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Editorial

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EDITORIAL

Commenting upon the Revenue Act of 1921

In considering the revenue act of 1921 and the general disappointment with which it was received, it must be remembered that congress was confronted with the necessity of raising about three and a quarter billion dollars for the year 1921. That this amount could be raised without dissatisfaction to a considerable group of citizens was of course out of the question.

One of the most interesting bits of history recorded in the passing of the bill was the part played in it by the group of senators and representatives which, without regard to party affiliations, considers itself as representing the interests of the farmers as distinguished from the interests of the nation as a whole. This is a radical departure from the accepted theory upon which our republic has functioned heretofore. The "farmers' bloc" has its opponents and its defenders, but a magazine such as THE JOURNAL OF ACCOUNTANCY is not the proper place to discuss its merits or demerits.

However, to a few it seems that the creation of the farmers' bloc marks a step in the natural development of our ideas of government. If a farmers' bloc is a natural development, successive steps would be a miners' bloc, a transportation bloc, a bloc representing the financial interests, etc. This development was prophesied a number of years ago by a very learned student of economics who has evolved a philosophy which he calls the "American Philosophy." This philosophy is so far-seeing and far-reaching in its concepts as to seem visionary to most of those to whom it has been unfolded. One of the less important thoughts contained in it is that our congress, which is at present builded upon geographic lines and proportioned to population, and the functions of which until recently have been directed more to sociological than economic questions, should be amplified by having representatives of what he terms "commercial states."

Commercial states according to this student are made up of those engaged in a like industry, e.g., the state of finance, the state of transportation, the state of mining, the state of grain, the state of textiles, etc., etc.

The part the prophesies of this man play in this matter is that as the only one of the so-called commercial states that is now represented in congress is the agricultural, this governmental agency throws out of equilibrium the entire structure, and as has been seen, the commercial state of the farm is pressing for measures for its interest without proper regard for the interests of the other "commercial states" and the nation as a whole.

As a natural result of this lack of balance we have the excess-profits tax with us for the year 1921, but beginning with January 1, 1922, this law will no longer be a burden to the business of the country. In view of the financial stress and business depression during the entire year 1921, the statistics of the revenues from excess-profits taxes will make interesting reading when they are finally compiled.

The old excess-profits tax with its basis in a concept of invested capital has been a great educator to a majority of the business world. The members of this majority have had put before them in concrete form the fact that there is a relationship between the capital invested in a given enterprise and the profits that capital should earn. True, the revenue acts of 1916, 1917 and 1918 placed that corporation at a disadvantage which had closely figured the capital necessary to its successful operation and had distributed among its stockholders all above such amount of capital. It also placed at a disadvantage corporations whose management had, following conservative methods, been in the habit of valuing its assets at lower figures than was, perhaps, proper, and having made these low valuations had not made any record of the shrinkage so taken. This class has learned that books of account are most necessary, and are valuable only when all the financial history of the enterprise is properly set forth therein.

The great lesson that has been learned, however, is that books of account are most essential to intelligent operation, and that such books are the principal evidence of accuracy of the salient and necessary facts of the business. The days are about gone when successful management will look upon accounting records

as something simply to be tolerated, and that accuracy is only required in the recording the flow of the cash and in the keeping of accounts with the debtors and creditors of the business.

So, while there is general relief because of the passing of the excess-profits tax, we feel that its memory should be treated with respect. Great ingenuity was exercised in its creation and also in the administration of its provisions.

In the following paragraphs we will set forth observations and comment upon some of the more important features of the revenue act of 1921. Much more could be said with respect to each of the several matters treated of, but we cannot hope to exhaust the subject in the few pages allotted to it, and if this were possible the last word could not be spoken at this time.

Government statistics have shown that the vast majority of returns are made by taxpayers whose income is five thousand dollars or less. The interests of these taxpayers have been given due consideration by increasing the personal exemption of married persons or the heads of families from $2,000 to $2,500. There is a limiting provision whereby those whose income is only slightly above $5,000 will be permitted to take advantage of this exemption. This additional $500 exemption does not apply to married persons or heads of families whose income is $5,020 or more, nor to single persons. It has been estimated that this additional exemption will save this group of taxpayers about three millon five hundred thousand dollars. The newspapers have made much of the action of congress in thus relieving the taxpayers with small incomes of comparatively considerable tax. While the exemption will be felt by a great number of taxpayers, the aggregate amount of saving is pitifully small.

