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Federal Taxation of Corporations*

By F. R. Carnegie Steele

The Principal Taxes

The principal federal taxes to which corporations are subject are the income tax, excess profits tax and capital stock tax. All these are imposed under the revenue act of 1918, which, though enacted so recently as February, 1919, became effective retroactively as of January 1, 1918. In order to apprehend the drastic character and the magnitude of such taxes, it should be borne in mind that for the year 1918 a sum exceeding three billions of dollars (more than one-half of the total revenue anticipated under the act) was assessed solely upon corporations, and that a very substantial part of this vast sum was assessed upon Massachusetts industries.

Both the income tax and the excess profits tax are levied upon taxable income (after excluding dividends and certain exemptions), but the excess profits tax is imposed at graduated rates on the difference between the taxable income and an exemption comprising 8% on invested capital plus $3,000.00, this exemption being termed the "excess profits credit." The capital stock tax is a special excise tax with respect to carrying on or doing business, and is levied at the rate of $1.00 per thousand on the fair average value of a company's capital stock in excess of an exemption of $5,000.00.

Corporation executives have become familiar with the general operation and scope of such tax legislation, because similar taxes were in force under the former revenue act of 1917, so, on the present occasion, it seems unnecessary and inappropriate to submit a detailed digest of the present statute, but rather to discuss the practical aspects of such of its more important provisions as are of especial significance to manufacturing organizations.

Reduced Tax Rates for 1919

It is gratifying to note the following striking changes in corporation tax rates and procedure, effective for the calendar year 1919 and thereafter.

*An address delivered at the annual meeting of the Associated Industries of Massachusetts, at Boston, 1919.

The income tax rate for corporations is reduced from 12% to 10%. It should be noted, however, that since an individual's maximum normal income tax is reduced from 12% to 8%, a discrepancy occurs between the normal tax of a corporation at 10%, and the normal tax of an individual at 8%, from which the dividends he receives are exempted. Therefore, a dividend when received by one corporation from another corporation is exempted from a 10% tax, but when received by an individual the exemption is only 8%.

The war profits tax, levied on 1918 income at 80% on all income in excess of the war profits credit, has been abolished, except as to war contracts. This effects a material reduction, not only in taxes, but also in the labor of compiling tax returns, inasmuch as the elaborate schedules regarding earnings, assets and liabilities and invested capital, for the three pre-war years, no longer are required.

With regard to the graduated excess profits tax, the rate under the first bracket is reduced from 30% to 20% on taxable income over the excess profits credit and less than 20% of the invested capital; and the rate under the second bracket is reduced from 65% to 40% on taxable income over 20% of the invested capital. The maximum limit for this tax is also reduced from 30% to 20% on taxable income over $3,000.00 and less than $20,000.00, while for income exceeding $20,000.00 the rate is reduced from 80% to 40%.

Determination of Taxable Income

General Comments

According to the computations of the treasury department, the net income of corporations in the United States for the year 1918 amounted to the enormous sum of ten billions of dollars, from which, of course, the statutory abatements and credits were deductible in arriving at taxable income.

The credits against net income include dividends received from corporations similarly taxable and interest received on tax-exempt securities. The value of property acquired by gift, devise or descent is exempt income, but sums received by corporations as the proceeds of life insurance policies upon the lives of officers or stockholders are taxable to the extent that they are in excess of the amount of premiums paid and not deducted in previous

income-tax returns. Corporations are thus unjustly penalized, inasmuch as the proceeds of life insurance policies paid to the insured's estate or to individual beneficiaries are tax exempt. In computing taxable income, items deductible from gross income include all the ordinary and necessary business expenses paid or incurred during the taxable year and all interest paid or accrued within the taxable year, excepting interest on indebtedness incidental to investments in tax-exempt securities other than Liberty bonds. Payments for federal income tax and excess profits tax and war excess profits tax may not be deducted, but the excess profits tax payable for the taxable year is deductible in arriving at a corporation's net income subject to income tax. Losses deductible are no longer limited to the extent of any offsetting profits from similar transactions, but corporations (unlike individuals) are not allowed to deduct as an expense contributions or gifts for religious, charitable, scientific or educational purposes. This unfair discrimination against corporations ought to be abolished. Another hardship occurs in the case of income resulting from the sale of capital assets, which is taxable for the year in which received. Upon the sale of such assets, which usually represent accumulations through the gradual development of a business during a series of years, the proceeds are equivalent to accretions to capital and should be treated as such instead of being regarded as income; or, at least, the apparent profit on sale should be pro-rated over the number of years during which the property was owned by the taxpayer.

