

8-1917

Federal Taxation Legislation

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Recommended Citation

Davies, W. Sanders and Richardson, A. P. (1917) "Federal Taxation Legislation," *Journal of Accountancy*. Vol. 24: Iss. 2, Article 1.

Available at: <https://egrove.olemiss.edu/jofa/vol24/iss2/1>

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The Journal of Accountancy

Official Organ of the American Institute of Accountants

Vol. 24

AUGUST, 1917

No 2

Federal Taxation Legislation

[This memorandum was prepared for the purpose of demonstrating certain undesirable features and probable effects of portions of the finance bill now before congress.]

The American Institute of Accountants desires in this memorandum to draw attention to three questions affecting the senate finance bill as to which it believes amendment to that bill is desirable.

The institute represents the practising public accountants in the United States and is not affiliated with any interest specially affected by the proposed enactment. Its members have, however, had wide experience in connection with the administration of income tax and excess profit tax laws and two of its three recommendations are designed solely to eliminate uncertainties and bring about more uniform and equitable application of the taxation proposed. The third recommendation looks to the elimination of a tax which it believes to be economically unsound and opposed to the best interests of the country.

The general nature of the objections and the remedies suggested will first be briefly indicated and thereafter the three recommendations will be discussed separately.

The first suggestion is designed to insure that for the purposes of determining the capital employed in a business one value shall not be assigned to property in respect of the pre-war period and another and higher value to the same property in respect of a taxable period. The recommendation is that in clause C, section

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205, after the first paragraph (page 18, line 21 of the bill as reported June 28th) there should be inserted the following clause:

"The value of any property acquired prior to or during the pre-war period shall not at any time be taken to exceed the value assigned to such property in determining the capital employed in the pre-war period, except to the extent of expenditures for improvements to such property made subsequent to the pre-war period and not claimed as deductions from the taxable income of any year, nor shall the value of any property acquired since the pre-war period be taken to exceed the actual cash cost thereof."

The second recommendation aims to eliminate the inequalities which would result from the provision that excess profit tax shall be computed on the basis of the net income returned under the special excise and income tax laws from time to time in force. The deductions allowed under these different laws have varied from time to time and it is clearly desirable that the profits of the pre-war period and the profits of the taxable period shall be placed as nearly as possible on the same basis of determination. The recommendation made is that the last five lines of the first paragraph of section 206, lines 23, 24 and 25 on page 20 and lines 1 and 2 on page 21 should be struck out and that there should be substituted therefor the following clause:

"except that the amounts received by it as dividends upon the stock or from the net earnings of other corporations, joint-stock companies or associations, or insurance companies, subject to the tax imposed by title I of such act of September eighth, nineteen hundred and sixteen, and all interest paid by it, shall be deducted from gross income, and such adjustments shall be made as shall be necessary to establish the income of the respective periods as nearly as may be upon the same basis of determination."

The third recommendation looks to the elimination of the proposed tax on undistributed profits, effect to be given thereto by striking out sub-section 2 of section 1206, page 107.

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POINT I

The bill as it stands provides that capital shall be deemed to be the fair average value of the assets actually invested and employed in the trade or business less the average amount of the liabilities incurred in respect to such trade or business. This

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provision is subject to certain limitations as to the valuation of goodwill, franchises, patents and other intangible assets.

It seems clear that under this provision the capital for each year would require to be determined on the basis of the fair value of the assets in that year, so that where the value of assets (other than intangible assets) has increased, possibly as the result of increased earning capacity due to the war, the tax-payer would be entitled to a return on the enhanced value of such assets at the same rate as was earned on the lower value of the assets in the pre-war period before becoming liable to excess profit tax.

