Journal of Accountancy

Volume 25 | Issue 2 Article 1

2-1918

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Recommended Citation
Bentley, Arthur (1918) "Defects of Title 2 of the Federal Revenue Act of October 3, 1917 Viewed from the Accounting Standpoint," *Journal of Accountancy*: Vol. 25: Iss. 2, Article 1.
Available at: https://egrove.olemiss.edu/jofa/vol25/iss2/1

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The Journal of Accountancy

Official Organ of the American Institute of Accountants

Vol. 25 FEBRUARY, 1918 No 2

Defects of Title 2 of the Federal Revenue Act of October 3, 1917*

VIEWED FROM THE ACCOUNTING STANDPOINT

By Arthur Bentley

Title 2 forms part of the federal revenue act of October 3, 1917, "An act to provide revenue to defray war expenses and for other purposes," and is termed "war excess profits tax."

The writer views the scope of the subject and in particular the expression "viewed from the accounting standpoint" as being very broad. It is not his intention to confine his criticism merely to defects in connection with the preparation of tax returns and the interpretation of the act for this purpose, but also to those which indicate inequalities or discrimination in the application of the tax to the different classes of taxpayers subject thereto.

The caption "war excess profits tax" would indicate that the purpose of the law under this title is to impose a tax on those profits in excess of the normal profits (as indicated and judged by the profits made in a pre-war period) made directly or indirectly through increased business arising out of the present abnormal conditions. Similar taxes levied in other countries appear to lend weight to this supposition.

*A thesis submitted at the November, 1917, examinations of the American Institute of Accountants.

The act, however, entirely departs from this purpose inasmuch as it applies to every corporation, partnership or individual other than certain corporations, partnerships or individuals declared exempt. All trades and businesses come within the scope of the act, which is further construed to include professions and occupations. Thus the source or nature of the business from which the income or profit is derived is not limited to those industries which have been directly or indirectly benefited by the furnishing of war supplies and munitions or commodities to replace those which cannot be supplied from the source usually obtaining owing to the effect of the war, but is universal.

By this application a business not affected by the war, with profits of purely normal growth, is taxed in the same degree as those businesses whose income or profits have been swollen by reason of the war. The modern principle of graduated taxation, designed for the purpose of placing the proper burden on abnormal or excessive incomes is thus not equally applied. This discrimination is emphasized by the fact that the definitions of the terms used in the act bring within its scope salaried employees in receipt of remuneration in excess of $6,000 per annum.

Earned or Unearned Incomes

A glaring instance of discrimination is seen in the operation of the law as between earned and unearned incomes. Recent taxation in other countries has shown a tendency to tax unearned incomes at a higher rate than earned incomes. Under the present title the tax is laid on the earnings of trades and businesses, which includes professions and occupations. It would therefore appear that a person having a large income derived from investments and possibly rentals is entirely free from the application of this tax. It does not appear equitable that a person engaged in a useful and necessary occupation of benefit to the country and his community should have a greater burden placed upon him than is placed upon one not as usefully employed.

Exemption of Officers and Employees Under the United States and Others

A further discrimination is made by section 201—(a), which provides that the compensation or fees received by officers and em-

ployees under the United States or any state, territory or the District of Columbia or any subdivision thereof as such officers or employees shall be exempt from the operation of this act.

It appears unreasonable that the class of citizens indicated should thus be benefited over all other citizens or residents.

In his study of the act several matters have been noted by the writer which appear in his judgment as defects.

Briefly stated the act levies, on that part of the income of the calendar or fiscal year which is in excess of the normal income and a statutory exemption, a graduated tax based on certain fixed percentages on the capital invested in the business.

In order to ascertain what is considered the normal income, an average is obtained of the income for the years 1911, 1912 and 1913, and the percentage which this income bears to the average invested capital for the same period is applied on the invested capital of the taxable year. The sum thus obtained, plus a statutory allowance of $3,000 for domestic corporations or $6,000 for a resident or citizen or a domestic partnership, is considered as the normal income.

