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The Influence of Accounting on the Development of an Economy

By George O. May

II. Capital Value and Annual Income

One of the most striking contrasts between American and English financial and accounting practice is to be found in the fact that here we regard gains or losses on the sale of capital assets as finding a place in the income account, while in England they are regarded as increasing or decreasing capital. In this article I propose to consider some of the economic policies which may be in part at least attributable to the habit of mind which our practice reflects.

Unquestionably, the difference in practice does reflect a difference in habit of mind. Anyone who has lived both here and in England will recognize the truth of the statement that here we think in terms of capital value and there they think in terms of annual income. Inquire whether a man is well-to-do here and you will be told he is probably worth so many dollars; ask a similar question in England and the answer (if you get one at all) will certainly be that he is probably worth so much a year. It is not difficult to understand why this should be so. In England, modern business developed in a community in which previously the predominant interest had been in land and which already thought in terms of annual produce. The opening sentence of Adam Smith's *The Wealth of Nations* (1776) reads:

> "The annual labor of every nation is the fund which originally supplies it with all the necessaries and conveniences of life which it annually consumes, and which consists always either in the immediate produce of that labor, or in what is purchased with that produce from other nations."

Cannan, in his edition of the work, comments on this passage as follows:

> "This word (*i.e.*, 'annual'), with 'annually' just below, at once marks the transition from the old British economists' ordinary practice of regarding the wealth of a nation as an accumulated fund" (Note 1, p. 1).

He says, further, that:

> "The conception of the wealth of nations as an annual produce, annually distributed . . . has been of immense value" (Introduction, p. xxxiii).

With us, business developed in a new country: the great opportunities for gain lay in sharing in the growth of the country rather than in securing a part of its current annual yield.

Three fields in which the effects of the difference in the point of view may be discovered at once suggest themselves—those of local taxation, rate regulation, and income taxation.

In colonial days, according to Seligman, there were many cases in which, while the tax was imposed on property, the assessment was made on the basis of annual value. This was true of Massachusetts, Rhode Island, New Hampshire, New York, Delaware and Virginia.* Bullock, in discussing the local general property tax, also mentions that Massachusetts as a province levied taxes on the basis of the annual value of property, but that the second tax law passed after the adoption of the Constitution of 1780 changed to the basis of capital value, which is today, in general, the basis of local taxation throughout the States.† Whether the causes of the change were in any way related to those which produced the more momentous political developments of that time, I am not sufficiently versed in history to say.

When we turn to rate regulation, it is apparent that the principles we have adopted were based upon the Federal Constitution as interpreted by the Supreme Court in a series of cases of which the most important was perhaps *Smyth* v. *Ames* (1898). So, too, the enactment of what was really an income tax law in 1909, and of an avowed income tax law in 1913, brought definitions of income in conformity with the same habit of mind in the cases of *Stratton's Independence* v. *Howbert, Doyle* v. *Mitchell Bros. Co.*, and *Eisner* v. *Macomber.*

In *Smyth* v. *Ames* the Supreme Court decided for the first time that the basis for all calculations as to the reasonableness of rates must be the "fair value" of the property being used for the convenience of the public. Giving only the most general indication of how this value was to be determined by reciting some of the factors that must be considered without any expression of opinion as to the weight to be assigned to each, and making the clear

* *The Income Tax*, 2nd ed., p. 380.
† C. J. Bullock, *Selected Readings in Public Finance*, 3rd ed., p. 311.

reservation that there might be still other factors to be considered, the Court started that pursuit of the will-o-the-wisp of fair value which is still being carried on with no greater success than was to be anticipated. The charge made by Jevons against Ricardo, that he "shunted the car of economic science on to a wrong line," might perhaps with more justice be made against those who were responsible for bringing about the decision in *Smyth* v. *Ames*.

In *Doyle* v. *Mitchell* the Court held, first, that the value, at the date of the passage of the taxing act, of capital assets converted into manufactured articles and sold, must be deducted from the proceeds of sale before anything to be taxed as income could be arrived at; and, secondly, that the proceeds of sale or conversion in excess of that basic value were income.