The point may be easily illustrated by taking the case of a corporation owning a single ship, the fair value of which in the pre-war period was \$500,000 and the fair value of which today is \$1,500,000. This is by no means an extreme or unlikely case. Under the wording of the bill as it stands such a company would be liable for excess profit tax only on the earnings in excess of three times the earnings in the pre-war period. It is not believed that this is the intention of the act and it is therefore recommended that a clause should be inserted providing that assets shall not be taken at any higher value in respect to a taxable period than was assigned to them in the pre-war period and that assets acquired since the pre-war period shall be valued at not to exceed cost. The amendment suggested is repeated here as follows:

In clause C, section 205, after the first paragraph (page 18, line 21 of the bill as reported June 28th) there should be inserted the following clause:

“The value of any property acquired prior to or during the pre-war period shall not at any time be taken to exceed the value assigned to such property in determining the capital employed in the pre-war period, except to the extent of expenditures for improvements to such property made subsequent to the pre-war period and not claimed as deductions from the taxable income of any year, nor shall the value of any property acquired since the pre-war period be taken to exceed the actual cash cost thereof.”

POINT II

The second recommendation aims to insure as far as possible that the profits for the pre-war period and for the taxable period shall be determined on the same basis. Incidentally, it proposes

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to eliminate a slight inequality in the treatment of interest. The deductions from taxable income in respect of interest, depletion of minerals, taxes, and possibly other items, have varied under the different laws from time to time in force. It is obviously equitable, and it is in the interests of the government that these variations should be adjusted in making a comparison of the income of the taxable period with the income of the pre-war period.

A minor point in which the proposed bill is inequitable is in the treatment of interest. In the determination of capital for purposes of the bill all indebtedness is required to be deducted from the assets irrespective of the question whether such indebtedness is in excess of the capital stock or not. Clearly, therefore, in the determination of the income earned on such capital all interest should be allowed as a deduction irrespective of the relation of the interest-bearing indebtedness to the capital stock of the corporation. The clause designed to give effect to the views herein expressed is repeated as follows:

The last five lines of the first paragraph of section 206, lines 23, 24 and 25 on page 20 and lines 1 and 2 on page 21 should be struck out and there should be substituted therefor the following clause:

"except that the amounts received by it as dividends upon the stock or from the net earnings of other corporations, joint-stock companies or associations, or insurance companies, subject to the tax imposed by title I of such act of September eighth, nineteen hundred and sixteen, and all interest paid by it, shall be deducted from gross income and such adjustments shall be made as shall be necessary to establish the income of the respective periods as nearly as may be upon the same basis of determination."

POINT III

The third recommendation looks to the elimination of the proposed tax of 15% on undistributed profits. It is assumed that this tax is proposed with a view to compelling the declaration of dividends and the resulting payment of supertax by large stockholders. It is respectfully urged, however, that the vicious results which would ensue are more than sufficient to offset what might be accomplished in this direction and that the clause would work grievous hardship on a large number of corporations. It is suggested that the provision be eliminated and that the remedy where

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dividends are unreasonably withheld is to be found in a more vigorous enforcement of the powers conferred on the department of internal revenue by section 3 of the income tax act of 1916 and if necessary the enlargement of those powers. That section provides :

“For the purpose of the (this) additional tax, the taxable income of any individual shall include (embrace) the share to which he would be entitled of the gains and profits, if divided or distributed, whether divided or distributed or not, of all corporations, joint-stock companies, or associations, or insurance companies, however created or organized, formed or fraudulently availed of for the purpose of preventing the imposition of such tax through the medium of permitting such gains and profits to accumulate instead of being divided or distributed;

and the fact that any such corporation, joint-stock company or association, or insurance company, is a mere holding company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a fraudulent purpose to escape such tax;

but the fact that the gains and profits are in any case permitted to accumulate and become surplus shall not be construed as evidence of a purpose to escape the said tax in such case unless the secretary of the treasury shall certify that in his opinion such accumulation is unreasonable for the purposes of the business.

“When requested by the commissioner of internal revenue, or any district collector of internal revenue, such corporation, joint-stock company, or association, or insurance company shall forward to him a correct statement of such gains and profits and the names and addresses of the individuals or shareholders who would be entitled to the same if divided or distributed.”

The main objections to the proposed tax are :

- (1) That the excess profits earned will not be in many cases in such a form as to be available for distribution.

On account of rising prices the actual amount of working capital needed by corporations engaged in ordinary industry is steadily increasing and the profits of such companies exist largely in the form of inventories and accounts receivable which cannot be distributed as dividends.