Value to Be Placed on Goodwill and Other Intangible Property

To arrive at the amount of average invested capital, the act defines the method which must be adopted. Under this method the amount allowed to be included as invested capital for goodwill, trade marks, trade brands, franchise of a corporation or partnership, or other intangible property, when paid for bona fide for and with interests or shares in a partnership or by shares in the capital stock of a company, is an amount not to exceed 20 per cent. of the total interest or shares in the partnership or of the total capital stock of the corporation. In passing we note that the act only refers in its provisions to goodwill and intangible property bought prior to March 3, 1917.

While it is well known that some corporations have issued their capital stock in excessive amounts for goodwill, the hard and fast provision outlined above makes no allowance for a company which issues bona fide its capital stock on a fair and not excessive basis in the purchase of goodwill or other intangible property.

Nominal Capital

Section 209 provides that, in the case of a trade or business having no invested capital or not more than a nominal capital, the tax under this title shall be levied at the rate of 8 per cent. on the net income in excess of certain statutory deductions.

The phrase "or not more than a nominal capital" is very vague. No information is given anywhere in the act which would act as a guide, and the matter is left so that corporations, partnerships and individuals may use their own interpretation of its meaning. This will frequently necessitate correction by government inspectors, revisions of assessments and the irritations and annoyances naturally caused thereby. The writer submits that nominal capital herein should be interpreted as being the capital in those businesses which do not earn their income by the turning over or lending of their capital. This class would include lawyers, accountants, architects, insurance brokers, commission merchants selling on commission solely, stock-brokers doing a purely commercial business and so forth. At present the matter is in doubt, and there have not yet been any treasury decisions or legal interpretations on the point. While it is true that professional practices and businesses whose earnings are made up of commissions have capital (so called), which consist chiefly of book debts, office furniture and equipment, it is submitted that the invested capital in these cases has no relation to the income and is not of any use in its production. The law is not clear as to whether such capital is regarded as nominal or invested.

Invested Capital

The lack of definition in the law in the case of nominal capital applies in a somewhat less degree to invested capital. While the law furnishes a general definition of invested capital, the writer fears that its application in practice will be difficult and practically impossible in many cases. It appears that the officers of the treasury department are already aware of this condition, which is evidenced by the request sent out by Commissioner Daniel C. Roper for suggestions as to the methods of computing the amount to be used as invested capital.

It may well happen that there are corporations which will obtain a benefit to which they are not strictly entitled in con-

nection with their invested capital. A corporation might be formed, as happened within the knowledge of the writer, solely for the purpose of manufacturing a commodity essential to and largely used in the prosecution of the war. The capital was purely nominal, being merely sufficient to meet the organization expenses. Contracts were obtained for the manufacturing of the product at highly profitable rates, and the business was financed by means of loans secured on these contracts. It would appear that the company would be entitled, under section 209, to be assessed on its profits at the rate of 8 per cent., thus escaping the heavier taxation under the graduated rates for those corporations having invested capital of more than a nominal amount.

Section 210 makes provision, in cases where the secretary of the treasury is unable satisfactorily to determine the invested capital, that the deduction representing the normal income shall be the same percentage of its income received in the taxable year as that of representative concerns engaged in a like or similar trade or business.

Presumably the same condition will exist in the taxable year as in the pre-war years regarding the inability of the secretary of the treasury satisfactorily to determine the amount of the invested capital. As it is necessary, however, in the computation of the tax, to have knowledge of the amount of the invested capital on which to apply the various tax rates, it is not clear what the procedure will be in these cases. It appears, therefore, that the act is defective in this regard.

Average Pre-War Income of 1911-1912 and 1913

For the purpose of ascertaining the average pre-war income, the act stipulates that the income returned and assessed in 1911-1912 and 1913, subject to certain minor changes, shall be used. It is suggested that for the purpose of a profits tax this stipulation may work a hardship as between taxpayers, inasmuch as in certain cases the profits therein returned are in excess of the true profits in the following particulars:

> Corporations were not allowed to deduct the whole of the interest charges incurred in the conduct of their businesses and the earning of their incomes.

