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Correspondence: Profit on Sale of Investments

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Profit on Sale of Investments

Editor, The Journal of Accountancy:

SIR: I have read with considerable interest your editorial in the January issue of THE JOURNAL OF ACCOUNTANCY in regard to the federal decision of *Brewster v. Walsh,* which holds that profits realized from the sale of investments or capital assets are not income and therefore not taxable under the sixteenth amendment of the constitution.

I have also read with renewed interest, in your February issue, opposite views regarding the question from Mr. John Bauer and Mr. George O. May.

As this federal decision is of vital importance to the business world, I presume public accountants have given the matter more or less consideration and are expressing their views on the one side or the other.

Like the question of interest on investment, it will be impossible to obtain unanimity of opinion from accountants on this question, and the only thing that can be expected is the presentation of the process of reasoning leading to their different conclusions.

My point of view coincides with Mr. Bauer's rather than with Mr. May's. As Mr. Bauer points out, if A owns real estate costing $100,000.00 on which he earns $8,000.00, he is complying with the law when he pays a tax on $8,000.00 because this amount is *income* on his investment. If his real estate appreciates in value to $200,000.00 on which he subsequently earns $16,000.00 and he pays a tax on $16,000.00 he is still complying with the law because $16,000.00 is his income or return on his investment. Now if A sells his real estate later for the appreciated amount of $200,000.00 and pays a tax on the appreciation of $100,000.00 he is certainly paying a tax on *capital* instead of on *income.* It is obvious that there is an increment of $100,000.00, but we must discriminate between increment arising from capital increases, which we will call capital increment, and that arising from the use of capital, or revenue increment.

Mr. May states that if increments of capital are in no circumstances income, decrements of capital cannot be allowed to enter into the computation of income, and therefore depreciation on machinery used in production would not be a proper deduction. In my opinion the two cases are not parallel. Nearly all capital necessary to be invested in an enterprise for operating returns is in a larger sense an expense. This is true whether the capital is used as working capital to pay for operating labor, to purchase operating supplies, or is invested in buildings or machinery.

The only difference is that labor and supplies become almost immediately a current operating expense, while the capital invested in machinery and buildings has to be absorbed through operation periodically in the form of depreciation. In other words these diminishing assets must be charged against operation to find correct costs on which to compute net income. However, if capital assets actually increase in value, actually increase the investment of the business beyond the original amount, is not this a capital accretion? What has it to do with revenue? It increases the net worth of the business, but the net worth may be increased through capital accretions as well as through revenue accretions, and logically only revenue or income accretions should be taxable. This is fully recognized in the fact that the capital stock of a corporation sold by the corporation at a premium is not taxable, because it is a capital accretion. This is fully realized by all practising accountants when in corporation accounting they endeavor to differentiate between capital surplus and revenue surplus on the books of the corporation, as well as on their balance-sheets.

Let us take another example. Suppose a business man be so shortsighted as to be without fire insurance on his plant, and it takes fire and becomes a complete loss. Or suppose a company operating a fleet of vessels carried no insurance against losses by storm, etc., and they foundred. Logically, these must be considered capital losses and have nothing to do with revenue and therefore should not be considered in income-tax matters.

I am not interested particularly at this time in the items which are deductible or not deductible under the present income-tax law. Law speaks in an imperative manner. As Blackstone says "it commands or prohibits" and it must be obeyed after enactment. But law is supposed to be founded upon justice and equitable principles, and a frank and full discussion of principles by the people has everything to do with the laws which ultimately remain on our statute books.

I contend with Mr. Bauer that capital accretions should not be taxable and that only revenue accretions or income should be taxable under an *income-tax* law.

Yours truly,

ARTHUR BERRIDGE.

Portland, Oregon, March 18, 1921.