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Students' Department

H. P. Baumann

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H. P. Baumann, *Editor*

This department has been requested to solve the following problem which was submitted by F. C. Schneider of Louisville, Kentucky.

Tax Problem

Question:

1. John P. Evans Company, a Kentucky corporation, operates a store at Uniontown, Kentucky, dealing in general merchandise.
2. The corporation is subject to all state laws of the commonwealth of Kentucky as well as all United States federal laws affecting a corporation.
3. State of Kentucky has an income-tax law, under which there is levied a 4 per cent. income tax on the net profits of this corporation.
4. For the calendar year 1936 the corporation had a net profit of $21,364.12, which includes an item of $500 for dividends received from other corporations. Fifteen per cent. of the dividend item of $500 received is subject to federal normal tax and federal excess-profits tax under the 1936 federal revenue act.
5. The corporation has capital stock issued and outstanding of $30,000, of which it declared and paid in cash during the year 1936 a 5 per cent. dividend on the stock outstanding.
6. In calculating Kentucky state income tax no deductions are to be made from net income of $21,364.12 for dividends received or dividends paid.
7. The corporation filed its federal capital-stock tax return as of June 30, 1936, and showed thereon a declared value of its capital stock of $60,000.
8. Kentucky state income tax is to be deducted from net income before calculating any of the federal income tax.
9. All federal taxes are to be deducted from net income before calculating any Kentucky state income tax.
10. In calculating the federal taxes the rates for all classifications as shown in the revenue act of 1936, approved June 22, 1936, 9:00 P.M. eastern standard time, are to be used.
11. Based on the facts as stated above the following information is desired.
    (a) What is the correct amount of federal income tax the corporation owes for taxable calendar year 1936 consisting of normal tax, surtax and excess-profits tax?
    (b) What is the correct amount of Kentucky state income tax the corporation owes for the taxable calendar year 1936?

Note.—The corporation files both its federal and state income-tax returns on calendar-year basis.

Solution:

For convenience, the sections of the revenue act of 1936 applicable to the problem are shown below:

"Section 13. *Normal tax on corporations.*

Upon normal-tax net incomes not in excess of $2,000, 8 per centum.

$160 upon normal-tax net incomes of $2,000; and upon normal-tax net incomes in excess of $2,000 and not in excess of $15,000, 11 per centum in addition of such excess.

$1,590 upon normal-tax net incomes of $15,000; and upon normal-tax net incomes in excess of $15,000 and not in excess of $40,000, 13 per centum in addition of such excess.

$4,840 upon normal-tax net incomes of $40,000; and upon normal-tax net incomes in excess of $40,000, 15 per centum in addition to such excess.

Section 14. *Surtax on undistributed profits.*

(a) Definitions.—As used in this title—

(1) The term "adjusted net income" means the net income minus the sum of . . .

(a) The normal tax imposed by section 13.

. . . . .

(2) The term "undistributed net income" means the adjusted net income minus the sum of the dividends-paid credit provided in section 27 . . .

(b) Imposition of tax.—There shall be levied, collected and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to the application of the specific credit as provided in subsection (c):

7 per centum of the portion of the undistributed net income which is not in excess of 10 per centum of the adjusted net income.

12 per centum of the portion of the undistributed net income which is in excess of 10 per centum and not in excess of 20 per centum of the adjusted net income.

17 per centum of the portion of the undistributed net income which is in excess of 20 per centum and not in excess of 40 per centum of the adjusted net income.

22 per centum of the portion of the undistributed net income which is in excess of 40 per centum and not in excess of 60 per centum of the adjusted net income.

27 per centum of the portion of the undistributed net income which is in excess of 60 per centum of the adjusted net income.

(c) Adjusted net income less than $50,000.—

(1) Specific credit.—If the adjusted net income is less than $50,000, there shall be allowed a specific credit equal to the portion of the undistributed net income which is in excess of 10 per centum of the adjusted net income and not in excess of $5,000, such credit to be applied as provided in paragraph (2).

(2) Application of specific credit.—If the corporation is entitled to a specific credit, the tax shall be equal to the sum of the following:

(a) A tax computed under subsection (b) upon the amount of the undistributed net income reduced by the amount of the specific credit, plus

(b) 7 per centum of the amount of the specific credit.

