of the "Nays" undoubtedly reflected objections to specific provisions of the proposed new schedule. But predominantly, brokers appeared to have realized that higher charges are not likely to increase the volume of trading.

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buried footnote reference to a stock supplement. In the yield calculations, which are part of nearly all statistical presentations, only the cash rate is taken into account and the stock payment is also relegated to a footnote reference. Thus at its June 30 price of 52½ the yield on Caterpillar Tractor is given in Standard & Poor's Stock Guide at 3.8%, with the ambiguous addition of "also stock." Since the May 31 yield was stated at 5% on a price of 60, the change in dividend policy *appears* highly unfavorable.

There is here a paradoxical conflict between the views of investors *as a whole*—i.e., "the market"—regarding cash dividends and the personal interest and arithmetic of the *individual* investor. Recent surveys show clearly that most dividends are received by people who do not need the cash itself for living expenses, who pay a high rate of tax thereon, and who would much prefer capital gains to dividend income. A Harvard study published this year ("Effects of Taxation—Investments by Individuals," by Butters, Thompson and Bollinger) calculates that 75% of the stock held by private owners belongs to the top 3% of the spending units, and that 65% of all stock is owned by spending units with net worth in excess of $250,000. It states further that the top 5% of the income receivers is responsible for over 55% of the total annual savings. In other words, they do not have to spend their dividends, in spite of their heavy tax load. Complementing this study is that made by the New York Stock Exchange of stock transactions on March 18 and March 25, 1953. Information was assembled on the reasons for buying shares. The figures show, in substance, that only 16% of purchases are made for income return, about 33% for quick or short-term gain, and 51% for ultimate long-term gain.

These analyses suggest quite clearly that the typical investor wants cash dividends, not for the sake of spendable income, but rather "for the sake of his stocks." He knows that market prices are governed to a great extent by the cash dividend rate, and that the surest way to realize his coveted capital gain is by having the cash dividend raised. Conversely, he realizes that stock dividends are not a popular substitute for cash in the view of the market; and consequently he is himself opposed to such a substitution because it will hurt the price of his shares. Thus, we see that the representative investor wants his shares to pay taxable cash dividends rather than non-taxable stock dividends because that is what *other investors* want. The thinking of each individual is here shaped by the market—which is none other than the aggregate of these very individuals. This is a kind of vicious circle which operates as a formidable barrier to the introduction of newer and sounder thinking in the matter of dividend policy.

This barrier could, however, be partially overcome were corporations more explicit in their dividend declarations. Thus, in the case of Caterpillar Tractor, much confusion would have been obviated had the company explained its policy in some such terms as these: "Directors of Caterpillar Tractor have determined to revise their dividend policy in order to give the stockholders a larger evidence than heretofore of the company's earnings, and at the same time to conserve cash for substantial capital needs. The current dividend rate is being set at $4.30 annually, payable $2 in cash and $2.30 in the form of 4% in stock, valued at $57½ per share. It is the directors' views that the company's earning power, past and projected, will justify the $4.30 distribution rate. The stock-dividend portion of the total will represent earnings that are being reinvested in additional facilities, which in turn are expected to add to the company's future profits."

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We are far from asserting, however, that all that is needed to gain proper acceptance for a stock-dividend policy is the right kind of statement by the corporation at the time dividends are declared. The problem of educating stockholders, their advisers, investment services, and other significant agencies, to a proper evaluation of systematic stock dividends is one of major importance. We do not believe that a company could *today* successfully substitute stock dividends even for cash dividends plus repeated stock offerings. The matter would first have to be widely discussed in the financial community, and a general acknowledgment secured of the logic and advantage of the new approach. The second step would be taken by individual companies in advising stockholders of their intention to adopt a systematic stock dividend policy at a specified *future* date. The lapse of a fair amount of time, and the right sort of educational campaign in the interim, should together achieve adequate acceptance of the new policy by the stockholders.

An important additional area for education and change of practice lies in the legal, accounting, and "journalistic" treatment of systematic stock dividends. The financial community as a whole must be persuaded to treat stock dividends as the equivalent of a specified amount of cash, *to the extent that they are so denominated by the declaring corporation.* Thus, in our Caterpillar Tractor example, if the "new" dividend were specified as being at the annual rate of $4.30, payable $2 in cash and $2.30 in stock, then the newspapers and the financial services should designate the dividend in the same fashion. The basic difference would be that instead of calling the rate $2, with a footnote addition "plus stock"—as they now do—they would call the rate $4.30 with the footnote addition, "partly in stock." The dividend *yield* should be calculated on the basis of $4.30, instead of $2, as at present.

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If a stock dividend policy is to become more widespread, there would of course have to be a change in the accounting practices affecting all administered funds, and probably in the legal provisions governing trust funds. In the latter category it is the standard rule that stock dividends, even if regularly received and regularly disposed of for cash, do not constitute distributable income. Income beneficiaries from such funds would therefore suffer unless present practice, and probably present law, were changed. In the case of other administered portfolios—such as mutual trust funds, insurance company holdings, and funds managed by investment advisors—there is at present no standard procedure for handling stock dividends as the equivalent of cash dividends in calculating normal income or yield from the fund. This situation, however, could be changed if paying corporations clearly designate their stock dividends as equivalent to a specified amount of cash distribution.

An innovation of this basic nature may seem too heavy an assignment for the financial world to cope with. Maybe it is. But the question is well worth thinking over and arguing about, because there is something obviously foolish in paying out cash dividends subject to personal tax, and taking back the same money in payment for new stock. Hundreds of millions of stockholders' money can be saved annually by adjusting dividend theories and policies to present-day realities. No less important, a well defined cash and stock dividend policy might contribute powerfully to reconciling the real interests of the modern corporation with the interests and the desires of its shareholders.

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