On the first point, there is at least some appearance of inconsistency between this decision and that in *Stratton's Independence*, in which the Court held that the proceeds of mining could be taxed as income without any allowance for the exhaustion of the mine which was a necessary incident of the operation. However, no distinction between the two cases was made in the decision in *Eisner* v. *Macomber* which provided what has become the accepted legal definition of income in our Courts:

> "After examining dictionaries in common use (Bouvier's Law; Standard; Webster's International and the Century), we find little to add to the succinct definition adopted in two cases arising under the corporation tax act of 1909 (*Stratton's Independence* v. *Howbert*, 231 U. S. 399, 415; *Doyle* v. *Mitchell Bros. Co.*, 247 U. S. 179, 185): 'Income may be defined as the gain derived from capital, from labor, or from both combined', provided it be understood to include profit gained through a sale or conversion of capital assets, to which it was applied in the Doyle case" (252 U. S. 207).

It may be noted that in presenting the Income Tax Bill of 1913 Congressman (now Secretary) Hull expressed the view that an occasional purchase not for immediate resale, followed after a substantial interval by sale at a higher price, would not produce taxable income thereunder. It would have been well, perhaps, if his view had prevailed.

The decision in *Smyth* v. *Ames* forced the question of present value of capital assets upon the attention of all public utility companies. The income tax decisions made the value of capital assets at March 1, 1913 a question of cardinal importance for all

corporations owning capital assets at that date. The attention thus focused on the subject of present fair value, and the marked change in price levels which took place during the war period, together constitute an adequate explanation of the extent to which the practice of readjusting book values of capital assets to so-called present values was carried in the 1920's, which was criticized in the previous article of this series.

That the principles and practices, established as I have outlined, have met with scant approval in economic circles is indicated by examination of the works of economists of high standing. Upon the question of local taxation, Bullock says:

> "After forty years' discussion, the United States has the most crude, inequitable, and unsatisfactory system of local taxation —if, indeed, we can call 'system' that which more resembles chaos—than can be found in any important country in the civilized world." *

And T. S. Adams speaks of the system as "A hypocritical pretense, a source of wholesale lawbreaking and chronic inequality, a by-word for inefficiency and injustice." †

Undeterred by this experience, we enacted Federal capital stock tax laws which required taxpayers to report annually under oath the "fair value" of property for which no market existed or was desired, and any real valuation of which would have involved the difficulties and complexities mentioned in my previous article and would have been useless for any other purpose than compliance with the law. Needless to say, in practice no real attempt to fix fair value was made—instead, the tax being relatively small, the taxing authority was usually able to collect substantially more than was justly due because the additional tax was less than would have been the cost of demonstrating its injustice.

This tax was abolished in 1926, but in 1933 it was revived in the particularly obnoxious form of the linked capital tax and excess profits tax—the corporate taxpayer was first permitted (and required) to fix the taxable fair value itself, with the knowledge that placing the taxable value low would increase its liability to excess profits tax on its income. The two taxes were imposed at the bottom of a depression, when the market value of capital invested in industry was generally far below the amount actually

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* Bullock, *op. cit.*, p. 289.
† *Ibid.*, p. 982.

invested—thus the taxpayer was faced with the choice of paying a capital stock tax on a value that did not exist, or an excess profits tax on profits which were not excessive upon the test set forth in the law of what constituted an excess. It is hard to conceive of a tax device better calculated to bring the taxing system into disrepute.

In England, local taxation has for centuries been based on the annual value of property.* In national taxation the influence of the landowning classes was for a long time dominant, and prior to 1894 even death duties on land were levied only on the capitalized value of an annuity equal to the net rental value of the land for the life of the heir. In that year, however, land was subjected to death duties (estate duty) on the basis of its full capital value, at progressive rates which have since been greatly increased.† In 1909, a further step was taken. A system of taxation on the increment in land value was initiated, but the administrative difficulties proved so great that this experiment was abandoned. Thus, apart from transaction taxes, such as stamp duties on the transfer of property, death duties remain as the one case (of course, an important case) in which English taxes are levied on the basis of capital values.

The estimation of the capital value of land from the annual value, which is fostered by the English practice, serves a useful purpose in checking too optimistic valuation. Had this method of approach been general here, the disastrous Florida land boom could hardly have occurred, and fewer of our farmers would have found themselves ruined through acquiring by the use of borrowed money additional lands at prices out of proportion to the annual yield obtainable therefrom. A writer in the *University of Pennsylvania Law Review* for December, 1935, has suggested that there is a tendency today to give more weight to current annual value in establishing valuations of real property for purposes of local taxation.

