The effect of the income and excess profits tax on the corporation surplus accounts

Joseph Robert Hilgert
State University of Iowa

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THE EFFECT OF THE INCOME AND EXCESS PROFITS TAX ON THE CORPORATION SURPLUS ACCOUNTS

By

Joseph Robert Hilgert

A Thesis Submitted in Partial Fulfillment of the Requirements for the Degree of Master of Arts

The State University of Iowa

1920
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FOREWORD

No Federal law passed within the last decade has caused so much discussion as the Income and Excess Profits Tax Act. This need not to be wondered at when one stops to consider that it affects all unmarried individuals whose net income is $1000 or more, and all married persons or "head" of families whose income is $2000 or more, as well as the various forms of business organizations. It is quite obvious that every one ought to have some fundamental concepts of the provisions of the law.

Prior to 1917, however, the income tax law was quite simple as far as it affected business organizations. However, when the Excess Profits and War Profits Tax was added, an additional tax was put on the corporations and the computation of the tax became quite involved. As the Excess Profits Tax is based on the net earnings of a corporation in relation to its invested capital, questions repeatedly
come up as to the accounting policies that might be pursued to lighten the tax burden.

In this dissertation the writer has attempted to show how the Surplus Accounts might be affected by the Income and Excess Profits Tax, and what the probable policy of corporations will be in order to accumulate large amounts of Surplus. In order to do this, it was necessary to give a brief history of the income tax legislation. There are certain dates in this connection that are significant in the computation of the tax.

Attempt has also been made to give the reader concepts of the fundamental terms, as Income, Deductions and Credits etc. This is followed by a detailed analysis of the excess profits tax in relation to the corporation and the effect of the tax on the Surplus Accounts.
THE EFFECT OF THE INCOME AND EXCESS PROFITS TAX
ON THE CORPORATION SURPLUS ACCOUNTS

INTRODUCTION

The Income Tax Law of the United States is quite a new institution when we consider the fact that the real income tax law of our country went into effect in 1913. However, the idea of taxing incomes goes back to the time of the Civil War.

In 1861 the people of the United States experienced the first income tax law which was amended from time to time until it was finally repealed in 1871. It rates were not very high. Notwithstanding, under this act $376,290,600.56 of revenue was collected which was paid by 276,661 persons.

The next income tax law was passed in 1894. It was very shortlived, however, as it was declared unconstitutional the following year on the ground that it was a direct tax which was in conflict with the Constitution. One of its most serious objections was that it did not
exempt the interest on state and municipal bonds. In this it placed an undue burden on the sovereign State and their municipalities.

Nearly two decades elapsed until another law taxing income was passed by Congress. This came in 1909 when Congress levied an excise tax on corporations which included joint stock companies or associations organized for profit and having a capital stock as well as insurance companies organized under the laws of the United States.

Notwithstanding the fact that this act was an excise law, it had some provisions like the income tax law in force at the present time. In computing net income, operating and maintenance expenses, including franchises, rentals, depreciation, and other losses not compensated for by insurance, were deducted from the gross income. This law is of little historical significance and has nothing to do with the later income tax laws.

The real income tax era of the United States began March 1, 1913. During this year the Sixteenth Amendment was added to the Constitution which gave Congress
the power to lay and collect taxes on incomes without regard to population apportionment. The first Income Tax Law was passed in October of 1913, but it was retroactive to March 1, as the Sixteenth Amendment was confirmed on February 28, 1913.

Under the 1913 Act, corporations as well as individuals were taxed on their net income. Partnerships were not required to report their income unless so requested by the Department of Internal Revenue. Demand for such a return might be made to enable the Internal Revenue Department to check the income of the individual partners. One very inequitable feature of the act was the provision which required a double tax on the dividends which passed from one corporation to another. For example, if the A. B. Co. had stock in the I. X. Co., and the latter company declared a dividend such a dividend was taxed. Then when the A. B. Co. distributed the dividend among its stockholders it was taxed again. Gross income less deductions constituted net income on which a normal tax was levied. Like the income tax laws which followed, interest on municipal bonds, and salaries of state and local officials were specifically exempted. Expenses
incurred in carrying-on the business and other outlays as taxes, interest paid on borrowed capital and losses sustained which were not compensated for by insurance, were allowable deductions. The normal tax rate was one per cent per annum and a graduated surtax on incomes of individuals in excess of $20,000. One of the significant provisions of the law was that of collecting taxes at the source. Income paid by corporations or persons to individuals in the form of rent, wages, or interest, in excess of $3000 or $4000 had to be deducted to the extent of 1% which was paid to the revenue collector or by the withholding agent.

After the European War was in progress for some two years our imports decreased to such an extent that the revenue from customs became seriously inadequate to meet the current expenditures of the government. With the right to tax income now established, Congress on September 8, 1916 repealed the 1913 Income Tax Law and enacted a new similar income tax law which provided for much higher rates than the 1913 Act. The normal tax rate was increased to from 1% to 2%, and the maximum surtax on incomes over $500,000 was increased to 13%.
Another important provision was the extension of the $4000 exemption to include "head of family" as well as married persons.

The need for more revenue caused Congress to amend the 1916 Income Tax Law on March 3, 1917. On this date the Excess Profits Tax Law was added which imposed a tax on corporations, joint stock companies or associations, insurance companies and partnerships. The rate was 8% of the net income in excess of the sum of $5000 and 8% of the actual capital invested and used in the business.

The entry of the United States into the World War on April 6, 1917 created additional demand for revenue. Therefore, on October 3, 1917, the Income Tax Law was still further amended, and the rates were increased. It was really a double tax. A person with an income of considerable size made out a single report but he paid, the tax as provided under the 1916 Act and also a tax as provided under the 1917 rates. The exemptions were reduced from $3000 and $4000 to $1000 and $2000 for single and married persons respectively.

The excess profits tax which was enacted March 3,
1917 was succeeded by the "War Excess Profits Tax. The function of this law was to impose a tax on income in excess of specified deductions and exemptions, graduated rates of tax according as the net income which fell within certain percentages of invested capital. The minimum rate was 20% on the amount of net income in excess of the allowable deductions and not in excess of 15% of the invested capital. The maximum rate of 60% was applied to income in excess of 33% of the invested capital.

It might be well to go a little more into detail in regard to the excess profits tax and the war profits tax. An excess profits tax is a tax on profits in excess of a certain percentage on the invested capital. For example, one corporation with an invested capital of $100,000 might earn $8,000, while another concern with the same amount of invested capital might have a net income of $20,000. The former earned profits at a rate of 8%; the latter at the rate of 20%. If a law should tax all incomes in excess of 8% of the invested capital, the latter concern would pay an excess profits tax while the former would not.
"The war excess profits tax is a tax on profits in excess of the profits earned before the war, with an allowance, of course, for increases in invested capital, the theory being that the increased earnings are due to the public's and the government's demands growing out of the war, which demands should not be turned to advantage without subjecting the owner of the business to heavy taxes."¹

The unprecedented government expenses of 1918 incurred in organizing and equipping the army and navy again called for an enormous amount of revenue. The Secretary of Treasury asked that a bill be passed which would yield $8,000,000,⁰⁰⁰. Congress, then, began to work out an income tax law that would be adequate to produce the desired amount, and at the same time eliminate some of the inequities of the income tax law which was then in effect. The income tax law which followed was approved February 6, 1919, but was retroactive to January 1, 1918.

Both the income and the war excess profits rates were increased considerably. Partnerships and personal service corporations were exempted from the income and

Prentice-Hall Tax Service, 1919, p. 6
excess profits tax. These organizations have to make out an income tax return, showing the details of their net income; but they pay no income tax. The shareholders and stockholders are taxed upon the earnings according to the amount each one receives whether the net profits be withdrawn from the business or not.