There are other factors of special significance in the computation of taxable income, and with regard to these the following comments are submitted.

Claim for Loss through Inventory Shrinkages

In the determination of taxable income no subject is of greater importance to manufacturers than the valuation of inventories, but, unfortunately, the official regulations concerning the admissibility of claims for losses arising from their over-valuation under war conditions have aroused widespread dissatisfaction and are believed to be contrary to the apparent intent of the statute.

Section 234, sub-section 14a of the federal revenue act of 1918, specifically provided that at the time of filing a return for the taxable year 1918 a taxpayer might file a claim in abatement, based

on the fact that he had sustained a substantial loss (whether or not actually realized by sale or other disposition), resulting from any material reduction (not due to temporary fluctuations), of the value of the inventory for such taxable year; or, if no such claim were filed, but it were shown to the satisfaction of the commissioner that during the taxable year 1919 the taxpayer had sustained a substantial loss of this character, such loss should be deducted from the net income for the taxable year 1918, and the taxes for such year should be redetermined accordingly.

It would seem that the true construction or intent of this section would be that if there were a material reduction of the value of the articles included in the inventory, the taxpayer would be entitled to have the closing inventory for the 1918 year adjusted to the replacement value of the goods included in such inventory, upon their sale or other disposition, or, in the case of goods still on hand at the time of the filing of the claim, to the replacement value of the goods at the time of filing such claim (or even at a later date), so as to prevent the injustice of computing and taxing the 1918 net income on the basis of a closing inventory taken at what proved to be an inflated value. Of course, if it had been possible to know what would be the values for 1919 applying to the goods included in the 1918 inventory, it would have been made permissible to use such values. That being impossible, provision apparently was made for the adjustment of the inventory to the later reduced values. It was believed that corporations would thus be relieved from paying heavy war taxes upon "paper profits," because any over-valuation of inventories at the close of the year 1918 might be adjusted so that only the actual profits realized on sale of such inventories would become taxable in the year 1919, and at the lower tax rates then in force.

Nevertheless, the official regulations regarding this subject, which appear to be opposed to the spirit of the act, render it exceedingly difficult, if not impossible, for a manufacturer to obtain the relief from the taxation of paper profits for the year 1918 that the law was designed to afford. It is held that the losses mentioned must be net losses, allowable only (a) where goods included in inventory at the end of the year 1918 have been sold at a loss during the succeeding taxable year (and this loss can only be claimed when the inventory price exceeds the sale price, less

selling expense, etc., attributable to such goods) or (b) where they remain unsold throughout the year 1919 and at its close have a then market value, not resulting from a temporary fluctuation, materially below the value at which they were inventoried at the end of 1918. This in effect denies relief to taxpayers who proceed to use their goods in manufacture and sale, while giving relief to those who retain them on hand.

On May 28, 1919, representatives of the Associated Industries of Massachusetts, in conference with the commissioner of internal revenue, urged him to amend the official regulations concerning claims for inventory losses, in order that such regulations might fairly interpret the obvious intent of the statute, but no action thereon has yet been taken. The official regulations state that deductions for inventory losses may be claimed either by a claim in abatement or by a claim for refund and must not be entered on the regular return.

It was required that claims in abatement be filed with the collector on form 47 when the return for the taxable year 1918 was made, but, as the law states that at the time of filing a return for the taxable year 1918 a taxpayer may file a claim for abatement, the commissioner holds that the law does not mandatorily provide that the claim shall be filed at the time of rendering the return. Therefore such an abatement claim will be considered by the internal revenue bureau if filed before or within ten days after the mailing of the collector's notice and demand on form 17. In the case of a claim in abatement filed with a return, payment of the amount of the tax covered thereby shall not be required until the claim is decided, provided the taxpayer files therewith a bond on form 1124 with surety or securities of double the amount of the tax covered by the claim with the condition for the payment of any part of such tax found to be due with interest at the rate of 12 per cent. per annum.