Economic opinion on the theory of value in relation to rate regulation scarcely calls for comment, if that opinion is, as I

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* Cf. *Cannan, History of Local Rates in England, passim.*

† These provisions were the subject of a sharp difference of opinion between the Prime Minister (Lord Rosebery) and the Chancellor of the Exchequer (Sir William Harcourt) who had been the rival candidates for the succession to Mr. Gladstone. It is interesting to find in the Chancellor's reply to the Prime Minister's criticism this comment:

"Your observations upon the American attempt at a *property tax* are well founded, but everybody admits the objections to a *property tax*, which is levied annually on the possessors do not apply to a *death duty* which occurs only once in a generation on the transmission of estates into other hands."

A. G. Gardiner, *Life of Sir William Harcourt*, Vol. II, p. 285.

believe it to be, accurately summed up in the following quotation from J. C. Bonbright:

> "I think I am speaking the truth when I say that every economist without a single exception agrees that whatever is the proper basis of rate control . . . that basis cannot logically be the value of the property . . . this country alone of all the countries in the world attempts to use valuation as a basis of rate control." *

I shall, however, discuss some special phases of the problem of regulation in my final article.

In the third field already mentioned, that of income taxation, economic opinion has not, I think, generally approved the taxation of capital gains as income, even though the practice has escaped the wholesale condemnation which has been visited on our systems of local taxation and rate regulation. For myself, I have long felt that though it may seem unfair that unearned increment should escape taxation while earned income is heavily taxed, the weight of the argument is against the taxation of capital gains. And I am still more opposed to the treatment of capital gains as income for purposes other than those of taxation—indeed, one of the minor objections to the taxation of such gains as income is that it encourages the taxpayer to treat them as income in ordering his own affairs, instead of adding them to his capital or holding them in reserve against the all too probable future capital loss.

In an article written in 1922†, I recited some of the reasons that led me to the conclusions which I still hold, and I shall now do no more than consider what further light on the question the events of the intervening years have afforded. They have shown that the tax operates to produce artificial markets for securities, by preventing sales which, but for the tax, would be made, and thus has tended to make the fall more violent when it comes. They have also demonstrated with disconcerting completeness the validity of the argument that an equitable tax, designed to give relief in respect of losses commensurate with the tax on gains will, on balance, adversely affect the revenue, and that the adverse effect will be felt when the revenue is least able to bear it. As a result, changes have been made in the law which implicitly admit that capital gains are not income but leave them

* J. C. Bonbright, *Accounting Review*, Vol. V, pp. 111 and 122.
† See "Taxation of Capital Gains," JOURNAL OF ACCOUNTANCY, Vol. XXXIV.

subject to tax as if they were, changes which sacrifice justice to immediate revenue, through the continuation of the tax on net gains and the practical denial of relief in respect of net losses.

The new provisions, by which a portion of the gain on sale of assets held for a period of years is taxed as income at rates which are reached by adding that portion of the gain to what happens to be the income of the year in which the gain is realized, are difficult to justify upon any theory of ability to pay or equality of sacrifice, or upon any of the canons of sound taxation. The denial of allowances for losses on property sold is manifestly unjust and results in such absurdities as taxpayers being led to sacrifice substantial salvage values in order to preserve the right to take deductions for losses which are allowable if property is abandoned but not if it is sold. There is, moreover, something repugnant to one's sense of justice in the sight of a Government deliberately devaluing the currency and taxing the difference between the price received in depreciated currency and the price paid prior to devaluation in the undepreciated currency as a gain and at the same time denying to taxpayers relief in respect of losses occasioned by the fall in prices which is pleaded in justification of the devaluation.

The provisions of the law relating to non-taxable reorganizations and exchanges, and other provisions necessitated by the taxation of capital gains, are constantly adding to the complexities and uncertainties of taxation. Meanwhile, the great argument for the taxation of capital gains—that without it unearned increment would go untaxed—has been greatly weakened by the enactment of high gift and estate taxes.

