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Federal Taxes in Relation to Business

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By Homer N. Sweet

The subject before this meeting has already received earnest consideration on the part of your association. I understand that the association has proceeded in this matter, as in many others, with broad purposes in view and with an aim to public service. The special war tax advisory committee of your association made a comprehensive study of tax legislation in 1918. It laid before the appropriate committee of each house of congress a brief containing practical recommendations, many of which were recognized in the final bill as enacted in February of this year.

We may well confine our discussion today to the more recent developments affecting the relation of federal taxes to business. The taxes to which I refer are the corporation income tax and the corporation excess profits or war profits tax. After declaration of war by our country a large war tax levy was to be expected and it should be willingly paid. These taxes, nevertheless, must be reckoned with in appraising the earning power or financial stability of any corporate enterprise.

Sound accounting demands that the obligation of a corporation to the United States government for accrued taxes shall be represented on the balance-sheet among the quick liabilities, and sound financing requires that adequate funds shall be set aside and made available for meeting these taxes. Unfortunately, owing to the intricacies of the excess profits tax, corporations cannot be at all certain that they have computed their taxes correctly. The internal revenue department will make numerous adjustments in tax returns as filed and corporations will be liable for reassessments during the five years following any taxable year. We shall have to deal to a greater extent than ever before with contingent liabilities and contingent assets. That is one of the most difficult tax problems with which business men in general and credit men in particular now have to contend.

The income and excess profits taxes assessed on all corporations for 1917 amounted to nearly $2,320,000,000. On the average

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these taxes were about 22% of corporate net income. The taxes for 1918 are estimated at $3,275,000,000, or about 33% of the total estimated net income of all corporations.

Let us assume, for example, that a corporation having an annual net income of $1,000,000 would be taxed at the average rates mentioned. For the year 1916, when there was no excess profits tax and the income tax rate was only 2%, such a corporation would be taxed $20,000; but for 1917 the tax would be $220,000, and for 1918 $330,000.

These amounts measure the great increases in taxes which have been levied on corporation income throughout the country. It should be remembered that these are average figures. In the every-day experience of a credit department, the average corporation is perhaps the exception. Certainly, many concerns in the iron and steel industry will pay much larger taxes in proportion to net income than the average corporation.

The balance-sheets for December 31, 1918, of 15 typical corporations in the iron and steel industry show percentages of tax liability to total current assets varying from 1% to 42%, with the average around 18%. This constitutes a substantial draft upon resources.

According to pre-war standards, the amount of tax appears large in proportion to net income and current assets. Corporations would nevertheless be able, in the great majority of cases, to arrange satisfactorily for the liquidation of this liability at the proper times, provided the amounts could be definitely ascertained at the time of closing the books. But, however conscientious a corporation may be in its attempt to comply with the law and regulations, later rulings and court decisions may result in additional assessments. Taxes of prior years, which were thought to have been completely liquidated, may later be increased, and assessment of the additional amounts may fall as an unexpected draft upon cash resources. In view of this contingency, a corporation cannot define its dividend policy with assurance. Investment of surplus earnings in needed additions to plant either may be postponed or may be undertaken at the risk of placing the corporation in a position where it could not meet the additional assessments except through loans.

The tax of one corporation has been calculated by two experts. One finds the tax to be $2,000,000; the other figures it at $500,000.

The difference of $1,500,000 in the two amounts is due to opposite interpretations of a doubtful point of law which may not be settled for several years. There are so many special cases of this kind to be brought before the advisory tax board that we cannot reasonably expect that they will be promptly settled.

I will mention only a few of the various contingent factors which make the determination of taxes so uncertain for corporations. Owing to the wide fluctuations in tax rates for the years 1917, 1918 and 1919, the amounts of taxes are materially affected by the methods employed in the accruing of income and expense for each twelve-month period during these three years. The internal revenue department will take exception to the accounting methods followed by many corporations, and it may be expected that higher taxes will be levied after returns have been amended. Delayed settlements of government contracts will postpone for several years the final determination and assessment of 1918 taxes of many corporations. Certain regulations of the department and decisions of the courts will be retroactive and will result in reassessments in cases where returns were made exactly in accordance with the rulings in force at the time. Liquidations and reorganizations often raise tax problems which will not be finally decided for several years.

Such is the situation which has grown out of the complexity of the law and its application. The possibility of large reassessments should not be overlooked in analyzing the credit standing of a corporation. We have been accustomed in the past to make conservative allowances for shrinkages of assets which may not realize the full amount of their book value upon sale. We must now make some reservation for the understatement of liabilities for taxes. No general rule can be laid down for proving whether a corporation has completely met its tax liabilities. Analysis of balance-sheets for successive years cannot be depended upon to reveal underpayments of taxes. Judgment must be based mainly upon the general character and trustworthiness of the corporation. Companies which are known to adhere to conservative policies in finance can be depended upon as a rule to consult competent counsel and to make ample provision for tax liability.

Were it not for the fact that many balance-sheets which have come to my notice have not contained any reserves for taxes, I would not think it necessary to repeat that accrued taxes are an actual obligation which should be included among the quick liabilities on financial statements. Even with the plan of payment by instalments, which is provided for in the existing law, the full amount of liability should be represented among the quick liabilities because it is due within twelve months.

Many published financial statements of the past year or two indicate plainly that the responsible officers did not have a clear conception of the financial requirements imposed by income tax laws, or else they purposely evaded these requirements. Not a few statements have contained no specific provision whatsoever for tax liability. Financial statements for 1918 rarely state whether the reserves for federal taxes have been computed under the 1917 act or under the higher rates prescribed by the law passed by congress in February, 1919.

The situation is relieved considerably by the quarterly payment scheme. Inasmuch as the instalments are spread over the twelve months following the year for which the taxes are assessed, the current earnings can be drawn upon in case of need to defray a portion, at least, of the previous year's taxes. It would be unsafe, however, for a corporation to place dependence upon future earnings to the extent of disbursing its entire surplus funds in dividends, or investing them in plant additions. Such a policy would be highly speculative. If anticipated earnings were not realized, such a corporation might find itself unable to meet the tax instalments as they came due. This has actually been the experience of one corporation, as I happen to know. That company was forced to borrow money on unfavorable terms in order to pay its tax bill.

It should be the policy of a corporation, therefore, not only to establish on the books adequate reserves for tax liabilities but also to set aside funds of corresponding amounts to be available as instalments fall due. Such funds should preferably be invested temporarily in United States certificates of indebtedness. Examination of the balance-sheets of corporations in strong financial positions shows that these companies held certificates of indebtedness and Liberty bonds on December 31, 1918, in amounts approximating the tax liabilities.

I will conclude with a brief statement of the practice which, in my opinion, should govern the policy of corporations with respect to taxes.

1. All possible care should be taken to determine the correct amount of tax which would be imposed under a reasonable interpretation of the law.
2. The balance-sheet for the end of the fiscal year should include, as a separate item among the quick liabilities, the amount of federal income and excess profits taxes assessable on the net income earned to that date.
3. The balance-sheet for any date other than the close of the fiscal year should include, as a separate item among the quick liabilities, an amount representing estimated taxes accrued for the current year.
4. The balance-sheet for any date should designate the act under which the liability for federal taxes was calculated—otherwise, inquiry may properly be raised as to whether the taxes were figured in accordance with the provisions of the most recent act.
5. Funds to meet taxes should preferably be invested temporarily in certificates of indebtedness. In no event should funds required for taxes be distributed in dividends or invested in fixed assets.