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American Institute of Accountants

SPRING EXAMINATIONS

The spring examinations conducted by the Board of Examiners of the American Institute of Accountants will be held May 15 and 16, 1919.

Examinations will be conducted wherever necessary to meet the convenience of a reasonable number of applicants.

Examinations will include Commercial Law, Auditing, Accounting Theory and Practice (including optional questions in the Elements of Actuarial Science).

Application blanks and rules of the Board may be obtained upon request. Copies of the questions of past examinations may be obtained at ten cents a copy at the offices of the Board. Applications for the spring examinations must be in the hands of the Secretary on or before March 31, 1919.

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CONTENTS FOR MARCH, 1919

THE JOURNAL OF ACCOUNTANCY is the organ of the professional accountants of the United States. In its articles and editorial columns it treats, from the accountant's point of view, of business problems and conditions.

The editor will be glad to receive and to consider for publication articles from well-informed persons, and will welcome especially contributions from public accountants. The manuscripts of articles not available for publication will be returned on request.

All changes of address should be sent to the publishers on or before the 22nd of each month to insure prompt receipt of succeeding issues. Both new and old addresses must be given.

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AUTHOR OF ARTICLE

In This Issue of

THE JOURNAL OF ACCOUNTANCY

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The Journal of Accountancy

Official Organ of the American Institute of Accountants

Vol. 27 MARCH, 1919 No. 3

Work of the Excess Profits Tax Investigator*

By R. G. Cranch

Investigators under the excess profits tax law require two distinct branches of preparation: first, in the practical interpretation of the law and its application to difficult cases and, second, in those principles of accounting which control and govern the correct determination of earnings and invested capital.

The excess profits tax investigator must recognize only one standard in his work, and that is absolute fairness and justice in the application of the law, without attempting to favor either the taxpayer or the government. Where there are two possible solutions to a problem in taxation, the solution that most nearly accords with common sense should be chosen, even though a purely technical interpretation of the law might yield a greater revenue to the government. It is equally important that no taxpayer should be permitted to evade just taxation through mere technicalities, when the spirit and intent of the law have been violated.

While the legal side of the internal revenue service is intensely interesting, we must pass on to our subject, which involves the relation of accounting principles to the work of the excess profits tax investigator.

The object of the science of accounting might be described, from the practical point of view, as the accurate determination of the net worth of various businesses, the fixing of the true amount of their earnings, and the ways and means by which those earnings may be legitimately increased by better methods, both in production and in the elimination of waste.

*An address delivered before the internal revenue agents and inspectors of the Philadelphia division January 18, 1919.

From this brief practical definition, it is clear how closely the work of the accountant is allied to that of the excess profits tax investigator. In fact the chief difference between the work of these two classes of men is that the accountants are called upon to determine the results in the first instance, before even the owners of the business have decided what would be a fair statement of their profits, while the excess profits tax investigator nearly always finds carefully prepared statements of earnings and of net worth, his chief function being to verify legitimate items and to call in question all illegitimate items and conclusions. We must always remember that destructive criticism is easier than the doing of constructive work and be a little careful how we tear down what others have built up, until we have something better to put in its place.

One will frequently find statements of earnings and net worth, some of them prepared by public accountants, which leave much to be desired in the way of clearness and accuracy, but before rejecting them as unfair, one should find out if the practical circumstances would permit an internal revenue agent to make better statements. If not, then the best practical adjustment will have to be made, guided almost exclusively by common sense and a desire to be fair to all parties concerned.

There are a few concrete suggestions in regard to investigations, which I would like to submit, from my past experience as a public accountant, for consideration and discussion.

First, I would emphasize the importance, wherever possible, of actually seeing the physical property which goes to make up the invested capital of the company being investigated. In this way one will soon secure a working knowledge of about how much machinery, building construction, mine tunnels or other assets should be represented by an expenditure of $10,000.00, $100,000.00 or $1,000,000.00, in the industries which are common in the district. Of course, you will constantly be meeting exceptional cases, but the broader your experience grows, the easier it will be to handle the unusual problems.

If you have carefully examined a detailed asset and liability statement and profit and loss account, covering the business you are investigating, and then thoroughly inspect the operations of

the plant, you will be surprised how readily and quickly you can put yourself in a position judiciously to question the taxpayer regarding the results of his business.

This introduces a second suggestion, which is that you study briefly, but most carefully, the character of the men with whom you are dealing. The men you will meet can be roughly divided into three classes:

a. Those whose actions are plainly guided by principles of right and justice.

b. Those who believe "honesty is the best policy," but don't hesitate to put a selfish and narrow construction on that policy, and

c. Those who deliberately plan to defraud the government of taxes due and would defraud anyone else, provided the opportunity presented itself and they were not afraid of being found out.

The surest way to draw a man out, without giving offense, is to take a genuine interest in the growth and development of his business. This is not hard, for if a man loves his work as an accountant or as an excess profits tax investigator, he will have a keen interest in the success of his work, which after all is bound up with and dependent upon the success of the business man and taxpayer.

If a man feels that you take a personal interest in his business, he will take pains to see that you have a correct understanding of it. Every time you reach such a correct understanding of a man's business, your future work is made easier.

In the handling of the human element in making tax investigations, it is of the utmost importance to prove to the taxpayer the intention and desire of congress and the bureau of internal revenue to treat the public fairly. Often a taxpayer will be nursing a grievance, which can be entirely removed by a straightforward explanation. I have in mind a man in New York who believed it was grossly unfair for the government not to allow the deduction of income taxes as an expense of the business.

After explaining how impracticable it would be for the government to make such an allowance, due to the resultant shrinkage of revenue in following years, and after explaining further that the government, under the stress of war and our struggle for national existence, had a right to consider itself a partner

in every man's business, this particular taxpayer was well satisfied to regard his payments to the government as a division of the profit, rather than as a business expense. This simple explanation cleared his mind of a feeling of grievance, and in spite of the assessment of considerable extra tax, I firmly believe that he had a more friendly feeling toward the government after the verification of his income tax return than before.

Probably the most difficult and unpleasant type of excess profits tax investigation is that covering cases of intentional fraud. In these cases there are hardly any limits to which the internal revenue agent is not obliged to go in order to right the wrong, and the procedure of examination will have to be as thorough and comprehensive as that adopted by the most skillful of the public accountants who are engaged to uncover defalcations and other business dishonesty. It would take many hours to discuss the matter of fraudulent returns; therefore we proceed to the consideration of more normal cases.

The great bulk of our tax recoveries is not made from the deliberately dishonest class, but is rather the result of returns made without full knowledge of how the tax laws apply. Also there are heavy recoveries to be made from companies whose business methods have been so conservative that they have never allowed their full earnings to appear in their profit and loss account or balance-sheet. In such cases a knowledge of accounting will be found very helpful.

This brings us to a third suggestion, relative to the best methods for making detailed verification of the items appearing on the balance-sheet. In this work probably the greatest difficulties encountered will be to ascertain that the original or March 1, 1913, values. on the balance-sheet represent bona fide cash values, and what items appear at figures above or below actual cash values.

One great stumbling block which will be frequently found is the excessive valuation placed upon certain assets in order to meet the legal requirements covering the issuance of stock full-paid and non-assessable. Many taxpayers try to avoid a search into such legally established values for fear that the result will have some effect in undermining the legality of the stock issue. To this objection I have always answered that adequate legal

consideration and fair cash value for taxation purposes do not need to be the same—in fact frequently cannot be the same under the regulations prescribed by the internal revenue service.

The internal revenue agent cannot be expected to have the same knowledge as to plant values that is possessed by the professional appraiser, but his daily experience will soon enable him to detect rank overvaluation of assets, and where this condition exists he is forced to seek some remedy. Usually the best way is to make such an investigation of the original costs and subsequent additions as will reveal the source of the padded valuation. It will sometimes be found that plant values have been improperly built up through capitalizing renewals and sometimes even supplies. In other cases one will find a mixed total of tangible and intangible property given for capital stock, making it difficult to secure a separate valuation of the physical property. Sometimes one will find new appraisements ingeniously worked into the book values in such a way as to conceal the true costs.

Insurable values are frequently obtainable, and often make a very good basis for criticism of the plant values shown in the books. I have in mind one case where a common sense knowledge of machinery values satisfied me that the figures submitted were seriously inflated. The first attempt was to establish the overvaluation through a comparison with costs, but this was not satisfactory, because much of the plant was about forty years old. It was very apparent, however, that many items of maintenance had been capitalized.

As costs were not available in any serviceable form, we turned to insurable values, found that the plant had been carefully appraised by mutual fire insurance underwriters, and that the insurable value was much below the capital value claimed. We then based the invested capital figures on the appraisement of the fire underwriters, which was the maximum figure we felt that the taxpayer could justify.

Closely connected with the question of plant values and appraisements is the question of depreciation. Thanks to the invested capital clauses of the excess profits tax law, this question is a little easier to deal with than formerly.

If a man wants to take an excessive depreciation into the income account, the solution lies in insisting that the same high depreciation must be used in arriving at his invested capital. In

this way you can set the taxpayer's desire for a high depreciation to be charged against earnings in his income account against his desire for a high invested capital, thereby arriving at a happy medium.

Reserves for bad debts and some other reserves, while they may be justified from the accounting point of view, must be cut out in considering tax returns, as they do not represent expenses or losses which are completed transactions.

Depreciation of inventories is a frequent source of tax evasion. Of course the new rule permitting inventories to be taken at cost or market prices, whichever are lower, constitutes a very liberal provision, and care must be taken that the taxpayer does not abuse his privileges to evade legitimate taxation. Some taxpayers believe they have the right to inventory on the basis of cost or market prices, whichever are higher. It is easy to see that if this were permitted great efforts would be made to swing a part of the 1918 profits over into 1919 by this method, in order to secure the benefit of the presumably lower rates of 1919.

Many times evasion will be practised by completely eliminating large items from inventories on the plea that they are worthless. Of course, if this action is not based on the facts, it will soon prove a boomerang, because when the merchandise is used, it cannot be included a second time as a cost of goods manufactured. If the tax rate has decreased since the time of the improper writing down of the inventory, the taxpayer is ahead, but if it has increased since that time, the taxpayer is going to pay more tax than his actual earnings demand. A taxpayer with fraudulent intent, when faced with this condition, is not unlikely to change the figures of his previous inventory. This must be watched very closely by comparison with the returns of the previous year.

Great care must be taken to see that the liabilities are accurately stated, and that no loans to the company are camouflaged as part of the invested capital.

There are many suggestions to be considered in the verification of the income account. In a company which keeps good and accurate accounts it is often the best practice to examine the income account first, but in all cases of rough or approximate records I like to consider the invested capital first, on account of the insight it gives into physical values and operating processes.

It is very good practice in verifying the income or profit and loss account, to turn first to the surplus account (or capital account if you are investigating a partnership); determine the net worth of the business at the beginning of the period and at the end of the period; and then to the increase in net worth add all dividends or drawings paid out during the year. This will give you the figure with which the profit and loss account must be brought into agreement. Of course a close inspection must be made of all special surplus or adjustment accounts to determine that part of the earnings has not been diverted from the usual channels in order to make the income appear smaller than it really is. The plea is frequently made that certain earnings are the result of previous years' operations, and that they should not enter into the current profit and loss account. In such cases you will sometimes find income transferred directly to surplus account, which must be brought back into the income for the current period, unless amended returns are filed for the previous period.

Revenue agents should fully realize the value and importance of the basic principle of double-entry bookkeeping, that the net income revealed by the profit and loss account must reflect itself in the asset and liability statement by an increase in the net worth of exactly the same amount, if no dividends have been paid. If dividends have been paid the increase in net assets, plus the dividends, will exactly equal the income reported for the year.

A great step forward was taken by the department when it first required the taxpayer to report his gross sales, cost of sales and gross income as adjusted by inventories, from which are then deducted the allowable expenses. Formerly the confusion as to how gross income should be calculated made a great deal of trouble for examining officers, while now it is relatively easy, for nearly all companies have a satisfactory record of gross sales.

Wherever there is the least doubt as to the honesty of the taxpayer, every effort should be made to see that his gross sales fairly represent the total production of his factory, as adjusted by inventories. Very useful partial proofs of the accuracy of the gross sales can be secured in indirect ways, according to the nature of the business. If the finished product is nearly all composed of metal, or if the metal used is represented by a uniform percentage of the total weight of shipments, a rough proof can

be obtained by comparing the weight of metal consumed with the sales reported, with an allowance of course for wastage and inventory changes.

Frequently the rough production records of a factory will show the number of machines produced, which should be accounted for either in sales or as an increase in inventory. The advantage of going back to the factory records is that they are less likely to have been dishonestly tampered with in order to defeat the purposes of an honest examination.

In the case of yarn spinners, the yarn produced should bear a definite relation to the wool purchases. In other businesses there are other ways of proving the honesty of the gross sales reported, and this is one of the most vital points in those cases where fraud is suspected.

In the case of a coal mine, the railroad weights of shipments can be used as an almost perfect proof of how many tons should appear in the sales accounts. In cases of suspected fraud such information could be obtained direct from the railroad after securing proper authority.

There is considerable difference of opinion as to what should be allowed under cost of sales. I believe that this should be confined to direct labor and direct material. In many cases this item should receive peculiarly careful verification in order to determine that it does not include payments at higher than market prices to affiliated companies or to other favored parties. In extreme cases of this kind, the revenue agent should secure authority for the making of a consolidated return, as frequently the interrelated companies do not own as much as 95% of each other's stock, and therefore do not come under the ordinary application of the rules covering consolidated returns.

Of course the general expenses must receive careful consideration. Here you will find donations to be disallowed, excessive and illegitimate traveling expenses, private automobiles charged to company expenses, capital expenditures made to look like expenses, and the thousand and one other items constantly appearing on the border lines between legitimate expenses and impositions on the government.

The deductions for losses should be subject to very close scrutiny. The chief difficulty is definitely to justify them as losses of the period under review, although of course you will occasion-

ally find losses claimed which are nothing short of ridiculous, such as the cutting in half of normal expenditures on the plea that values are temporarily inflated.

Depreciation we have already considered under invested capital, but there is one additional point to be mentioned. The standard forms call for an allowance for depreciation, from which shall first be deducted the cost of repairs and maintenance, the balance only to be charged to profit and loss. A recent court decision points out that repairs and maintenance are no part of the allowance made for depreciation, but that depreciation represents the loss, which is gradually reducing the value of the property to the point where it must be discarded as worthless, and is over and above all maintenance and repair charges. This is common sense accounting, and will no doubt be recognized by the department, though of course under this interpretation the rates would be lower than where depreciation is expected to cover maintenance and repair charges, as well as the gradual extinguishment of the effective life of the machine.

In closing, I will summarize briefly a few of the important points:

1. See the physical property you are dealing with to obtain an understanding of its real value.

2. Know the man you are investigating and fit the thoroughness of your examination to his probable character.

3. In verifying the assets shown on the balance-sheet keep constantly in mind the influences which would cause the taxpayer to use book values which are different from the cash values, such as the legal necessity for issuing capital stock full-paid and non-assessable.

4. In verifying the liabilities take special care to see that all liabilities are bona fide, and do not allow the inclusion of credit balances in favor of interested parties, made to cover up and support improper charges to expenses.

5. In verifying capital accounts and surplus, see that no loans from deceased partners or others are allowed to appear as capital, and that reserve accounts included as capital have not also been written off to the expenses.

6. In verifying income satisfy yourself that the gross sales are correct, and that all income items are proved in aggregate by the results shown in the balance-sheet.

Last, but not least, remember that fairness to the honest taxpayer demands that the revenue agent pursue his work diligently, and in such a way as to lose the minimum of tax income justly due to the government.

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EDITORIAL

The Revenue Act, 1918

This issue of THE JOURNAL OF ACCOUNTANCY might fitly be described as "income tax number." The text of titles 1, 2, 3 and 14 of the revenue act of 1918 are printed in the income tax department and occupy the bulk of the magazine.

No apology is necessary for this extended reproduction of the tax provisions of the revenue act. No piece of legislation is of comparable importance with it from the accountant's point of view, and while most readers of THE JOURNAL OF ACCOUNTANCY have seen the full text of the law it is desirable that they should have in the magazine all those provisions to which reference will be made in later issues in the form of treasury decisions, court judgments, etc.

The revenue act of 1918, of course, is far from perfect. It seems to be humanly impossible to prepare a taxing measure which will be regarded as faultless. But taken as a whole the act is an infinite improvement upon its predecessor, and we believe that by means of judicious administration it will be productive of an enormous amount of revenue with a minimum of public discomfort.

No government can extract six billion dollars from the pockets of one hundred million people and avoid annoyance and even actual injustice. Probably many of the taxpayers of the United States will feel themselves seriously aggrieved by the methods of administration adopted by the treasury department, and no doubt many of them will have good grounds for their complaints. But these things are inseparable from taxation on a grand scale. The

probability is that the great bulk of taxes will be assessed and collected without undue annoyance to the taxpayer, and without arousing general opposition.

Most Americans feel that the greater the amount of taxes raised, provided the proceeds be judiciously used, the better for the country at this particular time. We are saddled with a stupendous national debt and we enjoy enormous national prosperity. It seems, therefore, that the course of wisdom is to wipe out as much of the debt as is practicable during these times of prosperity and thus rid posterity of a burden of continuing debt.