For individuals the normal tax for the calendar year 1919 was six per cent on the first $4000 of net taxable income, and 12 per cent upon the amount in excess of $4000. For the calendar year of 1919 and subsequent years, the rate was four per cent of the first $4000 and eight per cent on the amount in excess of $4000. In addition to the normal tax there is a graduated surtax on the net taxable income of individuals, ranging from one per cent of the amount of the net taxable income in excess of $5000 to 65 of the amount by which the net taxable income exceeds $1,000,000. For detailed graduated surtax rates, see table below.

### SURTAX RATES FOR 1918-19.

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<th>Rate.</th>
<th>Total surtax on each amount.</th>
<th>Amount of net income.</th>
<th>Rate.</th>
<th>Total surtax on each amount.</th>
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The income tax on corporations is at the rate of 12 per cent of the net income for the calendar year of 1918, and 10 per cent for 1919 and subsequent years.

The War-Profits and Excess Profits Tax for the calendar year of 1918 was computed under three brackets as follows:

First Bracket—30 per centum of the amount of the net income in excess of the excess profits credit and not in excess of 20 per centum of the invested capital;

Second Bracket—65 per centum of the amount of the net income in excess of 20 per centum of the invested capital;

Third Bracket—The sum, if any, by which 80 per centum of the amount of the net income in excess of the war profits credit exceeds the amount of the tax computed under first and second brackets.¹

For the calendar year of 1919 and subsequent years, the rates for the First Bracket were 20 per cent; for the Second Bracket, 40 per cent. The Third Bracket is omitted after 1918.

The excess profits tax, as has already been shown, varies with the amount of invested capital as well as with the net earnings. If the earnings are small in

¹ 1918 Law, Sec. 301
in proportion to the invested capital, there will be a corresponding large excess profits credit and a proportionately smaller excess profits tax. If on the other hand, the profits are large in proportion to the invested capital, there will be a small excess profits credit. Hence the excess profits tax will be relatively large. The Internal Revenue Department recognizes a reasonable allowance for depreciation. However, the charging of depreciation is optional, and no allowance need be made in computing the income and excess profits tax. Depreciation expense will reduce the valuation of the assets and thus lessen the proprietary equities which constitute the invested capital. However, the income tax for the year in which it is paid will be reduced by charging depreciation. For the year in which the income and excess profits tax is paid, the amount of the excess profits tax is not reduced by omitting to charge depreciation. However, for the ensuing year, there will be a larger invested capital if the depreciation expense was omitted during the preceding year. It is the purpose of this thesis to determine what the probable policy of corporations will be in regard to extending the invested capital, and whether the surplus accounts will be increased or diminished.
With the history of the income tax laws given, we are ready to make an analysis of "income", "deductions", and "credits" as provided by the 1918 Act.

Every person receiving a net/income for the taxable year of 1918 and thereafter in excess of $1000, and who is not entitled to any of the stipulated exemptions as provided in the Law, must pay the normal income tax at a rate of 4% per annum on the first $4000, and 8% per annum on any amount in excess of $400. If his net taxable income exceeds he is also subject to a graduated surtax as stated in a previous paragraph.

For the purpose of computing the normal tax there are certain credits which may be deducted. Among these are personal exemption, dividends received from a corporation and dividends received from a personal service corporation which pays an income tax; and the amount received as "interest upon obligations of the United States and bonds issued by the War Finance Corporation which is included in the gross income under Section 213."¹

The exemption for a single person without dependents is $1000. However, if a single person is "head" of a family, his exemption is $2000, the same as in the

¹ Section 216, 1918 Law
case of a married person living with husband or wife. For each child under eighteen years of age, a "head" of a family or husband or wife is entitled to $200 additional exemption. If those persons living with him in the same house have some source of income they not a sufficient amount to support themselves wholly, the exemption claim of $200 is not interfered with.

The term "net income" as applied to individuals means the gross income as defined in the Income Tax Law, Section 213, less deductions allowed by Section 214.

"Gross income", less certain items of income specifically exempt by the Law, minus the allowable deductions results in "net taxable income." The Normal Tax is imposed on the "net taxable income" LESS/credits, while the Surtax is assessed on the"net income". The following items are specifically exempt and are not included in gross income:

"The proceeds of life insurance policies paid upon the death of the insured to individual beneficiaries or to the estate of the insured;

"The amount received by the insured as a return of premium or premiums paid by him under life insurance, endowment, or annuity contracts,

1 A person is "head" of a family if he is the sole support of close relations (by blood, marriage or adoption) living in the same house with him and looked upon by them to exercise a greater or less amount of control in the matters of affecting the support and maintenance of the household. GEN LETTER NO. 1, INTERNAL REVENUE CORRESPONDENCE SERVICE.
Either during the term or at the maturity of the term mentioned in the contract or upon surrender of the contract;

"The value of property acquired by gift, bequest, devise, or descent (income derived from this property is taxable; likewise, if property is sold, the excess selling price over the value at the time the gift was received (or March 1, if received prior thereto) is taxable;

"Interest upon the obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia;

"Interest upon securities issued under the provisions of the Federal Farm Loan Act of July 17, 1916;

"Interest upon the obligations of the United States issued prior to September 1, 1917, or its possessions;

"Interest upon bonds issued by the War Finance Corporation: Provided, that every person owning any of the obligations, securities or bonds enumerated above shall in the return required by this title, submit a statement showing the number and amount of such obligations, securities and bonds owned by him and the income received therefrom, in such form and with such information as the Commissioner may require."

Section 213, 1918 Law.

Thus, it will be seen that as the title of the law indicates, the tax is imposed on income. In a broad sense income "means all wealth which flows in to the taxpayer other than as mere return of capital."¹ It includes the forms of income specifically described as gains and profits, including gains derived from sale or other disposition of capital assets.² Income is not limited to cash, because the statute recognizes other factors of income, such as increase in inventories, accounts receivable etc.; and property exhaustion and accounts payable for allowable deductions.

¹ Income Tax Regulations 45, Art. 21
² ibid 21
To be more specific, "gross income" includes gains, profits, wages and compensation for personal service, such as fees of professional people lawyers, physicians, dentists etc. In general, then, income includes interest, rent, dividends or profits from any source whatever.

Next will be taken up in a general way the allowable deductions. Under this heading is included all reasonable items of expense that are incurred in the taxable year in carrying on a business. This includes reasonable amounts paid for salaries, wages, rent, insurance etc.; interest paid or accrued during the taxable year on borrowed capital, (except "on indebtedness incurred or continued to purchase or carry securities, such as municipal bonds, the interest upon which is exempt from tax, (other than U. S. bonds issued after September 24, 1917; business losses sustained that were not covered by insurance; debts found to be worthless; a reasonable amount for depletion of mineral deposits, gas and oil wells, including depreciation on the equipment in the mines and wells; and charitable contributions and gifts made within the taxable year to an aggregate amount not in excess of 15 per cent of the taxpayer's net income.
Depreciation is quite an important item among the deductions and needs to be clearly understood in order to follow the letter and spirit of the Income Tax Law. Any article or property used in business or otherwise, whether in use or idle will decrease or shrink in value, (barring of course, the present market price fluctuations), and a certain amount must be set aside from year to year in order to make the replacement of the asset when it becomes worn out.

The Internal Revenue Department allows reasonable charges for wear and tear and obsolescence of property used in business. The Revenue Act is based upon the economic fact that depreciation is a legitimate expense and must be recognized in order to keep the finances of a business on a sound basis. It also allows deductions to be made annually for obsolescence, for new inventions and discoveries have the tendency of making appliances and equipment worthless long before they become exhausted. However, depreciation does not include all economic losses that property used in business might suffer. Depreciation is limited to the loss in value of business property that
is caused by natural disintegration and wear and tear. To illustrate, if a business building suddenly depreciates seriously in value on account of certain business which is taken to some other part of the city, no more than the normal depreciation can be deducted in the income tax return.