Claims for refund are to filed on form 46 not later than 30 days after the close of the taxable year 1919. Each claim must contain a concise statement of the amount of the loss sustained and the basis upon which it has been computed, together with all pertinent facts necessary to enable the commissioner to determine the allowability of the claim. The amount allowed by the com-

missioner in respect to any such claim shall be deducted from the net income for the taxable year 1918 and the taxes shall be recomputed accordingly. Any amount paid in excess of the tax due shall be credited or refunded to the taxpayer. In computing income for the taxable year 1919 the opening inventory must be properly adjusted by the taxpayer in respect of any claim allowed for the year 1918.

A claim for loss in inventory not realized by sale will be decided only after the close of the taxable year 1919 upon the basis of any permanent reduction in the level of market values, which may occur during such year, from the inventory values taken at the close of the taxable year 1918. Not later than thirty days after the close of the taxable year 1919 a taxpayer who has filed either a claim in abatement or a claim for refund, or both, shall submit to the commissioner a descriptive statement showing the quantity and kind of all goods included in the 1918 inventory which have been (a) sold at a loss in the taxable year 1919, (b) sold at a profit during the taxable year 1919 or (c) not sold or otherwise disposed of during the taxable year 1919, together with such other information in respect of such goods as the commissioner may require. A claim filed with the 1918 return for a loss not then realized by sale will be passed upon in the light of any sales thereafter made during the taxable year 1919. A claim filed with the return is authorized for the purpose of allowing the taxpayer to utilize, where justified, a preliminary allowance for inventory losses, and not to provide a deduction essentially different from that taken by way of a claim filed at the end of the taxable year 1919.

Claim for Amortization of Equipment for War Work

Under the revenue act of 1918 it is clearly provided that a "reasonable deduction" for amortization of the cost of equipment for war work (incurred after April 6, 1917) may be made by a taxpayer in computing taxable income, and that at any time within three years after the termination of the war the commissioner may, and, at the request of the taxpayer, shall, reexamine the return; and if he then finds as a result of an appraisal or from other evidence that the deduction originally allowed was incorrect, the taxes shall be redetermined accordingly. Notwithstanding the

clear and unequivocal terms of this statutory provision, the regulations and decisions issued by the treasury department concerning it appear unduly to restrict its practical application.

In general terms these regulations, which are quite complex, provide that the amortization allowance shall be the difference between the equipment's original cost, less any depreciation or deductions taken prior to January 1, 1918, and a residual value, defined, under specified conditions, as follows:

(1) Salvage value at date discarded, (in the case of property useful only during the war period and permanently discarded at the date of the return); or

(2) Salvage value as of the date when the property will be permanently discarded, (in the case of property still in use which will not be required for future use and is certain to be permanently discarded before the last payment of the tax covered by the return); or

(3) Estimated value to the taxpayer in terms of its actual use or employment in his going business, in no case less than sale or salvage value or more than 25% of cost, (in the case of all other property). In this case the final determination of the amortization allowance is to be ascertained upon the basis of stable post-war conditions under regulations to be promulgated when those conditions become apparent.

The amortization is to be pro-rated in proportion to net income (computed for this purpose without benefit of the amortization allowance) between January 1, 1918, and the date when the residual value adopted, as outlined above, is determined.

It is understood, therefore, that a taxpayer will not be required to charge off any amortization in a year in which there are no profits to absorb it, but will charge it only as and when there are profits available.

The Claim for Depreciation and Obsolescence

In computing taxable income a reasonable allowance for the exhaustion, wear and tear and obsolescence of property used in the trade or business may be deducted from gross income. The proper allowance for such depreciation of any property used in the trade or business is that amount which should be set aside for

the taxable year in accordance with a consistent plan by which the aggregate of such amounts for the useful life of the property in the business will suffice, with the salvage value, at the end of such useful life to provide in place of the property its cost or its value as of March 1, 1913, if acquired by the taxpayer before that date.