An exemption of $400, instead of $200 as heretofore, is allowed for each dependent of all taxpayers. The above exemptions are effective for the year 1921.

Every individual having a gross income for the taxable year of $5,000 or more, regardless of his net income, is required to make a return. Husband and wife living together whose aggregate gross income is $5,000 or more or whose aggregate net income is $2,000 or more are required to make returns. These returns may be made jointly or individually.

Net losses sustained in trade or business by taxpayers in any taxable year after December 31, 1920, are deductible from the

net income of the succeeding taxable year and if such net loss is in excess of the net income of the succeeding year the excess of such net loss may be deducted from the net income for the next succeeding year. Considerable care has been used in defining how these net losses shall be determined and the language should be given thoughtful consideration as there will probably be many instances where the deductions may be made.

Taxpayers have quite frequently taken advantage of the provision of the former laws wherein losses upon the sale of securities, particularly liberty bonds, were allowed as a deduction in determining net income. Having made the sale they would purchase them again at the lower figures, or purchase like securities. Under the new law and effective as of January 1, 1921, such losses will not be deductible wherein it appears that within thirty days prior or subsequent to such sale the taxpayer has acquired securities representing substantially identical property and the taxpayer has held the new property for any period after such sale.

It will no longer be possible for taxpayers who contemplate the sale of property at a profit, to evade the tax upon such transaction by giving the property, at a value at or near the contemplated selling price to a near relation who would thereby be freed from paying the proper amount of tax upon the sale of the gift property because the selling price was only slightly in excess, or not at all, of the appraised value of the property at time of its acquisition by gift. The new law provides that upon sale or other disposition of property obtained as a gift the net gain shall be computed by deducting from the sale price the cost of such property to the donor or last preceding owner, with proper modifying provisions for such computation in case the property was acquired by the donor or preceding owner prior to March 1, 1913.

The new law has enacted the principles laid down in the several treasury decisions regarding the determination of gains or losses upon the sale or other disposition of capital assets acquired before March 1, 1913.

Congress has taken note of the retardng effect upon business of taxing gains upon sales of capital assets at the same rate as that upon ordinary business income. The new law distinguishes between these two classes of income and by its provisions limits

the tax upon gains from sale or other disposition of capital assets. This limitation is effective as of December 31, 1921, and thereafter such gains will be taxable at 12½ per cent. These provisions apply to individuals, partnerships and estates, but do not apply to the gains of corporations. Capital assets are defined as "property acquired and held by the taxpayer for profit or investment for more than two years (whether or not connected with his trade or business) but does not include property held for personal use or consumption of the taxpayer or his family, or stock in trade."

Beginning January 1, 1922, corporations will be subject to an income tax at 12½ per cent. of its taxable net income instead of 10 per cent. as heretofore.

Former income-tax laws have allowed all corporations an exemption of $2,000 to be applied before computing income taxes. As of January 1, 1921, this exemption is abolished, except to those whose income is $25,000 or less. There is a limiting clause extending this exemption to those corporations whose income is slightly in excess of $25,000.

If an individual or partnership is carrying on a business in which capital is a material income-producing factor and in which the net income for the taxable year 1921 is not less than 20 per cent. of the invested capital and the tax upon income derived therefrom is in excess of what it would be if the said business was incorporated, such business may be incorporated if done "within four months after the passage of the act." As the act was passed November 23, 1921, it is apparently necessary to take advantage of this provision prior to March 23, 1922. In case such business is incorporated within the stipulated time the entire income from January 1, 1921, may be returned and is taxable as if it were a corporation. It seems highly probable that this privilege will be extended to those who incorporated in 1921, "prior" to four months after the passage of the act instead of just those who incorporated "within" the said four months' period.

As there will be no excess-profits taxes after January 1, 1922, there will be no personal service corporations, heretofore recognized as being subject to a limited amount of excess-profits tax. Nor will the stockholders in such corporations be obliged to include in their returns the undistributed earnings of such cor-

porations. No provisions of the former laws were the cause of so much controversy, perhaps, as were those pertaining to the taxation of personal service corporations, and it will be a great relief to all concerned that this bone of contention is removed.

After January 1, 1921, taxpayers having income from tax-free-covenant bonds will not be required to include as income the tax paid for them upon such bonds by the corporation, as has heretofore been required.