There are several methods of computing depreciation. The Internal Revenue Department does not stipulate which method should be used. The "Straight line" method is probably the most practical for charging off depreciation for income tax computations. When this method is followed the first thing to be done is to determine the residual value of a unit of property at the time when it will not be fit for further use. Make an estimate of the life of the unit of property. From the cost of the property, deduct the salvage value, and then divide the remainder by the number of years it is estimated to be of value to the business. The quotient will be the amount that can be annually be charged for depreciation. This method of computing depreciation might be illustrated with a simple item of property as a typewriter. Assume the cost to be
$100; the estimated life of the machine for business purposes five years, and the salvage value $10. In this case the correct annual charge to depreciation would be $18. At the end of five year the machine will sell for $10 and the amount set aside in the reserve will be $90. With these two amounts sufficient funds will have been provided to replace the machine.

The losses, in order to be accepted by the Internal Revenue Department "must usually" be evidenced by closed and completed transaction. The Internal Revenue Department defined on August 3, 1917 a "closed and completed transaction as one in which an asset is disposed of for cash, or at a fixed or determined value."

To illustrate the "closed and completed transaction", we might take stocks and bonds which have shrunk in value thru market changes. Until they are sold no loss can be claimed even tho a loss apparently exists.

Up to this point a general application of the Income Tax Law as it applies to income of individuals has been taken up. The following paragraphs of this chapter will take up the corporation in relation to
the income and excess profits tax.

"Corporation" as defined in Section 1, in the Revenue Act of 1918, includes "associations, joint-stock companies, and insurance companies." The law does not specifically state what forms of organization the term "corporation" embraces. The Commissioner of Internal Revenue by virtue of the authority conferred on him by the law, in Section 1309, sets forth in Regulations 45, Articles 1502 and 1508 what forms of organization the terms "association," "joint-stock company," and "insurance company should include. "Associations and joint-stock companies include associations, common law trusts and organizations by whatever name known, which act or do business in an organized capacity, whether created under and pursuant to state laws, agreements, declarations of trust, or otherwise, the net income of which, if any, is distributed or distributable among the members or shareholders on the basis of the capital stock which holds or, where there is no capital stock, on the basis of the proportionate share or capital which each has invested in the business or property of the organization."¹

¹ Income Tax Regulations 45, Art. 1502.
The Supreme Court of the United States on March 17, 1917 reversed the decision of the U. S. Circuit Court of Appeals in the case of Malley V. Crocker and held that a Massachusetts trust was not an association.

The term "insurance companies" includes mutual companies and mutual benefit insurance companies. It does not, however, include voluntary unincorporated associations of employees which are for the purpose of assisting sick and aged members.

As already mentioned, the Revenue Act of 1918 imposes an income tax and an excess profits tax on corporations as defined in a previous paragraph. A detailed discussion of the excess profits tax is given in Chapter III.

Every domestic corporation, unless exempt under Section 231, is subject to the income tax, even though it receives no income from sources within the United States. Like individuals, the corporation is taxed on its net income. "Net income" means gross income as defined in Section 233, less the deductions allowed by Section 234 of the Revenue Act. In general, the

1 Income Tax Regulations 45, Art. 1508
net income of corporations is determined in the same way as the net income of individuals, except that life insurance companies do not have to include in their gross income such portion of any actual premium paid in by a policy holder which is paid back or credited to him to lessen the premium of such policyholder within the taxable year. In a few minor respects the deductions allowed a corporation are different from those allowed individuals. For instance, donations made by corporations are not an allowable deduction. On the other hand corporations may deduct the amount received as dividends from other corporations providing those concerns from whom the dividends are received have paid an income tax.

The income tax is imposed on the net income less the credit as provided in Section 236, and 238.

The credits provided for in the above sections are as follows: "The amount received as interest upon obligations of the United States and bonds issued by the War Finance Corporation" which is included in gross income under Section 223; and the amount which is paid as excess profits tax for the same taxable
year. In addition to this, an exemption of $2000, the same as a personal exemption for a married person is allowed.

The income tax for 1918 as already stated was 12 per cent per annum, and for 1919 and subsequent years, 10 per cent per annum.
II

The definition of a corporation in relation to the income and excess profits tax has already been discussed. The methods of taxing a corporate concern have been briefly given. In the present chapter the organization of a corporation insofar as it relates to the income and excess profits tax will be considered.

Assets for various reasons are grouped under many different headings by accountants. In connection with the computation of the income tax it will probably be most practical to arrange assets into two groups: fixed and current assets, and tangible and intangible assets.

The fixed tangible assets represent such durable items as, land, machinery, buildings and plant equipment. A large portion of the capital of a business enterprise is invested in this type of assets. These property items remain a part of the invested capital for a number of years, and they constitute the productive equipment of the business.
Some of the equipment, however, consists of items of a less durable nature, such as small tools, and other articles of a similar character which are practically consumed each year. These are current assets. It is important that a distinction be made between these two types of assets for, the Internal Revenue Department allows a reasonable amount for depreciation on fixed assets, while those articles used up within a year or less are charged to expense.

In order to make proper allowance for depreciation each year it is necessary that there is a record on file showing the date of purchase of each asset and its estimated life. This is of special importance in connection with units of assets in which a fairly good sum of capital is invested. Some assets depreciate more rapidly than others. An adding machine or typewriter will depreciate much more rapidly than a safe, office desk, or bookcase. A similar situation would be found in a factory where various kinds of equipment is used. By keeping an exact record as to the date of acquisition of the large units of assets, and knowing the estimated life of each, no difficulty should be experienced.
in estimating depreciation. Not only will such data facilitate the work of making out an income tax return, but it is necessary to have such information for, the Internal Revenue Department requires that such a schedule be submitted in the form of a property schedule, when the income tax return is made.

On the other hand it is possible to distribute the earnings of a business more equitable from time to time by charging off depreciation annually on an intelligent basis. Funds for making replacements of the assets will be on hand and the annual dividend will not be interrupted.

The intangible assets consist of patents, copyrights, goodwill, franchises, trade-marks etc. The value of these assets depends on their earning power. Very frequently this class of assets is over-capitalized for one reason or another. This is particularly true of goodwill. Very often when a concern issues securities beyond the actual valuation of its assets the amount of the discrepancy is represented by the goodwill. This is altogether illegitimate and goodwill in such cases becomes fictitious.\(^1\)

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1 Paton & Stevenson, Prin. of Accounting, p. 532
In computing the income tax the question of depreciation on intangibles comes up. As mentioned in the preceding paragraph the value of an intangible asset is in its earning power. Some of them usually remain productive only for a limited time, as a patent, or copyright for instance. The right to these assets are limited by the government to a definite number of years. The question then arises, how much depreciation shall be charged off annually for depreciation in the case of intangibles? The Internal Revenue Department allows depreciation on intangibles which were secured by capital outlay, provided it is known from experience that the asset in question is of value to the business only for a limited period, and the length of which can be estimated from experience with reasonable certainty. Even in such cases the depreciation is not allowed, unless the facts are fully shown in the return or prior thereto to the satisfaction of the Commissioner of Internal Revenue. The fixed liabilities consist of obligations that run longer than one year. Typical examples are bonds, long-term notes, and mortgages etc. The most convenient and popular way of financing

Treasury Decision No. 2929, of Internal Revenue Department
American corporations issue means of issuing bonds. The capital raised by issuing bonds range all the way from 15% to 40%. There are many different kinds of bonds. Most of them draw a fixed rate of interest. They are contractual equities. The same is true of other long-term securities previously mentioned.

