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Inadmissible Assets

By Milton Rindler

In my income-tax experience, I have learned that the average business man does not even know what an inadmissible asset is—much less its effect on a corporation's excess-profits tax. If this element of invested capital were of little importance, this ignorance might be excused. But corporations make many investments, which have an important effect on their invested capital and consequently on their tax.

The government regulations define inadmissible assets as "stocks, bonds and other obligations (other than obligations of the United States) the dividends or interest from which are not included in computing net income." The law proceeds on the theory that if the income from an obligation is not taxed, the capital invested in that obligation should not be included as part of the corporation's invested capital. In other words, it would be double exemption first to exempt the interest on a state bond and then to exempt 8 per cent of the capital invested in that bond. The only exceptions are United States obligations, which may be included in invested capital.

Thus, stock in a domestic corporation, municipal and state bonds are inadmissible, while Liberty bonds are admissible.

A clear idea of what is and what is not an inadmissible asset may be gained from the following distinctions:

As the term "obligations of the United States" includes only direct obligations, bonds of Porto Rico are inadmissible. War finance bonds are not considered obligations of the United States and are inadmissible to the extent of a principal of $5,000.00, because only the interest on a principal of $5,000.00 of these bonds is exempt. The stock of federal reserve banks and federal farm loan bonds are inadmissible.

The law exempts from tax dividends from a corporation which is taxable upon its net income. Where dividends are received on stock of a foreign corporation, which derives income (no matter how small) from sources within the United States, and to that

extent is taxable under the law, the dividends so received are entirely exempt. Thus, the stock of a foreign corporation, which derives income from sources within the United States, is inadmissible, whereas stock of a foreign corporation, which derives no income from sources within the United States, is admissible.

The fact that no income is received from the obligation during the year does not affect its status as an inadmissible.

If part of the income from a stock or bond is exempt and another part, such as income from the sale of the obligation, is taxable, that proportion of the entire amount held of the obligation from which this income is derived which the taxable income bears to the total income is admissible. Take, for example, the following case:

A corporation owns $15,000 of A stock and $40,000 of B bonds at the beginning of the taxable year. It receives $750 in dividends on the A stock (Jan. 1-July 1—$500.00.—July 1-Dec. 31 —$250.00.) and $500 profit on the sale of $5,000 of the stock on July 1st of the taxable year. On the B bonds, interest of $2,000 is received during the year. The corporation pays during the year $1,000 in interest on money borrowed to purchase the bonds. The following schedule shows the amounts used in the computation and the results:

Obligation	*Principal*	*Total income*	*Non-taxable*	*Taxable*	*Inad-missible*	*Period*
A stock..	$15,000	$1,000	$500	$500	$7,500	Jan. 1-July 1
A stock..	10,000	250	250	.....	10,000	July 1-Dec. 31
B bonds..	40,000	2,000	2,000	1,000	20,000	Jan. 1-Dec. 31

As the profit on the sale of A stock is one-half of the total income, one-half of the stock is admissible from January 1st to July 1st, the date of the sale. From July 1st to the end of the year, the corporation holds $10,000. of inadmissibles. The law provides that interest paid on indebtedness incurred or continued to purchase obligations (other than obligations of the United States issued after September 24, 1917), the interest upon which is wholly exempt, is not deductible in computing net taxable income. The disallowance of the interest paid is the same in effect as taxing that much of the interest received on the obligation for which the indebtedness was incurred. Therefore, that proportion of the bonds for which the indebtedness was incurred

which the disallowed interest (i. e. taxable interest) bears to the total interest received on the bonds is admissible.

Under section 207 of the 1917 law and article 44 of regulations 41, borrowed money and inadmissibles could not be included in invested capital. It was found in the working out of the law that, if this provision were carried out, many businesses would have no invested capital. Furthermore, it was inequitable because the inadmissibles had been purchased partly or entirely with borrowed money. Assuming that they had been purchased with borrowed money, it was entirely wrong to eliminate both from invested capital. Being pressed for a quick solution to the problem, the treasury department passed a ruling giving the taxpayer the benefit of the doubt by assuming that all inadmissibles had been purchased with borrowed money. Only the excess of the inadmissibles over the total liabilities was deemed to have been acquired out of capital and for that reason had to be deducted in schedule C of the 1917 excess-profits blank in computing invested capital.

At first, this ruling was carried out by simply taking the amount of inadmissibles and the amount of liabilities at the beginning and end of the year, and using the average of each to determine the amount to be deducted. But it was found that in many cases, a monthly average of liabilities and inadmissibles was substantially different from a yearly average. Therefore, wherever there was a substantial difference, the monthly average was used.

