Journal of Accountancy

Volume 31 | Issue 2 Article 3

2-1921

# Invested Capital from a Legal Standpoint as Applied to Excess and War Profits Taxation

Keene H. Addington

Follow this and additional works at: https://egrove.olemiss.edu/jofa

Part of the Accounting Commons, and the Taxation Commons

## Recommended Citation

Addington, Keene H. (1921) "Invested Capital from a Legal Standpoint as Applied to Excess and War Profits Taxation," *Journal of Accountancy*: Vol. 31: Iss. 2, Article 3.
Available at: https://egrove.olemiss.edu/jofa/vol31/iss2/3

This Article is brought to you for free and open access by the Archival Digital Accounting Collection at eGrove. It has been accepted for inclusion in Journal of Accountancy by an authorized editor of eGrove. For more information, please contact egrove@olemiss.edu.

# Invested Capital from a Legal Standpoint as Applied to Excess and War Profits Taxation*

By Keene H. Addington

I dared to select this subject because it is vital, because it is alive, because it seems to afford the opportunity for a lawyer at least to supplement to some extent the vast amount of accounting knowledge which flows into the final reservoir.

I am going to speak almost wholly on the 1918 law. Of course I cannot say for the 1917 law, what I say in very truth of the 1918 law, that in many respects the 1918 law is one of the greatest laws ever placed upon our statute books. In draftsmanship it is masterly, and I have no sympathy with the man who hides his ignorance with the statement that he cannot understand its terms. It is a great law from other standpoints. From the standpoint of its great flexibility to meet the vast and varied questions which arise under it and go to questions of justice and equality in taxation, it is a great law. As this law is developed principally in your hands and partly in the hands of my profession, I think many of the objections to it will disappear, because in my experience I have yet to see an aggravated case which tended to an unjust and unequal tax, for which this law did not provide, if you were ingenious enough and diligent enough, substantial although perhaps not complete relief. I have been before the department in many cases, and it has been a sort of an obsession with me not to get into the courts. I have not one single case that is going to the courts that the department has not asked me to take there in order to settle some difficult and doubtful legal question.

This law is a great law from another point of view. It is great from the standpoint of the constructive opportunity which it affords to your profession and to mine—constructive opportunity in the organization of new enterprises, creating them on sound bases with the utmost of economy in taxation.

I say without any extravagance of praise that I think, when you measure the entire administration of both the 1917 and the

* Taken from an address delivered at the regional meeting of the American Institute of Accountants, Chicago, November 19, 1920.

1918 laws by the officers at Washington, you will find that we have had an administration there that is quite as wise, quite as broad, quite as intelligent, quite as enlightened and quite as liberal as the law's opportunities will afford.

While I will not say the regulations (which represent the treasury department's interpretation of these laws) are a sacred book, they are at least a work which should command our highest respect. In the main they are sound. They have many errors, like all things human. They have many inadequacies and incompletenesses, like all things which are done by human minds; but in the main those regulations represent genius in constructive effort and are, I think, 95 per cent, the work of your profession rather than of mine. We started a little later than you did. We are pouring our thought only gradually into the development of this law, but I think we are beginning to diffuse new ideas upon the general principles which are now represented by the administration of these laws.

I am going to start tonight with one of the great pivotal sections of the law which relates to the ascertainment of invested capital: section 331 of the 1918 law.

This section, of course, must be construed with section 326, the great section definitive of invested capital; but that section, as you know, directs the manner of the ascertainment of the invested capital of a consolidated company—that is to say, one company organized in 1901, another in 1902, a third in 1903 and a fourth, which absorbed the first three, in 1904. The date to which you go for the purpose of ascertaining the values of your assets and of determining your invested capital is the 1904 date. You practically ignore the other three dates. That is settled. There is no question about that, as you all know.

But assume a corporation that reorganized in 1904, absorbing three previously existing units; assume that the spirit of conservatism prevailed intensely among the organizers of that 1904 corporation. They did the thing which created the right to revalue, but they did not have the power to draw aside the veil that hid the future and know what 1917 would bring in the way of laws, and therefore they did not revalue. I give you this question—it is unsettled today: May such a corporation now revalue and get the value of those assets as of 1904, predicating that re-

valuation upon facts and conditions known to exist in 1904, and taking that revaluation in conjunction with what was the fact, that the officers of that corporation knew at the time they consolidated in 1904 that those assets were worth more than the sum of the stock which they issued against them?

Am I talking radicalism? Am I not suggesting a proposition of paid-in surplus upon a present day valuation as of that date, which is sound both under the law and the regulation? That question has not been decided. It is a question I expect to argue before another spring comes upon us.