The amount of capital gains spent as income though large in itself is small in comparison with the aggregate of such gains. If gains are offset by later losses, it is grossly unjust that heavy taxes should be levied on the gains with no compensating relief in respect of the losses; if they are added to capital, that capital is heavily taxed whenever it is transferred by gift or bequest.

Students of taxation have agreed that an income tax at high rates cannot long continue to be successfully levied unless the law is generally regarded as broadly just in its form and administration. It can not, I think, be maintained that this is true of our existing income tax system, and those who deny its justice can point to the provisions respecting capital gains and losses as striking evidence to support their position. It is inevitable that

provisions which the taxpayer regards as deliberately unfair shall encourage deliberate evasion; and even if it is true that evasion existed prior to the enactment of these unjust provisions this hardly seems sufficient ground for a policy of deliberate injustice on the part of the Legislature. Congress would be well advised to abandon the policy of taxing capital gains—or, if that is deemed to be politically impossible, to tax them as something other than income at a flat rate not high enough to act as a deterrent to the taking of profits. This could be done without awaiting the general revision of our federal tax system, which is so urgently needed.

Sooner or later, however, we must broaden the scheme of federal taxation, and particularly the basis of the income tax. Not until this has been done can we hope to enjoy the relative stability of revenue which England has experienced in spite of the depression and of the magnitude of its tax burden.

Turning from the tax aspect of the question of capital gain, I would draw attention to a danger against which some safeguards are, I think, urgently required. This danger arises from the alarming habit which seems to be developing of regarding every annual report as a new edition of a prospectus. Even those who contend that realized capital gains are a form of income must concede that such gains and recurrent income have no common relationship to earning capacity, except to the small extent that capital gains may represent recurring income that has not been distributed. Apart from this item, which for practical purposes may be disregarded, the gain normally represents either (a) the capitalized value of a change in capacity to earn recurring income (demonstrated or assumed); or (b) a change in the rate of capitalization applied to an unchanged earning capacity; or (c) a combination of the two. This being so, such a capital gain can not properly be added to a recurring earning capacity (which has not already been capitalized) to form the basis from which, by multiplication, a capital value may be determined. To my mind, few points are of more importance in connection with the problem of presenting illuminating reports to investors than that of taking some steps which will tend to prevent investors from including capital gains with current income in one sum, from which they will compute capital value by a single multiplication.

The treatment of capital gains as income reached its most pernicious development during the boom period in the practice of re-

garding stock dividends as income in an amount equal to the market value of the stock, the evil being especially marked in the case of pyramided holding companies. To the extent that the amount included in income exceeded the amount of earnings which formed the basis of the distribution by the company declaring the dividend, the credit to income by the receiving company represented nothing except an unrealized capital appreciation. Another unsound practice is that of requiring investments of insurance companies to be carried in their reports at "market value" even if above cost. When market prices rise to dizzy heights, as in 1928–29, the assets of such companies as reported under the regulations rise with them. When prices fall too precipitately, however, the evidence of the market is rejected and artificial market prices are constructed by the Commissioners. The result in practice is, therefore, that the portfolios of what should be our safest and soundest institutions are carried at quoted market prices if those are very high but above market prices if those are very low. The fact that resort to artificial prices was deemed necessary three times within a quarter of a century suggests that the Commissioners should at least recognize the limited significance of market quotations when they are high as well as when they are low.

From the point of view of the technical accountant, it is a curious contradiction that we, who have gone further than any other country in refining double-entry bookkeeping and distributing charges over successive periods by elaborate systems of accrual, should in our thinking have, in effect, adhered to the old single-entry method of determining gain or income by deducting worth at the end of the period from worth at the beginning thereof.

Some of our economists and statisticians have even undertaken to include fluctuations in the value of the "national" capital in computations of the "national" income. In doing so, they have exaggerated the growth of wealth in boom periods and its decline in periods of depression with, as I think, unfortunate results. In a recent article, Sir Josiah Stamp commented on this procedure as follows:

"American writers have included the rise in the market value of capital assets under income (or the fall as a deduction), but the practice is not generally accepted in other countries." *

* "Methods Used in Different Countries for Estimating National Income," *Journal of the Royal Statistical Society* (1934), pp. 449–50.

