Realization of income and separation from capital

The concepts of economic income and realized income have been subjects of controversy for a long time in corporate accounting and related areas. Those arguments have been repeated in a variety of forms, not only in attempts to reconsider the concept of income in the light of economic income but also in the related area such as taxation on corporate income and restrictions on dividend for the company law purpose. In this section, take a quick look at an early judicial precedent in US 6), as a clue to a review of the process of interaction of income concept and establishment of realization concepts.

The judicial precedent at issue is the case of Eisner vs. Macomber ruled by the US Federal Supreme Court in 1920. Although this case was originally a dispute over the provision of the Internal Revenue Code that deemed stock dividends as taxable income, it became a leading case that left a significant impact to posterity, in that it established the conceptual norms such as what constitutes income.

The court decision set out the interpretation of the realization concept that a mere increase in the value of capital is not enough to constitute income if it is not separated from capital, thereby denied that stock dividend is income. The court decision defined the income generated from capital as an inflow of goods that has been separated from capital and the recipient can independently use or dispose of, not a mere increase in the value of the capital. It pointed out that, whereas in case of cash dividends the shareholders acquire a property with exclusive ownership and can freely decide its disposal, stock dividend provides only an evidence of what the shareholders already holds. It also noted that the increase in the value of capital arising before the dividend should not be deemed as realization of income, as long as the shareholders do not have discretion to reinvest or consume it.

This was an attempt to describe the “inflow of cash or cash equivalent” test for realization of income, which had already been established with regard to taxation on capital gains, using more essential attributes. This rule, which deems the increase of the value realized separately from capital as income, tried to derive the accounting concept of realized income by adding the “availability for consumption” condition, whereas it started from the concept of economic income, that is, value increase arising on capital. However, separation from capital would not be necessary, if satisfaction of the “availability for consumption” condition were just enough. Even before the cash flow is realized, an increment in capital value is consumable through borrowing. Even though the increment is not separated from capital, capital is maintained as far as the surplus is consumed. It follows that the “availability for consumption” condition can be also met by economic income. Although stock dividend itself has nothing to do with the income of shareholders, the increase in the value of their interest, resulted from accumulation of earnings before that, should have brought consumable income to the shareholders.

Nevertheless, this court decision determined that the shareholders’ equity in retained earnings is capital, not income. The basic stance of this decision was that income is cash flow, not the expectation of it. Stock dividend was excluded from the income of the shareholders because it neither makes the company worse off nor the shareholders better off. A transfer of wealth involving cash flows (that is, realized income), not mere appreciation of capital value, was the element of income as defined here.

The above discussion reveals that the realized income as an accounting concept should be viewed as a concept conflicting with the economic income concept ab initio, rather than a subordinated concept derived from that. It was not a concept derived from the economic income by imposing an additional condition. Instead, it seems that realization as cash flows was regarded as a necessary condition from the beginning and that condition was explained by the concept of separation from capital. This means that economic income and realized income are independent concepts with different objectives and origins. Although they can be compared with each other, consistency between them cannot be expected.