An individual was not permitted to charge any losses incurred on transactions entered into for profit but not connected with his business or trade, though expected to account for all profits on like transactions.

Donations and gifts were not allowed as a deduction, though paid as a matter of business welfare.

Bonuses or gifts to employees at Christmas and other times were not deductible though operating to create a more active interest and incentive on behalf of the employer in the employees.

Depreciation and depletion allowances were not allowed in full in all cases.

Limitation Placed on Percentage of Pre-War Income

Section 203 provides for the deduction from the income of the taxable year as representing the normal pre-war income an amount not less than 7 or more than 9 per cent. of the invested capital for the taxable year. The enforcement of these arbitrary limits on a taxpayer will undoubtedly in some cases work a great hardship. The income of many businesses for the pre-war period was considerably in excess of 9 per cent. yet this maximum rate only will be allowed and all income in excess of this allowance and the fixed exemptions of $3,000 or $6,000 will be subjected to the heavy rates of taxation herein. In England, where an excess profit tax is also operative, rates of profits of over 20 per cent. have in special cases been permitted. It is the opinion of the writer that 9 per cent. is not a reasonable return in many businesses of a rising or fluctuating nature.

Years 1911-1912 and 1913 to be Used for Averaging Pre-War Income

In ascertaining the normal pre-war income, the taxpayer is not permitted to select any one year or two years in lieu of the average of the three years. It may quite reasonably happen that the income of one or more of these pre-war years was considerably below the normal, or that the years in question were the commencing years of the business. For the taxable year 1917, the income of that year, calendar or fiscal, is used, no option being

allowed to average it with one or more of the immediately preceding years. The principle of averaging the pre-war income is admitted, but not applied to the taxable year. By a combination of circumstances it may happen that the average pre-war income is subnormal by reason of averaging, while the taxable year's income is abnormally high by reason of non-averaging. Other countries, for example England and New Zealand, recognize this defect and permit a choice in the selection or averaging of the pre-war years within certain limits.

Payment of Taxes

The taxes payable under this title are high and in many cases the amount of money involved is considerable. As an instance which is within the writer's knowledge, a corporation with profits of $26,000,000 will have to pay an amount estimated at $15,000,-000. There are undoubtedly numerous cases where larger amounts are involved.

No provision is made in the act for gradual payments of the tax. The principle of paying taxes in half-yearly instalments is recognized in city taxation and works well for city and taxpayer. The taxes under this title must be paid on June 15th of the year next following the close of the taxable (calendar) year. In the case of corporations having very large sums to pay by June 15th, the effect would be to embarrass or cramp their business. The profits from which the tax is payable may not be realized but be represented by book debts, or they may be locked up in inventories and other assets. Under the present law this may compel taxpayers to obtain loans wherewith to pay their taxes, or in the event of their not being able to negotiate a loan, to submit to heavy penalties.

Partnership Incomes

This title imposes a tax on the net income of partnerships. The tax is placed upon the income as of the partnership and not of the partners in their individual capacities. The income tax law recognizes the partners in their individual capacity, and the partnership income by section 7 (e) of the income tax act of September 8, 1916, as amended October 3, 1917, is liable to the income tax only in the partners' individual capacities. Under the provision of the income tax law the partners are each entitled to

the statutory deductions. Under the excess profits tax the partnership income (domestic) is only allowed one deduction of $6,000. It is submitted that as a partnership is composed of individuals and their interests in the partnership are individual the same principal of taxation should be recognized under this title as under the income tax law. As showing the difference made by the two methods, the following figures are given of a partnership of four partners having a net income of $40,000 divisible in equal shares, with a nominal capital.

Partnership basis—$40,000 income less $6,000 exemption, taxable income $34,000 at 8 per cent. equals $2,720 or each partner $680.