The four Liberty bond issues and the fifth, if it be issued, will make demands upon the national treasury to an unprecedented extent. It will be well to meet all obligations even before the date of their maturity if it can be done without jeopardizing the stability and efficiency of the business machine of the country.

The new revenue act provides for a levy upon practically everyone outside the class of unskilled labor. The taxes run in the case of high incomes to a point which leaves comparatively little for the pocket of the taxpayer, but we do not hear complaints as to the burden of taxation. The public demands an equitable and fairly administered tax law. So long as it has that there will be no widespread opposition to paying our bills as a nation.

After the tax has been collected, however, the public will demand that some attention be paid to the fundamental principles of economy. We have run into a time of billions, and it will be hard work for the national mind as expressed in government to get back to thinking in mere millions. Thousands, of course, are inconsiderable.

It is to be feared that we were not long enough in the war. The people of the country were beginning to feel the pinch of war and to learn the value of conservation and saving. The government, however, reached the point of magnificent ideas without having experienced any difficulty in obtaining money, and a spirit of extravagance of the most ridiculous kind pervaded congressional and administrative departments of the government.

The Republicans having acquired control of both houses of congress are making loud protestations of their intentions to supplant extravagance by economy, to call a halt on unconsidered expenditures—and generally to clean house. The history of party government reveals many such protestations and comparatively few ful-

fillments. But it is to be hoped that at least some of the undertakings of what has now become the majority party may be carried out. Goodness knows there is room for improvement.

The public will not protest against heavy taxation fairly applied, but it will protest vigorously and effectively against continued disregard of the laws of economy.

It has been said that the new law is an improvement on its predecessor. The double taxation which was created by the 1917 amendment to the 1916 law is ended, and we have a straightforward tax which the ordinary man will be able to understand if he applies himself intelligently to the matter.

Many people are expressing the opinion that the revenue bill is incomprehensible. As a matter of fact, most of those who make this statement have not even read the bill, but going by precedent and bearing in mind the hopeless muddle of 1917 have come to the conclusion that 1918 can be no better.

There are, of course, many things which the ordinary business man would desire to amend in the new act, but it marks so great an improvement that adverse criticism might well be suspended until we see how the administration of the law will turn out. The government has recently had the advantage of the advice of many accountants, and we believe that much of the improvement in the act is due to the influence of expert advisors in the department.

As time goes on the question of income taxation will resolve itself more and more into a science. Ultimately it may not be Utopian to hope that a few men who really understand the principles of taxation will find their way into congress and will be able to embody their ideas in law. We are still in the experimental stage, but finally we shall come to the point where the public may reasonably expect that congress can be relied upon to enact tax measures conforming to the sound principles of business and economics.

Filing Income Tax Returns

Under the provisions of the new revenue act returns must be filed by March 15th accompanied by a payment of 25 per cent. of the amount of the tax estimated by the taxpayer to be due. The law contains a provision that extension of time may be granted in the discretion of the commissioner of internal revenue. This year

the circumstances are peculiar and it is necessary that the treasury, in order to meet certain certificates of indebtedness falling due, should receive the amount of tax revenue required by the law.

With this thought in mind the secretary of the treasury made an announcement to the effect that there would be no extension granted in any case. Apparently he did not stop to consider the effect of such a statement if literally interpreted, and there was in consequence great consternation among taxpayers. The forms were not expected to be available before March 1st, and it was immediately recognized that it would be a physical impossibility for all the taxpayers in the country to make returns within fifteen days after receipt of forms.

The thing was so manifestly impossible that the public came to the conclusion that an extension must be granted whether the secretary agreed or not.

The bureau of internal revenue on February 13th issued a statement, which was printed in part in many of the daily papers, explaining how an extension might be obtained, and this considerably relieved the anxiety of the public. Unfortunately, however, many taxpayers seem to have seen the statement of the secretary of the treasury and to have missed the announcement of the bureau of internal revenue.

In view of the great importance of the question we reproduce in full the announcement of the bureau.

Bureau of Internal Revenue,
Washington, D. C.

Although no general extension of time will be authorized for filing federal income tax returns due March 15, the commissioner of internal revenue has approved a novel feature of tax collection which will serve for all practical purposes as a possible extension of 45 days for the filing of corporation income and excess profits tax returns in cases where corporations are unable to complete and file their returns by March 15.

If a corporation finds that, for good and sufficient reason, it is impossible to complete its return by March 15, it may make a return of the estimated tax due and make payment thereof not later than March 15. If meritorious reason is shown as to why the corporation is unable to complete its return by the specified date, the collector will accept the payment of the estimated tax and agree to accept the revised and completed tax returns within a period of not more than 45 days.

Under the plan adopted for corporation payments and returns, the government will be able to collect approximately the amount of tax due on or before March 15, thus meeting its urgent needs; and corporations actually requiring further time for the preparation of their complete returns will be granted ample time in which to do so.

One of the advantages of this plan is that it relieves the taxpayer of one-half of one per cent. interest per month that would attach to the payment of the taxes under an extension granted at the request of the tax-

payer. The taxpayer will, of course, not be relieved of interest on such amount as his payment may fall short of the tax found later to be due on the basis of his final return.

Should the payment on March 15 of the estimated tax due be greater than the tax eventually found to be due on examination of the completed return, the excess payment will automatically be credited to the next instalment which will be due on June 15.

Provision for systematically handling this new feature will be made in the construction of the new return blanks for corporations. The new form will be a combined income and excess profits blank, embodied in which is a detachable letter of remittance. Any corporation which finds that, for sufficient reasons, it cannot complete its return by March 15, may detach and fill out the letter of remittance and forward same to the collector on or before March 15, together with a cheque, money-order or draft for the tax due on that date.

If the exact date is not known, the estimated tax due will be paid in this manner. A statement in writing of the reasons why it is impossible for the corporation to complete the return by the specified date must accompany every such remittance.

Individual taxpayers will be given similar privileges in cases in which it is made clear by the taxpayer that the time available is not sufficient to enable him to complete his return by March 15. No reason exists, according to the internal revenue officials, for delaying the filing of the returns of individual incomes, except in unusually difficult cases.

Forms for returns of individual incomes up to $5,000 will be distributed by collectors within a few days. Forms for larger incomes will be available about February 24. Corporation blanks will be distributed by March 1. Regulations governing the administration of the new income tax will also be available before March 1.

Reading between the lines of this announcement we think it might be safe to say that the taxpayer, corporate or individual, with a valid reason for requesting extension, will have small difficulty if he will observe the rules laid down in the foregoing announcement, estimate the probable tax and send a cheque for 25 per cent. of the amount.

As there will be hundreds of thousands of requests for extension it may reasonably be expected that extensions will be granted without unnecessary questionings and delays.

In other words the bureau of internal revenue realizes that it must coöperate with the taxpayer in order to achieve results, and there is no reason to expect needless rigidity in the administration of the law.

Income Tax Department

EDITED BY JOHN B. NIVEN, C.P.A.

The subject matter in this issue is the new income tax law, to be known as the revenue act of 1918. The text of titles I, II, III and XIV of the act is here published. Title I contains general definitions, title II the income tax law, title III the war profits and excess profits tax provisions, and title XIV the repeal provisions, etc.

Accountants are advised to post themselves on the fundamental features of the law from the statute itself, rather than to depend on outside comment for their information. A thorough perusal is, therefore, recommended. Some of the universally significant points that should be particularly observed by all may, however, be very shortly summarized with profit here:

The new date for filing (Sec. 227), and the payment of the tax in quarterly instalments (Sec. 250), the first accompanying the return.

The normal income tax rates for individuals (Sec. 210-a) and the point at which surtaxes begin (Sec. 211-a).

What items, such as insurance and gifts, may be excluded from individual income (Sec. 213); what credits are allowed for dividends, exempt interest and specific allowances (Sec. 216); what are legitimate deductions (Sec. 214-a), and also what are not (Sec. 215).

The "personal service corporation" (Sec. 200), the income of which, like that of partnerships, is taxed to the members and not to the business (Sec. 218-a and e). But the partnership (Sec. 224) and the corporation (Sec. 239) must nevertheless make a return.

The normal rate for corporations (Sec. 230-a-1); what the previously deductible "excess profits tax" is (Sec. 301-a, first and second brackets) and the "war profits tax" (Sec. 301-a, third bracket), and their rates; the limit on these taxes (Sec. 302); what the "excess profits credit," based on "invested capital," consists of (Sec. 312), and the "war profits credit," based, first, on pre-war earnings and increased capital (Sec. 311-a, 1-2) but with a minimum based on present invested capital (Sec. 311-a-3); what "invested capital" is (Sec. 326-a), being determined from the capital accounts, modified in regard to "intangibles" (Sec. 326-a-4-5) and "inadmissible assets" (Sec. 326-c), as defined in Sec. 325-a. The deductions allowed to corporations (Sec. 234), which do not include "contributions."

Consolidated returns are now required for affiliated corporations by the statute (Sec. 240), in place of merely being the subject of treasury regulations as formerly.

Where the fiscal year overlaps the calendar year, taxes are paid on proportionate amounts of income at the rates of the respective calendar years (Sec. 205-a, Sec. 335).

The exemptions on Liberty bond interest (given in the December, 1918, issue) must be considered with the limitations on the deductibility of interest paid (Sec. 214-a-2 and 234-a-2).

We also publish two treasury decisions (T. D. 2787 and 2791). The first relates to the earlier income tax laws. The second is of current interest because it settles definitely the status of reserves for federal taxes in the computation of invested capital, the amounts of taxes paid being deductible from invested capital from the dates when they became due and payable.

TREASURY DECISIONS

(T. D. 2791, February 17, 1919).

For the Purposes of Invested Capital, Income and Excess Profits Taxes are deemed to have been Paid out of the Net Income for the Taxable Year for which the Taxes are Levied.

To Collectors of Internal Revenue and Others Concerned:

For the purpose of determining invested capital under title II of the act of October 3, 1917, *income and excess profits taxes shall be deemed to have been paid out of the net income for the taxable year for which such taxes are levied.* Amounts payable on account of income and excess profits taxes for any year *may be included in computing surplus and undivided profits for the succeeding years only for the proportionate part of the year represented by the period of time between the close of the taxable year and the date or dates upon which such taxes become due and payable.* (Read question No. 71, 1918, *Excess-Profits Tax Primer*).

(T. D. 2787, January 31, 1919).

Income tax.

Interest paid by a corporation on mortgage indebtedness which has not been assumed by it is deductible from gross income in returns of income under the acts of August 5, 1909, and October 3, 1913, as payments required to be made as a condition to the continued use or possession of property.

To Collectors of Internal Revenue, Internal-revenue Agents and Others Concerned:

In ascertaining the net income of a corporation under section 38 of the act of August 5, 1909 (36 Stat., 112), and under section 2, paragraph G (b) (first) of the act of October 3, 1913, which has taken title to real property subject to a mortgage, but has not assumed the indebtedness secured thereby, interest paid on such indebtedness may be deducted from the gross income in a tax return as payments required to be made as a condition to the continued use or possession of the property.

T. D. 1865 of July 14, 1913, is hereby revoked.

AN ACT

To provide revenue, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

TITLE I.—GENERAL DEFINITIONS.

Section 1. That when used in this act—

The term "person" includes partnerships and corporations as well as individuals;

The term "corporation" includes associations, joint-stock companies, and insurance companies;

The term "domestic" when applied to a corporation or partnership means created or organized in the United States;

The term "foreign" when applied to a corporation or partnership means created or organized outside the United States;

The term "United States" when used in a geographical sense includes only the states, the territories of Alaska and Hawaii, and the District of Columbia;

The term "secretary" means the secretary of the treasury;

The term "commissioner" means the commissioner of internal revenue;

The term "collector" means collector of internal revenue;

The term "revenue act of 1916" means the act entitled "An act to increase the revenue, and for other purposes," approved September 8, 1916;

The term "revenue act of 1917" means the act entitled "An act to provide revenue to defray war expenses, and for other purposes," approved October 3, 1917;

The term "taxpayer" includes any person, trust or estate subject to a tax imposed by this act;

The term "government contract" means (a) a contract made with the United States, or with any department, bureau, officer, commission, board, or agency, under the United States and acting in its behalf, or with any agency controlled by any of the above if the contract is for the benefit of the United States, or (b) a subcontract made with a contractor performing such a contract if the products or services to be furnished under the subcontract are for the benefit of the United States.

The term "government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive" when applied to a contract of the kind referred to in clause (a) of this paragraph, includes all such contracts which, although entered into during such period, were originally not enforceable, but which have been or may become enforceable by reason of subsequent validation in pursuance of law;

The term "military or naval forces of the United States" includes the marine corps, the coast guard, the army nurse corps, female, and the navy nurse corps, female, but this shall not be deemed to exclude other units otherwise included within such term;

The term "present war" means the war in which the United States is now engaged against the German government.

For the purposes of this act the date of the termination of the present war shall be fixed by proclamation of the president.

TITLE II.—INCOME TAX.

PART I.—GENERAL PROVISIONS.

DEFINITIONS.

Sec. 200. That when used in this title—

The term "taxable year" means the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the net income is computed under section 212 or section 232. The term "fiscal year" means an accounting period of twelve months ending on the last day of any month other than December. The first taxable year, to be called the taxable year 1918, shall be the calendar year 1918 or any fiscal year ending during the calendar year 1918;

The term "fiduciary" means a guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for any person, trust or estate;

The term "withholding agent" means any person required to deduct and withhold any tax under the provisions of section 221 or section 237;

The term "personal service corporation" means a corporation whose income is to be ascribed primarily to the activities of the principal owners or stockholders who are themselves regularly engaged in the active conduct of the affairs of the corporation and in which capital (whether invested or borrowed) is not a material income-producing factor; but does not include any foreign corporation, nor any corporation 50 per centum or more of whose gross income consists either (1) of gains, profits, or income derived from trading as a principal, or (2) of gains, profits, commissions, or other income, derived from a government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive;

The term "paid," for the purposes of the deductions and credits under this title, means "paid or accrued" or "paid or incurred," and the terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under section 212.

DIVIDENDS.

Sec. 201. (a) That the term "dividend" when used in this title (except in paragraph (10) of subdivision (a) of section 234) means (1) any distribution made by a corporation, other than a personal service corporation, to its shareholders or members, whether in cash or in other property or in stock of the corporation, out of its earnings or profits accumulated since

February 28, 1913, or (2) any such distribution made by a personal service corporation out of its earnings or profits accumulated since February 28, 1913, and prior to January 1, 1918.

(b) Any distribution shall be deemed to have been made from earnings or profits unless all earnings and profits have first been distributed. Any distribution made in the year 1918 or any year thereafter shall be deemed to have been made from earnings or profits accumulated since February 28, 1913, or, in the case of a personal service corporation, from the most recently accumulated earnings or profits; but any earnings or profits accumulated prior to March 1, 1913, may be distributed in stock dividends or otherwise, exempt from the tax, after the earnings and profits accumulated since February 28, 1913, have been distributed.

(c) A dividend paid in stock of the corporation shall be considered income to the amount of the earnings or profits distributed. Amounts distributed in the liquidation of a corporation shall be treated as payments in exchange for stock or shares, and any gain or profit realized thereby shall be taxed to the distributee as other gains or profits.

(d) If any stock dividend (1) is received by a taxpayer between January 1 and November 1, 1918, both dates inclusive, or (2) is during such period bona fide authorized or declared, and entered on the books of the corporation, and is received by a taxpayer after November 1, 1918, and before the expiration of thirty days after the passage of this act, then such dividend shall, in the manner provided in Sec. 206, be taxed to the recipient at the rates prescribed by law for the years in which the corporation accumulated the earnings or profits from which such dividend was paid, but the dividend shall be deemed to have been paid from the most recently accumulated earnings or profits.

(e) Any distribution made during the first sixty days of any taxable year shall be deemed to have been made from earnings or profits accumulated during preceding taxable years; but any distribution made during the remainder of the taxable year shall be deemed to have been made from earnings or profits accumulated between the close of the preceding taxable year and the date of distribution, to the extent of such earnings or profits, and if the books of the corporation do not show the amount of such earnings or profits, the earnings or profits for the accounting period within which the distribution was made shall be deemed to have been accumulated ratably during such period.

BASIS FOR DETERMINING GAIN OR LOSS.

Sec. 202. That for the purpose of ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, the basis shall be—

(1) In the case of property acquired before March 1, 1913, the fair market price or value of such property as of that date; and

(2) In the case of property acquired on or after that date, (a) the cost thereof; or (b) the inventory value, if the inventory is made in accordance with section 203.

When property is exchanged for other property, the property received in exchange shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value, if any; but when in connection with the reorganization, merger, or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value, no gain or loss shall be deemed to occur from the exchange, and the new stock or securities received shall be treated as taking the place of the stock, securities, or property exchanged.

When in the case of any such reorganization, merger or consolidation the aggregate par or face value of the new stock or securities received is in excess of the aggregate par or face value of the stock or securities exchanged, a like amount in par or face value of the new stock or securities received shall be treated as taking the place of the stock or securities exchanged, and the amount of the excess in par or face value shall be treated as a gain to the extent that the fair market value of the new stock or securities is greater than the cost (or if acquired prior to March 1, 1913, the fair market value as of that date) of the stock or securities exchanged.