In computing the amount of inadmissibles to be deducted, all liabilities were taken into consideration. Even though the liability could be directly connected with a specific admissible asset, such as money borrowed to purchase Liberty bonds, the liability was included in the computation. An exception arose, however, when, because of the limitation of interest under the 1917 law, a part of the borrowed money was allowed as invested capital. As soon as the borrowed money became invested capital, it could not be considered a liability to be included in the computation of inadmissibles. To consider it in the computation would be to contradict the theory upon which the deduction for inadmissibles in 1917 was based.

In the 1918 law, we find the provision for inadmissibles much more logical than under the 1917 law. The present law provides

that "there shall be deducted from invested capital as defined above a percentage thereof equal to the percentage which the amount of inadmissible assets is of the amount of admissible and inadmissible assets held during the taxable year." The following hypothetical case will illustrate the treatment of inadmissibles under the 1918 law:

The AB Corporation's balance-sheet of Jan. 1, 1919

Assets			*Liabilities and Capital*	
Cash		$10,000	Accounts payable.........	$20,000
Accts. receivable...	$50,000		Notes payable............	10,000
Less reserve for bad debts......	1,000	49,000		
Notes receivable...	$5,000		Mortgage on plant........	10,000
Less notes rec. discounted	1,000	4,000		
			Capital stock.............	100,000
Inventory, mdse....		20,000	Surplus	43,000
Plant and mach....	$100,000			
Less reserve for depreciation ...	10,000	90,000		
Stocks, at cost.....		10,000		
		$183,000		$183,000

On May 1, 1919, inadmissibles costing $20,000 were purchased. On November 1, 1919, inadmissibles costing $10,000. were purchased. On December 31, 1919, the total admissible assets, as adjusted, amounted to $150,000.

In computing the percentage of inadmissibles, the assets must first be "adjusted in accordance with the provisions of the statute." Thus, for example, goodwill purchased with stock must be reduced to 25 per cent of the total capital stock outstanding on March 3, 1917, or at the beginning of the taxable year, depending upon the date when the goodwill was acquired.

As the reserve for bad debts is not allowable deduction in computing net taxable income, it should be regarded as part of surplus, leaving accounts receivable at the unadjusted value of $50,000.

"Notes receivable discounted" represents the contingent liability for notes which have been sold to the bank. These notes are

no longer assets of the corporation and are properly deducted as shown in the balance-sheet from the total notes receivable, leaving the net amount of $4,000.

"Plant and machinery" should be adjusted as shown in the balance-sheet by deducting the reserve for depreciation, leaving a net value of $90,000 to be used in the computation. If any part of the reserve for depreciation has been disallowed as a deduction, that part should not be deducted from the asset, but should be regarded as part of surplus. "Mortgage on plant" does not enter into the computation, as it does not reduce the value of the asset but simply represents the amount of capital borrowed to acquire the asset.

The assets at their adjusted values would then be as follows:

Cash	$10,000
Accounts receivable	50,000
Notes receivable	4,000
Inventory	20,000
Plant and machinery	90,000
Total admissible assets January 1, 1919	$174,000
Total admissible assets December 31, 1919	150,000
Total	$324,000
Average admissible assets	$162,000

The regulations provide that if at any time a substantial change has taken place either in the amount of inadmissible assets or in the total amount of admissible and inadmissible assets, the effect of such change shall be averaged exactly from the date on which it occurred. An example of such a change would be an issue of bonds or stock by a corporation during the year. The incoming cash would cause a substantial change in the amount of admissible assets. In our hypothetical case, there have been two substantial changes in the amount of inadmissibles during the year, which necessitate averaging from the date of each change. If the amount of merchandise inventory at the end of each month were known, and the books were fully posted each month, the amounts of admissible and inadmissible assets could be averaged monthly. In this case, however, only a yearly average of admissibles can be taken.

The inadmissibles would be averaged as follows:

Date of change	*Amount*	*Number of days*	*Fraction of year*	*Average amount*
Jan. 1, 1919.........	$10,000	365	......	$10,000.00
May 1, 1919.........	20,000	245	49/73	13,424.66
Nov. 1, 1919.........	10,000	61	61/365	1,671.23
Average inadmissibles				$25,095.89

Average admissibles	$162,000.00
Average inadmissibles	25,095.89
Average total admissible and inadmissible assets......	$187,095.89

Percentage of average inadmissibles to average of total assets equals 13.4 per cent.

This percentage of the invested capital gives the amount to be deducted, leaving the net invested capital.