Companies engaged in more distinctly war industries have as a rule largely increased investments in plant and equipment and in working capital. Experience has shown that many such companies undertaking contracts for the allied governments have suffered serious financial embarrassment from these causes at a time when they were undeniably making large profits. It is not too much to say that many

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such companies will have difficulty in finding the cash needed to pay excess profit taxes quite irrespective of the payment of dividends.

Under existing conditions while profits are large there is a much greater danger of error in the determination of profits than in normal times. It must always be remembered that statements of profits are at best estimates. In particular many companies will be required to pay heavy excess profit taxes, the amount of which will necessarily be uncertain until their returns have been approved by the internal revenue department. It would be most unsound financial policy to distribute a large percentage of the profits shown by such companies with such a large uncertain liability outstanding.

Corporations which were financially embarrassed prior to the present period of increased profits are looking to those profits to restore completely their solvency and could not justifiably distribute any large part thereof in dividends.

Other corporations have made financial plans calling for the application of profits now being earned to defray the cost of new construction already contracted for or for the retirement of maturing obligations.

It is true that the bill provides that 20 per cent. of the year's net income may remain undistributed without the company being liable for tax, but this exemption would in many cases be totally inadequate to meet the conditions just recited.

- (2) That the government will be requiring many corporations to provide additional facilities for war work and the natural way to provide for such facilities is as far as possible by the retention of profits in the business. It is bound to be increasingly difficult to finance such requirements by borrowing, especially in view of the government's prospective borrowings. It is, therefore, not in the interests of the government that such companies should practically be compelled to distribute their profits.
- (3) That it is part of the national policy to encourage economy throughout the nation at this time and the distribution of extra dividends to small stockholders would undoubtedly lead to extravagance on their part. The cash if retained by the corporations would be much more available for purposes of the government, either by investment in loans or otherwise, than if so dissipated.
- (4) Many corporations have agreed with their preferred stockholders, creditors, bondholders, or others, to apply in redemption of preferred stock or long term indebtedness an amount of cash equal or bearing a fixed relation to the amount distributed in dividends on common stock in excess of a given small percentage. Many corporations would be unable to distribute 80 per cent. of their net income and to comply with such agreements without grievously impairing their financial position and credit.
- (5) That looking at the matter from the standpoint of the specific purposes sought by the proposed clause, it is apparent that it will result

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in small stockholders suffering in many cases a penalty which is intended to be placed on the large stockholders. Many cases will doubtless arise where a large capitalist controlling a corporation can afford to pay a 15 per cent. tax rather than distribute the dividends and pay a supertax on his personal income, and he will prefer to postpone distribution until some later date when it can be made at a less cost. The penalty for the postponement will fall not wholly on him, but partly on the minority stockholders who would not be liable to supertax if distributions were made, and are unable to compel distributions.

- (6) That if the clause results, as it is evidently intended to result, in full distribution of dividends, such distributions will tend to create inflated values for stocks quoted on exchanges and those financial interests which are able to see the whole situation in its true perspective will be afforded an opportunity to sell stocks at high prices to the general public who will be deceived by the large distributions.

Broadly speaking, the policy of conservatism in the distribution of dividends which has characterized the more important American companies has undoubtedly been one of the main elements in the attainment of its present strength by American industry, and the general effect of an official government ban on such conservatism would be most unfortunate.

In passing it may be pointed out that it is impossible for many corporations to determine their profits and take considered action on a dividend within 60 days after the end of the calendar or fiscal year as contemplated in section 1206.

It is doubtless true that a considerable amount of taxation of individuals has been avoided by the wilful withholding of profits which might reasonably be distributed, but it is believed that such cases can best be reached by a more general application of the powers conferred on the treasury department by section 3 of the income tax law of 1916 and that it would be better to supplement such powers than to impose a general tax which would bear inequitably upon so many companies and their stockholders.

For the American Institute of Accountants,

W. SANDERS DAVIES, *President.*

A. P. RICHARDSON, *Secretary.*

New York, July 19, 1917.