INVENTORIES.

Sec. 203. That whenever in the opinion of the commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the commissioner, with the approval of the secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

NET LOSSES.

Sec. 204. (a) That as used in this section the term "net loss" refers only to net losses resulting from either (1) the operation of any business regularly carried on by the taxpayer, or (2) the bona fide sale by the taxpayer of plant, buildings, machinery, equipment or other facilities, constructed, installed or acquired by the taxpayer on or after April 6, 1917, for the production of articles contributing to the prosecution of the present war; and when so resulting means the excess of the deductions allowed by law (excluding in the case of corporations, amounts allowed as a deduction under paragraph (6) of subdivision (a) of section 234) over the sum of the gross income plus any interest received free from taxation both under this title and under title III.

(b) If for any taxable year beginning after October 31, 1918, and ending prior to January 1, 1920, it appears upon the production of evidence satisfactory to the commissioner that any taxpayer has sustained a net loss, the amount of such net loss shall under regulations prescribed by the commissioner with the approval of the secretary be deducted from the net income of the taxpayer for the preceding taxable year; and the taxes imposed by this title and by title III for such preceding taxable year shall be redetermined accordingly. Any amount found to be due to the taxpayer

upon the basis of such redetermination shall be credited or refunded to the taxpayer in accordance with the provisions of section 252. If such net loss is in excess of the net income for such preceding taxable year, the amount of such excess shall under regulations prescribed by the commissioner with the approval of the secretary be allowed as a deduction in computing the net income for the succeeding taxable year.

(c) The benefit of this section shall be allowed to the members of a partnership and the beneficiaries of an estate or trust under regulations prescribed by the commissioner with the approval of the secretary.

FISCAL YEAR WITH DIFFERENT RATES.

Sec. 205. (a) That if a taxpayer makes return for a fiscal year beginning in 1917 and ending in 1918, his tax under this title for the first taxable year shall be the sum of: (1) the same proportion of a tax for the entire period computed under title I of the revenue act of 1916 as amended by the revenue act of 1917 and under title I of the revenue act of 1917, which the portion of such period falling within the calendar year 1917 is of the entire period, and (2) the same proportion of a tax for the entire period computed under this title at the rates for he calendar year 1918 which the portion of such period falling within the calendar year 1918 is of the entire period: provided, that in the case of a personal service corporation the amount to be paid shall be only that specified in clause (1).

Any amount heretofore or hereafter paid on account of the tax imposed for such fiscal year by title I of the revenue actof 1916 as amended by the revenue act of 1917, and by title I of the revenue act of 1917, shall be credited towards the payment of the tax imposed for such fiscal year by this act, and if the amount so paid exceeds the amount of such tax imposed by this act, or in the case of a personal service corporation, the amount specified in clause (1), the excess shall be credited or refunded in accordance with the provisions of section 252.

(b) If a taxpayer makes a return for a fiscal year beginning in 1918 and ending in 1919, the tax under this title for such fiscal year shall be the sum of: (1) the same proportion of a tax for the entire period computed under this title at the rates specified for the calendar year 1918 which the portion of such period falling within the calendar year 1918 is of the entire period, and (2) the same proportion of a tax for the entire period computed under this title at the rates specified for the calendar year 1919 which the portion of such period falling within the calendar year 1919 is of the entire period.

(c) If a fiscal year of a partnership begins in 1917 and ends in 1918 or begins in 1918 and ends in 1919, then notwithstanding the provisions of subdivision (b) of section 218, (1) the rates for the calendar year during which such fiscal year begins shall apply to an amount of each partner's share of such partnership net income (determined under the law applicable to such year) equal to the proportion which the part of such fiscal year falling within such calendar year bears to the full fiscal year, and (2) the rates for the calendar year during which such fiscal year ends shall

apply to an amount of each partner's share of such partnership net income (determined under the law applicable to such calendar year) equal to the proportion which the part of such fiscal year falling within such calendar year bears to the full fiscal year: provided, that in the case of a personal service corporation with respect to a fiscal year beginning in 1917 and ending in 1918, the amount specified in clause (1) shall not be subject to normal tax.

PARTS OF INCOME SUBJECT TO RATES FOR DIFFERENT YEARS.

Sec. 206. That whenever parts of a taxpayer's income are subject to rates for different calendar years, the part subject to the rates for the most recent calendar year shall be placed in the lower brackets of the rate schedule provided in this title, the part subject to the rates for the next preceding calendar year shall be placed in the next higher brackets of the rate schedule applicable to that year, and so on until the entire net income has been accounted for. In determining the income, any deductions, exemptions or credits of a kind not plainly and properly chargeable against the income taxable at rates for a preceding year shall first be applied against the income subject to rates for the most recent calendar year; but any balance thereof shall be applied against the income subject to the rates of the next preceding year or years until fully allowed.

PART II.—INDIVIDUALS.

NORMAL TAX.

Sec. 210. That, in lieu of the taxes imposed by subdivision (a) of section 1 of the revenue act of 1916 and by section 1 of the revenue act of 1917, there shall be levied, collected, and paid for each taxable year upon the net income of every individual a normal tax, at the following rates:

(a) For the calendar year 1918, 12 per centum of the amount of the net income in excess of the credits provided in section 216: provided, that in the case of a citizen or resident of the United States the rate upon the first $4,000 of such excess amount shall be 6 per centum;

(b) For each calendar year thereafter, 8 per centum of the amount of the net income in excess of the credits provided in section 216: provided, that in the case of a citizen or resident of the United States the rate upon the first $4,000 of such excess amount shall be 4 per centum.

SURTAX.

Sec. 211. (a) That, in lieu of the taxes imposed by subdivision (b) of section 1 of the revenue act of 1916 and by section 2 of the revenue act of 1917, but in addition to the normal tax imposed by section 210 of this act, there shall be levied, collected, and paid for each taxable year upon the net income of every individual, a surtax eaqual to the sum of the following:

1 per centum of the amount by which the net income exceeds $5,000 and does not exceed $6,000;

2 per centum of the amount by which the net income exceeds $6,000 and does not exceed $8,000;

3 per centum of the amount by which the net income exceeds $8,000 and does not exceed $10,000;

4 per centum of the amount by which the net income exceeds $10,000 and does not exceed $12,000;

5 per centum of the amount by which the net income exceeds $12,000 and does not exceed $14,000;

6 per centum of the amount by which the net income exceeds $14,000 and does not exceed $16,000;

7 per centum of the amount by which the net income exceeds $16,000 and does not exceed $18,000;

8 per centum of the amount by which the net income exceeds $18,000 and does not exceed $20,000;

9 per centum of the amount by which the net income exceeds $20,000 and does not exceed $22,000;

10 per centum of the amount by which the net income exceeds $22,000 and does not exceed $24,000;

11 per centum of the amount by which the net income exceeds $24,000 and does not exceed $26,000;

12 per centum of the amount by which the net income exceeds $26,000 and does not exceed $28,000;

13 per centum of the amount by which the net income exceeds $28,000 and does not exceed $30,000;

14 per centum of the amount by which the net income exceeds $30,000 and does not exceed $32,000.

15 per centum of the amount by which the net income exceeds $32,000 and does not exceed $34,000;

16 per centum of the amount by which the net income exceeds $34,000 and does not exceed $36,000;

17 per centum of the amount by which the net income exceeds $36,000 and does not exceed $38,000;

18 per centum of the amount by which the net income exceeds $38,000 and does not exceed $40,000;

19 per centum of the amount by which the net income exceeds $40,000 and does not exceed $42,000;

20 per centum of the amount by which the net income exceeds $42,000 and does not exceed $44,000;

21 per centum of the amount by which the net income exceeds $44,000 and does not exceed $46,000;

22 per centum of the amount by which the net income exceeds $46,000 and does not exceed $48,000;

23 per centum of the amount by which the net income exceeds $48,000 and does not exceed $50,000;

24 per centum of the amount by which the net income exceeds $50,000 and does not exceed $52,000;

25 per centum of the amount by which the net income exceeds $52,000 and does not exceed $54,000;

26 per centum of the amount by which the net income exceeds $54,000 and does not exceed $56,000;

27 per centum of the amount by which the net income exceeds $56,000 and does not exceed $58,000;

28 per centum of the amount by which the net income exceeds $58,000 and does not exceed $60,000;

29 per centum of the amount by which the net income exceeds $60,000 and does not exceed $62,000;

30 per centum of the amount by which the net income exceeds $62,000 and does not exceed $64,000;

31 per centum of the amount by which the net income exceeds $64,000 and does not exceed $66,000;

32 per centum of the amount by which the net income exceeds $66,000 and does not exceed $68,000;

33 per centum of the amount by which the net income exceeds $68,000 and does not exceed $70,000;

34 per centum of the amount by which the net income exceeds $70,000 and does not exceed $72,000;

35 per centum of the amount by which the net income exceeds $72,000 and does not exceed $74,000;

36 per centum of the amount by which the net income exceeds $74,000 and does not exceed $76,000;

37 per centum of the amount by which the net income exceeds $76,000 and does not exceed $78,000;

38 per centum of the amount by which the net income exceeds $78,000 and does not exceed $80,000;

39 per centum of the amount by which the net income exceeds $80,000 and does not exceed $82,000;

40 per centum of the amount by which the net income exceeds $82,000 and does not exceed $84,000;

41 per centum of the amount by which the net income exceeds $84,000 and does not exceed $86,000;

42 per centum of the amount by which the net income exceeds $86,000 and does not exceed $88,000;

43 per centum of the amount by which the net income exceeds $88,000 and does not exceed $90,000;

44 per centum of the amount by which the net income exceeds $90,000 and does not exceed $92,000;

45 per centum of the amount by which the net income exceeds $92,000 and does not exceed $94,000;

46 per centum of the amount by which the net income exceeds $94,000 and does not exceed $96,000;

47 per centum of the amount by which the net income exceeds $96,000 and does not exceed $98,000;

48 per centum of the amount by which the net income exceeds $98,000 and does not exceed $100,000;

52 per centum of the amount by which the net income exceeds $100,000 and does not exceed $150,000;

56 per centum of the amount by which the net income exceeds $150,000 and does not exceed $200,000;

60 per centum of the amount by which the net income exceeds $200,000 and does not exceed $300,000;

63 per centum of the amount by which the net income exceeds $300,000 and does not exceed $500,000;

64 per centum of the amount by which the net income exceeds $500,000 and does not exceed $1,000,000;

65 per centum of the amount by which the net income exceeds $1,000,000.

(b) In the case of a bona fide sale of mines, oil or gas wells, or any interest therein, where the principal value of the property has been demonstrated by prospecting or exploration and discovery work done by the taxpayer, the portion of the tax imposed by this section attributable to such sale shall not exceed 20 per centum of the selling price of such property or interest.

NET INCOME DEFINED.

Sec. 212. (a) That in the case of an individual the term "net income" means the gross income as defined in section 213, less the deductions allowed by section 214.

(b) The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 200 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

If a taxpayer changes his accounting period from fiscal year to calendar year, from calendar year to fiscal year, or from one fiscal year to another, the net income shall, with the approval of the commissioner, be computed on the basis of such new accounting period, subject to the provisions of section 226.

GROSS INCOME DEFINED.

Sec. 213. That for the purposes of this title (except as otherwise provided in section 233) the term "gross income"—

(a) Includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including in the case of the president of the United States, the judges of the supreme and inferior courts of the United States, and all other officers and employees, whether elected or appointed, of the United States, Alaska, Hawaii, or any political subdivision thereof, or the District of Columbia, the compensation received as such), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the wonership or use of or interest in such property; also from interest, rent, dividends, securities,

or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. The amount of all such items shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to properly accounted for as of a different period; but

(b) Does not include the following items, which shall be exempt from taxation under this title:

(1) The proceeds of life insurance policies paid upon the death of the insured to individual beneficiaries or to the estate of the insured;

(2) The amount received by the insured as a return of premium or premiums paid by him under life insurance, endowment, or annuity contracts, either during the term or at the maturity of the term mentioned in the contract or upon surrender of the contract;

(3) The value of property acquired by gift, bequest, devise, or descent (but the income from such property shall be included in gross income);

(4) Interest upon (a) the obligations of a state, territory, or any political subdivision thereof, or the District of Columbia; or (b) securities issued under the provisions of the federal farm loan act of July 17, 1916; or (c) the obligations of the United States or its possessions; or (d) bonds issued by the war finance corporation; provided, that every person owning any of the obligations, securities or bonds enumerated in clauses (a), (b), (c), and (d) shall, in the return required by this title, submit a statement showing the number and amount of such obligations, securities and bonds owned by him and the income received therefrom, in such form and with such information as the commissioner may require. In the case of obligations of the United States issued after September 1, 1917, and in the case of bonds issued by the war finance corporation, the interest shall be exempt only if and to the extent provided in the respective acts authorizing the issue thereof as amended and supplemented, and shall be excluded from gross income only if and to the extent it is wholly exempt from taxation to the taxpayer both under this title and under title III;

(5) The income of foreign governments received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments, or from interest on deposits in banks in the United States of moneys belonging to such foreign governments, or from any other source within the United States;

(6) Amounts received, through accident or health insurance or under workmen's compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness;

(7) Income derived from any public utility or the exercise of any essential governmental function and accruing to any state, territory, or the District of Columbia, or any political subdivision of a state or territory, or income accruing to the government of any possession of the United States, or any political subdivision thereof.

Whenever any state, territory, or the District of Columbia, or any political subdivision of a state or territory, prior to September 8, 1916, entered in good faith into a contract with any person, the object and purpose of which is to acquire, construct, operate, or maintain a public utility, no tax shall be levied under the provisions of this title upon the income derived from the operation of such public utility, so far as the payment thereof will impose a loss or burden upon such state, territory, District of Columbia, or political subdivision; but this provision is not intended to confer upon such person any financial gain or exemption or to relieve such person from the payment of a tax as provided for in this title upon the part or portion of such income to which such person is entitled under such contract;

(8) So much of the amount received during the present war by a person in the military or naval forces of the United States as salary or compensation in any form from the United States for active services in such forces, as does not exceed $3,500.

(c) In the case of non-resident alien individuals, gross income includes only the gross income from sources within the United States, including interest on bonds, notes, or other inetrest-bearing obligations of residents, corporate or otherwise, dividends from resident corporations, and including all amounts received (although paid under a contract for the sale of goods or otherwise) representing profits on the manufacture and disposition of goods within the United States.

DEDUCTIONS ALLOWED.

Sec. 214. (a) That in computing net income there shall be allowed as deductions:

(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered, and including rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business of property to which the taxpayer has not taken or is not taking title or in which he has no equity;

(2) All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917), the interest upon which is wholly exempt from taxation under this title as income to the taxpayer, or, in the case of a nonresident alien individual, the proportion of such interest which the amount of his gross income from sources within the United States bears to the amount of his gross income from all sources within and without the United States;

(3) Taxes paid or accrued within the taxable year imposed (a) by the authority of the United States, except income, war profits and excess profits taxes; or (b) by the authority of any of its possessions, except the amount of income, war profits and excess profits taxes allowed as a credit

under section 222; or (c) by the authority of any state or territory, or any county, school district, municipality, or other taxing subdivision of any state or territory, not including those assessed against local benefits of a kind tending to increase the value of the property assessed; or (d) in the case of a citizen or resident of the United States, by the authority of any foreign country, except the amount of income, war profits and excess profits taxes allowed as a credit under section 222; or (e) in the case of a nonresident alien individual, by the authority of any foreign country (except income, war profits and excess-profits taxes, and taxes assessed against local benefits of a kind tending to increase the value of the property assessed), upon property or business;

(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in trade or business;

(5) Losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit, though not connected with the trade or business; but in the case of a nonresident alien individual only as to such transactions within the United States;

(6) Losses sustained during the taxable year of property not connected with the trade or business (but in the case of a nonresident alien individual only property within the United States) if arising from fires, storms, shipwreck, or other casualty, or from theft, and if not compensated for by insurance or otherwise;

(7) Debts ascertained to be worthless and charged off within the taxable year:

(8) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence;

(9) In the case of buildings, machinery, equipment, or other facilities, constructed, erected, installed, or acquired, on or after April 6, 1917, for the production of articles contributing to the prosecution of the present war, and in the case of vessels constructed or acquired on or after such date for the transportation of articles or men contributing to the prosecution of the present war, there shall be allowed a reasonable deduction for the amortization of such part of the cost of such facilities or vessels as has been borne by the taxpayer, but not again including any amount otherwise allowed under this title or previous acts of congress as a deduction in computing net income. At any time within three years after the termination of the present war, the commissioner may, and at the request of the taxpayer shall, reexamine the return, and if he then finds as a result of an appraisal or from other evidence that the deduction originally allowed was incorrect, the taxes imposed by this title and by title III for the year or years affected shall be redetermined; and the amount of tax due upon such redetermination, if any, shall be paid upon notice and demand by the collector, or the amount of tax overpaid, if any, shall be credited or refunded to the taxpayer in accordance with the provisions of section 252;

(10) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted; provided, that in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date; provided further, that in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery, or within 30 days thereafter; such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the commissioner with the approval of the secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee;

(11) Contributions or gifts made within the taxable year to corporations organized and operated exclusively for religious, charitable, scientific, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual, or to the special fund for vocational rehabilitation authorized by section 7 of the vocational rehabilitation act, to an amount not in excess of 15 per centum of the taxpayer's net income as computed without the benefit of this paragraph. Such contributions or gifts shall be allowable as deductions only if verified under rules and regulations prescribed by the commissioner, with the approval of the secretary. In the case of a nonresident alien individual this deduction shall be allowed only as to contributions or gifts made to domestic corporations, or to such vocational rehabilitation fund;

(12) (a) At the time of filing return for the taxable year 1918 a taxpayer may file a claim in abatement based on the fact that he has sustained a substantial loss (whether or not actually realized by sale or other disposition) resulting from any material reduction (not due to temporary fluctuation) of the value of the inventory for such taxable year, or from the actual payment after the close of such taxable year of rebates in pursuance of contracts entered into during such year upon sales made during such year. In such case payment of the amount of the tax covered by such claim shall not be required until the claim is decided, but the taxpayer shall accompany his claim with a bond in double the amount of the tax covered by the claim, with sureties satisfactory to the commissioner, conditioned for the payment of any part of such tax found to be due, with interest. If any part of such claim is disallowed then the remainder of the tax due shall on notice and demand by the collector be paid by the taxpayer with interest at the rate of 1 per centum per month from the time the tax would have been due had no such claim been filed. If it is shown to the satisfaction of the commissioner that such substantial

loss has been sustained, then in computing the tax imposed by this title the amount of such loss shall be deducted from the net income. (b) If no such claim is filed, but it is shown to the satisfaction of the commissioner that during the taxable year 1919 the taxpayer has sustained a substantial loss of the character above described then the amount of such loss shall be deducted from the net income for the taxable year 1918 and the tax imposed by this title for such year shall be redetermined accordingly. Any amount found to be due to the taxpayer upon the basis of such redetermination shall be credited or refunded to the taxpayer in accordance with the provisions of section 252.