Now—suggesting another proposition which is the reverse, in a way—we have three similar corporations; we have a similar consolidation; but we have not in this other consolidation of which I am now speaking the same spirit of conservatism. The directors of that company, when they issued the stock against the three original underlying companies' properties, went to the extreme limit in the matter of valuation; they poured all they could into their appraisement, which was the predicate of the stock issue, and did that both as to tangibles and intangibles. The directors, as you know, always value properties when they issue stock against them.

We find the department looking through the stock to determine whether it was fully paid or not. We find possibly—not probably—in the field an examiner at work in an effort to reduce those values to smaller sums. Your records are in poor shape. Your means of proof are difficult. Is there another answer?

I frankly say there are two sides to the proposition. But, is not the resolution of the board of directors, which fixed that value, binding and conclusive upon the treasury department? How can it possibly be? someone may say. I answer you that where the courts of this country have had to do with such resolutions and such valuations in cases brought by creditors to enforce stock liability, the uniform holding has been that if the valuation has been made in good faith, if it has not been fraudulent, if the valuation has not been grossly and excessively made with knowledge of the excess, it is binding upon the courts and the stock issue is held to be fully paid and non-assessable. That is held in cases in which the litigant is a creditor, a wage claimer. Such litigants are favored in law. The construction is always

liberal in their favor and against the stockholder defending. Why, all the more, might not the same principle apply in a case in which the government is enforcing a tax law, when the construction of the law must be strict against the government, liberal in favor of the taxpayer, and all doubts must be resolved against the government and in favor of the taxpayer?

Thus far I have spoken of section 331 with the idea in mind, although what I have said may apply as well to the second subdivision of 331, that we have to draw a line through the center of the section, because you know there is a date there, March 3, 1917, and in order for your invested capital to be different from that of the underlying companies, if the reorganization has taken place after March 3, 1917, there must be a 50 per cent change of ownership.

Assume your same three companies, one organized in 1901, one in 1902 and one in 1903, each of them having a small invested capital, at least very much below the present day values; each of them of equal size; all of them susceptible of being joined together in one harmonious whole. Now, what can you do? Consolidate them and then revalue all their assets. A simple proposition effecting, not only the economies which flow from consolidation, but a vast economy in the matter of taxation.

Now—along the same lines, a matter of finance—assume a corporation which has a large bonded debt and some floating indebtedness. It is pretty wise financial policy to refund that debt. The invested capital of this company is small, and its tax is large, for its profits are large. Transform that bonded debt and that floating indebtedness into a preferred stock issue and sell enough additional stock, if it is necessary, so that the preferred stock issue represents more than 50 per cent of the whole. Now you have your 50 per cent change of ownership. Now you have your reorganization and now you have created the right, under section 331, to get an up-to-date valuation of your assets and your invested capital is repaired.

I am going to pass section 331 and I am proceeding warily and cautiously, because I am a lawyer and you are accountants, to talk on the question of consolidated invested capital—that is to say, the invested capital of a group of corporations required to consolidate under section 240, which have not been merged in a

single corporation so as to come within the provisions of section 331.

Of course, we must ascertain our invested capital according to the different regulations governing that matter. In order to ascertain the consolidated invested capital of such a group you go to the regulations, principally regulations 864 to 868 both inclusive.

Regulation 864 I believe you will grant is at once the most complicated, the most difficult and the most important single regulation in the book. It is a wonderful regulation; and I want to say that I do not doubt for a moment that it represents sound accounting. Practical experience has shown me that the application of article 864 and the succeeding regulations in at least nineteen cases out of twenty reaches the same result that is reached by the method of ascertaining invested capital which I say is the legal way, the sound accounting method to the contrary notwithstanding.

I want to cite a few illustrations to show you some strange results that take place in following that regulation in ascertaining consolidated invested capital.

Under the regulations, article 860, an operating deficit is none the less invested capital. Money which has been lost was originally paid in and is still invested capital, but a company with an operating deficit, the moment it consolidates with a company having an earned surplus at least as much as the operating deficit, loses its invested capital represented by that operating deficit.

Let us see now what can be done. I am a minority stockholder in the corporation which loses that invested capital, and I do not think it is quite fair to require, because of that consolidation, an increase in my tax, and I complain. I think I have a right to complain, a substantial legal right. But someone may assert that section 240 says these two corporations can apportion the tax among themselves, and it may be that by apportioning the tax my complaint is removed. All right. Let us grant it. The moment you do that you are increasing the tax of the other corporation, and some other Mr. Minority-man steps up with the right of complaint.