It should be noted that the amount on which depreciation may be computed is not limited to the book value of depreciable property. The past practice of conservative industrial managers has been to charge off as expense additions and improvements which were in fact capital expenditure. This, however, does not preclude a claim for depreciation upon the actual value of plant as of March 1, 1913 (the date when the first income-tax law became effective under the eighteenth amendment to the constitution of the United States), plus the cost of subsequent additions to plant regardless of the value at which the plant is carried on the taxpayer's books.

When through some change in business conditions the usefulness of capital assets is suddenly terminated, so that the taxpayer discontinues the business or discards such assets permanently from use in the business, he may claim as a loss (obsolescence), for the year in which he takes such action, the difference between the cost or the fair market value as of March 1, 1913, of any asset so discarded (less any depreciation allowance) and its salvage value remaining. This exception to the rule requiring a sale or other disposition of property in order to establish a loss requires proof of some unforeseen cause by reason of which the property must be prematurely discarded, as, for example, where machinery or other property must be replaced by a new invention, or where an increase in the cost of or other change in the manufacture of any product makes it necessary to abandon such manufacture, to which special machinery is exclusively devoted, or where new legislation directly or indirectly makes the continued profitable use of the property impossible. This exception does not extend to a case where the useful life of property terminates solely as a result of those gradual processes for which depreciation allowances are authorized. It does not apply to inventories or to other than capital assets. The exception applies to buildings

only when they are permanently abandoned or permanently devoted to a radically different use, and to machinery only when its use as such is permanently abandoned.

With regard to depreciation of intangible assets, an important concession has just been authorized by the treasury department, under which the former regulation to the effect that "there can be no such allowance in respect to goodwill, trade names, trademarks, trade brands, secret formulae or processes" has now been abrogated. This innovation gives taxpayers the right to claim depreciation upon the intangible assets named, as well as on patents, copyrights, licenses, etc., the term of which is definitely limited, subject to the approval of the commissioner of internal revenue.

A depreciation allowance, in order to constitute an allowable deduction from gross income, must be charged off. The particular manner in which it is charged off is not material, except that the amount measuring a reasonable allowance for depreciation must be either deducted directly from the book value of the assets or preferably credited to a depreciation reserve account, which must be reflected in the annual balance-sheet. The allowances should be computed and charged off with express reference to specific items, units or groups of property, each item or unit being considered separately or specifically included in a group with others to which the same factors apply.

Deduction for Compensation of Officers

The deductions allowed in computing taxable income under the revenue law include "a reasonable allowance for salaries or other compensation for personal services actually rendered." The determination of what is a reasonable allowance rests with the internal revenue bureau, and it is true that charges for compensation of officers and managers reported by corporations in their tax returns have commonly been reduced and their taxable income increased by the disallowance of compensation deemed to be excessive or deemed to be a dividend based upon, or bearing a close relationship to, the stock holdings of the recipients. The test of deductibility in the case of compensation payments is whether or not they are in fact payments purely for services and are such as would ordinarily be paid for like services by like enterprises in like circumstances. If contingent compensation is paid pursuant to a free bargain between the enterprise and the

individual, made before the services are rendered, for securing on fair and advantageous terms the services of the individual, it is regarded as an allowable deduction. Excessive compensation disallowed as a dividend, corresponding with stock holdings, is, of course, exempt from normal tax in the hands of recipients, but it is held that if such payments constitute an appropriation of assets of the corporation, the amount of the excess, while disallowed as a deduction by the corporation, is to be treated as compensation subject to both normal tax and surtax of the recipient.

The Excess Profits Tax

The present excess profits tax, unlike the tax of the same name imposed under the former law of 1917, is applicable to corporations only, and is levied in a graduated scale upon their net income, after deducting an exemption, termed the "excess profits credit," comprising $3,000.00 plus an amount equivalent to 8% upon invested capital. The graduated rates for this tax are as follows: 20% on income over the excess profits credit and under 20% of invested capital, plus 40% on all income over 20% of invested capital. There is, however, a maximum limit for this tax, designed to relieve corporations with small income and small invested capital, which provides that the total tax may not exceed 20% of the income over an exemption of $3,000.00 and less than $20,000.00, plus 40% of all income exceeding $20,000.00.