He went on to express the opinion that this was "all of a piece with the strange compound of capital charges and income in the American system of taxation". In fairness to American economists, however, it may be questioned whether the views which he criticized are shared by more than a small minority of them. In publishing his paper, he printed the following interesting footnote:

"On the day of reading, the latest official publication was received from Washington.* In this, the whole method has been abandoned: 'the inclusion of gains and losses yielded by such changes in asset values would be either a duplication, since it would amount to counting both a change in net income, and the change in capitalization of that income, or a distortion of the national income estimate as a measure of the economic system's end product.' It seems clear that the publication to the nation of figures of national income already heavily diminished, but reduced to a minus quantity by the special deduction of the huge shrinkage in capital values for 1932–3, was too much for any realistic official statisticians to face."

The preoccupation with capital and capital gains is also to be found in the securities legislation passed under the present administration, which is obviously, if unconsciously, framed in the interest of the short-time speculator for the rise rather than of the long-time investor for the yield. Even the members of the Securities Commission seem to have developed doubts on the question whether the acts were really necessary or will prove beneficial in relation to issues of securities by seasoned corporations. Further, some of the information which is required by the Commission in registration statements and annual reports would seem possibly to be helpful to speculators (though more clearly to competitors), but more likely to injure than to benefit the long-time investors, whose interests surely deserve special consideration.

It has seemed to me particularly unfortunate that at a time when devaluation, inflation, and apprehension of further experimentation with our fiscal system were impairing confidence in what had been regarded as high-grade securities and tempting small savers to gamble in equities, the whole emphasis of the Administration and of Congress should be upon efforts to diminish slightly the hazards of stock gambling, and none upon the magnitude of the hazards that were bound to remain.

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* *National Income, 1929–1932,* Department of Commerce in coöperation with the National Bureau of Economic Research, Inc.

Granting the desirability of telling the public that great losses had been caused by the misdeeds of issuers and vendors of securities, it was at least equally desirable to tell the public that these losses were but a small fraction of those resulting from the financial, industrial and political hazards to which all business is subject, and that enormous losses on investment in enterprise and invention are a part of the price we must pay for progress.* The two Securities Acts are calculated to create expectations which they can not satisfy; and although they may perhaps be made to serve a useful purpose, the hope would be stronger if the Acts had been less theoretical and punitive in conception, and had had more regard to what is remedial and practical. It lies in continued wise administration and judicious amendment rather than in the Acts themselves. Indeed, one of the dangers of the admitted excellence of administration by the Securities Commission up to the present time is that it may tend to blind us to the inherent defects of the law.

The same emphasis on capital value is, I think, also in large measure responsible for the laws passed in recent years making the propriety of dividends dependent on there being an excess of assets over liabilities and capital, thus displacing the old rule under which the source of income to a stockholder was the earning of a profit by the corporation in which he held stock, and the declaration of a dividend merely fixed the time when it became income to him. This change, whether desirable or undesirable, may obviously have very important economic consequences, particularly in conjunction with the no par value stock laws. If generally adopted, it would rob the word "dividend" of its old significance, since under it the payment of a dividend does not imply the previous earning of a profit and a dividend may be, in every real sense, a distribution of capital. Though perhaps the new law represents only an attempt to escape from the difficulties with which we are familiar without adequate thought of the new difficulties which may be encountered, to me it seems to be fraught with great possibilities of evil.

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* I expressed substantially these views when securities legislation was pending, both in 1933 and 1934. In my testimony before the Senate Committee on Banking and Currency in 1934, I said:

"My feeling on this question, I think, must be very much that which the committee feels in regard to the larger subject. You want to do everything that you can to make buying and selling securities, particularly by the small man, safer and surrounded with more information. But you must realize that all you can do will not reduce the risks that he is bound to run very greatly, and there is always the danger that by legislating you create a feeling of confidence in the securities that are offered which legislation cannot possibly impart to them" (*Hearings*, p. 7176).