The significance of the discussion of liabilities in relation to the income and excess profits tax is simply this: interest paid on liabilities is an allowable deduction; but for the purpose of determining the excess profits credit none of the liability items, regardless as to whether they are current or fixed, can be included in invested capital. A full discussion of the invested capital is given in Chapter III.

The proprietary interests in the case of a corporation are represented by capital stock and surplus or deficit accounts. Surplus is the difference between the net worth of a business and the par value of the capital stock outstanding. Deficit is a negative surplus, and represents the amount by which the par of the capital stock exceeds proprietorship.

With the assets of a corporation briefly surveyed in relation to the income-tax, an analysis of the equi-

1 Kester, AUDITING THEORY AND PRACTICE, p. 362
ties will next be considered. "The equities like the asset items may have a variety of forms." ¹ "Equities" is used in the place of "liabilities" to denote those items appearing on the right side of the balance sheet. The equities naturally fall into two groups in relation to the investors of a business enterprise: Those interests which have immediate control of the policies of the concern, and those investors who have indirect or remote control of the management of the particular business. The former have a proprietary interest, which is in the form of capital stock, including common and preferred, and accumulated earnings that have not been distributed; this class assumes the greater risk and shares the residual income. The latter class have a smaller element of risk to bear and they have a contractual right to income. They represent the liabilities of the concern and receive a fixed rate of interest on their investment before the proprietary investors share any of the earnings.

"Liabilities may be conveniently grouped into fixed and current items." ² Every concern has those liabilities which consist of accounts payable and notes payable.

1 Paton & Stevenson, Prin. of Accounting p
2 Paton & Stevenson, Prin. of Accounting P. 314
These obligations run only for a short time, less than a year. They are not secured by any of the assets of the business, and are retired with cash or an equivalent.

Before any of the profits are distributed to any of the equities discussed, such obligations as wages payable, and rent must first be met. These are equities in a way, but not to the extent that their claim represents an investment. It is customary to retire these debts soon after the books are closed. When these claims have been paid, the contractual equities are paid. The residual revenue remaining belongs to the proprietary equities. If sufficient profit for distribution is available the directors of the enterprise may declare a dividend for a portion of the profits and put the remainder into the Surplus account. The Surplus thus remaining in the business is found under various names, as undivided profits, reserve for contingencies etc.
ANALYSIS OF INVESTED CAPITAL FOR DETERMINING EXCESS PROFITS CREDIT

III

As already mentioned in Chapter I, the excess profits tax is computed in two brackets by application of progressive rates upon successive portions of income, after allowance for the specific exemption and excess profits credit has been taken. The expression "invested capital" in relation to the excess profits tax is not synonymous with the meaning of that term as it is used and understood by the business man. "Invested capital" in this relation has quite a technical meaning. It is the purpose of present chapter to make a careful analysis of invested the capital of corporate concerns in relation to the determination of the excess profits credit.

The excess profits tax for the taxable year is based on the same taxable income as the income tax, except, that in computing the excess profits tax the law provides in Section 236 that the following credits which are permitted in the income tax computation shall not be allowed:

(a) interest on obligations of the United States and the War Finance Corporation, which is subject to the excess
tax, (b) excess and war profits tax, (c) the income tax specific exemption of $2000. The main difference between these two methods of taxation is that the income tax is based solely on income, while the excess profits tax taxes income; but it is based on invested capital. Before the excess profits tax becomes operative, an excess profits credit is deducted which is 8% on the invested capital, plus $3000. That is, the excess profits tax is computed on the net income in two brackets as previously stated. However, the excess profits tax is a tax on earnings which are in excess of 8%, plus $3000. The law assumes that this exemption is a fair return and no excess profits tax is assessed if the net earnings do not exceed this exemption. This form of tax is not concerned with the amount of net earnings a corporation receives during any year, whether they be $10,000 or $30,000, so long as they are not more than 8%, plus $3000 on the invested capital as defined in the subsequent pages of this chapter. It is entirely possible for a corporation to pay a sizable income tax and at the same time pay very little excess profits tax. Such a situation is quite common with financial institutions, as banks where
the net earnings do not run very high. The point at issue can be conveniently illustrated by taking three hypothetical cases with an invested capital of $100,000; $90,000; and $80,000 respectively.

<table>
<thead>
<tr>
<th>COMPANY</th>
<th>Invested capital for taxable year</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>Net Earnings (this is 20% of invested cap.)</td>
<td>20,000</td>
</tr>
<tr>
<td></td>
<td>Specific credit</td>
<td>$3,000</td>
</tr>
<tr>
<td></td>
<td>Credit of 8% on Inv. Cap.</td>
<td>$8,000</td>
</tr>
<tr>
<td></td>
<td>Net Taxable income</td>
<td>$11,000</td>
</tr>
<tr>
<td></td>
<td>First Bracket 20% of $9000--</td>
<td>$1,800</td>
</tr>
<tr>
<td></td>
<td>Second Bracket. There is no tax because the net income is only $20,000, which is not in excess of 20% of the invested capital, $100,000.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>COMPANY</th>
<th>Invested capital</th>
<th>$90,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>B</td>
<td>Net Earnings (20% of invested capital)</td>
<td>20,000</td>
</tr>
<tr>
<td></td>
<td>Specific credit</td>
<td>$3,000</td>
</tr>
<tr>
<td></td>
<td>Credit of 8% on inv. cap.</td>
<td>$7,200</td>
</tr>
<tr>
<td></td>
<td>Net Taxable income</td>
<td>$7,800</td>
</tr>
<tr>
<td></td>
<td>First Bracket. 20% of $7,800--</td>
<td>$1,560</td>
</tr>
<tr>
<td></td>
<td>Second Bracket. 40% ($20,000 - 18,000)</td>
<td>$800</td>
</tr>
<tr>
<td></td>
<td>Total tax</td>
<td>$2,360</td>
</tr>
<tr>
<td>C COMPANY</td>
<td></td>
<td></td>
</tr>
<tr>
<td>----------------------------------------------</td>
<td>-----</td>
<td></td>
</tr>
<tr>
<td>Invested capital for taxable year</td>
<td>$80,000</td>
<td></td>
</tr>
<tr>
<td>Net Earnings</td>
<td>20,000</td>
<td></td>
</tr>
<tr>
<td>20% of invested capital</td>
<td>16,000</td>
<td></td>
</tr>
<tr>
<td>Specific credit</td>
<td>$3,000</td>
<td></td>
</tr>
<tr>
<td>Credit of on inv. cap.</td>
<td>6,400</td>
<td></td>
</tr>
<tr>
<td>Net Taxable income</td>
<td>6,600</td>
<td></td>
</tr>
<tr>
<td>First Bracket. 20% of $6,600</td>
<td>$1,320</td>
<td></td>
</tr>
<tr>
<td>Second Bracket. 40%($20,000-16,000)</td>
<td>1,600</td>
<td></td>
</tr>
<tr>
<td>Total tax</td>
<td>$2,920</td>
<td></td>
</tr>
</tbody>
</table>

It is evident that in concerns where the earnings are equal, the excess profits tax varies as the invested capital varies.

MEANING OF INVESTED CAPITAL

According to the statute, invested capital is the "capital actually paid in to the corporation by the stockholder, including Surplus and Undivided Profits. It includes (a) "the cash paid in for stock, (b) the tangible property paid in for stock, (c) the Surplus and Undivided Profits, and (d) the intangible property paid in for stock (to a limited amount), less, however, the same proportion of such aggregate sum as the amount
vested capital is not based on the present worth of the assets at any given moment, nor on the fair market value as of March 1, 1913. It is very obvious then, that invested capital can not be ascertained by an appraisal. Current valuation of assets cannot be taken into account in determining invested capital as appreciation is not allowable. The basis for valuing assets is cost. Appreciation cannot be recognized in invested capital unless there has been a sale or transfer of assets to a new owner of 50% or more of the original assets. This case of transfer of assets would take place in the reorganization, or consolidation of a trade or business. The law assumes that in case there has been no sale to an outside interest, there has been no realization of the increases in values; that without a bona fide realization there can be no trustworthy measure of the alleged appreciation.