From an accounting standpoint you must have held up your hands in holy horror when the treasury department said that an

operating deficit or invested capital money lost still counted as though in the business, so you cannot always reconcile sound accounting and invested capital. Invested capital was a thing brought into the world by this statute without heritage, and I think most people hope it will have no posterity. But at least it is an artificial thing, and congress has not said that invested capital shall be ascertained according to the principles of sound accounting. It has written certain hard and fast rules and it is a question how much they violate your principles, because you must admit that those hard and fast rules in section 326, in their application, at least, do at times violate the very soundest and most hallowed principles of accounting. It is a question of degree.

Assume, for instance, that I am a minority stock-holder in a corporation with an operating deficit, and the majority stockholders, more than 95 per cent, want to sell. There are two purchasers in the field, Mr. Gore here who is in accounting practice and whose business is not a corporation. He would not have to consolidate if he bought. But Mr. Reckitt here, who we will assume is in some other corporation, having a 95 per cent interest in that corporation is also a potential buyer. The moment Mr. Reckitt buys that company he is confronted, and he knows he is confronted, with the obligation to consolidate. Mr. Gore knows that he can buy and not have to consolidate. Mr. Reckitt knows if he buys he is going to lose some invested capital, and that the property is going to carry a higher rate of tax in consequence of the loss of invested capital. He is therefore going to suffer. Mr. Gore knows he is going to lose no invested capital. Therefore the corporation of Mr. Reckitt can afford to offer more for the business, as his taxes will be less. You see this regulation by adhering to accounting principles does a collateral harm—it affects the market value of stock.

I say that this regulation, wonderful in its conception, magnificent in its intricacy, which works out beautifully in most cases, has in its essence certain unsound principles which ought to be eradicated. You might think that this is an unusual case. I assure you it is not.

A gentleman came up here from Cincinnati this morning and brought this very case into my office this morning, although I have had a similar situation before in another case. Unfortu-

nately, some of these propositions I am not permitted to argue at Washington because other propositions are granted by the department, I get what I consider a fair tax and then quit. I am not in sympathy at all with any effort to reduce a tax to the very least sum. I feel that a prosperous corporation should pay large taxes, and that has been the spirit of my clients. Therefore when I reach a point where I think the tax is just, I stop, even though from a professional standpoint I may want to go on and argue other questions.

Perhaps you want me to tell you how I would ascertain invested capital? Ascertain the invested capital of my several units and add that together; and even though the principles of sound accounting are not observed by that simple process, I assert the principles of sound law are maintained.

Now what is the practical value of a proposition of this kind? When you have such a case, if I may venture the suggestion, try my method and see if you have lost any invested capital as compared with the effect of consolidating according to sound accounting principles. If you find you have, maybe you have got a point that is worth using.

In other words, where the principles of sound accounting and sound law do not coincide, I assert that the principles of sound accounting must yield. Congress was a very determined parent. Congress made up its mind that the commissioner had to enter into a matrimonial alliance with somebody, and so it took Mr. Commissioner and Miss Law by the hand and led them to the altar, and the commissioner is married to sound law and has no right to flirt with Miss Accounting no matter how winsome her charms or radiant her beauty.

Before I leave that point I want to show you a single expression of congress which rather supports my view that congress meant that the simple layman-like method of adding these several units together is the way to compute consolidated invested capital. You will find it in section 240, which determines when there must be a consolidation of returns. Incidentally, there is an expression there with respect to consolidated invested capital, and in regulation 864 the commissioner does not mention it. This section provides that in the event of the consolidation of certain corporations, and if it is found in the examination of the return that

one of them a corporation organized after August 1, 1914, has derived more than 50 per cent of its income from gains, profits, commissions and so on, made on war contracts, in such case the corporation so organized which has made such profits shall be taken out and assessed on the basis of its own invested capital and net income, and the remainder of the affiliated group shall be assessed on the basis of the remaining consolidated invested capital and net income.

In other words, this section first provides something that is to come in, then something that is to go out and then that there is to be a remainder. Do you assume for a moment that congress thought one sum would go in and another sum would go out and a different sum would be left? I do not think so for a moment. I think that there is a clear although incidental expression by congress to the effect that you must determine the invested capital of each company and add these amounts together, and that that shall be your consolidated invested capital according to law, whatever it may be according to sound accounting.

I am going to pass section 330 and discuss for a moment with you an important point with regard to tangibles and intangibles.

