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Correspondence: “Proposed Taxation of Stock Dividends”; Intercompany Profits

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Correspondence

"Proposed Taxation of Stock Dividends"

Editor, The Journal of Accountancy:

SIR: Mr. James Walton of Washington, D. C., has called my attention to a slight inadvertence in the use of language in my article entitled *Proposed Taxation of Stock Dividends* which appeared in the August issue of THE JOURNAL OF ACCOUNTANCY. On page 100, there is found this sentence: "But if he accepts the first, he can not deduct capital losses, whereas if he accepts the second, he can deduct such losses." The sentence should read: "But if he accepts the first, he can not deduct net loss in 'ordinary net income' (that is, if instead of other income, he sustains a net loss in business), whereas if he accepts the second, he can deduct such loss."

Yours truly,

WALTER J. MATHERLY.

Chapel Hill, North Carolina, August 15, 1923.

Intercompany Profits

Editor, The Journal of Accountancy:

SIR: I have read the article by Mr. Carson on the *Elimination of Intercompany Profits in Consolidated Statements* in the July JOURNAL with unusual interest, principally, no doubt, because it appears to have been germinated by my article in the May issue.

In my article, I attempted to lead the proponents of the theory that the total intercompany profits in inventories should be eliminated into a position where they would admit that the minority's share of such profits should be recognized when the subsidiary was the selling company. Mr. Carson apparently desired to lead them the remainder of the way and insist that the minority's proportion of such profits shall be recognized, regardless of whether the selling company is the parent or the subsidiary. The reasoning which he presents appears to me to be open to a number of objections.

On pages 4 and 5 he presents an illustration in which the parent company sells to the subsidiary, and he supports his contention that the minority's portion of the purchase should be taken into the consolidated statement at the intercompany's sales price in the following words:

> "That the $1,000 of such profit, which the minority interest has paid, is realized will become apparent if we assume a liquidation of the subsidiary and a distribution of its assets in kind or if we split the subsidiary up into two parts—80 per cent. and 20 per cent. —and consolidate the former with the parent company."

The first point that occurs to me is of little importance, but might be misinterpreted by some. As I understand it the minority interest has not paid $1,000 profit; the subsidiary corporation has paid $15,000, which might be divided up into different costs and profits. I do not wish to be understood as taking issue with Mr. Carson's statement, because I do not infer that he has made this a basis of his argument, but I do wish to make it clear that the transfer of cash from the subsidiary to the parent does not alter the status of the intercompany profits. There are two conditions upon which Mr. Carson builds his argument:

1. If we assume a liquidation of the subsidiary and a distribution of its assets in kind.
2. If we split the subsidiary up into two parts—80 per cent. and 20 per cent.—and consolidate the former with the parent company.

It was not clear to me at first whether the second condition was distinct from or explanatory of the first condition. Upon further consideration the latter appealed to me as the more probable meaning, since the obvious method of splitting the subsidiary up into its component parts is to liquidate and distribute the assets.

To support his argument, then, Mr. Carson assumes "a liquidation of the subsidiary and a distribution of its assets in kind." All these questions which we are discussing concerning consolidated statements are dependent upon the existence of the relation of parent and subsidiary corporations. If we assume the liquidation of the subsidiary, we assume the disappearance of this relation; and there is no consolidated statement and the basis of all argument has been done away with. In other words, we cannot predicate our reasoning upon the non-existence of that which is the first premise of our argument.

The writer frankly admits that he has never seen a liquidation made by distributing merchandise or real estate assets in kind; although he almost handled such a distribution which was ultimately abandoned after considerable bickering, because a basis for valuation could not be agreed upon. Perhaps this experience has inspired an unfair distrust of the idea in general. However, the gist of the matter seems to me to be this:

The accountants hold:

1. That profits are made only on sales.
2. That a sale must occur between at least two transacting parties.
3. That, looking behind the corporate existence, if two corporations are controlled by the same interests, there is only one transacting party in fact; and that sales upon which profits can be based cannot arise from deals between two such corporations.

Then it appeals to me that if, following Mr. Carson's assumption, "we assume a liquidation of the subsidiary and a distribution of its assets in kind," the sale in fact occurs when the majority interests persuade the minority stockholders to accept such a liquidation or, failing that, persuade a court to uphold such a liquidation—and not before. In other words, the sale of merchandise which cost $10,000 for $15,000, was handled by one transacting party, the majority interests, and hence was not a sale for the purpose of determining a profit from the accounting standpoint. The price or the quantity might be manipulated to suit the purposes of that one transacting party as it saw fit. For example, it might have sold the whole of the parent company's inventory to the subsidiary for $100,000. Would it be proper to contend that by this transaction the parent company had made a profit of $16,000—1/5 of ($100,000 — $20,000)? If this were an accepted method, an avenue for gross manipulation would be opened—an avenue which the accountants have tried to close. But if the minority stockholders sanctioned the transfer of merchandise at a given valuation (either by agreeing to the liquidation or in any other way) the matter would assume a different aspect. At the time of such approval the real sale is made—in respect to the minority—not when the merchandise is transferred or the purchase recorded on the books.