(b) In the case of a nonresident alien individual the deductions allowed in paragraphs (1), (4), (7), (8), (9), (10), (12), and clause (e) of paragraph (3), of subdivision (a) shall be allowed only if and to the extent that they are connected with income arising from a source within the United States; and the proper apportionment and allocation of the deductions with respect to sources of income within and without the United States shall be determined under rules and regulations prescribed by the commissioner with the approval of the secretary.

ITEMS NOT DEDUCTIBLE.

Sec. 215. That in computing net income no deduction shall in any case be allowed in respect of—

(a) Personal, living, or family expenses;

(b) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate;

(c) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made; or

(d) Premiums paid on any life insurance policy covering the life of any officer or employee, or of any person financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy.

CREDITS ALLOWED.

Sec. 216. That for the purpose of the normal tax only there shall be allowed the following credits:

(a) The amount received as dividends from a corporation which is taxable under this title upon its net income, and amounts received as dividends from a personal service corporation out of earnings or profits upon which income tax has been imposed by act of congress;

(b) The amount received as interest upon obligations of the United States and bonds issued by the war finance corporation, which is included in gross income under section 213;

(c) In the case of a single person, a personal exemption of $1,000, or in the case of the head of a family or a married person living with husband or wife, a personal exemption of $2,000. A husband and wife living together shall receive but one personal exemption of $2,000 against

their aggregate net income; and in case they make separate returns, the personal exemption of $2,000 may be taken by either or divided between them;

(d) $200 for each person (other than husband or wife) dependent upon and receiving his chief support from the taxpayer, if such dependent person is under eighteen years of age or is incapable of self-support because mentally or physically defective.

(e) In the case of a nonresident alien individual who is a citizen or subject of a country which imposes an income tax, the credits allowed in subdivisions (c) and (d) shall be allowed only if such country allows a similar credit to citizens of the United States not residing in such country.

NONRESIDENT ALIENS—ALLOWANCE OF DEDUCTIONS AND CREDITS.

Sec. 217. That a nonresident alien individual shall receive the benefit of the deductions and credits allowed in this title only by filing or causing to be filed with the collector a true and accurate return of his total income received from all sources corporate or otherwise in the United States, in the manner prescribed by this title, including therein all the information which the commissioner may deem necessary for the calculation of such deductions and credits; provided, that the benefit of the credits allowed in subdivisions (c) and (d) of section 216 may, in the discretion of the commissioner, and except as otherwise provided in subdivision (e) of that section, be received by filing a claim therefor with the withholding agent. In case of failure to file a return, the collector shall collect the tax on such income, and all property belonging to such nonresident alien individual shall be liable to distraint for the tax.

PARTNERSHIPS AND PERSONAL SERVICE CORPORATIONS.

Sec. 218. (a) That individuals carrying on business in partnership shall be liable for income tax only in their individual capacity. There shall be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year, or, if his net income for such taxable year is computed upon the basis of a period different from that upon the basis of which the net income of the partnership is computed, then his distributive share of the net income of the partnership for any accounting period of the partnership ending within the fiscal or calendar year upon the basis of which the partner's net income is computed.

The partner shall, for the purpose of the normal tax, be allowed as credits, in addition to the credits allowed to him under section 216, his proportionate share of such amounts specified in subdivisions (a) and (b) of section 216 as are received by the partnership.

(b) If a fiscal year of a partnership ends during a calendar year for which the rates of tax differ from those for the preceding calendar year, then (1) the rates for such preceding calendar year shall apply to an amount of each partner's share of such partnership net income equal to the proportion which the part of such fiscal year falling within such

calendar year bears to the full fiscal year, and (2) the rates for the calendar year during which such fiscal year ends shall apply to the remainder.

(c) In the case of an individual member of a partnership which makes return for a fiscal year beginning in 1917 and ending in 1918, his proportionate share of any excess profits tax imposed upon the partnership under the revenue act of 1917 with respect to that part of such fiscal year falling in 1917, shall, for the purpose of determining the tax imposed by this title, be credited against that portion of the net income embraced in his personal return for the taxable year 1918 to which the rates for 1917 apply.

(d) The net income of the partnership shall be computed in the same manner and on the same basis as provided in section 212, except that the deduction provided in paragraph (11) of subdivision (a) of section 214 shall not be allowed.

(e). Personal service corporations shall not be subject to taxation under this title, but the individual stockholders thereof shall be taxed in the same manner as the members of partnerships. All the provisions of this title relating to partnerships and the members thereof shall so far as practicable apply to personal service corporations and the stockholders thereof; provided, that for the purpose of this subdivision amounts distributed by a personal service corporation during its taxable year shall be accounted for by the distributees; and any portion of the net income remaining undistributed at the close of its taxable year shall be accounted for by the stockholders of such corporation at the close of its taxable year in proportion to their respective shares.

ESTATES AND TRUSTS.

Sec. 219. (a) That the tax imposed by sections 210 and 211 shall apply to the income of estates or of any kind of property held in trust, including—

(1) Income received by estates of deceased persons during the period of administration or settlement of the estate;

(2) Income accumulated in trust for the benefit of unborn or unascertained persons or persons with contingent interests;

(3) Income held for future distribution under the terms of the will or trust; and

(4) Income which is to be distributed to the beneficiaries periodically, whether or not at regular intervals, and the income collected by a guardian of an infant to be held or distributed as the court may direct.

(b) The fiduciary shall be responsible for making the return of income for the estate or trust for which he acts. The net income of the estate or trust shall be computed in the same manner and on the same basis as provided in section 212, except that there shall also be allowed as a deduction (in lieu of the deduction authorized by paragraph (11) of subdivision (a) of section 214) any part of the gross income which, pursuant to the terms of the will or deed creating the trust, is during the taxable year paid to or permanently set aside for the United States, any state, territory, or

any political subdivision thereof, or the District of Columbia, or any corporation organized and operated exclusively for religious, charitable, scientific, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual; and in cases under paragraph (4) of subdivision (a) of this section the fiduciary shall include in the return a statement of each beneficiary's distributive share of such net income, whether or not distributed before the close of the taxable year for which the return is made.

(c) In cases under paragraph (1), (2), or (3) of subdivision (a) the tax shall be imposed upon the net income of the estate or trust and shall be paid by the fiduciary, except that in determining the net income of the estate of any deceased person during the period of administration or settlement there may be deducted the amount of any income properly paid or credited to any legatee, heir or other beneficiary. In such cases the estate or trust shall, for the purpose of the normal tax, be allowed the same credits as are allowed to single persons under section 216.

(d) In cases under paragraph (4) of subdivision (a), and in the case of any income of an estate during the period of administration or settlement permitted by subdivision (c) to be deducted from the net income upon which tax is to be paid by the fiduciary, the tax shall not be paid by the fiduciary, but there shall be included in computing the net income of each beneficiary his distributive share, whether distributed or not, of the net income of the estate or trust for the taxable year, or, if his net income for such taxable year is computed upon the basis of a period different from that upon the basis of which the net income of the estate or trust is computed, then his distributive share of the net income of the estate or trust for any accounting period of such estate or trust ending within the fiscal or calendar year upon the basis of which such beneficiary's net income is computed. In such cases the beneficiary shall, for the purpose of the normal tax, be allowed as credits in addition to the credits allowed to him under section 216, his proportionate share of such amounts specified in subdivisions (a) and (b) of section 216 as are received by the estate or trust.

PROFITS OF CORPORATIONS TAXABLE TO STOCKHOLDERS.

Sec. 220. That if any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its stockholders or members through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, such corporation shall not be subject to the tax imposed by section 230, but the stockholders or members thereof shall be subject to taxation under this title in the same manner as provided in subdivision (e) of section 218 in the case of stockholders of a personal service corporation, except that the tax imposed by title III shall be deducted from the net income of the corporation before the computation of the proportionate share of each stockholder or member. The fact that any corporation is a mere holding

company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax; but the fact that the gains and profits are in any case permitted to accumulate and become surplus shall not be construed as evidence of a purpose to escape the tax in such case unless the commissioner certifies that in his opinion such accumulation is unreasonable for the purposes of the business. When requested by the commissioner, or any collector, every corporation shall forward to him a correct statement of such gains and profits and the names and addresses of the individuals or shareholders who would be entitled to the same if divided or distributed, and of the amounts that would be payable to each.

PAYMENT OF TAX AT SOURCE.

Sec. 221. (a) That all individuals, corporations and partnerships, in whatever capacity acting, including lessees or mortgagors of real or personal property, fiduciaries, employers, and all officers and employees of the United States, having the control, receipt, custody, disposal, or payment, of interest, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income, of any nonresident alien individual (other than income received as dividends from a corporation which is taxable under this title upon its net income) shall (except in the cases provided for in subdivision (b) and except as otherwise provided in regulations prescribed by the commissioner under section 217) deduct and withhold from such annual or periodical gains, profits, and income a tax equal to 8 per centum thereof; provided, that the commissioner may authorize such tax to be deducted and withheld from the interest upon any securities the owners or which are not known to the withholding agent.

(b) In any case where bonds, mortgages, or deeds of trust, or other similar obligations of a corporation contain a contract or provision by which the obligor agrees to pay any portion of the tax imposed by this title upon the obligee, or to reimburse the obligee for any portion of the tax, or to pay the interest without deduction for any tax which the obligor may be required or permitted to pay thereon or to retain therefrom under any law of the United States, the obligor shall deduct and withhold a tax equal to 2 per centum of the interest upon such bonds, mortgages, deeds of trust, or other obligations, whether such interest is payable annually or at shorter or longer poriods and whether payable to a nonresident alien individual or to an individual citizen or resident of the United States or to a partnership: *provided,* that the commissioner may authorize such tax to be deducted and withheld in the case of interest upon any such bonds, mortgages, deeds of trust or other obligations, the owners of which are not known to the withholding agent. Such deduction and withholding shall not be required in the case of a citizen or resident entitled to receive such interest, if he files with the withholding agent on or before February 1, a signed notice in writing claiming the benefit of the credits provided in

subdivisions (c) and (d) of section 216; nor in the case of a nonresident alien individual if so provided for in regulations prescribed by the commissioner under section 217.

(c) Every individual, corporation, or partnership required to deduct and withhold any tax under this section shall make return thereof on or before March first of each year and shall on or before June 15th pay the tax to the official of the United States government authorized to receive it. Every such individual, corporation, or partnership is hereby made liable for such tax and is hereby indemnified against the claims and demands of any individual, corporation, or partnership for the amount of any payments made in accordance with the provisions of this section.

(d) Income upon which any tax is required to be withheld at the source under this section shall be included in the return of the recipient of such income, but any amount of tax so withheld shall be credited against the amount of income tax as computed in such return.

(e) If any tax required under this section to be deducted and withheld is paid by the recipient of the income, it shall not be recollected from the withholding agent; nor in cases in which the tax is so paid shall any penalty be imposed upon or collected from the recipient of the income or the withholding agent for failure to return or pay the same, unless such failure was fraudulent and for the purpose of evading payment.

CREDIT FOR TAXES

Sec. 222. (a) That the tax computed under part II of this title shall be credited with:

(1) In the case of a citizen of the United States, the amount of any income, war-profits and excess-profits taxes paid during the taxable year to any foreign country, upon income derived from sources therein, or to any possession of the United States; and

(2) In the case of a resident of the United States, the amount of any such taxes paid during the taxable year to any possession of the United States; and

(3) In the case of an alien resident of the United States who is a citizen or subject of a foreign country, the amount of any such taxes paid during the taxable year to such country, upon income derived from sources therein, if such country, in imposing such taxes, allows a similar credit to citizens of the United States residing in such country; and

(4) In the case of any such individual who is a member of a partnership or a beneficiary of an estate or trust, his proportionate share of such taxes of the partnership or the estate or trust paid during the taxable year to a foreign country or to any possession of the United States, as the case may be.

(b) If accrued taxes when paid differ from the amounts claimed as credits by the taxpayer, or if any tax paid is refunded in whole or in part, the taxpayer shall notify the commissioner who shall redetermine the

amount of the tax due under part II of this title for the year or years affected, and the amount of tax due upon such redetermination, if any, shall be paid by the taxpayer upon notice and demand by the collector, or the amount of tax overpaid, if any, shall be credited or refunded to the taxpayer in accordance with the provisions of section 252. In the case of such a tax accrued but not paid, the commissioner as a condition precedent to the allowance of this credit may require the taxpayer to give a bond with sureties satisfactory to and to be approved by the commissioner in such penal sum as the commissioner may require, conditioned for the payment by the taxpayer of any amount of tax found due upon any such redetermination; and the bond herein prescribed shall contain such further conditions as the commissioner may require.

(c) These credits shall be allowed only if the taxpayer furnishes evidence satisfactory to the commissioner showing the amount of income derived from sources within such foreign country or such possession of the United States, and all other information necessary for the computation of such credits.

INDIVIDUAL RETURNS.

Sec. 223. That every individual having a net income for the taxable year of $1,000 or over if single or if married and not living with husband or wife, or $2,000 or over if married and living with husband or wife, shall make under oath a return stating specifically the items of his gross income and the deductions and credits allowed by this title. If a husband and wife living together have an aggregate net income of $2,000 or over, each shall make such a return unless the income of each is included in a single joint return.

If the taxpayer is unable to make his own return, the return shall be made by a duly authorized agent or by the guardian or other person charged with the care of the person or property of such taxpayer.

PARTNERSHIP RETURNS.

Sec. 224. That every partnership shall make a return for each taxable year, stating specifically the items of its gross income and the deductions allowed by this title, and shall include in the return the names and addresses of the individuals who would be entitled to share in the net income if distributed and the amount of the distributive share of each individual. The return shall be sworn to by any one of the partners.

FIDUCIARY RETURNS.

Sec. 225. That every fiduciary (except receivers appointed by authority of law in possession of part only of the property of an individual) shall make under oath a return for the individual estate or trust for which he acts (1) if the net income of such individual is $1,000 or over if single or if married and not living with husband or wife, or $2,000 or over if married and living with husband or wife, or (2) if the net income of such estate or trust is $1,000 or over or if any beneficiary of such estate or

trust is a nonresident alien, stating specifically the items of the gross income and the deductions and credits allowed by this title. Under such regulations as the commissioner with the approval of the secretary may prescribe, a return made by one of two or more joint fiduciaries and filed in the office of the collector of the district where such fiduciary resides shall be a sufficient compliance with the above requirement. The fiduciary shall make oath that he has sufficient knowledge of the affairs of such individual, estate or trust to enable him to make the return, and that the same is, to the best of his knowledge and belief, true and correct.

Fiduciaries required to make returns under this act shal be subject to all the provisions of this act which apply to individuals.

RETURNS WHEN ACCOUNTING PERIOD CHANGED.

Sec. 236. That if a taxpayer, with the approval of the commissioner, changes the basis of computing net income from fiscal year to calendar year a separate return shall be made for the period between the close of the last fiscal year for which return was made and the following December 31. If the change is from calendar year to fiscal year, a separate return shall be made for the period between the close of the last calendar year for which return was made and the date designated as the close of the fiscal year. If the change is from one fiscal year to another fiscal year a separate return shall be made for the period between the close of the former fiscal year and the date designated as the close of the new fiscal year. If a taxpayer making his first return for income tax keeps his accounts on the basis of a fiscal year he shall make a separate return for the period between the beginning of the calendar year in which such fiscal years ends and the end of such fiscal year.