The question of what is a tangible and what is an intangible of course is important when you have a proposition of wiping out the excess of intangibles over 25 per cent under the 1918 law and 20 per cent under the 1917 law; and the more tangibles you can sustain as being in your capital stock issue, the better you are off. Likewise, this question becomes important under the present rulings of the department with regard to paid-in surplus. Under the present rulings paid-in or earned surplus may not be predicated upon intangibles. I do not think that is correct, although it is the present ruling, and I understand that there may be handed down shortly a decision to the contrary effect.

I have had occasion to go into this question fully and have found an interesting situation in the law as laid down by the supreme court of the United States in various cases. When you sum up the result of all those cases, you find practically that, before section 325 was enacted, tangible property consisted principally of physical assets. Everything else was intangible. Yet the supreme court of the United States in one case said that when you combine various properties into one company, you thereby

create a new asset, intangible in character, but perhaps worth more than all the properties standing alone before the consolidation. However, the definition of "intangible" before section 325 was very narrow. Congress saw that it was too narrow a definition, and I believe meant to give us a broad definition and defined the term "intangible property" as patents, copyrights and so forth and so on. In 1917 patents were tangibles, and curious questions arose as the result. Questions of paid-in surplus and all sorts of questions came up and the incongruous situation exists that the commissioner has to administer patents as tangibles for 1917 and intangibles for 1918. Today we have the following definition:

"The term 'intangible property' means patents, copyrights, secret processes and formulæ, goodwill, trade-marks, trade-brands, franchises, and other like property."

"The term 'tangible property' means stocks, bonds, notes and other evidences of indebtednesses, bills and accounts receivable, leaseholds and other property other than intangible property."

I simply mention this point because it took one of my assistants a month to go through all the cases and to get down to the proposition of what was a tangible and what was an intangible. The conclusion from that investigation is that practically everything except those things specifically named in section 325 as intangibles are in reality tangibles.

I pass now to the last section I shall discuss, namely, 326, which is the great yard-measure for the determination of invested capital.

Again I want to suggest a question which affords an idea of some of the vast number of constructive opportunities afforded by this law. We all know that before a corporation is organized it frequently happens that the incorporators do much work, and by that work produce things of value. In the old days we would capitalize freely the result of that work and the assets acquired. We are not, however, quite so free to do that now because of the danger of imposing a personal income tax on the incorporators. And if we do not capitalize such assets we know at the same time we are losing what would be valuable for that new corporation in the way of invested capital.

Now, how can you secure the invested capital and not the personal income tax? The answer is simple in most cases. You

can organize your corporation and have your incorporators pay for their stock in cash, or in such manner as may be provided, and then, preserving to these incorporators what they have done as individuals, have them transmit it to the organization as a gift, thus creating a paid-in surplus, non-taxable as personal income. I simply throw that out as a suggestion.

It frequently happens that field examiners go out and find some poor, old corporation, organized in the days before the flood, whose invested capital, because of the accident of time or form of organization is low enough. Then they start in and apply rates of depreciation to the assets which were turned in at the time of the incorporation and, when they are through, what has the poor corporation left?

Section 326 does not say a word about the right of the department to reduce the value of an asset which has originally been paid in as payment for stock—not one single word, and the department recognizes that it does not say so. It recognizes also that it has no right under section 326 to make any deduction. The reason for holding that an operating deficit is still invested capital is that very reason, as I understand it. In other words, there is no provision that in the event of a loss of original and invested capital, the amount of the loss can be deducted.

I am a great friend of the excess-profits tax law. I am sorry we have to have so much money, but if we must have it I do not know any better way of raising it than this way; and I think that law will become more popular as it is better understood and better applied. The great harm that is being done in this country by taxation does not come so much from the excess-profits tax which, as I have observed it, corporations have been able to pay and still go on in prosperous ways, but it arises more from the large surtaxes, because they reduce the initiative of men of means who usually are men of brains, who frequently are our captains of industry. When such men realize that if they make a profit it is largely to be taken from them and turned in to the government, they hesitate to chance their capital upon an enterprise in part speculative.

It seems to me from what I have heard in Washington that the tendency is—and certainly it would seem to be sound economics—to have the excess-profits tax stand and the income tax

and surtaxes reduced, so that capital will not be inert and idle but will be willing to step out and take its chances in the world again, paying heed to the needs of national industry and our national resources and pouring itself into them. The moment you stop initiative in individual investment, you strike at the heart of national prosperity.

Our country has become what it is largely because great rewards have been offered to capital for its investment. It may always be that capital to an extent will be over-rewarded. You must over-reward capital so that it can lay up against contingencies which are largely unexpected, in order that it may advance conservatively and use its best efforts in the upbuilding of industry. The moment you stagnate capital by high surtaxes, you stop the development of national prosperity.