Section 23. *Deductions from gross income.*

(c) Taxes generally.—Taxes paid or accrued within the taxable year, except—

(1) Federal income, war-profits and excess-profits taxes (other than the excess-profits tax imposed by section 106 of the revenue act of 1935:)

Section 26. *Credits of corporations.*

(b) Dividends received.—85 per centum of the amount received as dividends from a domestic corporation which is subject to taxation under this title. . . .

Section 402. *Excess-profits tax.*

(a) Section 106 (b) of the revenue act of 1935 is amended by striking out "except that there shall be deducted the amount of income tax imposed for such year by section 13 of the revenue act of 1934, as amended" and inserting in lieu thereof "computed without the deduction of the tax imposed by this section, but with a credit against net income equal to the credit for dividends received provided in section 26 (b) of the revenue act of 1936."

The rates of excess-profits tax prescribed by the 1935 act, (which are applicable to this problem) are:

Six per centum of that portion of the excess-profits tax net income which is in excess of 10 per centum but not in excess of 15 per centum of the declared value of the capital stock.

Twelve per centum of that portion of the excess-profits tax net income which is in excess of 15 per centum of the declared value of the capital stock.

No provision is made in this solution for accrued capital taxes deductible in the current year, because all pertinent information relative to the computation of this tax is not available in the problem.

The bases for the various taxes and the sections of the revenue act applicable thereto are as follows:

Kentucky state income tax:

Section 9 of the problem which states "all federal taxes are to be deducted from net income before calculating any Kentucky state income tax."

This may be expressed as follows:

4% (net income minus normal tax, excess-profits tax and surtax on undistributed profits), or

(1) $K = .04\ (\$21{,}364.12 - N - E - S)$

Normal tax:

This may be expressed as follows:

Various percentages of [net income minus 85% of the dividends received (Sec. 26 b), Kentucky state income tax (Sec. 23 c), and excess-profits tax (Sec. 23 c—1)].

The various percentages are:

8% of \$ 2,000

11% of \$13,000

13% of remainder.

Expressed algebraically:

(2) $N = .08\ (\$2{,}000) + .11\ (\$13{,}000) + .13\ [\$21{,}364.12 - \$15{,}000.00 - .85\ (\$500) - K - E]$

Excess-profits tax:

This may be expressed as follows:

Various percentages (after credit) of net income minus 85% of the dividends received (Sec. 402 a) and Kentucky state income tax.

The various percentages are:

As the declared value of the capital stock was \$60,000 there is no tax payable on 10% (\$6,000) of such declared value.

Net income which is in excess of 10% but not in excess of 15% of the declared value, or \$3,000, is subject to a tax of 6%, and that in excess of 15% is subject to a 12% rate.

Expressed algebraically:

$$(3)\ E = .06\ (\$3{,}000) + .12\ [\$21{,}364.12 - \$3{,}000 - \$6{,}000 - .85\ (\$500) - K]$$

Surtax on undistributed profits:

This may be expressed as follows:

Various percentages (net income minus Kentucky state income tax, excess-profits tax (Sec. 23 c 1), normal tax (Sec. 14 a 1 A), specific credit (Sec. 14 c—1) and dividends paid (Sec. 14 a—2).

Expressed algebraically:

$$\begin{aligned}(4)\ S = {} & .07\ [.10\ (\$21{,}364.12 - K - N - E)] + \\ & .12\ [.10\ (\$21{,}364.12 - K - N - E)] + \\ & .17\ [.20\ (\$21{,}364.12 - K - N - E)] + \\ & .22\ [.20\ (\$21{,}364.12 - K - N - E)] + \\ & .27\ (\$21{,}364.12 - K - N - E) - \\ & \quad .60\ (\$21{,}364.12 - K - N - E) - \$1{,}500 - [\$5{,}000 - \\ & \quad .10\ (\$21{,}364.12 - K - N - E)] + .07\ [\$5{,}000 - .10 \\ & \quad (\$21{,}364.12 - K - N - E)].\end{aligned}$$