In all of the above cases the net income shall be computed on the basis of such period for which separate return is made, and the tax shall be paid thereon at the rate for the calendar year in which such period is included; and the credits provided in subdivisions (c) and (d) of section 216 shall be reduced respectively to amounts which bear the same ratio to the full credits provided in such subdivisions as the number of months in such period bears to twelve months.

TIME AND PLACE FOR FILING RETURNS.

Sec. 227. (a) That returns shall be made on or before the fifteenth day of the third month following the close of the fiscal year, or, if the return is made on the basis of the calendar year, then the return shall be made on or before the fifteenth day of March. The commissioner may grant a reasonable extension of time for filing returns whenever in his judgment good cause exists and shall keep a record of every such extension and the reason therefor. Except in the case of taxpayers who are abroad, no such extension shall be for more than six months.

(b) Returns shall be made to the collector for the district in which is located the legal residence or principal place of business of the person

making the return, or, if he has no legal residence or principal place of business in the United States, then to the collector at Baltimore, Maryland.

UNDERSTATEMENT IN RETURNS.

Sec. 228. That if the collector or deputy collector has reason to believe that the amount of any income returned is understated, he shall give due notice to the taxpayer making the return to show cause why the amount of the return should not be increased, and upon proof of the amount understated, may increase the same accordingly. Such taxpayer may furnish sworn testimony to prove any relevant facts and if dissatisfied with the decision of the collector may appeal to the commissioner for his decision, under such rules of procedure as may be prescribed by the commissioner with the approval of the secretary.

PART III—CORPORATIONS.

TAX ON CORPORATIONS.

Sec. 230. (a) That, in lieu of the taxes imposed by section 10 of the revenue act of 1916, as amended by the revenue act of 1917, and by section 4 of the revenue act of 1917, there shall be levied, collected, and paid for each taxable year upon the net income of every corporation a tax at the following rates:

(1) For the calendar year 1918, 12 per centum of the amount of the net income in excess of the credits provided in section 236; and

(2) For each calendar year thereafter, 10 per centum of such excess amount.

(b) For the purposes of the act approved March 21, 1918, entitled "An act to provide for the operation of transportation systems while under federal control, for the just compensation of their owners and for other purposes," five-sixths of the tax imposed by paragraph (1) of subdivision (a) and four-fifths of the tax imposed by paragraph (2) of subdivision (a) shall be treated as levied by an act in amendment of title I of the revenue act of 1917.

CONDITIONAL AND OTHER EXEMPTIONS.

Sec. 231. That the following organizations shall be exempt from taxation under this title—

(1) Labor, agricultural, or horticultural organizations;

(2) Mutual savings banks not having a capital stock represented by shares;

(3) Fraternal beneficiary societies, orders, or associations, (a) operating under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system, and (b) providing for the payment of life, sick, accident, or other benefits to the members of such society, order, or association or their dependents;

(4) Domestic building and loan associations and cooperative banks without capital stock organized and operated for mutual purposes and without profit;

(5) Cemetery companies owned and operated exclusively for the benefit of their members;

(6) Corporations organized and operated exclusively for religious, charitable, scientific or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual;

(7) Business leagues, chambers of commerce, or boards of trade, not organized for profit and no part of the net earnings of which inures to the benefit of any private stockholder or individual;

(8) Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare;

(9) Clubs organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, no part of the net earnings of which inures to the benefit of any private stockholder or member;

(10) Farmers' or other mutual hail, cyclone, or fire insurance companies, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations of a purely local character, the income of which consists solely of assessments, dues, and fees collected from members for the sole purpose of meeting expenses;

(11) Farmers', fruit growers', or like associations, organized and operated as sales agents for the purpose of marketing the products of members and turning back to them the proceeds of sales, less the necessary selling expenses, on the basis of the quantity of produce furnished by them;

(12) Corporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization which itself is exempt from the tax imposed by this title;

(13) Federal land banks and national farm-loan associations as provided in section 26 of the act approved July 17, 1916, entitled "An act to provide capital for agricultural development, to create standard forms of investment based upon farm mortgage, to equalize rates of interest upon farm loans, to furnish a market for United States bonds, to create government depositaries and financial agents for the United States, and for other purposes";

(14) Personal service corporations.

NET INCOME DEFINED.

Sec. 232. That in the case of a corporation subject to the tax imposed by section 230 the term "net income" means the gross income as defined in section 233 less the deductions allowed by section 234, and the net income shall be computed on the same basis as is provided in subdivision (b) of section 212 or in section 226.

GROSS INCOME DEFINED.

Sec. 233. (a) That in the case of a corporation subject to the tax imposed by section 230 the term "gross income" means the gross income as defined in section 213, except that:

(1) In the case of life insurance companies there shall not be included in gross income such portion of any actual premium received from any individual policyholder as is paid back or credited to or treated as an abatement of premium of such policyholder within the taxable year.

(2) Mutual marine insurance companies shall include in gross income the gross premiums collected and received by them less amounts paid for reinsurance.

(b) In the case of a foreign corporation gross income includes only the gross income from sources within the United States, including the interest on bonds, notes, or other interest-bearing obligations, of residents, corporate or otherwise, dividends from resident corporations, and including all amounts received (although paid under a contract for the sale of goods or otherwise) representing profits on the manufacture and disposition of goods within the United States.

DEDUCTIONS ALLOWED.

Sec. 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered, and including rentals or other payments required to be made as a condition to the continued use or possession of property to which the corporation has not taken or is not taking title, or in which it has no equity;

(2) All interest paid or accrued within the taxable year on its indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917) the interest upon which is wholly exempt from taxation under this title as income to the taxpayer, or, in the case of a foreign corporation, the proportion of such interest which the amount of its gross income from sources within the United States bears to the amount of its gross income from all sources within and without the United States;

(3) Taxes paid or accrued within the taxable year imposed (a) by the authority of the United States, except income, war profits and excess-profits taxes; or (b) by the authority of any of its possessions, except the amount of income, war profits and excess-profits taxes allowed as a credit under section 238; or (c) by the authority of any state or territory, or any county, school district, municipality, or other taxing subdivision of any state or territory, not including those assessed against local benefits of a kind tending to increase the value of the property assessed; or (d) in the case of a domestic corporation, by the authority of any foreign country, except the amount of income, war-profits and excess-profits taxes allowed as a credit under section 238; or (e) in the case of a foreign corporation, by the authority of any foreign country (except income, war-profits and excess-profits taxes, and taxes assessed against

local benefits of a kind tending to increase the value of the property assessed), upon the property or business: *provided,* that in the case of obligors specified in subdivision (b) of section 221 no deduction for the payment of the tax imposed by this title or any other tax paid pursuant to the contract or provision referred to in that subdivision, shall be allowed;

(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise;

(5) Debts ascertained to be worthless and charged off within the taxable year;

(6) Amounts received as dividends from a corporation which is taxable under this title upon its net income, and amounts received as dividends from a personal service corporation out of earnings or profits upon which income tax has been imposed by act of congress;

(7) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence;

(8) In the case of buildings, machinery, equipment, or other facilities, constructed, erected, installed, or acquired, on or after April 6, 1917, for the production of articles contributing to the prosecution of the present war, and in the case of vessels constructed or acquired on or after such date for the transportation of articles or men contributing to the prosecution of the present war, there shall be allowed a reasonable deduction for the amortization of such part of the cost of such facilities or vessels as has been borne by the taxpayer, but not again including any amount otherwise allowed under this title or previous acts of congress as a deduction in computing net income. At any time within three years after the termination of the present war the commissioner may, and at the request of the taxpayer shall, reexamine the return, and if he then finds as a result of an appraisal or from other evidence that the deduction originally allowed was incorrect, the taxes imposed by this title and by title III for the year or years affected shall be redetermined; and the amount of tax due upon such redetermination, if any, shall be paid upon notice and demand by the collector, or the amount of tax overpaid, if any, shall be credited or refunded to the taxpayer in accordance with the provisions of section 252.

(9) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: *provided,* that in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date: *provided further,* that in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon

the fair market value of the property at the date of the discovery, or within 30 days thereafter; such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the commissioner with the approval of the secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee:

(10) In the case of insurance companies, in addition to the above: (a) the net addition required by law to be made within the taxable year to reserve funds (including in the case of assessment insurance companies the actual deposit of sums with state or territorial officers pursuant to law as additions to guarantee or reserve funds), and (b) the sums other than dividends paid within the taxable year on policy and annuity contracts;

(11) In the case of corporations issuing policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan continuing for life and not subject to cancellation, in addition to the above, such portion of the net addition (not required by law) made within the taxable year to reserve funds as the commissioner finds to be required for the protection of the holders of such policies only;

(12) In the case of mutual marine insurance companies, there shall be allowed, in addition to the deductions allowed in paragraphs (1) to (10), inclusive, amounts repaid to policyholders on account of premiums previously paid by them, and interest paid upon such amounts between the ascertainment and the payment thereof;

(13) In the case of mutual insurance companies (other than mutual life or mutual marine insurance companies) requiring their members to make premium deposits to provide for losses and expenses, there shall be allowed, in addition to the deductions allowed in paragraphs (1) to (10), inclusive, (unless otherwise allowed under such paragraphs) the amount of premium deposits returned to their policyholders and the amount of premium deposits retained for the payment of losses, expenses, and reinsurance reserves;

(14) (a) At the time of filing return for the taxable year 1918 a taxpayer may file a claim in abatement based on the fact that he has sustained a substantial loss (whether or not actually realized by sale or other disposition) resulting from any material reduction (not due to temporary fluctuation) of the value of the inventory for such taxable year, or from the actual payment after the close of such taxable year of rebates in pursuance of contracts entered into during such year upon sales made during such year. In such case payment of the amount of the tax covered by such claim shall not be required until the claim is decided, but the taxpayer shall accompany his claim with a bond in double the amount of the tax covered by the claim, with sureties satisfactory to the commissioner, conditioned for the payment of any part of such tax found to be due, with interest. If any part of such claim is disallowed then the remainder of the tax due shall on notice and demand by the collector be paid by the taxpayer with interest at the rate of 1 per centum per month

from the time the tax would have been due had no such claim been filed. If it is shown to the satisfaction of the commissioner that such substantial loss has been sustained, then in computing the taxes imposed by this title and by title III the amount of such loss shall be deducted from the net income. (b) If no such claim is filed, but it is shown to the satisfaction of the commissioner that during the taxable year 1919 the taxpayer has sustained a substantial loss of the character above described then the amount of such loss shall be deducted from the net income for the taxable year 1918 and the taxes imposed by this title and by title III for such year shall be redetermined accordingly. Any amount found to be due to the taxpayer upon the basis of such redetermination shall be credited or refunded to the taxpayer in accordance with the provisions of section 252.

(b) In the case of a foreign corporation the deductions allowed in subdivision (a), except those allowed in paragraph (2) and in clauses (a), (b), and (c) of paragraph (3), shall be allowed only if and to the extent that they are connected with income arising from a source within the United States; and the proper apportionment and allocation of the deductions with respect to sources of income within and without the United States shall be determined under rules and regulations prescribed by the commissioner with the approval of the secretary.

ITEMS NOT DEDUCTIBLE.

Sec. 235. That in computing net income no deduction shall in any case be allowed in respect of any of the items specified in section 215.

CREDITS ALLOWED.

Sec. 236. That for the purpose only of the tax imposed by section 230 there shall be allowed the following credits:

(a) The amount received as interest upon obligations of the United States and bonds issued by the war finance corporation, which is included in gross income under section 233;

(b) The amount of any taxes imposed by title III for the same taxable year: *provided,* that in the case of a corporation which makes return for a fiscal year beginning in 1917 and ending in 1918, in computing the tax as provided in subdivision (a) of section 205, the tax computed for the entire period under title II of the revenue act of 1917 shall be credited against the net income computed for the entire period under title I of the revenue act of 1916 as amended by the revenue act of 1917 and under title I of the revenue act of 1917, and the tax computed for the entire period under title III of this act at the rates prescribed for the calendar year 1918 shall be credited against the net income computed for the entire period under this title; and

(c) In the case of a domestic corporation, $2,000.

PAYMENT OF TAX AT SOURCE.

Sec. 237. That in the case of foreign corporations subject to taxation under this title not engaged in trade or business within the United States and not having any office or place of business therein, there shall be

deducted and withheld at the source in the same manner and upon the same items of income as is provided in section 221 a tax equal to 10 per centum thereof, and such tax shall be returned and paid in the same manner and subject to the same conditions as provided in that section: *provided,* that in the case of interest described in subdivision (b) of that section the deduction and withholding shall be at the rate of 2 per centum.

CREDIT FOR TAXES.

Sec. 238. (a) That in the case of a domestic corporation the total taxes imposed for the taxable year by this title and by title III shall be credited with the amount of any income, war-profits and excess-profits taxes paid during the taxable year to any foreign country, upon income derived from sources therein, or to any possession of the United States.

If accrued taxes when paid differ from the amounts claimed as credits by the corporation, or if any tax paid is refunded in whole or in part, the corporation shall at once notify the commissioner who shall redetermine the amount of the taxes due under this title and under title III for the year or years affected, and the amount of taxes due upon such redetermination, if any, shall be paid by the corporation upon notice and demand by the collector, or the amount of taxes overpaid, if any, shall be credited or refunded to the corporation in accordance with the provisions of section 252. In the case of such a tax accrued but not paid, the commissioner as a condition precedent to the allowance of this credit may require the corporation to give a bond with sureties satisfactory to and to be approved by him in such penal sum as he may require, conditioned for the payment by the taxpayer of any amount of taxes found due upon any such redetermination; and the bond herein prescribed shall contain such further conditions as the commissioner may require.

(b) This credit shall be allowed only if the taxpayer furnishes evidence satisfactory to the commissioner showing the amount of income derived from sources within such foreign country or such possession of the United States, as the case may be, and all other information necessary for the computation of such credit.

(c) If a domestic corporation makes a return for a fiscal year beginning in 1917 and ending in 1918, only that proportion of this credit shall be allowed which the part of such period within the calendar year 1918 bears to the entire period.

CORPORATION RETURNS.

Sec. 239. That every corporation subject to taxation under this title and every personal service corporation shall make a return, stating specifically the items of its gross income and the deductions and credits allowed by this title. The return shall be sworn to by the president, vice-president, or other principal officer and by the treasurer or assistant treasurer. If any foreign corporation has no office or place of business in the United States but has an agent in the United States, the return shall be made by the agent. In cases where receivers, trustees in bankruptcy,

or assignees are operating the property or business of corporations, such receivers, trustees, or assignees shall make returns for such corporations in the same manner and form as corporations are required to make returns. Any tax due on the basis of such returns made by receivers, trustees, or assignees shall be collected in the same manner as if collected from the corporations of whose business or property they have custody and control.

Returns made under this section shall be subject to the provisions of sections 226 and 228.

When return is made under section 226 the credit provided in subdivision (c) of section 236 shall be reduced to an amount which bears the same ratio to the full credit therein provided as the number of months in the period for which such return is made bears to twelve months.

CONSOLIDATED RETURNS.

Sec. 240. (a) That corporations which are affiliated within the meaning of this section shall, under regulations to be prescribed by the commissioner with the approval of the secretary, make a consolidated return of net income and invested capital for the purposes of this title and title III, and the taxes thereunder shall be computed and determined upon the basis of such return: *provided,* that there shall be taken out of such consolidated net income and invested capital, the net income and invested capital of any such affiliated corporation organized after August 1, 1914, and not successor to a then existing business, 50 per centum or more of whose gross income consists of gains, profits, commissions, or other income, derived from a government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive. In such case the corporation so taken out shall be separately assessed on the basis of its own invested capital and net income and the remainder of such affiliated group shall be assessed on the basis of the remaining consolidated invested capital and net income.

In any case in which a tax is assessed upon the basis of a consolidated return, the total tax shall be computed in the first instance as a unit and shall then be assessed upon the respective affiiliated corporations in such proportions as may be agreed upon among them, or, in the absence of any such agreement, then on the basis of the net income properly assignable to each. There shall be allowed in computing the income tax only one specific credit of $2,000 (as provided in section 236); in computing the war-profits credit (as provided in section 311) only one specific exemption of $3,000; and in computing the excess-profits credit (as provided in section 312) only one specific exemption of $3,000.

(b) For the purpose of this section two or more domestic corporations shall be deemed to be affiliated (1) if one corporation owns directly or controls through closely affiliated interests or by a nominee or nominees substantially all the stock of the other or others, or (2) if substantially all the stock of two or more corporations is owned or controlled by the same interests.

(c) For the purposes of section 238 a domestic corporation which owns a majority of the voting stock of a foreign corporation shall be deemed to have paid the same proportion of any income, war-profits and excess-profits taxes paid (but not including taxes accrued) by such foreign corporation during the taxable year to any foreign country or to any possession of the United States upon income derived from sources without the United States, which the amount of any dividends (not deductible under section 234) received by such domestic corporation from such foreign corporation during the taxable year bears to the total taxable income of such foreign corporation upon or with respect to which such taxes were paid: *provided,* that in no such case shall the amount of the credit for such taxes exceed the amount of such dividends (not deductible under section 234) received by such domestic corporation during the taxable year.