There was doubtless a time when the assets test was regarded as protecting the interests of creditors and necessary for that purpose; but with the law and common practice permitting legal capital to be fixed at nominal figures, such a rule adds little or nothing to the common proviso that no dividends shall be paid when a corporation is insolvent or when payment of the dividend would make it so. It is noteworthy that even this last provision is deemed unnecessary in England; it was in the English law of 1855, but was eliminated in 1862. Since then, apart from the general Statute of Frauds, the sole reliance in England for protection against improper dividends (and also against the acquisition by a corporation of its own capital stock) has been the section which sets forth the way, and the only way, in which the share capital may be reduced. This protection seems to have been adequate; no doubt its effectiveness has been increased by vigorous declarations such as that of Lord Campbell in *Burnes* v. *Pennell*, (1849): "Dividends are supposed to be paid out of profits only, and when directors order a dividend, to any given amount, without expressly saying so, they impliedly declare to the world that the company has made profits which justify such a dividend." This dictum is commonly reflected in articles of association in the form of a terse declaration that "No dividend shall be paid otherwise than out of profits."

In its new form (*e. g.*, in Delaware), the assets test is, of course, nothing more than a device to permit directors to declare dividends when there are no profits. The power conferred by that law to make the legal capital of a corporation only a fraction of its economic capital makes such dividend declaration possible without insuring any substantial margin of protection to creditors.

An anomalous situation is presented by the New York law as at present construed by the courts of that state (the construction and the constitutionality of the provision, however, are at present involved in cases pending in the Court of Appeals of the State). It makes directors of a business corporation liable if they declare a dividend unless, after the declaration of the dividend, the value of the remaining assets is at least equal to the liabilities and the legal capital of the corporation. The elusive term "value" is not further defined, and as the law is at present construed, no defense of good faith or reasonable care will protect the director if it is subsequently found by a court of competent jurisdiction that

upon some theory of value accepted by it the value of the assets fell short of the required standard.

Now, in any such legislation, the relationship between the theories governing the definition of capital and the restriction of dividends is of the first importance. A rigid rule regarding dividends may be made tolerable by liberal rules defining capital. If the law seeks to make legal capital and actual capital correspond closely, then a dividend rule like New York's becomes unreasonably harsh.

It is obvious that in the case of a company whose legal capital is approximately the same as its actual capital, such a law would subject directors to a hazard which they would not be warranted in assuming; a director could only vote at his peril for the distribution by way of dividends of unquestioned current earnings. New York, which took the leading part in adopting the questionable device of stocks without par value has, however, afforded domestic corporations an opportunity to make their legal capital a purely nominal figure which may be only a fraction of the true capital. This provision, while open to many objections, does afford a way in which the hazards of the dividend rule may be avoided.

However, the New York law goes further than to establish a rule applicable to domestic corporations—it imposes the same liability on directors of foreign corporations which transact business in New York. Now, outside the State of New York, and particularly outside the United States, there are many jurisdictions in which either the law or custom makes the legal capital substantially the true capital of the corporation and in which the law permits the distribution of current profits without regard to fluctuations in the value of capital assets not intended to be sold. Such an approach to the question is at least as reasonable as that of the State of New York, but it will be observed that the directors of a company formed in such a jurisdiction, but transacting business in New York, are placed in a peculiarly unhappy position. For the capital of the corporation will be determined by the laws of the jurisdiction in which it is incorporated, but the question whether a dividend paid was warranted will be determined by a New York court, under New York law, and upon New York theories of value. The law so construed seems to constitute an obnoxious attempt to impose New York ideas of questionable soundness upon corporations formed in other jurisdic-

tions but transacting business within the state. If the Court of Appeals sustains the current construction, modification of the law would seem to be called for.

In each of the several fields which have been considered, the habit of thinking in terms of capital value seems to me to have encouraged economic tendencies which are harmful to the community. It is clear, also, that while it is seldom possible to determine annual income precisely, and sometimes difficult to arrive at even an approximation thereto, the problem of determining income is easier than that of establishing capital value. This for the simple reason that value, itself, must be dependent mainly on the income prospects; and in order to measure it, we must first estimate earnings. Then we still have to face the difficulty of determining what is the capital value of an earning capacity of the kind with which we are dealing.

Economists, teachers, legislators and accountants should all do what is in their power to bring home to our people the truth of Adam Smith's doctrine that the annual produce constitutes the wealth of the country; and to encourage them to rely for economic security on the income derived from their work and their property, rather than upon the hope of enhancement of capital value, which may seem to offer the easy road to affluence but more often proves a lure to disaster. Then the *Economist* may no longer be able to say as it did on October twelfth last that:

"Even today, in spite of depression and Securities Acts, the capital profit is still as completely monarch in Wall Street as the income yield is in Throgmorton Street."