I grant that the accountant must give due consideration to the interests of preferred stockholders; but he must also give similar consideration to the interests of the banker who has made loans to the corporation and the interests of the manager who is working for a bonus share of the profits and the interests of the common stockholders who have taken the major load of the risk. It has been the writer's experience that "conservatism" is a wise policy for the accountant in safeguarding so many interests. True, it may not satisfy some of the interested parties at the time, but ultimately it gains him added respect, even from the dissatisfied persons. But in this case it is not a matter simply of conservatism; it is a matter of determining when a real sale is made, and, speaking from an accounting standpoint, it appears that the sale is not made merely because the merchandise is transferred from one affiliated company to another at a price set by the majority interests. The sale may occur in respect to the minority interests in the purchasing company when they concur in the transaction.

In regard to the illustration used in Mr. Carson's article, it is probable that the preferred stockholders could insist from a legal standpoint that the whole $5,000 profit in the sale was legally available as profits to the parent company—not merely $1,000 of that profit. We must remember that the legal and accounting viewpoints of holding companies are different; the law looks upon these corporations as separate corporate entities; accountancy looks upon them as one business separated into units by a legal fiction. Mr. Finney in his book on *Consolidated Statements* states:

> "For while it is true from a legal standpoint that the holding company owns merely the stock, it is also true from a business standpoint that the holding company virtually owns and actually controls the subsidiary's net assets which the stock represents.
>
> "In the second place, if we look past the legal fiction of separate corporate entities and view the related companies as a single organization, we find that no single balance-sheet shows the total assets and liabilities of the organization, and the total stock of the organization in the hands of the public.
>
> "The consolidated balance-sheet is a device for avoiding these two disadvantages of separate balance-sheets."

And this brings me to a point that I wish to emphasize. In my article in the May issue I spoke of accounting problems and my discussion has been more or less influenced by this limitation to the idea of problems presented by a written statement of facts rather than facts developed in the course of actual work in practice. Such written statements of facts are always much less complete as to attendant circumstances than the facts developed during the course of an audit. These "problems" say: What would you do if these were all the facts you had? And it is almost humanly impossible to state every circumstance which might influence an accountant's attitude toward certain items. For example, I am informed that in preparing the consolidated balance-sheet of one large holding company, certain intercompany profits in inventories are carried to the balance-sheet without any reservation whatsoever. At first glance that sounds like accounting heresy. But the attendant circumstances are these: When a certain subsidiary is in the market for certain materials it sends out bids to all manufacturers including several of its affiliated companies. It buys from the lowest bidder regardless of whether that bidder is in the combination or not. These bids are all on file ready for the accountant's inspection, so that he may know that the sale is in nowise influenced.

This leads us back to the purpose underlying the elimination of intercompany profits in inventory. The purpose is to prevent manipulation of profits through affiliated companies. In practice this may be safeguarded against in many ways. In handling accounting problems, the solver of the problems demonstrates his knowledge of the existence of such a situation by eliminating (or not eliminating) the profits in the most logical manner consistent with the stated facts. Where the problem is silent as to attendant circumstances, there is much to be said in favor of eliminating all intercompany profits remaining in the inventories. It seems to the writer, however, more sound to eliminate all of the profits only when those profits are in the parent company's surplus. In addition to the reasons set forth in my article, the following reasoning appears to support this plan of procedure where no attendant circumstances are stated:

1. If the sale is made by the parent company to the subsidiary, the adding of an exorbitant profit will work to the advantage of the majority holdings and to the disadvantage of the minority holdings.
2. If the sale is made by the subsidiary to the parent company, the adding of an exorbitant profit will work to the disadvantage of the majority and to the advantage of the minority.

Since the majority is in control there is less likelihood of an exorbitant profit being added when the sale is made by the subsidiary to the parent; but if the profits are being manipulated it is likely to occur when the sale is made by the parent to the subsidiary. It is the writer's contention that the accounting student might indicate his knowledge of this difference by eliminating all of the profits in inventory when the parent sells to the subsidiary, and by eliminating only the majority's share of such profits when the subsidiary sells to the parent.

In actual practice, the accountant will, of course, guide his actions by the attendant circumstances which cannot (or, at least, usually are not) given in a stated accounting problem.

Yours very truly,

W. T. Sunley.

Chicago, July 9, 1923.

The governor of Massachusetts has appointed the following members of the board for the registration of certified public accountants authorized under the amended C. P. A. law of that state: Edwin L. Pride, chairman; Daniel B. Lewis, secretary; George L. Bishop, Patrick F. Crowley and James F. Fox.