Additions to reserves for bad debts are recognized as deductible items under the new law provided they are considered reasonable. Also, when the taxpayer can produce satisfactory evidence that a debt will probably be paid only in part, he may consider the total amount of the debt as bad, charge it off and deduct it from income. This latter provision is subject to the discretion of the commissioner of internal revenue, and is quite a departure from the limitation upon deductions for bad debts that has heretofore been held necessary. It will be remembered that before a deduction could be made for bad debts, they had to be "charged off" in the books of account, and the taxpayer was obliged to show evidence that the debt could be considered uncollectible. Of any part of it was collectible the debt could not be charged off until final payment was made of that part.

In case of exchanges of property, other than those made in reorganizations, the net income shall be computed upon the "readily realizable market value" under provisions of the new law instead of the "fair market value" as heretofore.

Other provisions which render needed relief to the free flow of business are those revising the former law which taxed as income such gain as might be indicated by the transfer of property of an individual to a corporation wherein the individual still maintained a controlling interest in the corporation to which the property was transferred.

As this is written the regulations covering this law are not yet distributed and until then we cannot hope to know all the points there may be brought out, but with such information that is available it would seem fair to say that the law is better than those that preceded it. The enacting bodies have not been obliged to blaze a new trail as they were in 1917, and they were not confronted with ever-mounting budgets as they were in 1918, and so with the mass of court and treasury decisions on the former

laws, and with the accumulated experience of the administrative officials, they have passed a law that has eliminated almost all the flaws of the former ones.

There will, no doubt, be revisions made in this law and many of its provisions will be attacked but for a time at least it will be the law of the land and as such is worthy of respect and the obedience that all good citizens are glad to give it.

Causes of Examination Failure

One of the questions which is greatly concerning the board of examiners of the Institute, the various state boards of accountancy throughout the country and the many applicants for C. P. A. certificates and Institute membership is the small percentage of success in examination.

Thirty-eight states are using the Institute's examinations and the number of applicants increases steadily. The utmost care is exercised in the preparation of examination questions and every possible effort is made to present to applicants abundant opportunity to demonstrate their ability to practise as public accountants. Every criticism is given careful consideration and nothing is left undone which would be likely to render the examinations clear, easily understood and fair.

Yet, in spite of all that has been done, the percentage of success is lamentably small. Many reasons have been assigned for the failure of so many applicants, and we believe that the most important and valid of these is the evident lack of adequate preliminary study and practice on the part of applicants.

There are, however, other reasons which deserve careful consideration and in order to present these fairly, we have obtained from examiners employed by the board of examiners expressions of opinion as to the cause or causes of failure.

One of the examiners, whose field is accounting theory and practice, writes as follows:

"Several reasons may be advanced as to why so many of the candidates taking the examinations for membership of the American Institute of Accountants fail to secure the requisite number of marks to satisfy the examiners that they are qualified to pass.

"The one foremost is, undoubtedly, nervousness. Few candidates, however well prepared and equipped, enter the examination room with the *savoir faire* borne in the every-day routine of the

office, no matter how arduous and complicated the office engagements may be.

"The mental hazards preparatory to and upon entering the examination room are various and depend upon the temperament and healthful condition of the candidate; but for the most part they dwell upon the uncertainty regarding the subjects to be met —whether these subjects will be such as are familiar; to what extent and whether it will be possible to answer all the questions and problems in the time alloted.

"It is obvious that many candidates do not read the questions carefully and as thoroughly as they should in order to grasp the true situation and ascertain exactly what is required. They imagine that they do so, attempt a problem hurriedly and spend considerable time thereon only to find later that they have mistaken its purport. Many answer the theoretical questions (which invariably carry less weight than the problems) first and then, proceeding with the problems, realize suddenly that too much time has been devoted to the former and that there is insufficient time satisfactorily to complete the latter. These either finish the problems in error or do not finish them at all.

"Many candidates waste much time, and stationery, by making unnecessary transcripts of the data, such as lists of balances, before them.

"There are usually several evidences of good work but slow, and the result of this is that problems are omitted entirely in either part 1 or part 2, sometimes both, and of course the entire loss of points for such omissions. Some papers give evidence of a good knowledge of one particular subject, notably the income and profits-tax problems, but a woful lack of knowledge of all other subjects. Others show good book-keeping ability but very little experience in higher accountancy subjects. Then (sad to relate) there are candidates who should not present themselves for the examinations at all, displaying an incompetence and ignorance truly deplorable.