Individual basis—$40,000 income, individual share $10,000 less exemption $6,000. Taxable income $4,000 at 8 per cent. equals $320.

Rates of Tax—20 Per Cent. Clause

The writer believes there is as much doubt as to the interpretation of the first clause of section 201, governing the rates of tax, as to any other section. The wording was subject to honest interpretations in conflict with each other and proof of this is seen in the opposite view taken of the clause in the explanatory pamphlets issued by the Bankers Trust Company and many other institutions to that expressed in a pamphlet issued by the New York Trust Company. The clause reads:

> Twenty per centum of the amount of net income in excess of the deduction (determined as hereinafter provided) and not in excess of fifteen per centum of the invested capital for the taxable year.

Mostly the opinion was held that the amount of income taxable at 20 per cent. is an amount not exceeding 15 per cent. of the invested capital less the statutory deductions, while others considered that in cases where there was sufficient net income in excess of the deduction to amount to 15 per cent. invested capital, the full 15 per cent. of the invested capital should be used.

Recently a treasury decision has been made to the effect that the deduction allowed from the net income can only be applied in computing the 20 per cent. rate in the scale of percentages. While this decision has cleared much of the doubt as to the correct interpretation, it leaves the writer with a feeling that some injustice is

occasioned. As a direct consequence and unless changed by legal interpretation this ruling limits the statutory deduction to an amount not exceeding 15 per cent. of the invested capital for the taxable year, irrespective of the amount of the normal income and deduction. An example illustrating this follows:

Invested capital		$30,000.00
Rate of pre-war income		9%
Allowance to corporation		3,000.00
Profits of taxable year		15,000.00
Deductions would be 9% of $30,000 + 3,000 =		5,700.00
15% of invested capital $30,000 =		4,500.00
	Income taxed	*Tax payable*
20% of 15% of invested capital = $4,500	$4,500.00	$.......
Less allowance 5,700	....	....
25% of 20% — 15% of invested capital =	1,500.00	375.00
35% of 25% — 20% of invested capital =	1,500.00	525.00
45% of 33% — 25% of invested capital =	2,400.00	1,080.00
60% of $15,000 — 33% invested capital =	5,100.00	3,060.00
	$15,000.00	$5,040.00

The amount of tax payable in this case according to the views of the writer as to an equitable rendering of the title and ignoring the recent treasury decision relating to the deduction would be as follows:

	Income taxable *Net income in excess of deduction*	*Tax payable*
20% of amount of net income in excess of deduction = $15,000 — $5,700 = $9,300 not exceeding 15% of invested capital 15% of invested capital =	$4,500.00	$900.00
25% of 20% — 15% of invested capital =	1,500.00	375.00
35 %of 25% — 20% of invested capital =	1,500.00	525.00
45% of 33% — 25% of invested capital (balance) =	1,800.00	810.00
	$9,300.00	$2,610.00

The writer's view of an equitable interpretation of this clause coincides with the views of those who hold that so long as there is sufficient net income in excess of the deduction to amount to 15 per cent. of the invested capital, the taxpayer is entitled to full 15 per cent. of the invested capital at the 20 per cent. rate. In the event of there not being sufficient income in excess of the deduction to amount to 15 per cent. of the invested capital, under the 20 per cent. clause should be included the full amount of income taxable. The view seems reasonable, in a graduated scale of taxes, that each rate should receive its maximum amount at that rate before passing under a higher rate.

Under the generally accepted understanding of this clause, it may frequently happen that there will be no income taxable under the 20 per cent. rate, while there is income taxable at the higher rates. In all cases where the nominal income and deduction exceeds 15 per cent. of the invested capital, this condition will exist.

Many questions of great interest from an accounting standpoint will arise in preparing returns under this title. Some matters which now appear as difficulties will be elucidated when the forms for preparing the returns are issued and further difficulties and defects may then be brought into view. Little information is obtainable from the officers of the treasury department who appear to be as little informed on matters in doubt as is the man in the street.