Multiplying and grouping:

$$\begin{aligned}(1)\ K &= \$854.56 - .04\ N - .04\ E - .04\ S \\ (2)\ N &= \$160 + \$1{,}430 + .13\ (\$21{,}364.12 - \$425 - K - E - \$15{,}000) \\ &= -\ .13\ K - .13\ E + \$2{,}362.09. \\ (3)\ E &= \$180 + .12\ (\$11{,}939.12 - K) \\ &= \$1{,}612.69 - .12\ K \\ (4)\ S &= (.19 \times .10 + .39 \times .20)\ (\$21{,}364.12 - K - N - E) + \\ &\quad .27\ [.50\ (\$21{,}364.12 - K - N - E) - \$6{,}500] + \$350 - \\ &\quad .007\ (\$21{,}364.12 - K - N - E) \\ &= .097\ (\$21.364.12 - K - N - E) + .135\ (\$21{,}364.12 - \\ &\quad K - N - E) - \$1{,}755 + \$350 - .007\ (\$21{,}364.12 - \\ &\quad K - N - E) \\ &= .225\ (\$21{,}364.12 - K - N - E) - \$1{,}405 \\ &= \$3{,}401.93 - .225\ K - .225\ N - .225\ E\end{aligned}$$

Transposing:

$$\begin{array}{lrcl} (1) & \$\ 854.56 & = & K + .04\ N + .04\ E + .04\ S \\ (2) & \$2{,}362.09 & = & .13\ K + N + .13\ E \\ (3) & \$1{,}612.69 & = & .12\ K + E \\ (4) & \$3{,}401.93 & = & .225\ K + .225\ N + .225\ E + S \\ (5)\ (4) \times .04 & \$136.08 & = & .009\ K + .009\ N + .009\ E + .04\ S \\ (1) & \underline{854.56} & = & \underline{K + .040\ N + .040\ E + .04\ S} \\ (6)\ (1)\text{ minus }(5) & \$718.48 & = & .991\ K + .031\ N + .031\ E \\ (7)\ (2) \times .031 & \underline{73.22} & = & \underline{.00403\ K + .031\ N + .00403\ E} \\ (8)\ (6)\text{ minus }(7) & \$645.26 & = & .98697\ K + .02697\ E \\ (9)\ (3) \times .02697 & \underline{43.49} & = & \underline{.003236\ K + .02697\ E} \end{array}$$

(10) (8) minus (9) $\$601.77 = .983734\ K$, or
(11) $K = \$611.72$

Transposing and substituting the value of K in (3):
(3) $E = \$1,612.69 - .12\ (\$611.72)$, or
$E = \$1,539.28$

Transposing and substituting the values of K and E in (2):
(2) $N = \$2,362.09 - .13\ (\$611.72) - .13\ (\$1,539.28$, or
$\$2,362.09 - \$79.52 - \$200.11$, or
$N = \$2,082.46$

Transposing and substituting the values of K, E, and N in (4):
(4) $S = \$3,401.93 - .225\ (\$611.72) - .225\ (\$2,082.46) -$
$.225\ (\$1,539.28)$, or
$S = \$3,401.93 - .225\ (\$4,233.46)$, or
$S = \$3,401.93 - \$952.53$, or
$S = \$2,449.40$

Proof

Kentucky state income tax:		
Net income		$21,364.12
Deduct federal taxes:		
Normal tax	$2,082.46	
Excess-profits tax	1,539.28	
Surtax	2,449.40	6,071.14
Net income subject to Kentucky state income tax		$15,292.98
Kentucky state income tax—4% of $15,292.98		$ 611.72
Federal normal tax:		
Net income		$21,364.12
Deduct:		
Dividend credit—85% of $500	$ 425.00	
Kentucky state income tax	611.72	
Excess-profits tax	1,539.28	2,576.00
Net income subject to normal tax		$18,788.12
Portion of $18,788.12 subject to 8% rate		$ 2,000.00
Portion of $18,788.12 subject to 11% rate		13,000.00
Portion of $18,788.12 subject to 13% rate		3,788.12
Total		$18,788.12
Computation of normal tax:		
8% of $ 2,000.00		$ 160.00
11% of $13,000.00		1,430.00
13% of $ 3,788.12		492.46
Total		$ 2,082.46