However, if the assets of a concern have been written down to a point below cost less reasonable depreciation, or if additions or new buildings have been charged to maintenance, the assets may be revalued and their value

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1 Income Tax Regulations 45, Art. 831
2 Letter to J. W. Rourke, New from Commissioner Roper of Internal Revenue Department, July 15, 1919.
3 1918 Law, Section 331.
may be increased to the point of cost or cost of construction, plus any additions or betterments, less proper charges for depreciation up to the time of its revaluation. Such a valuation brings up the value of the assets to the point where they reflect cost less reasonable depreciation. The amount by which the assets are increased may be included in invested capital.

The proper starting point for the calculation of invested capital is at the beginning of the year. The amount of the invested capital is the aggregate of the entire capital stock, surplus, and undivided profits as shown by the books of account. This includes all reserve accounts that are appropriated to surplus, such as reserves for various contingencies and, in general, all reserves which have not been allowed as income tax deductions. In this connection it is important to note that invested capital is computed as at the beginning of the taxable year and not at the close of the year.

Invested capital on the other hand need not be reduced beyond the amount originally paid in, except where there has been a liquidation or return of investment to stockholders. In as much as deficits are usually treated
in effect as a deduction from capital stock in preparing a Balance Sheet, it might be inferred that such a reduction would reduce the capital stock for determining the excess profits credits. However, this is not the case. If the deficit arises from operating loss or losses, allowable for income tax purposes, the law does not require that the original capital be reduced thereby, and the loss need not be deducted from the capital stock. An illustration will make this clear. Assume that a concern has an invested capital of $150,000 paid up in capital stock and a surplus of $25,000 on December 31, 1916. In 1917 the corporation suffers a loss of $40,000 thru fire. This wipes out the surplus and creates a deficit of $15,000. The invested capital will be $150,000 for the purpose of computing the excess profits credit. "No new surplus, however, can be included in the invested capital until the full loss which is carried as a deficit has been made good." 1

As has been stated in a previous paragraph, the invested capital for the purpose of computing the income tax, consists of the capital stock, surplus, and reserves (excluding depreciation reserves) which are shown on the books at the beginning of the year. However, this invested capital
is subject to limitations, because the law defines invested capital as the "average" invested capital during the fiscal period of a business concern but excludes the profits earned during the same period. In other words, the profits of the year in which the tax is computed cannot be added to get the average invested capital. If dividends are paid after 60 days following the close of the taxable year, it will be presumed that they have been paid out of the current earnings of the year. However, if current earnings are not sufficient, the invested capital is reduced by the average excess over the current earnings. There are many ways by which the invested capital as shown by the books at the beginning of the year may be increased or reduced. In the following sections additions and reductions of invested capital will be taken up in detail.

**ADDITIONS TO INVESTED CAPITAL**

An increase in the capital stock becomes effective on the date when cash or other assets are received in payment for the stock. "The amount so added or deducted in each case is the amount of the change averaged for the time remaining in the period during which it is in effect. The fraction used in finding such average is the
number of days remaining in the period (including the
day on which the change occurs) over the number of days
in the period.\textsuperscript{1} This may be made clear by an illus-
tration. A corporation organized July 1, 1918 with an
invested capital of $50,000. On October 1, $20,000
more was added. The addition to invested capital for
$20,000 paid in October 1, 1918 to December 31, 1918 (92)
days in proportion to the number of days in period covered
by return (184).

July, 1918 paid in
October 1, 1918 paid in $20,000 \times \frac{92}{184} = \frac{50,000}{10,000}$

Invested capital for purpose of tax is here figured
on the basis of the proportion of the number of months
covered by the return to 12 months which is $6/12$ or $1/2$
of $60,000 equals $30,000, the invested capital for the
purpose of tax.

If any time during the taxable year some of the shares
of the original stock are sold at premium, the invested
capital will be reduced to the extent of the par value of
each stock sold, but the premium should be credited to
capital surplus and may be included in "paid-in surplus."
The premium is not income. If a corporation sells the
stock which was donated by the stockholders the amount so

\textsuperscript{1} Income Tax Regulations 45, Art. 853
received may be treated as invested capital.

The reserve accounts are likely to cause some confusion in the computation of invested capital, because of the double meaning which the term "reserves" conveys. The way the term is used may mean an equity account, as a portion of the surplus of the corporation, as for example, Reserve for Contingencies, Reserve for Inventory Fluctuations etc.; or it may mean a valuation account, as Reserve for Depreciation. In the latter case the reserve account belongs to a fixed asset account and is in "no sense a part of any of the proprietary or any of the other equity accounts." If, for example, the automobile account of a concern shows a debit balance of $7,000 and Reserve for Depreciation on Automobiles shows a credit balance of $1,000, the present estimated value of the automobiles is $6,000. When these accounts are read together the exact status of the automobile account is disclosed.

As previously mentioned, many of the so-called reserves are in reality segregated surplus accounts and properly appear among the items in that classification. It does not make any particular difference so far as the determination of the invested capital is concerned whether there are various reserves, or if the entire amount of

1 Income Tax Regulations 45, Art. 542.
2 Payton & Stevenson, Prin. of Accounting, p. 107
surplus appears in one surplus account. The important thing is to ascertain the true nature of reserve accounts as has been pointed out.

To the aggregate of the invested capital and surplus at the beginning of the taxable year may be added all reserves which have not been allowed by the Treasury Department as deductions in income tax returns. The reserve for bad debts can be included as part of the invested capital, because no deductions are allowed in the income tax return for bad debts until the amount has been positively and accurately ascertained.

However, the reserves representing reasonable amounts for depreciation or depletion cannot be included in invested capital because they are valuation accounts. If, however, reserves for depreciation or depletion in the past have been excessive, a re-adjustment can be made and the credit arising out of such revaluation may be taken out of these reserves and put into the surplus account.¹

It is important to note that reserves set up for various purposes, except those which are valuation

¹ Income Tax Regulations 45, Art. 844.
accounts, may be included in invested capital until such reserves have been used. For instance, A Reserve for Federal income tax, if set up at the close of the fiscal period will serve as invested capital until it is withdrawn for that purpose. Likewise, there may be a Reserve for Contingencies which suddenly has to be withdrawn during the year. Up to the time it is taken out of the business it is invested capital. The same is true of all reserve accounts which are not valuation accounts.

There are, however, certain definite limitations on invested capital which should be understood. A discussion of the main items which are not included in invested capital will now be considered.

"Intangible property paid in for stock or shares prior to March 3, 1917 may be valued at either (a) the actual cash value of the property at the time it was acquired, (b) the par value of the stock issued therefor, or (c) in the aggregate 25% of the par value of the total stock or shares outstanding on March 3, 1917 whichever is lower." It is difficult to establish accurately the value of intangibles and

1 Treasury Decision 2971
2 1913 Law, Section 326 a
and as a general rule neither the government nor the taxpayer will attempt to do so. Practically, therefore, the limitations upon the valuation at which intangibles may be included in invested capital are the par value of the stock issued therefor, or 25% of the par value of the total stock outstanding on March 3, 1917, whichever is the lower figure.

The capital stock account as shown on the books, must be reduced if a corporation's own stock which has been issued full-paid is returned to the corporation by gift or for a consideration for less than the par value of the stock. The proceeds of treasury stock sold during the year will increase the invested capital from the day the cash or other assets are paid in.

If a corporation during the taxable year buys its own stock for the purpose of retirement, or holding it in the treasury, or for some other reason, the entire cost of such stock must be deducted from the invested capital. "Where such stock is purchased during the taxable year, a deduction from the invested capital as of the beginning of the taxable year and effective from the date of such purchase is required only to the

I Income Tax Regulations 45, Art. 861
that such stock has not been purchased out of undivided profits of the taxable year."