TIME AND PLACE FOR FILING RETURNS.

Sec. 241. (a) That returns of corporations shall be made at the same time as is provided in subdivision (a) of section 227.

(b) Returns shall be made to the collector of the district in which is located the principal place of business or principal office or agency of the corporation, or, if it has no principal place of business or principal office or agency in the United States, then to the collector at Baltimore, Maryland.

PART IV.—ADMINISTRATIVE PROVISIONS

PAYMENT OF TAXES

Sec. 250. (a) That except as otherwise provided in this section and sections 221 and 237 the tax shall be paid in four installments, each consisting of one-fourth of the total amount of the tax. The first installment shall be paid at the time fixed by law for filing the return, and the second installment shall be paid on the fifteenth day of the third month, the third installment on the fifteenth day of the sixth month, and the fourth installment on the fifteenth day of the ninth month, after the time fixed by law for filing the return. Where an extension of time for filing a return is granted the time for payment of the first installment shall be postponed until the date of the expiration of the period of the extension, but the time for payment of the other installments shall not be postponed unless the commissioner so provides in granting the extension. In any case in which the time for the payment of any installment is at the request of the taxpayer thus postponed, there shall be added as part of such installment interest thereon at the rate of ½ of 1 per centum per month from the time it would have been due if no extension had been granted, until paid. If any installment is not paid when due, the whole amount of the tax unpaid shall become due and payable upon notice and demand by the collector.

The tax may at the option of the taxpayer be paid in a single payment instead of in installments, in which case the total amount shall be paid

on or before the time fixed by law for filing the return, or, where an extension of time for filing the return has been granted, on or before the expiration of the period of such extension.

(b) As soon as practicable after the return is filed, the commissioner shall examine it. If it then appears that the correct amount of the tax is greater or less than that shown in the return, the installments shall be recomputed. If the amount already paid exceeds that which should have been paid on the basis of the installments as recomputed, the excess so paid shall be credited against the subsequent installments; and if the amount already paid exceeds the correct amount of the tax, the excess shall be credited or refunded to the taxpayer in accordance with the provisions of section 252.

If the amount already paid is less than that which should have been paid, the difference shall, to the extent not covered by any credits then due to the taxpayer under section 252, be paid upon notice and demand by the collector. In such case if the return is made in good faith and the understatement of the amount in the return is not due to any fault of the taxpayer, there shall be no penalty because of such understatement. If the understatement is due to negligence on the part of the taxpayer, but without intent to defraud, there shall be added as part of the tax 5 per centum of the total amount of the deficiency, plus interest at the rate of 1 per centum per month on the amount of the deficiency of each installment from the time the installment was due.

If the understatement is false or fraudulent with intent to evade the tax, then, in lieu of the penalty provided by section 3176 of the *Revised Statutes,* as amended, for false or fraudulent returns wilfully made, but in addition to other penalties provided by law for false or fraudulent returns, there shall be added as part of the tax 50 per centum of the amount of the deficiency.

(c) If the return is made pursuant to section 3176 of the *Revised Statutes* as amended, the amount of tax determined to be due under such return shall be paid upon notice and demand by the collector.

(d) Except in the case of false or fraudulent returns with intent to evade the tax, the amount of tax due under any return shall be determined and assessed by the commissioner within five years after the return was due or was made, and no suit or proceeding for the collection of any tax shall be begun after the expiration of five years after the date when the return was due or was made. In the case of such false or fraudulent returns, the amount of tax due may be determined at any time after the return is filed, and the tax may be collected at any time after it becomes due.

(e) If any tax remains unpaid after the date when it is due, and for ten days after notice and demand by the collector, then, except in case of estates of insane, deceased, or insolvent persons, there shall be added as part of the tax the sum of 5 per centum on the amount due but unpaid, plus interest at the rate of 1 per centum per month upon such amount from the time it became due: *provided,* that as to any such amount which

is the subject of a bona fide claim for abatement such sum of 5 per centum shall not be added and the interest from the time the amount was due until the claim is decided shall be at the rate of ½ of 1 per centum per month.

In the case of the first installment provided for in subdivision (a) the instructions printed on the return shall be deemed sufficient notice of the date when the tax is due and sufficient demand, and the taxpayer's computation of the tax on the return shall be deemed sufficient notice of the amount due.

(f) In any case in which in order to enforce payment of a tax it is necessary for a collector to cause a warrant of distraint to be served, there shall also be added as part of the tax the sum of $5.

(g) If the commissioner finds that a taxpayer designs quickly to depart from the United States or to remove his property therefrom, or to conceal himself or his property therein, or to do any other act tending to prejudice or to render wholly or partly ineffectual proceedings to collect the tax for the taxable year then last past or the taxable year then current unless such proceedings be brought without delay, the commissioner shall declare the taxable period for such taxpayer terminated at the end of the calendar month then last past and shall cause notice of such finding and declaration to be given the taxpayer, together with a demand for immediate payment of the tax for the taxable period so declared terminated and of the tax for the preceding taxable year or so much of said tax as is unpaid, whether or not the time otherwise allowed by law for filing return and paying the tax has expired; and such taxes shall thereupon become immediately due and payable. In any action or suit brought to enforce payment of taxes made due and payable by virtue of the provisions of this subdivision the finding of the commissioner, made as herein provided, whether made after notice to the taxpayer or not, shall be for all purposes presumptive evidence of the taxpayer's design. A taxpayer who is not in default in making any return or paying income, war-profits, or excess-profits tax under any act of congress may furnish to the United States, under regulations to be prescribed by the commissioner with the approval of the secretary, security approved by the commissioner that he will duly make the return next thereafter required to be filed and pay the tax next thereafter required to be paid. The commissioner may approve and accept in like manner security for return and payment of taxes made due and payable by virtue of the provisions of this subdivision, provided the taxpayer has paid in full all other income, war profits, or excess profits taxes due from him under any act of congress. If security is approved and accepted pursuant to the provisions of this subdivision and such further or other security with respect to the tax or taxes covered thereby is given as the commissioner shall from time to time find necessary and require, payment of such taxes shall not be enforced by any proceedings under the provisions of this subdivision prior to the expiration of the time otherwise allowed for paying such respective taxes.

RECEIPTS FOR TAXES.

Sec. 251. That every collector to whom any payment of any tax is made under the provisions of this title shall upon request give to the person making such payment a full written or printed receipt, stating the amount paid and the particular account for which such payment was made; and whenever any debtor pays taxes on account of payments made or to be made by him to separate creditors the collector shall, if requested by such debtor, give a separate receipt for the tax paid on account of each creditor in such form that the debtor can conveniently produce such receipts separately to his several creditors in satisfaction of their respective demands up to the amounts stated in the receipts; and such receipt shall be sufficient evidence in favor of such debtor to justify him in withholding from his next payment to his creditor the amount therein stated; but the creditor may, upon giving to his debtor a full written receipt acknowledging the payment to him of any sum actually paid and accepting the amount of tax paid as aforesaid (specifying the same) as a further satisfaction of the debt to that amount, require the surrender to him of such collector's receipt.

REFUNDS.

Sec. 252. That if, upon examination of any return of income made pursuant to this act, the act of August 5, 1909, entitled "An act to provide revenue, equalize duties, and encourage the industries of the United States, and for other purposes," the act of October 3, 1913, entitled "An act to reduce tariff duties and to provide revenue for the government, and for other purposes," the revenue act of 1916, as amended, or the revenue act of 1917, it appears that an amount of income, war-profits or excess-profits tax has been paid in excess of that properly due, then, notwithstanding the provisions of section 3228 of the *Revised Statutes,* the amount of the excess shall be credited against any income, war-profits or excess-profits taxes, or installment thereof, then due from the taxpayer under any other return, and any balance of such excess shall be immediately refunded to the taxpayer: provided, that no such credit or refund shall be allowed or made after five years from the date when the return was due, unless before the expiration of such five years a claim therefor is filed by the taxpayer.

PENALTIES.

Sec. 253. That any individual, corporation, or partnership required under this title to pay or collect any tax, to make a return or to supply information, who fails to pay or collect such tax, to make such return, or to supply such information at the time or times required under this title, shall be liable to a penalty of not more than $1,000. Any individual, corporation, or partnership, or any officer or employee of any corporation or member or empolyee of a partnership, who willfully refuses to pay or collect such tax, to make such return, or to supply such information at the time or times required under this title, or who willfully attempts in any manner to defeat or evade the tax imposed by this title, shall be guilty

of a misdemeanor and shall be fined not more than $10,000 or imprisoned for not more than one year, or both, together with the costs of prosecution.

RETURNS OF PAYMENTS OF DIVIDENDS.

Sec. 254. That every corporation subject to the tax imposed by this title and every personal service corporation shall, when required by the commissioner, render a correct return duly verified under oath, of its payments of dividends, stating the name and address of each stockholder, the number of shares owned by him, and the amount of dividends paid to him.

RETURNS OF BROKERS.

Sec. 255. That every individual, corporation, or partnership doing business as a broker shall, when required by the commissioner, render a correct return duly verified under oath, under such rules and regulations as the commissioner, with the approval of the secretary, may prescribe, showing the names of customers for whom such individual, corporation, or partnership has transacted any business, with such details as to the profits, losses, or other information which the commissioner may require, as to each of such customers, as will enable the commissioner to determine whether all income tax due on profits or gains of such customers has been paid.

INFORMATION AT SOURCE.

Sec. 256. That all individuals, corporations, and partnerships, in whatever capacity acting, including lessees or mortgagors of real or personal property, fiduciaries, and employers, making payment to another individual, corporation, or partnership, of interest, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed, or determinable gains, profits, and income (other than payments described in sections 254 and 255), of $1,000 or more in any taxable year, or, in the case of such payments made by the United States, the officers or employees of the United States having information as to such payments and required to make returns in regard thereto by the regulations hereinafter provided for, shall render a true and accurate return to the commissioner, under such regulations and in such form and manner and to such extent as may be prescribed by him with the approval of the secretary, setting forth the amount of such gains, profits, and income, and the name and address of the recipient of such payment.

Such returns may be required, regardless of amounts, (1) in the case of payments of interest upon bonds, mortgages, deeds of trust, or other similar obligations of corporations, and (2) in the case of collections of items (not payable in the United States) of interest upon the bonds of foreign countries and interest upon the bonds of and dividends from foreign corporations by individuals, corporations, or partnerships, undertaking as a matter of business or for profit the collection of foreign payments of such interest or dividends by means of coupons, checks, or bills of exchange.

When necessary to make effective the provisions of this section the name and address of the recipient of income shall be furnished upon demand of the individual, corporation, or partnership paying the income.

The provisions of this section shall apply to the calendar year 1918 and each calendar year thereafter, but shall not apply to the payment of interest on obligations of the United States.

RETURNS TO BE PUBLIC RECORDS.

Sec. 257. That returns upon which the tax has been determined by the commissioner shall constitute public records; but they shall be open to inspection only upon order of the president and under rules and regulations prescribed by the secretary and approved by the president: provided, that the proper officers of any state imposing an income tax may, upon the request of the governor thereof, have access to the returns of any corporation, or to an abstract thereof showing the name and income of the corporation, at such times and in such manner as the secretary may prescribe: *provided further,* that all bona fide stockholders of record owning 1 per centum or more of the outstanding stock of any corporation shall, upon making request of the commissioner, be allowed to examine the annual income returns of such corporation and of its subsidiaries. Any stockholder who pursuant to the provisions of this section is allowed to examine the return of any corporation, and who makes known in any manner whatever not provided by law the amount or source of income, profits, losses, expenditures, or any particular thereof, set forth or disclosed in any such return, shall be guilty of a misdemeanor and be punished by a fine not exceeding $1,000, or by imprisonment not exceeding one year, or both.

The commissioner shall as soon as practicable in each year cause to be prepared and made available to public inspection in such manner as he may determine, in the office of the collector in each internal-revenue district and in such other places as he may determine, lists containing the names and the post-office addresses of all individuals making income-tax returns in such district.

PUBLICATION OF STATISTICS.

Sec. 258. That the commissioner, with the approval of the secretary, shall prepare and publish annually statistics reasonably available with respect to the operation of the income, war-profits and excess-profits tax laws, including classifications of taxpayers and of income, the amounts allowed as deductions, exemptions, and credits, and any other facts deemed pertinent and valuable.

COLLECTION OF FOREIGN ITEMS.

Sec. 259. That all individuals, corporations, or partnerships undertaking as a matter of business or for profit the collection of foreign payments of interest or dividends by means of coupons, checks, or bills of exchange shall obtain a license from the commissioner and shall be subject to such regulations enabling the government to obtain the information re-

quired under this title as the commissioner, with the approval of the secretary, shall prescribe; and whoever knowingly undertakes to collect such payments without having obtained a license therefor, or without complying with such regulations, shall be guilty of a misdemeanor and shall be fined not more than $5,000, or imprisoned for not more than one year, or both.

CITIZENS OF UNITED STATES POSSESSIONS.

Sec. 260. That any individual who is a citizen of any possession of the United States (but not otherwise a citizen of the United States) and who is not a resident of the United States, shall be subject to taxation under this title only as to income derived from sources within the United States, and in such case the tax shall be computed and paid in the same manner and subject to the same conditions as in the case of other persons who are taxable only as to income derived from such sources.

PORTO RICO AND PHILIPPINE ISLANDS.

Sec. 261. That in Porto Rico and the Philippine Islands the income tax shall be levied, assessed, collected, and paid in accordance with the provisions of the revenue act of 1916 as amended.

Returns shall be made and taxes shall be paid under title I of such act in Porto Rico or the Philippine Islands, as the case may be, by (1) every individual who is a citizen or resident of Porto Rico or the Philippine Islands or derives income from sources therein, and (2) every corporation created or organized in Porto Rico or the Philippine Islands or deriving income from sources therein. An individual who is neither a citizen nor a resident of Porto Rico or the Philippine Islands but derives income from sources therein, shall be taxed in Porto Rico or the Philippine Islands as a nonresident alien individual, and a corporation created or organized outside Porto Rico or the Philippine Islands and deriving income from sources therein shall be taxed in Porto Rico or the Philippine Islands as a foreign corporation. For the purposes of section 216 and of paragraph (6) of subdivision (a) of section 234 a tax imposed in Porto Rico or the Philippine Islands upon the net income of a corporation shall not be deemed to be a tax under this title.

The Porto Rican or Philippine legislature shall have power by due enactment to amend, alter, modify or repeal the income tax laws in force in Porto Rico or the Philippine Islands, respectively.

TITLE III.—WAR-PROFITS AND EXCESS-PROFITS TAX.

PART I.—GENERAL DEFINITIONS.

Sec. 300. That when used in this title the terms "taxable year," "fiscal year," "personal service corporation," "paid or accrued," and "dividends" shall have the same meaning as provided for the purposes of income tax in sections 200 and 201. The first taxable year for the purposes of this title shall be the same as the first taxable year for the purposes of the income tax under title II.

PART II.—IMPOSITION OF TAX.

Sec. 301. (a) That in lieu of the tax imposed by title II of the revenue act of 1917, but in addition to the other taxes imposed by this act, there shall be levied, collected, and paid for the taxable year 1918 upon the net income of every corporation a tax equal to the sum of the following:

FIRST BRACKET.

30 per centum of the amount of the net income in excess of the excess-profits credit (determined under section 312) and not in excess of 20 per centum of the invested capital;

SECOND BRACKET.

65 per centum of the amount of the net income in excess of 20 per centum of the invested capital;

THIRD BRACKET.

The sum, if any, by which 80 per centum of the amount of the net income in excess of the war-profits credit (determined under section 311) exceeds the amount of the tax computed under the first and second brackets.

(b) For the taxable year 1919 and each taxable year thereafter there shall be levied, collected, and paid upon the net income of every corporation (except corporations taxable under subdivision (c) of this section) a tax equal to the sum of the following:

FIRST BRACKET.

20 per centum of the amount of the net income in excess of the excess-profits credit (determined under section 312) and not in excess of 20 per centum of the invested capital;

SECOND BRACKET.

40 per centum of the amount of the net income in excess of 20 per centum of the invested capital.

(c) For the taxable year 1919 and each taxable year thereafter there shall be levied, collected, and paid upon the net income of every corporation which derives in such year a net income of more than $10,000 from any government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive, a tax equal to the sum of the following:

(1) Such a portion of a tax computed at the rates specified in subdivision (a) as the part of the net income attributable to such government contract or contracts bears to the entire net income. In computing such tax the excess-profits credit and the war-profits credit applicable to the taxable year shall be used;

(2) Such a portion of a tax computed at the rates specified in subdivision (b) as the part of the net income not attributable to such government contract or contracts bears to the entire net income.

For the purpose of determining the part of the net income attributable to such government contract or contracts, the proper apportionment and allocation of the deductions with respect to gross income derived from such government contract or contracts and from other sources, respectively, shall be determined under rules and regulations prescribed by the commissioner, with the approval of the secretary.