Invested Capital

In general terms, invested capital is the capital actually paid in to a corporation, in cash or in property (subject to certain limitations), by its stockholders, plus surplus and undivided profits. It is not based upon the present net worth of a company's assets, as shown by an appraisal or in any other manner, and does not include borrowed capital. Moreover, the fair market value of the assets as of March 1, 1913, has no bearing on invested capital under the present law. The definitions of invested capital given in the law and official regulations are unnecessarily obscure because of a confusion of assets with liabilities in the language used in seeking to define the net worth of a company, substantially at cost, which is, of course, equivalent to the stockholders' equity, exclusive of appreciation. Broadly speaking, if a company's capital has been subscribed in cash or in tangible property at its

cash value, and if it holds no inadmissible assets (securities other than U. S. obligations, the income from which is not included in computing taxable income), its capital, plus any paid-in or earned surplus and undivided profits at the commencement of the taxable year, is its invested capital. But, if a company's surplus and undivided profits have been understated through charging off property previously paid for, or if it actually acquired on the issue of its stock tangible property of a cash value in excess of the par value of the stock issued therefor, such items may be reinstated or added, and the original value of the invested capital may be correspondingly increased. On the other hand, if it issued stock for goodwill, patents or other intangible property, a deduction from its invested capital must be made for the amount by which the book value of such assets exceeds 25% of the company's issued capital stock. If it holds any inadmissible assets there must also be deducted from the invested capital, as originally computed, an amount equal to the percentage which the amount of inadmissible assets is of the amount of both admissible and inadmissible assets held during the taxable year.

The status of Liberty bonds in the computation of a corporation's invested capital for the purpose of the excess profits tax has been quite generally misunderstood by the public, for it was commonly believed during the recent Liberty loan drives that corporations subscribing for Liberty bonds would thereby increase their invested capital and thus secure an increased exemption from the excess profits tax. Nevertheless, no Liberty bond of any issue is of any greater value than cash, merchandise, plan or accounts receivable in the computation of invested capital. If a corporation converts part of its cash into a Liberty bond it is not adding thereby one cent to its invested capital, for it is merely converting one form of admissible asset into another form of admissible asset of equal but of no greater value.

Relief Provisions

The present provisions with reference to the definition of invested capital are a little more favorable than those of the act of 1917 as interpreted by the treasury department. Under that act it was found that the effort to apply any set formula to the determination of invested capital resulted in grave discrimination in the amount of taxes payable in respect to different busi-

nesses apparently conducted under substantially similar conditions. To provide relief in cases of such discrimination, the present law specifies cases in which discrimination is recognized. Among these are cases in which as compared with representative corporations the corporation in question would be placed in a position of substantial inequality because of abnormal conditions affecting its capital or income or because of inability to determine its invested capital.

Affiliated Corporations

Corporations which are affiliated within the meaning of the law are now required to make both a consolidated income-tax return and a consolidated excess profits tax return. For such corporations under the act of October 3, 1917, only a consolidated excess profits tax return was permitted.

So far as its immediate effect is concerned, consolidation increases the tax in some cases and reduces it in others, but its general and permanent effect is to prevent tax evasion. Among affiliated corporations it frequently happened that the accepted inter-company accounting assigned too much income or invested capital to company A and not enough to a subsidiary company B. This might make the total tax for the parent corporation too much or too little, and although such procedure may not have developed from any consideration of taxation, there remained an incentive to discontinue any arrangement which served to increase taxes and to retain one by which taxes were diminished. Thus the former laws, which contained no requirement for consolidated tax returns, placed an almost irresistible premium on a segregation or a separate incorporation of activities which would normally be carried as branches of one concern. Nevertheless, it is believed that the consolidated return for affiliated companies has been adopted, not primarily because it operates to prevent evasion of taxes or because of its effect upon governmental revenue, but because the principle of taxing as a business unit what in reality is a business unit is sound and equitable both to the taxpayer and to the government

Capital Stock Tax

The capital stock tax is described in the statute as a "special excise tax with respect to carrying on or doing business." Unlike the income tax and the excess profits tax, which are federal

levies upon corporate income, the capital stock tax is substantially a federal levy upon corporate property, and thus becomes a very convenient and attractive agency for the exaction of much heavier contributions toward the national revenue than have hitherto been levied upon the property of corporations.