The provision in the law that invested capital includes all cash and tangible assets "paid-in" has caused some misunderstanding concerning the status (a) of assets which have depreciated from normal use or have declined in value and should be adjusted by charges to surplus; (b) of assets which have declined in value but cannot be charged to surplus, because the concern has no surplus. This is a situation where part of the original capital was spent by the business operations in the form of wear and tear or depletion. In the case of a mine where depletion of mineral contents took place during 1909 and 1912 when no allowance for depletion was allowed to be deducted, the paid-in capital sustained a reduction and adjustment will have to be made in order to get the invested capital under the Revenue Act of 1918. The same is true regarding depreciation in case no charges for depreciation were made in the tax returns and no depreciation written off in the accounts on the books. In such cases a reasonable amount will have to be deducted from paid-in capital for the taxable year.

1 Income Tax Regulations 45, Art. 862
Any withdrawal of capital or accumulated surplus during the taxable year decreases the invested capital as of the date of withdrawal. Probably the most common way of decreasing the capital is by paying dividends and federal taxes. Dividends are usually paid during the first sixty days and are presumed by the law to be a distribution of the earnings of the preceding year. If they are paid after the expiration of sixty days, they are deemed to be paid out of the earnings of the current year to the extent that the net income is available for such purpose when the payment is made. The surplus on the books of the corporation at the beginning of the taxable year will be reduced by the amount of all dividends paid during the first sixty days, and other distribution of dividends after that date to the extent that the latter payment of dividends exceeds the revenues of the taxable year. In case the dividends which are paid during the first sixty days are in excess of the surplus and undivided profits available at the beginning of the year, the excess will be deemed to be paid out of earnings of the current year as already mention in a preceding paragraph.¹

¹ Income Tax Regulations 45, Art. 858
INTANGIBLE AND INADMISSIBLE ASSETS

Intangible and inadmissible assets are very much confused. A clear conception of each is, however, very necessary in order to compute correctly the invested capital. Generally speaking, all assets for any taxable year, tangible or intangible, are admissible except those from which the income is not taxable (stocks and municipal and government bonds), and goodwill and patents when the total of such intangible exceeds a given proportion of the par value of the outstanding capital stock. While the amount of such intangible items as goodwill, patents, organization expenses etc., which may be included in invested capital where they have been acquired with capital stock is limited to 25% of the capital stock outstanding at the beginning of the year, they are never admissible assets. An illustration will show the limitation of intangible assets in invested capital if purchased with stock.

BALANCE SHEET OF A. B. COMPANY DECEMBER 31, 1919.

<table>
<thead>
<tr>
<th>Other assets</th>
<th>$100,000</th>
<th>Liabilities</th>
<th>$50,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Patents paid for in cash</td>
<td>5,000</td>
<td>Cap. Stock</td>
<td>200,000</td>
</tr>
<tr>
<td>Goodwill paid for in St'k</td>
<td>$150,000</td>
<td>Surplus</td>
<td>5,000</td>
</tr>
<tr>
<td></td>
<td>$255,000</td>
<td></td>
<td>$255,000</td>
</tr>
</tbody>
</table>

Amount of intangible property which cannot be included in invested capital is $1000,000. The patents which were purchased with cash are not subject to the limitation.
Therefore, the entire amount of intangible property which may be included in the invested capital in the A. B. Company is as follows:

- Patents ...................... $55,000
- Other assets .................. $100,000

$155,000

In this concern, $100,000 worth of intangible property has to be excluded from the invested capital. But the fact that these intangible assets cannot be included in the invested capital, does not put them in the class of inadmissible assets. The term inadmissible assets is used in a technical sense and is restricted in its application. Inadmissible assets as previously defined are "stocks, bonds or other obligations, the dividends or interest from which is not included in computing the net income."¹

The Law in Section 325 c further provides that all corporations having inadmissible assets in their invested capital must deduct therefrom "a percentage thereof equal to the percentage which the amount of admissible assets is of the total amount of admissible and inadmissible assets held during the taxable year." The 1918 Law, Section 325 a
following illustration will show the relation of inadmissible assets to invested capital.

| Stocks and bonds owned (inadmissible assets) | $30,000 |
| Other assets (admissible assets)              | 10,000  |
| **Total assets**                             | **$40,000** |

In accordance with Section 325 c of the 1918 Law, the invested capital must be reduced by 75% which is the ratio of the inadmissible assets to the total invested capital, thus making the invested capital in this case $2,500.

The topics in regard to the invested capital for income tax purposes as discussed in this chapter are the essential items. There are many transactions which occur during a fiscal period of a corporation which affect the invested capital. It is only by close application of the Law and Treasury Regulations that the correct status of the invested capital can be computed.
THE EFFECT OF THE EXCESS PROFITS TAX
ON THE SURPLUS ACCOUNTS

IV

The last chapter was concerned with the analysis of invested capital of a corporation. That there is some relation between the amount of invested capital and amount of excess profits tax has already been pointed out in the illustration of the three hypothetical cases. It is the purpose of this chapter to show how the excess profits tax affects surplus accounts and what the probable policy of corporations will be in regard to the distribution of the expenditures between the balance sheet and income sheet. The question may arise whether there will be a tendency to deduct excessively for annual maintenance and depreciation in order to reduce the income tax, or whether attempt will be made in the direction of increasing invested capital so as to decrease the excess profits tax.

When the invested capital is definitely known, the next step is to compute the excess profits credit. The excess profits credit consists of two items. The first allows 8% on the invested capital as discussed in Chapter III. The second is a blanket exemption of $3000 regardless of the amount of invested capital. An illustration
will make clear the two items in question. A concern with an invested capital of $20,000 would be entitled to the following excess profits credit:

8% on $20,000-----------------------------$1,600
Exemption-------------------------------------3,000

Total excess profits credit in this case is $4,600.

If the net earnings of a concern with an invested capital of $20,000 as given above do not exceed $4,600, it will not be subject to an excess profits tax, for the net income is not in excess of what the law allows.

By comparing the hypothetical cases of corporations given in Chapter III, it will be seen that the excess profits credit varies with the amount of invested capital. That is to say, the excess profits credit is inversely proportional to the amount of invested capital.

With the two forms of taxation, the excess profits and the income tax, some concerns are taxed more heavily than others because of their policy of improper maintenance and depreciation charges prior to the passage of the excess profits tax in 1917. During the first four years of the income tax era, there was no provision for placing an extra high tax on those cor-
porations which made unusual profits. There was but one way of taxing such organizations, and that was by means of the normal tax. This tax was very insignificant in comparison with the present rates, and it was not in any manner based upon capital actually invested. That is to say a corporation with an invested capital of $20,000, having an annual income of $12,000, was not taxed any more than a concern with an invested capital of $40,000 having a similar amount of net income. Prior to 1917 there was no inducement for increasing the capital organization of a concern for the purpose of reducing the government tax, as the invested capital played a neutral role so far as increasing or decreasing the tax was concerned.

The accounting policy pursued by corporations prior to the income tax era is responsible for the great discrepancy existing between the value of their invested capital and the true value of their capital assets. Every concern not regulated by the Interstate Commerce Commission had the right to make charges for expenditures the best way it saw fit. It rested entirely with the management as to whether the value of the capital
were to be stated correctly or not.

In the conservative management special efforts were made to over-state expenses and keep the capital assets at a figure below their actual worth. This was accomplished in various ways as indicated in the following paragraphs.

By charging excessively for depreciation, the value of assets was prematurely written off while the assets were still in first class condition for use in business. Likewise, with mines, by charging an excessive rate for depletion, the property of the mine became worthless, as far as the book values were concerned, long before the resources of the mine were exhausted.