(d) In any case where the full amount of the excess-profits credit is not allowed under the first bracket of subdivision (a) or (b), by reason of the fact that such credit is in excess of 20 per centum of the invested capital, the part not so allowed shall be deducted from the amount in the second bracket.

(e) For the purposes of the act approved March 21, 1918, entitled "An act to provide for the operation of transportation systems while under federal control, for the just compensation of their owners and for other purposes," the tax imposed by this title shall be treated as levied by an act in amendment of title II of the revenue act of 1917.

Sec. 302. That the tax imposed by subdivision (a) of section 301 shall in no case be more than 30 per centum of the amount of the net income in excess of $3,000 and not in excess of $20,000, plus 80 per centum of the amount of the net income in excess of $20,000; the tax imposed by subdivision (b) of section 301 shall in no case be more than 20 per centum of the amount of the net income in excess of $3,000 and not in excess of $20,000, plus 40 per centum of the amount of the net income in excess of $20,000; and the above limitation shall apply to the taxes computed under subdivisions (a) and (b) of section 301, respectively, when used in subdivision (c) of that section. Nothing in this section shall be construed in such manner as to increase the tax imposed by section 301.

Sec. 303. That if part of the net income of a corporation is derived (1) from a trade or business (or a branch of a trade or business) in which the employment of capital is necessary, and (2) a part (constituting not less than 30 per centum of its total net income) is derived from a separate trade or business (or a distinctly separate branch of the trade or business) which if constituting the sole trade or business would bring it within the class of "personal service corporations," then (under regulations prescribed by the commissioner with the approval of the secretary) the tax upon the first part of such net income shall be separately computed (allowing in such computation only the same proportionate part of the credits authorized in sections 311 and 312), and the tax upon the second part shall be the same percentage thereof as the tax so computed upon the first part is of such first part: *provided,* that the tax upon such second part shall in no case be less than 20 per centum thereof, unless the tax upon the entire net income, if computed without benefit of this section, would constitute less than 20 per centum of such entire net income, in which event the tax shall be determined upon the entire net income, without reference to this section, as other taxes are determined under this title. The total tax computed under this section shall be subject to the limitations provided in section 302.

Sec. 304. (a) That the corporations enumerated in section 231 shall, to the extent that they are exempt from income tax under title II, be exempt from taxation under this title.

(b) Any corporation whose net income for the taxable year is less than $3,000 shall be exempt from taxation under this title.

(d) [c?] In the case of any corporation engaged in the mining of gold, the portion of the net income derived from the mining of gold shall be exempt from the tax imposed by this title, and the tax on the remaining portion of the net income shall be the proportion of a tax computed without the benefit of this subdivision which such remaining portion of the net income bears to the entire net income.

Sec. 305. That if a tax is computed under this title for a period of less than twelve months, the specific exemption of $3,000, wherever referred to in this title, shall be reduced to an amount which is the same proportion of $3,000 as the number of months in the period is of twelve months.

PART III.—CREDITS

Sec. 310. That as used in this title the term "prewar period" means the calendar years 1911, 1912, and 1913, or, if a corporation was not in existence during the whole of such period, then as many of such years during the whole of which the corporation was in existence.

Sec. 311. (a) That the war-profits credit shall consist of the sum of:

(1) A specific exemption of $3,000; and

(2) An amount equal to the average net income of the corporation for the prewar period, plus or minus, as the case may be, 10 per centum of the difference between the average invested capital for the prewar period and the invested capital for the taxable year. If the tax is computed for a period of less than twelve months such amount shall be reduced to the same proportion thereof as the number of months in the period is of twelve months.

(b) If the corporation had no net income for the prewar period, or if the amount computed under paragraph (2) of subdivision (a) is less than 10 per centum of its invested capital for the taxable year, then the war-profits credit shall be the sum of:

(1) A specific exemption of $3,000; and

(2) An amount equal to 10 per centum of the invested capital for the taxable year.

(c) If the corporation was not in existence during the whole of at least one calendar year during the prewar period, then, except as provided in subdivision (d), the war-profits credit shall be the sum of:

(1) A specific exemption of $3,000; and

(2) An amount equal to the same percentage of the invested capital of the taxpayer for the taxable year as the average percentage of net income to invested capital, for the prewar period, of corporations engaged in a trade or business of the same general class as that conducted by the taxpayer; but such amount shall in no case be less than 10 per centum of the invested capital of the taxpayer for the taxable year. Such average

percentage shall be determined by the commissioner on the basis of data contained in returns made under title II of the revenue act of 1917, and the average known as the median shall be used. If such average percentage has not been determined and published at least 30 days prior to the time when the return of the taxpayer is due, then for purposes of such return 10 per centum shall be used in lieu thereof; but such average percentage when determined shall be used for the purposes of section 250 in determining the correct amount of the tax.

(d) The war-profits credit shall be determined in the manner provided in subdivision (b) instead of in the manner provided in subdivision (c), in the case of any corporation which was not in existence during the whole of at least one calendar year during the prewar period, if (1) a majority of its stock at any time during the taxable year is owned or controlled, directly or indirectly, by a corporation which was in existence during the whole of at least one calendar year during the prewar period, or if (2) 50 per centum or more of its gross income (as computed under section 233 for income tax purposes) consists of gains, profits, commissions, or other income, derived from a government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive.

(e) A foreign corporation shall not be entitled to a specific exemption of $3,000.

Sec. 312. That the excess-profits credit shall consist of a specific exemption of $3,000 plus an amount equal to 8 per centum of the invested capital for the taxable year.

A foreign corporation shall not be entitled to the specific exemption of $3,000.

PART IV.—NET INCOME

Sec. 320. (a) That for the purpose of this title the net income of a corporation shall be ascertained and returned—

(1) For the calendar years 1911 and 1912 upon the same basis and in the same manner as provided in section 38 of the act entitled "An act to provide revenue, equalize duties, and encourage the industries of the United States, and for other purposes," approved August 5, 1909, except that taxes imposed by such section and paid by the corporation within the year shall be included;

(2) For the calendar year 1913 upon the same basis and in the same manner as provided in Section II of the act entitled "An act to reduce tariff duties and to provide revenue for the government, and for other purposes," approved October 3, 1913, except that taxes imposed by section 38 of such act of August 5, 1909, and paid by the corporation within the year shall be included, and except that the amounts received by it as dividends upon the stock or from the net earnings of other corporations subject to the tax imposed by section II of such act of October 3, 1913, shall be deducted; and

(3) For the taxable year upon the same basis and in the same manner as provided for income tax purposes in title II of this act.

(b) The average net income for the prewar period shall be determined by dividing the number of years within that period during the whole of which the corporation was in existence into the sum of the net income for such years, even though there may have been no net income for one or more of such years.

PART V.—INVESTED CAPITAL.

Sec. 325. (a) That as used in this title—

The term "intangible property" means patents, copyrights, secret processes and formulae, good will, trade-marks, trade-brands, franchises, and other like property;

The term "tangible property" means stocks, bonds, notes, and other evidences of indebtedness, bills and accounts receivable, leaseholds, and other property other than intangible property;

The term "borrowed capital" means money or other property borrowed, whether represented by bonds, notes, open accounts, or otherwise;

The term "inadmissible assets" means stocks, bonds, and other obligations (other than obligations of the United States), the dividends or interest from which is not included in computing net income, but where the income derived from such assets consists in part of gain or profit derived from the sale or other disposition thereof, or where all or part of the interest derived from such assets is in effect included in the net income because of the limitation on the deduction of interest under paragraph (2) of subdivision (a) of section 234, a corresponding part of the capital invested in such assets shall not be deemed to be inadmissible assets;

The term "admissible assets" means all assets other than inadmissible assets, valued in accordance with the provision of subdivision (a) of section 326, section 330, and section 331.

(b) For the purposes of this title, the par value of stock or shares shall, in the case of stock or shares issued at a nominal value or having no par value, be deemed to be the fair market value as of the date or dates of issue of such stock or shares.

Sec. 326. (a) That as used in this title the term "invested capital" for any year means (except as provided in subdivisions (b) and (c) of this section):

(1) Actual cash bona fide paid in for stock or shares;

(2) Actual cash value of tangible property, other than cash, bona fide paid in for stock or shares, at the time of such payment, but in no case to exceed the par value of the original stock or shares specifically issued therefor, unless the actual cash value of such tangible property at the time paid in is shown to the satisfaction of the commissioner to have been clearly and substantially in excess of such par value, in which case such excess shall be treated as paid-in surplus: *provided,* that the commissioner shall keep a record of all cases in which tangible property is included in invested capital at a value in excess of the stock or shares issued therefor, containing the name and address of each taxpayer, the business in which engaged, the amount of invested capital and net income shown by the

return, the value of the tangible property at the time paid in, the par value of the stock or shares specifically issued therefor, and the amount included under this paragraph as paid-in surplus. The commissioner shall furnish a copy of such record and other detailed information with respect to such cases when required by resolution of either house of congress, without regard to the restrictions contained in section 257;

(3) Paid-in or earned surplus and undivided profits; not including surplus and undivided profits earned during the year;

(4) Intangible property bona fide paid in for stock or shares prior to March 3, 1917, in an amount not exceeding (a) the actual cash value of such property at the time paid in, (b) the par value of the stock or shares issued therefor, or (c) in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding on March 3, 1917, whichever is lowest;

(5) Intangible property bona fide paid in for stock or shares on or after March 3, 1917, in an amount not exceeding (a) the actual cash value of such property at the time paid in, (b) the par value of the stock or shares issued therefor, or (c) in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year, whichever is lowest: *provided,* that in no case shall the total amount included under paragraphs (4) and (5) exceed in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year; but

(b) As used in this title the term "invested capital" does not include borrowed capital.

(c) There shall be deducted from invested capital as above defined 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.

(d) The invested capital for any period shall be the average invested capital for such period, but in the case of a corporation making a return for a fractional part of a year, it shall (except for the purpose of paragraph (2) of subdivision (a) of section 311) be the same fractional part of such average invested capital.

The average invested capital for the prewar period shall be determined by dividing the number of years within that period during the whole of which the corporation was in existence into the sum of the average invested capital for such years.

Sec. 327. That in the following cases the tax shall be determined as provided in section 328:

(a) Where the commissioner is unable to determine the invested capital as provided in section 326;

(b) In the case of a foreign corporation;

(c) Where a mixed aggregate of tangible property and intangible property has been paid in for stock or for stock and bonds and the com-

missioner is unable satisfactorily to determine the respective values of the several classes of property at the time of payment, or to distinguish the classes of property paid in for stock and for bonds, respectively;

(d) Where upon application by the corporation the commissioner finds and so declares of record that the tax if determined without benefit of this section would, owing to abnormal conditions affecting the capital or income of the corporation, work upon the corporation an exceptional hardship evidenced by gross disproportion between the tax computed without benefit of this section and the tax computed by reference to the representative corporations specified in section 328. This subdivision shall not apply to any case (1) in which the tax (computed without benefit of this section) is high merely because the corporation earned within the taxable year a high rate of profits upon a normal invested capital nor (2) in which 50 per centum or more of the gross income of the corporation for the taxable year (computed under section 233 or title II) consists of gains, profits, commissions, or other income, derived on a cost-plus basis from a government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive.

Sec. 328. (a) In the cases specified in section 327 the tax shall be the amount which bears the same ratio to the net income of the taxpayer (in excess of the specific exemption of $3,000) for the taxable year, as the average tax of representative corporations engaged in a like or similar trade or business, bears to their average net income (in excess of the specific exemption of $3,000) for such year. In the case of a foreign corporation the tax shall be computed without deducting the specific exemption of $3,000 either for the taxpayer or the representative corporations.

In computing the tax under this section the commissioner shall compare the taxpayer only with representative corporations whose invested capital can be satisfactorily determined under section 326 and which are, as nearly as may be, similarly circumstanced with respect to gross income, net income, profits per unit of business transacted and capital employed, the amount and rate of war profits or excess profits, and all other relevant facts and circumstances.

(b) For the purposes of subdivision (a) the ratios between the average tax and the average net income of representative corporations shall be determined by the commissioner in accordance with regulations prescribed by him with the approval of the secretary.

In cases in which the tax is to be computed under this section, if the tax as computed without the benefit of this section is less than 50 per centum of the net income of the taxpayer, the installments shall in the first instance be computed upon the basis of such tax; but if the tax so computed is 50 per centum or more of the net income, the installments shall in the first instance be computed upon the basis of a tax equal to 50 per centum of the net income. In any case, the actual ratio when ascertained shall be used in determining the correct amount of the tax. If the correct amount of the tax when determined exceeds 50 per centum

of the net income, any excess of the correct installments over the amounts actually paid shall on notice and demand be paid together with interest at the rate of ½ of 1 per centum per month on such excess from the time the installment was due.

(c) The commissioner shall keep a record of all cases in which the tax is determined in the manner prescribed in subdivision (a), containing the name and address of each taxpayer, the business in which engaged, the amount of invested capital and net income shown by the return, and the amount of invested capital as determined under such subdivision. The commissioner shall furnish a copy of such record and other detailed information with respect to such cases when required by resolution of either house of congress, without regard to the restrictions contained in section 257.

PART VI.—REORGANIZATIONS.

Sec. 330. That in the case of the reorganization, consolidation, or change of ownership after January 1, 1911, of a trade or business now carried on by a corporation, the corporation shall for the purposes of this title be deemed to have been in existence prior to that date, and the net income and invested capital of such predecessor trade or business for all or any part of the prewar period prior to the organization of the corporation now carrying on such trade or business shall be deemed to have been the net income and invested capital of such corporation.

If such predecessor trade or business was carried on by a partnership or individual the net income for the prewar period shall, under regulations prescribed by the commissioner with the approval of the secretary, be ascertained and returned as nearly as may be upon the same basis and in the same manner as provided for corporations in title II, including a reasonable deduction for salary or compensation to each partner or the individual for personal services actually rendered.

In the case of the organization as a corporation before July 1, 1919, of any trade or business in which capital is a material income-producing factor and which was previously owned by a partnership or individual, the net income of such trade or business from January 1, 1918, to the date of such reorganization may at the option of the individual or partnership be taxed as the net income of a corporation is taxed under titles II and III; in which event the net income and invested capital of such trade or business shall be computed as if such corporation had been in existence on and after January 1, 1918, and the undistributed profits or earnings of such trade or business shall not be subject to the surtax imposed in section 211, but amounts distributed on or after January 1, 1918, from the earnings of such trade or business shall be taxed to the recipients as dividends, and all the provisions of titles II and III relating to corporations shall, so far as practicable, apply to such trade or business: *provided,* that this paragraph shall not apply to any trade or business the net income of which for the taxable year 1918 was less than 20 per centum of its invested capital for such year: *provided further,* that any taxpayer who takes advantage of this paragraph shall pay the tax imposed

by section 1000 of this act and by the first subdivision of section 407 of the revenue act of 1916, as if such taxpayer had been a corporation on and after January 1, 1918, with a capital stock having no par value.

If any asset of the trade or business in existence both during the taxable year and any prewar year is included in the invested capital for the taxable year but is not included in the invested capital for such prewar year, or is valued on a different basis in computing the invested capital for the taxable year and such prewar year, respectively, then under rules and regulations to be prescribed by the commissioner, with the approval of the secretary, such readjustments shall be made as are necessary to place the computation of the invested capital for such prewar year on the basis employed in determining the invested capital for the taxable year.

Sec. 331. In the case of the reorganization, consolidation, or change of ownership of a trade or business, o rchange of ownership of property after March 3, 1917, if an interest or control in such trade or business or property of 50 per centum or more remains in the same persons, or any of them, then no asset transferred or received from the previous owner shall, for the purpose of determining invested capital, be allowed a greater value than would have been allowed under this title in computing the invested capital of such previous owner if such asset had not been so transferred or received: *provided,* that if such previous owner was not a corporation, then the value of any asset so transferred or received shall be taken at its cost of acquisition (at the date when acquired by such previous owner) with proper allowance for depreciation, impairment, betterment or development, but no addition to the original cost shall be made for any charge or expenditure deducted as expense or otherwise on or after March 1, 1913, in computing the net income of such previous owner for purposes of taxation.

PART VII.—MISCELLANEOUS.

Sec. 335. (a) That if a corporation (other than a personal service corporation) makes return for a fiscal year beginning in 1917 and ending in 1918, the tax for the first taxable year under this title shall be the sum of: (1) the same proportion of a tax for the entire period computed under title II of the revenue act of 1917 which the portion of such period falling within the calendar year 1917 is of the entire period, and (2) the same proportion of a tax for the entire period computed under this title at the rates specified in subdivision (a) of section 301 which the portion of such period falling within the calendar year 1918 is of the entire period.

Any amount heretofore or hereafter paid on account of the tax imposed for such fiscal year by title II of the revenue act of 1917 shall be credited toward the payment of the tax imposed for such fiscal year by this title, and if the amount so paid exceeds the amount of the tax imposed by this title, the excess shall be credited or refunded to the corporation in accordance with the provisions of section 252.