"Of those who passed the last two examinations, the majority passed well, but of those who failed the greater number failed badly.

"Several candidates, not knowing whether they were successful or otherwise, have voluntarily admitted that former examination papers were fair. There was perhaps some little excuse for the frequent complaint of insufficient time at the previous examinations. At the November, 1921, examinations there could be no such excuse and, indeed, very little comment on this point was heard."

The subject of commercial law is one that seems to terrify many of the applicants. Obviously, examinations in this subject must deal only with the broad, fundamental principles rather than

any state statute. Any examination given in most of the states in the Union can be fair only if it deals with matters common throughout the country.

One of the examiners in commercial law expresses the following opinions:

"I think I should first outline the viewpoint of the examiner. The examiner selects questions which cover legal points that would be covered by a student in the proper study of commercial law. The object of the examination being to ascertain knowledge of the subject possessed by the applicant, questions are propounded the answering of which will of necessity disclose to the examiner the extent of such knowledge. It follows, therefore, that the reasoning of the applicant on which his answers to respective questions are based is of great importance. In fact the applicant may give an incorrect answer and yet by his reasoning disclose a knowledge of the subject which will warrant his receiving a good mark for the answer. The papers which I have corrected show a tendency on the part of applicants to pay little attention to the reasons for their answers and to expressing their reasons. It is possible that by changing the words which appear on the papers, 'Give reasons for all answers,' the importance of the reasons could be more strongly impressed upon the applicant's mind.

"Ordinarily failure is, of course, due to lack of knowledge of the subject. While commercial law is not the most important subject to be mastered by an accountant, every accountant and in fact every business man should have a thorough working knowledge thereof, and such knowledge cannot be acquired by a casual reading of some work on the subject nor by an intensified 'cramming' carried on for a short period prior to the examination. Applicants should take up the study of the subject with the idea that a knowledge of it is part of their equipment for successfully practising in the profession which they have chosen, and not, as many evidently do, with a view of passing some particular examination. There are some whose lack of knowledge is due not to improper application to study, but to use, through misinformation, of poor text-books. This is quite apt to be true with those who pursue the study by themselves.

"The greatest weakness shown is in the question of negotiable instruments. This branch of the law is largely a question of memory. Negotiable instruments law being uniform throughout the United States, applicants should thoroughly memorize the provisions of the act, not word for word, but the substance thereof, and, further, in the case of each section of the statute, should become familiar with the general practical application thereof. If the study of the negotiable instruments law is pursued

in that way, the memorizing of the statute will be easier and the knowledge of the subject more thorough.

"The same course should be pursued by applicants in acquiring a knowledge of the uniform sales act and the uniform partnership law. The uniform sales act is, of course, a most important branch of the law of contracts, and as it is gradually becoming uniform throughout the United States, it should be an important part of every course of study of commercial law. While at present the questions on partnership are not predicated on the uniform statute, nevertheless the statute for the most part is merely an enactment of the general principles of the common law, for which reason the study of the statute should be taken up, regardless of whether or not the uniform statute is a law of the state in which the applicant resides.

"I am also impressed by the evident failure of many of the applicants carefully to consider and analyze the questions before attempting to write the answers, as a result of which the applicant tries to discuss a point which a proper consideration of the question would show could not possibly be involved. More time should be taken in analyzing the questions; the answers, particularly the reasons therefor, should be carefully thought out; and the answers should be carefully and concisely expressed in writing. The applicant should take up the questions in the order in which they appear on the paper and not, as is apparently done by many, pick out from all the questions those which appear the easiest to the applicant, leaving those which appear most difficult to be taken up last. As a result of the latter course, it is impossible for the applicant to concentrate his mind on the particular questions which he is answering and there is a failure to give proper thought to the analyzing of each question.

"The poor results of the examination heretofore have been the effect, not of difficult questions, but rather of poorly equipped applicants."

We are glad to be able to present these expressions of opinion from examiners and trust that they will be given due consideration by future applicants.

It is quite generally admitted by institutions of learning that no examination test is absolutely fair. The element of personality and individual temperament must be ignored in preparing examination questions for any large group of candidates. But we are confident that the Institute examinations approach as near as possible the point of absolute fairness and we believe that the great majority of qualified applicants have passed and will continue to pass those examinations.