The capital stock tax is at the rate of $1.00 for each full $1,000.00 of the fair average value of the capital stock of a corporation in excess of the prescribed deduction of $5,000.00. The tax is not upon the par value of the capital stock, but upon its fair average value for the preceding fiscal year ending June 30th. As regards domestic corporations it is on an entirely different basis from the excess profits tax, which is concerned with invested capital and not with the present fair value of the capital. Moreover, the fair value of the entire capital stock of a corporation is not necessarily the product of the market value of each share multiplied by the number of shares. The fair average value of the capital stock of a corporation and the tax payable thereon are determined in accordance with the instructions in the form of return which provides in exhibit A for the book value of the capital stock, in exhibit B for the market value and in exhibit C for the value based on capitalizing the earnings. In reporting earnings for this purpose, it should be noted that federal taxes accrued may be brought into account, so as to show the actual net earnings. The statutory basis of the tax is not necessarily the book value or the market value or even the earning value, although it is often more directly dependent upon the last. It should usually be capable of appraisal by officers of the corporation having special knowledge of the affairs of the corporation and general knowledge of the business in which it is engaged. Provision is accordingly made in exhibit C of the return for the tentative determination of the fair value of the capital stock by capitalizing the net earnings of the corporation on a percentage basis fixed by the officers as fairly representing the conditions obtaining in the trade and in the locality. The capitalization of earnings at 12% as the equivalent of par value is mentioned on the return blank; but such fair value must not be set at a sum less than the reconstructed book value shown by exhibit A or the market value shown by exhibit B, unless the corporation is materially affected by extraordinary conditions which justify a lower figure. In any such case a full

explanation must accompany the return. The commissioner will estimate the fair value of the capital stock in cases regarded as involving any understatement or undervaluation.

Closing Comments

Taxability of Stock Dividends

In order to dispel the doubts that have been raised by the apparent conflict between court decisions and the revenue laws, stock dividends should be declared non-taxable. It will be recalled that the constitutionality of the federal laws with regard to their taxation has frequently been questioned, and that the appeal case in *Macomber vs. Eisner,* recently argued by Charles E. Hughes, has been reargued by him before the supreme court of the United States. It is my opinion that the supreme court will support Mr. Hughes' contention and will hold that stock dividends are not taxable as income of the distributees.

High Taxes on Corporate Incomes are Unsound in Principle

More than one-half of the total revenue raised under the federal revenue act of 1918 is derived from taxation of the income of corporations. In my judgment a corporation is not an appropriate subject for taxation on net income, because such taxation is an attempt to secure greater justice in taxation, to reach effectively the wealth of a community and to secure from it a contribution commensurate with its ability, and it is a personal tax felt by the individual which may be applied progressively, thus meeting the actual demands of the case for equality of burden. When applied to a corporation, however, it loses these characteristics, since a corporation is a collection of individuals who cannot be said to have placed therein their entire available wealth. To tax the net income of the corporation is a wholly different thing from taxing the individuals who compose it, for the incidence of the tax is no longer personal, and the whole potency and effect of a true net income tax is undermined. The taxes of a corporation are really borne by its members, and at a uniform rate in proportion to their respective stockholdings, without regard to the fact that the income of one stockholder, from all sources, may be such as to entitle him to exemption from individual income tax, while another stockholder may be a millionaire.

The appropriate function of a net income tax is to reach the fair contribution of an individual measured by his personal ability,

and the logical and harmonious plan, and the one which avoids to the greatest extent complications and difficulties (that are in certain respects inevitable under our complex form of government and highly developed use of the corporate form of doing business), is to apply the income tax principle to the individual, and to place only such a tax upon a corporation as will fairly cover its property value, including all elements which go to make up such value. While it would be impracticable to bring every individual under taxation through the operation of a personal income tax alone, I believe that the imposition of consumption taxes upon articles in general use would adequately supplement graduated taxes assessed on personal incomes, and that high taxes on corporate incomes, being unsound in principle, should not be imposed.