Another improper accounting charge which resulted in understatement of assets, was the practice of charging excessively for outstanding accounts.

The writer knows of a public utility concern whose valuation of physical units of property exceeded the book valuations by nearly a million dollars. This discrepancy was caused by improper accounting charges. An investigation showed that extensions and improvements were charged to maintenance instead of additions and
betterments. Units of property replaced by an improved and more expensive type were charged to expense. In the same company no record was made of property which had substantial salvage value and was still in the possession of the corporation.

It was customary in the past for railroads desiring a reputation for conservative management, either to mark down violently the value of the road, as the Chicago and Northwestern Railway did in 1893; or charge to operation and maintenance, material additions material additions of the physical property which the same road did for seven years in succession from 1900 to 1906. However, the most striking charge was that of the Pennsylvania Railway Company in 1906 when the sum of $13,000,000, part of the expenses for constructing a tunnel was charged to a special surplus.¹

The understating of assets was in the past especially a very popular practice with banks. It is said that some banks did not put on their books the real estate and fixtures they owned. A large enough hidden reserve was thus created to cover a very large defalcation. This could be done by bringing into the balance sheet enough

¹ Hatfield, Prin. of Accounting, p. 254
of the assets representing the secret reserve to cover the unusual loss. It was possible by such a manipulation to sustain large losses without changing the figures of the balance sheet.¹

As opposed to conservatism there is a type of corporate management which holds a different view in regard to the distribution of expenditures. Under-capitalization of assets is zealously guarded against for one reason or another. In case of capital expenditures, proper charges are made to capital accounts. Depreciation and depletion charges are usually light and in many instances are entirely omitted. Perhaps one reason for keeping assets on the books at an inflated figure is to get a better adjustment in case of fire.

It is quite evident that those concerns which followed a policy of conservatism, making liberal annual charges for maintenance, including items which were distinctly capital expenditures, and who made it a practice to consistently underrate their assets are now penalized as compared with those enterprises that made reasonable deductions for maintenances and depreciation and discriminated sharply between capital and revenue

¹ Hatfield, Prin. of Accounting, p. 253
That there has been much conservatism in regard to maintenance and depreciation charges and understatement of assets, is evidenced by the fact that a great many cases are now before the "Treasury Department representing attempts to correct understatement of the surplus account."\(^1\) The ill effects of improper accounting practices are now realized more than ever before, because it is very difficult to get the assets that have been written off reinstated on the books. Article 840, Income Tax Regulations 45, provides for the restoration to the surplus account the value of assets written off because of excessive charges for depreciation, depletion, and obsolescence on property still owned and in use. However, the burden of proof in such cases is on the taxpayer, for the article just quoted, in the opening sentence states that "a corporation's books of accounts will be presumed to show the facts." This is an important matter and in many cases results in gross inequities.

It is obviously true that the excess profits tax program and the Treasury rulings are bringing pressure...
to bear on correct accounting practices. The many cases pending before the Treasury Department clamoring for recognition of a larger surplus account because of the understatement of assets in the past, shows that taxpayers are studying the distribution of charges between the balance sheet and the income sheet more carefully than in the past. Proper accounting practices will be more rigidly followed in the future. However, taxpayers still show a tendency in the direction to reduce their net income figure. Notwithstanding, when business men once realize that the excess profits tax is to remain in force, undervaluations will soon cease to exist. In the event the excess profits tax should remain a law indefinitely, it would be more profitable for a corporation from the standpoint of paying Federal Income taxes to charge lightly for maintenance and depreciation and thus increase the invested capital. However, this procedure would not lessen the tax for the year in which it is levied as indicated in the series of hypothetical cases following this discussion. In fact, by not charging for the true amount of depreciation and maintenance which has actually accrued, the tax
would be higher for the year in which it is levied. For the next year, however, there would be a larger invested capital and consequently a larger invested capital which makes a larger excess profits credit. Thus the excess profits tax would be smaller. The following hypothetical cases illustrate how in a period of ten years it would be cheaper for a corporation to increase its invested capital instead of keeping down the current tax figures. By comparing the three problems carefully it will be seen that by increasing the surplus which increases the invested capital the increased excess profits credit in a decade will have reduced the excess profits tax to an extent which more than offsets the amount of tax which was saved by charging depreciation and maintenance.
Charges for Maintenance and Depreciation Deducted

First Year

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Stock</td>
<td>$140,000</td>
</tr>
<tr>
<td>Surplus</td>
<td>40,000</td>
</tr>
</tbody>
</table>

Net Earnings after deducting $20,000 for Maintenance and Depreciation, $80,000.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>20% of Invested Capital</td>
<td>36,000</td>
</tr>
<tr>
<td>8% of Invested Capital</td>
<td>14,400</td>
</tr>
<tr>
<td>Exemption</td>
<td>3,000</td>
</tr>
<tr>
<td>Excess profits credit</td>
<td>17,400</td>
</tr>
</tbody>
</table>

First Bracket

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>20% of Invested Capital</td>
<td>$36,000</td>
</tr>
<tr>
<td>Less: Excess profits credit</td>
<td>17,400</td>
</tr>
</tbody>
</table>
| At 20%                                           | 18,600  | $3,720

Second Bracket

Net Income in excess of 20% of Invested Capital

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>($80,000-36,000) At 40%</td>
<td>17,600</td>
</tr>
<tr>
<td>Excess profits tax</td>
<td>$21,320</td>
</tr>
</tbody>
</table>

Computation of Income Tax

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Income as given above</td>
<td>$80,000</td>
</tr>
<tr>
<td>Less: Excess profits tax</td>
<td>21,320</td>
</tr>
</tbody>
</table>
| At 10%                                           | 58,680  | 5,868

Total Tax                                        | $27,188 |
CASE ONE: "b"

No Charges for Maintenance and Depreciation Deducted

First Year

Capital Stock $140,000
Surplus 40,000

Net Earnings after deducting $20,000 for Maintenance and Depreciation, $80,000; without deductions, $100,000.

20% of Invested Capital $36,000
8% of Invested Capital $14,400
Exemption 3,000
Excess profits credit 17,400

First Bracket

20% of Invested Capital $36,000
Less: Excess profits credit 17,400
At 20% 18,600 3,720

Second Bracket

Net Income in excess of 20% of Invested Capital
($10,000-36,000) At 40% 25,600

Computation of Income Tax

Net Income as given above $100,000
Less: Excess profits tax 29,320
At 10% 70,680 7,068
Total tax $36,388

Limitation of Tax

Law, Sec. 302

20% of $17,000 $3,400
40% " 80,000 32,000

Total amount of tax to be paid $35,400
CASE ONE "c"

Charges for Maintenance and Depreciation Deducted
Second Year

Capital Stock $140,000
Surplus 60,000

Net Earnings after deducting $20,000 for Maintenance and Depreciation, $80,000.

20% of Invested Capital $40,000
8% of Invested Capital $16,000
Exemption 3,000
Excess profits credit 19,000

First Bracket

20% of Invested Capital $40,000
Less: Excess profits credit 19,000
At 20% 21,000

Second Bracket

Net Income in excess of 20% of Invested Capital
($80,000-40,000) At 40% 16,000
Excess profits tax $20,200

Computation of Income Tax

Net Income $80,000
Less: Excess profits tax 20,200
At 10% $59,800 5,380
Total Tax $26,180
CASE TWO "a"

Charges for Maintenance and Depreciation Deducted

First Year

Capital Stock $140,000
Surplus 40,000

Net Earnings after deducting $25,000 for Maintenance and Depreciation, $75,000.