Excess-profits tax:		
Net income		$21,364.12
Deduct:		
Dividend credit—85% of $500	$ 425.00	
Kentucky state income tax	611.72	1,036.72
Net income for excess-profits tax purposes		$20,327.40
Portion not taxable—10% of $60,000		$ 6,000.00
Portion taxable at 6%—5% of $60,000		3,000.00
Portion taxable at 12%—$20,327.40 less $9,000		11,327.40
Total		$20,327.40
Computation of excess-profits tax:		
6% of $ 3,000.00		$ 180.00
12% of $11,327.40		1,359.28
Total		$ 1,539.28
Surtax on undistributed profits:		
Net income		$21,364.12
Deduct:		
Kentucky state income tax	$ 611.72	
Excess-profits tax	1,539.28	
Normal tax	2,082.46	4,233.46
Adjusted net income		$17,130.66
Deduct dividends-paid credit		1,500.00
Undistributed net income		$15,630.66
Computation for specific credit:		
Undistributed net income, or $5,000, whichever is less		$ 5,000.00
Deduct—10% of adjusted net income		1,713.07
Specific credit		$ 3,286.93
Amounts of undistributed net income subject to specified rates:		
7% on first 10% of adjusted net income	$1,713.07	
12% on next 10% of adjusted net income	1,713.07	
17% on next 20% of adjusted net income	3,426.13	
22% on next 20% of adjusted net income	3,426.13	
27% on excess of undistributed net income reduced by specific credit ($3,286.93) over 60% of adjusted net income	2,065.33	
7% of specific credit	3,286.93	
Total		$15,630.66

Computation of surtax on undistributed profits:

7% of $1,713.07	$ 119.91	
12% of $1,713.07	205.57	
17% of $3,426.13	582.44	
22% of $3,426.13	753.75	
27% of $2,065.33	557.64	
7% of $3,286.93	230.09	
Total		$ 2,449.40

REORGANIZATION PROBLEM

Editor, Students' Department:

SIR: I represent a group of students taking a C. P. A. coaching course. There was so much difference of opinion as to the proper solution of a problem that we have decided to submit it to you for solution.

The problem is enclosed.

Thank you in advance for this service.

Yours truly,
(A Subscriber)

Los Angeles, California.

At June 30, 1935, the balance-sheet of the X Corporation stood as follows:

Assets

Current assets	$ 20,000
Fixed assets	87,000
Deferred charges and debits	5,000
Total	$112,000

Liabilities

Current liabilities	$ 25,200
Fixed liabilities	30,000
Deferred credits	1,800
Capital:	
Preferred stock, 500 shares at $100	50,000
Common stock	No par value
Surplus	5,000
Total	$112,000

The company needs more capital and, to procure it, authorizes an increase in capital stock as follows:

Preferred stock from 500 to 2,500 shares at $100 par.
Common stock from 250 to 4,000 shares, no par value.

The old stock was ordered in to be cancelled and new stock to be issued on the following basis:

Old stock outstanding	New issue
1 share common exchanged for	2 common
1 share preferred exchanged for	1 preferred, 1 common

Four of the original stockholders (A, B, C and D) of the company are also officers of the company, and of the current liabilities shown above, $5,200 ($1,300 each) is due them for salary.

The stock holdings of the original issue stood as follows:

	Preferred	Common
A	68	76
B	50	50
C	37	37
D	22	40
All others	323	47
Totals	500	250

After the original issue was taken care of, A, B, C and D took the remaining common stock, cancelled the salaries due them, and donated 1,000 shares (250 each) of it back to the company to be used to promote the sale of the remaining preferred, by giving one-half share of this donated stock with each share of new preferred sold. On December 31, 1935, $97,000 was the total issue of preferred to that date issued and paid for by cash or conversion.

Required:

Prepare the journal entries necessary to carry into effect the stock transactions.

Prepare a new balance-sheet.

What is the book value and number of shares of treasury stock at December 31, 1935?

Show the share holdings of A, B, C and D at December 31, 1935.

Solution:

An analysis of the stockholdings follows:

	Treasury stock	A	B	C	D	All others	Total
Common stock:							
The holdings of the original issue were		76	50	37	40	47	250
On a basis of two new shares for one old		152	100	74	80	94	500
One share of new common for each share of old preferred held		68	50	37	22	323	500
New common stock accepted in lieu of salary credits. (The entire unissued common stock remaining was distributed to the officers)		750	750	750	750		3,000
Totals		970	900	861	852	417	4,000
Shares donated to treasury by A, B, C and D to be used as a bonus to prospective purchasers of preferred stock	1,000	*250*	*250*	*250*	*250*		
Totals	1,000	720	650	611	602	417	4,000
Treasury stock issued to purchasers of 470 shares of new preferred stock	*235*					235	
Outstanding—December 31, 1935	765	720	650	611	602	652	4,000

Preferred stock:							
The holdings of the original issue were..................		68	50	37	22	323	500
Which were exchanged on the basis of one share of new preferred (and one of new common stock, see above)......		68	50	37	22	323	500
New preferred stock sold.....						470	470
Outstanding, December 31, 1935		68	50	37	22	793	970

As the balance-sheet given in the problem assigns no value whatever to the no-par common stock it is assumed in this solution that the statutes of the state of incorporation permit such treatment. However, when the company issued 3,000 shares of the new no-par common stock in cancellation of the salary credits totalling $5,200 a definite assignable value was set. This value of $1.73+ per share attaches only to the particular shares in the treasury and not to the total shares outstanding.

On this basis, the 1,000 shares of common stock donated to the treasury by the officers carried a value of ($\frac{1}{3}$ of $5,200) $1,733.33 which should be credited to a reserve for bonus on preferred stock, inasmuch as these 1,000 shares will be issued "to promote the sale of the remaining preferred, by giving one-half share of this donated stock with each share of new preferred sold."

The journal entries to record the transactions follow:

(1)

Common stock—authorized and unissued (3,750 shares)..................................	$	
To—common stock—no par value (3,750 shares).............................		$
To record the increase on June 30, 1935, from 250 to 4,000 shares of no-par common.		

(2)

Common stock (250 shares)..................		
To—common stock—authorized and unissued (250 shares)..................		
To record the issuance of 2 shares of new no-par common for 1 share of old no-par common.		

(3)

Preferred stock—authorized and unissued (2,000 shares)	$ 200,000.00	
To—preferred stock $100 par value (2,000 shares)		$ 200,000.00
To record the increase on June 30, 1935, from 500 to 2,500 shares of $100 par preferred stock.		

(4)

Preferred stock (500 shares)	50,000.00	
To—preferred stock (500 shares)		50,000.00
Common stock—authorized and unissued (500 shares)		
To record the issuance of 1 share of $100 preferred and 1 share of no-par common for each share of old preferred on June 30, 1935.		

(5)

Current liabilities (accrued salaries)	5,200.00	
To—common stock—no par value		5,200.00
Common stock—authorized and unissued (3,000 shares)		
To record the cancellation of accrued salaries of A, B, C, and D in exchange for 3,000 shares of no par common.		

(6)

Treasury stock—no par common (1,000 shares)	1,733.33	
To—reserve for bonus on preferred stock		1,733.33
To record the donation of 1,000 shares of no-par common stock.		

(7)

Current assets	47,000.00	
To—preferred stock—authorized and unissued		47,000.00
To record the issuance of 470 shares of preferred stock.		

(8)

Reserve for bonus on preferred stock	814.67	
To—treasury stock—no par common (470 shares)		814.67
To record the issuance of 470 shares of treasury stock as a bonus to the purchasers of 470 shares of preferred stock.		

X Corporation

Balance-sheet—December 31, 1935

Assets

Current assets	$ 67,000.00
Fixed assets	87,000.00
Deferred charges and debits	5,000.00
Total	$159,000.00

Liabilities and net worth

Current liabilities				$ 20,000.00
Fixed liabilities				30,000.00
Deferred credits				1,800.00
Net worth:				
Capital stock—				
Preferred—authorized—2,500 shares of a par value of $100 each—issued and outstanding—970 shares			$ 97,000.00	
Common stock—no par value—authorized				
and issued	4,000 shares	$5,200.00		
In treasury	765 shares	918.66		
Outstanding	3,235 shares		4,281.34	
Total capital stock outstanding			$101,281.34	
Surplus			5,000.00	
Reserve for bonus on preferred stock			918.66	107,200.00
Total				$159,000.00