20% of Invested Capital $36,000
8% of Invested Capital $14,000
Exemption 3,000
Excess profits credit 17,400

First Bracket

20% of Invested Capital $36,000
Less: Excess profits credit 17,400
At 20% 18,600 $ 3,720

Second Bracket

Net Income in excess of 20% of Invested Capital
($75,000-36,000) At 40% 15,600
Excess profits tax 19,320

Computation of Income Tax

Net Income $75,000
Less: Excess profits tax 19,320
At 10% 55,680 5,568

Total tax $24,888
CASE TWO "b"

No Charges for Maintenance and Depreciation Deducted

First Year

| Capital Stock | $140,000 |
| Surplus | 40,000 |

Net Earnings without deducting $25,000 for Maintenance and Depreciation, $100,000.

20% of Invested Capital  $36,000
30% of Invested Capital  $14,000
Exemption  3,000
Excess profits credit  18,600

First Bracket

20% of Invested Capital  $36,000
Less: Excess profits credit  17,400
At 20%  18,600  3,720

Second Bracket

Net Income in excess of 20% of Invested Capital
($100,000 - 36,000) At 40%
Excess profits tax  25,600  29,320

Computation of Income Tax

Net Earnings as given above $100,000.
Less: Excess profits credit  22,320
At 10%  70,680  7,068  36,328

Limitation of Tax

Law Section 302

20% of $17,000  $3,400
40% of 80,000  32,000

Maximum tax  35,400
Charges for Maintenance and Depreciation Deducted

Second Year

Capital Stock $140,000
Surplus 65,000

Net Earnings after deducting $25,000 for Maintenance and Depreciation $75,000.

20% of Invested Capital $16,400 $41,000
8% of Invested Capital Exemption 3,000 19,400

Excess profits credit $21,600

First Bracket

20% of Invested Capital $41,000
Less: Excess profits credit 19,400
At 20% 21,600 4,320

Second Bracket

Net Income in excess of 20% of Invested Capital

($75,000–41,000) At 40% 13,600
Excess profits tax 17,920

Computation of Income Tax

Net Income $75,000
Less: Excess profits tax 17,920
At 10% 57,080 5,708
Total Tax $23,628
CASH THREE "a"

Charges for Maintenance and Depreciation Deducted
First Year

Capital Stock $140,000
Surplus 40,000

Net Earnings after deducting $30,000 for Maintenance and Depreciation $70,000.

2% of Invested Capital $36,000
8% of Invested Capital $14,400
Exemption 3,000
Excess profits credit 17,400

First Bracket
20% of Invested Capital $36,000
Less: Excess profits credit
At 20% 18,600 $3,720

Second Bracket

Net Income in excess of 20% of Invested Capital
($70,000 - $36,000) At 40% 13,600
Excess profits tax 17,320

Computation of Income Tax

Net Earnings as given above $70,000
Less: Excess profits tax
At 10% $52,680 5,268
Total Tax $22,588
Charges for Maintenance and Depreciation not Deducted.

First Year

Capital Stock
Surplus

$140,000
40,000

Net Earnings without deducting $30,000 for Maintenance and Depreciation $100,000.

20% of Invested Capital $14,400
8% of Invested Capital
Exemption $3,000
Excess profits credit $17,400

First Bracket

20% of Invested Capital $36,000
Less: Excess profits credit $17,400
At 20% $18,600 $3,720

Second Bracket

Net Income in excess of 20% of Invested Capital
($100,000-36,000) At 40% $25,200
Excess profits tax $28,920

Computation of Income Tax

Net Earnings as given above $100,000.
Less: Excess profits tax $28,920.
At 10% $71,080 $7,108
Limitation of Tax Law Sec. 302.

20% of $17,000 $3,400
40% of 80,000 $32,000
Maximum Tax $35,400
Charges for Maintenance and Depreciation Deducted

Second Year

Capital Stock $140,000
Surplus 70,000

Net Earnings after deducting $30,000 for Maintenance and Depreciation $70,000.

20% of Invested Capital $42,000
8% of Invested Capital $16,000
Exemption 3,000
Excess profits credit 19,800

First Bracket

20% of Invested Capital $42,000
Less: Excess profits credit 19,800
At 10% 11,200 $4,440

Second Bracket

Net Income in excess of 20% of Invested Capital
($70,000-$42,000) At 40% 11,200
Excess profits tax $15,640

Computation of Income Tax

Net Income $70,000
Less: Excess profits Cr. 15,640
At 10% $54,360
Total Tax $21,076
SUMMARY OF EACH CASE GIVEN

CASE ONE

"a"
Annual Depreciation and Maintenance charges $20,000 are deducted.

Total Annual Tax:
For a ten-year period $27,188

"b"
Annual Depreciation & Maintenance charges $20,000 is not deducted.

Total Annual Tax for first year is $35,400
For the following year $26,180
For a ten-year period $271,020

CASE TWO

"a"
Annual Depreciation and Maintenance charges $25,000 are deducted.

Total Annual Tax $24,888
For a ten-year period $248,880

"b"
Annual Depreciation and Maintenance charges are not deducted.

Total Annual Tax for the first year $35,400
For the following year $23,628
For a ten-year period $248,052

CASE THREE

"a"
Annual Depreciation and Maintenance charges $30,000 are deducted.

Total Annual Tax $22,586
For ten years $225,680

"b"
Annual Depreciation and Maintenance charges $30,000 are not deducted.

Total Annual Tax for first year is $35,400
For the following year $21,076
For a ten-year period $225,084
Because of the fact that the exemption allowed by the excess profits tax is a fixed percentage on the invested capital, plus $3,000, it is quite obvious that every corporation is materially interested in having as large a surplus account as possible. As already stated in Chapter III, the invested capital is limited to the proprietary equities of a concern which includes the actual amount paid in by the stockholders and the surplus accumulation, plus or minus the amount obtained by adjustment of the valuation of the assets of a corporation. By increasing the amount of surplus, the excess profits credit will be increased, thus directly decreasing the amount of the excess profits tax to be paid.

Now if there were no other factor operative it would be correct to assume that the effect of the excess profits tax is to increase the surplus accounts; for it is to the interest of the corporate management to do that very thing in order to retain a sizable amount of the net earnings in the business. However, in theory there are very fundamental reasons why the effect of the excess profits tax would not be to accumulate large corporate savings from the annual net earnings of the business.
In the first place in the open corporation whose stock is owned by many different individuals it would not be feasible to reduce the regular dividend payments for the purpose of increasing the surplus. When an institution has been paying regular dividends and suddenly reduces the dividend payments, or stops paying them for a year or two, suspicion as to the financial status of that institution is at once aroused. The stockholders become alarmed and dissatisfied and the financial standing of the concern will be injured. Hence, the policy of retaining dividends for the purpose of accumulating a large surplus in an open corporation is not likely to be adopted.

On the other hand if it be a close corporation, the savings could not be very much increased beyond the amount held during normal times because of Section 220 in the law which provides that the government may tax the individual stockholders for their proportionate share of accumulated surplus which is not necessary for carrying on the business. With this provision, surplus accumulation would not be likely to take place for the reason that it would probably be cheaper to pay the excess profits tax than to be taxed as individuals of the corporation for the proportionate share of un-
distributed surplus, because those members of a close corporation usually have enough income any way to get them into the Surtax. Hence, they would very likely profit by having the corporation pay the excess profits tax.

In the second place it is not likely that the surplus accounts should show much growth, because there will be less earnings available for dividends. Economists are generally agreed that a tax upon positive excess profits or differential profits (i.e. profits in excess of what is necessary for the purpose of calling forth the necessary volume of capital and enterprise), which falls equally on all business concerns cannot be shifted on the consumer, but must fall on the immediate taxpayer. Assuming that the economic doctrine just given is correct, and the excess profits tax as the 1918 law provides, does tax true excess profits, it is obvious that such a tax will check the accumulation of earnings in corporate enterprises because of the impossibility to shift the tax burden.
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