(b) If a corporation makes return for a fiscal year beginning in 1918 and ending in 1919, the tax for such fiscal year under this title shall be

the sum of: (1) the same proportion of a tax for the entire period computed under subdivision (a) of section 301 which the portion of such period falling within the calendar year 1918 is of the entire period, and (2) the same proportion of a tax for the entire period computed under subdivision (b) or (c) of section 301 which the portion of such period falling within the calendar year 1919 is of the entire period.

(c) If a partnership or a personal service corporation makes return for a fiscal year beginning in 1917 and ending in 1918, it shall pay the same proportion of a tax for the entire period computed under title II of the revenue act of 1917 which the portion of such period falling within the calendar year 1917 is of the entire period.

Any tax paid by a partnership or personal service corporation for any period beginning on or after January 1, 1918, shall be immediately refunded to the partnership or corporation as a tax erroneously or illegally collected.

Sec. 336. That every corporation, not exempt under section 304, shall make a return for the purposes of this title. Such returns shall be made, and the taxes imposed by this title shall be paid, at the same times and places, in the same manner, and subject to the same conditions, as is provided in the case of returns and payment of income tax by corporations for the purposes of title II, and all the provisions of that title not inapplicable, including penalties, are hereby made applicable to the taxes imposed by this title.

Sec. 337. That in the case of a bona fide sale of mines, oil or gas wells, or any interest therein, where the principal value of the property has been demonstrated by prospecting or exploration and discovery work done by the taxpayer, the portion of the tax imposed by this title attributable to such sale shall not exceed 20 per centum of the selling price of such property or interest.

TITLE XIV.—GENERAL PROVISIONS.

Sec. 1400. (a) That the following parts of acts are hereby repealed, subject to the limitations provided in subdivision (b):

(1) The following titles of the revenue act of 1916:

Title I (called "income tax");

Title II (called "estate tax");

Title III (called "munitions manufacturers' tax"), as amended;

Title IV (called "miscellaneous taxes").

(2) The following parts of the act entitled "An act to provide increased revenue to defray the expenses of the increased appropriations for the army and navy and the extensions of fortifications, and for other purposes," approved March 3, 1917:

Title III (called "estate tax");

Section 402 (called "returns of dividends").

(3) The following titles of the revenue act of 1917:

Title I (called "war income tax");

Title II (called "war excess-profits tax");

Title III (called "war tax on beverages");

Title IV (called "war tax on cigars, tobacco, and manufactures thereof");

Title V (called "war tax on facilities furnished by public utilities, and insurance");

Title VI (called "war excise taxes");

Title VII (called "war tax on admissions and dues");

Title VIII (called "war stamp taxes");

Title IX (called "war estate tax");

Title X (called "administrative provisions");

Title XII (called "income tax amendments").

(b) Such parts of acts shall remain in force for the assessment and collection of all taxes which have accrued thereunder, and for the imposition and collection of all penalties or forfeitures which have accrued and may accrue in relation to any such taxes, and except that the unexpended balance of any appropriation heretofore made and now available for the administration of any such part of an act shall be available for the administration of this act or the corresponding provision thereof: *provided,* that, except as otherwise provided in this act, no taxes shall be collected under title I of the revenue act of 1916 as amended by the revenue act of 1917, or title I or II of the revenue act of 1917, in respect to any period after December 31, 1917: *provided further,* that the assessment and collection of all estate taxes and the imposition and collection of all penalties or forfeitures, which have accrued under title II of the revenue act of 1916 as amended by the act entitled "An act to provide increased revenue to defray the expenses of the increased appropriations for the army and navy and the extensions of fortifications, and for other purposes," approved March 3, 1917, or title IX of the revenue act of 1917, shall be according to the provisions of title IV of this act.

In the case of any tax imposed by any part of an act herein repealed, if there is a tax imposed by this act in lieu thereof, the provision imposing such tax shall remain in force until the corresponding tax under this act takes effect under the provisions of this act.

Title I of the revenue act of 1916 as amended by the revenue act of 1917 shall remain in force for the assessment and collection of the income tax in Porto Rico and the Philippine Islands, except as may be otherwise provided by their respective legislatures.

Sec. 1401. That section 1100 of the revenue act of 1917 is hereby repealed, to take effect on July 1, 1919, and thereafter the rate of postage on all mail matter of the first class shall be the same as the rate in force on October 2, 1917: *provided,* that letters written and mailed by soldiers, sailors, and marines assigned to duty in a foreign country engaged in the present war may be mailed free of postage, subject to such rules and regulations as may be prescribed by the postmaster general.

Section 1107 of such act is hereby repealed, to take effect July 11, 1919.

Sec. 1402. That if any clause, sentence, paragraph, or part of this act shall for any reason be adjudged by any court of competent jurisdiction

to be invalid, such judgment shall not affect, impair, or invalidate the remainder of this act, but shall be confined in its operation to the clause, sentence, paragraph, or part thereof directly involved in the controversy in which such judgment has been rendered.

Sec. 1403. That the revenue act of 1916 is hereby amended by adding at the end thereof a section to read as follows:

"Sec. 903. That this act may be cited as the 'revenue act of 1916.'"

Sec. 1404. That the revenue act of 1917 is hereby amended by adding at the end thereof a section to read as follows:

"Sec. 1303. That this act may be cited as the 'revenue act of 1917.'"

Sec. 1405. That this act may be cited as the "revenue act of 1918."

Sec. 1406. That all persons serving in the military or naval forces of the United States during the present war who have, since April 6, 1917, resigned or been discharged under honorable conditions (or, in the case of reservists, been placed on inactive duty), or who at any time hereafter (but not later than the termination of the current enlistment or term of service) in the case of the enlisted personnel and female nurses, or within one year after the termination of the present war in the case of officers, may resign or be discharged under honorable conditions (or, in the case of reservists, be placed on inactive duty), shall be paid, in addition to all other amounts due them in pursuance of law, $60 each.

This amount shall not be paid (1) to any person who though appointed or inducted into the military or naval forces on or prior to November 11, 1918, had not reported for duty at his station on or prior to such date; or (2) to any person who has already received one month's pay under the provisions of section 9 of the act entitled "An act to authorize the president to increase temporarily the military establishment of the United States," approved May 18, 1917; or (3) to any person who is entitled to retired pay; or (4) to the heirs or legal representatives of any person entitled to any payment under this section who has died or may die before receiving such pyament. In the case of any person who subsequent to separation from the service as above specified has been appointed or inducted into the military or naval forces of the United States and has been or is again separated from the service as above specified, only one payment of $60 shall be made.

The above amount, in the case of separation from the service on or prior to the passage of this act, shall be paid as soon as practicable after the passage of this act, and in the case of separation from service after the passage of this act shall be paid at the time of such separation.

The amounts herein provided for shall be paid out of the appropriations for "pay of the army" and "pay of the navy," respectively, by such disbursing officers as may be designated by the secretary of war and the secretary of the navy.

The secretary of war and the secretary of the navy respectively shall make all regulations necessary for the enforcement of the provisions of this section.

Sec. 1407. That the provisions of section 5 of the act entitled "An act making appropriations for the service of the post office department for the fiscal year ending June 30, 1918, and for other purposes," approved March 3, 1917, relating to intoxicating liquors in interstate commerce, as amended by section 1110 of an act entitled "An act to provide revenue to defray war expenses and for other purposes," approved October 3, 1917, be, and the same are hereby, made applicable to the District of Columbia.

Sec. 1408. That every person who on or after April 6, 1917, has entered into any contract, undertaking, or agreement with the United States, or with any department, bureau, officer, commission, board, or agency under the United States or acting in its behalf, or with any other person having contract relations with the United States, for the performance of any work or the supplying of any materials or property for the use of or for the account of the United States, shall, within thirty days after a request of the commissioner therefor, file with the commissioner a true and correct copy of every such contract, undertaking, or agreement.

Whoever fails to comply with such request of the commissioner shall be guilty of a misdemeanor and shall be punished by a fine of not more than $1,000, or by imprisonment for not more than one year, or both.

The commissioner shall (when not violative of the technical military or naval secrets of the government) have access to all information and data relating to any such contract, undertaking, or agreement, in the possession, control or custody of any department, bureau, board, agency, officer or commission of the United States and may call upon any such department, bureau, board, agency, officer or commission for a full statement and description of any allowance for amortization, obsolence, depreciation or loss, or of any valuation, appraisal, adjustment or final settlement, made in pursuance of any such contract, undertaking, or agreement.

Sec. 1409. That unless otherwise herein specially provided, this act shall take effect on the day following its passage.

Students' Department

EDITED BY SEYMOUR WALTON, C.P.A.

(ASSISTED BY H. A. FINNEY, C.P.A.)

INSTITUTE EXAMINATION

NOVEMBER, 1918

In regard to the following attempt to present the correct solutions to the questions asked in the examination held by the American Institute of Accountants in November, 1918, the reader is cautioned against accepting the solutions as official. They have not been seen by the examiners—still less endorsed by them.

ACCOUNTING THEORY AND PRACTICE

PART II

Question 1:

Mention and explain two common views concerning the treatment of donated capital stock.

Answer:

Two reasons may be mentioned for the donation of stock by the stockholders of a corporation: (a) for the purpose of providing working capital with which to carry on the business; and (b) to cover losses that have been incurred and thus to wipe out a deficit, or to change it into a surplus. The object for which the donation is made should govern the treatment.

(a) When a mine, a plantation for a prospective fruit ranch or some similar property is sold by a promoter to a corporation, it is quite common to issue to the promoter the entire capital stock of the corporation in full payment for the property. As the corporation would then have no means of raising money for the purpose of developing the property, and as the promoter's stock is of no value unless the property is developed, the promoter donates to the corporation part, usually half, of his stock to be sold for the purpose of providing working capital. As the stock was fully paid by the transfer of the property, it is legitimate to charge it to treasury stock, which can be sold at less than par without making the purchaser liable for the discount.

If the property acquired with the stock were really worth in cash the par value of the stock, this donation would represent a real profit and would be a legitimate credit to surplus. It is evident that such is not the case, because the promoter by his relinquishment of half of the stock acknowledges that the price was excessive. However, it will not do to credit the donated stock to the property account, because that would be to put on record the fact that the property was worth only part of what was paid for it. To avoid this, and also to designate the purpose for which the stock was donated, the proper credit is to donated working capital.

If the treasury stock is sold at a discount, the discount is eventually charged against donated working capital account. This will leave that

account with a credit balance equal to the cash received for the stock when it is all sold. This balance can be transferred to the credit of the property account, the latter account having been charged with the real assets and the development expenses paid for out of the proceeds of the treasury stock.

(b) When a business has been run at a loss for a time, but is showing signs of coming prosperity, the stockholders may agree to an assessment which will be an out-and-out gift and therefore a profit. This gift may be in stock to be sold, if the business needs ready money, or to be held as treasury stock until a time when the operating profits will justify the return of the stock by a stock dividend. As the object of the donation was to make good the previous deficit, the credit is properly to deficit account. If the donation is large enough to create a credit balance in deficit account, it will, of course, be transferred to surplus.

Question 2:

What is the status of a company in the hands of the alien property custodian with regard to the capital stock tax as required by the revenue act of September 8, 1916?

Answer:

A company in the hands of the alien property custodian would not be subject to the capital stock tax. This tax is imposed "with respect to the carrying on or doing business" by a corporation. It has been officially ruled that a corporation all of whose property and business is operated by or in the hands of the alien property custodian is not doing business.

Question 3:

A manufacturing concern having several branch offices for the sale of its product is in the habit of billing the branches at the wholesale price and expects each branch to show a profit. A balance-sheet is prepared in which the current accounts with the branches (after closing out their profits and losses into head office) are carried as accounts receivable. These branches carry a considerable stock of merchandise and have their own accounts receivable and possibly some outstanding accounts payable, How would the above balance-sheet have to be modified in order to show correctly the financial condition of the business?

Answer:

Carrying the debit balances of branch offices as accounts receivable of the head office is entirely wrong. The expression "accounts receivable" is always used to designate customers to whom goods have been sold in regular course of business. A branch office is not a customer, it is part of the main concern, and its assets and liabilities are those of the head office itself and should be so shown on the balance-sheet. They may be combined with the corresponding accounts of the head office or shown separately. Thus the merchandise may be included in the total merchandise on hand or may appear as an addition to the head office inventory thus:

Inventory, head office	xxxxxx	
Inventory at branches	xxxxxx	
		xxxxxxxxx

The valuation must be at cost—not at the wholesale selling price.

While it makes no difference in the net worth of the whole business, the inclusion of branch balances among the accounts receivable gives a wrong idea of the financial condition. Accounts of customers are supposed to be extremely quick assets. To include inventories with them is to give an erroneous impression of the ability of the business in regard to quickly available cash resources. In addition, there are still selling expenses to be incurred before the branch merchandise can be converted into true accounts receivable, not to mention the overvaluation.

Question 4:

(a) What items do you consider should be charged or credited direct to surplus?

(b) Would you regularly make small adjustments of subsequently discovered errors through this account?

(c) Is the balance at credit of surplus ever in any circumstances a liability, and, if so, to whom?

Answer:

(a) Those items which are not part of the regular, normal conduct of a business at any time, or, although of an ordinarily normal nature, are not applicable to the business of the current year,

In the first category fall such items as a loss by fire and the profit or loss consequent upon the sale of a fixed asset. The object of the profit and loss account is the determination of the amount of the net profit of a concern conducting a business of a certain character. If such a concern credits profit and loss with the gain on a piece of real estate sold, it has falsified the record and has destroyed the basis of comparison between the profits of different years.

In the second category fall those items that are corrections of erroneous charges or credits to profit and loss in previous years. As these errors affected the final net credit to surplus in the years in which they occurred, it follows that the present surplus is larger or smaller in consequence and therefore is the account to be corrected.

(b) If the items are few in number and trivial in size, one could not be very severely blamed for letting them appear in the current accounts. In the interest of exact statistics, errors that are of any importance should be adjusted through a surplus adjustment account, by the aid of which exact statements of the transactions of previous years may be prepared by recasting the previous statements.

(c) The balance at the credit of surplus can be considered a liability of the business to the stockholders who own the business, but only by those who claim that the business may be treated as distinct from the capital that owns it. Capital, including surplus, is a liability only in the sense that after all the outside liabilities are paid, capital can claim payment of what is left.

Question 5:

Give some idea of what taxes you would charge against income and what against surplus. Of the former, which, if any, would you take up into manufacturing costs? What provision, if any, would you make for income and excess profits taxes in closing accounts before the passing of

a pending act levying these taxes, either in general circumstances or when profits are partly divisible under some special contract or arrangement?

Answer:

If a reserve for taxes levied for the previous year, but not payable until the current year, was not set up at the close of that previous year, the tax when paid should be charged to surplus, and at the end of the current year a reserve should be set up for accrued taxes by a charge against income.

Real estate taxes on the factory, when it is owned by the business, should be charged as an overhead manufacturing cost. It is necessary that a factory should occupy land and buildings, therefore all the essential expenses of owning and maintaining them are part of the cost of the processes carried on in the buildings.

Personal property taxes should be considered a general or financial expense. Federal taxes are deductions from income, not chargeable as operating expenses, but are debited to profit and loss after the operating profit has been determined. However, income and excess profit taxes may be considered as disposition of profits and may then be charged to surplus. This is on the theory that the government is a preferred partner in the profits only, and that the tax is its preferred dividend.

If the amount of a tax that has accrued is not known when the accounts are closed, an estimate should be made of the probable amount, based on the indications that may be available as to the rate that may be finally adopted. If profits are partly divisible under some special contract, the amount must be agreed upon by all parties in interest, but a better plan would be to divide the profits after allowing for the highest possible tax, and then to adjust the division later, when the actual tax is known.

Question 6:

Give some principles to determine a proper disposition of the cost of enlarging a plant, including a partial re-building of the old portion.

In case you have insufficient data to enable you to apply these principles satisfactorily, offer some solution of the difficulty.

Answer:

All the cost of enlarging the plant should be charged to plant account, as the new construction is equivalent to building a new addition to it, increasing its intrinsic value to the extent of its cost.

The cost of re-building part of the old portion should be charged to reserve for depreciation to the extent that it is an exact reproduction. Any extra cost, constituting additional value, should be charged to plant account. The best way to accomplish this is to charge the new construction to plant, and then to credit plant and charge reserve for depreciation with the cost of the replaced portion.

If the payrolls, material vouchers and other data are not such as to make it possible to determine from them the cost of the new and the replacement work respectively, I would have to rely on the best judgment of the persons who superintended the work. If an architect were employed or if one contractor did all the work, the opinion of either of them would be conclusive.

Question 7:

What are the distinguishing characteristics of the "corporation" as compared with other forms of business organization? What privileges does it carry and what, if any, are its disadvantages?

Answer:

The two questions can be answered at the same time.

Advantages of incorporating.

(a) Limited liability. In a partnership, each partner is liable for the partnership debts to the full extent of his private fortune. In a corporation, the general rule is that the corporation's creditors must look to the corporation's assets for the payment of their claims, and the stockholder is thus liable to lose only the amount of his investment. There are some exceptions to this general rule.

(b) Continuous life. A partnership is automatically dissolved by the death or insolvency of any partner. A partner cannot sell his interest in the business without the consent of the other partners, and an attempted sale dissolves the partnership. If a partnership is for a fixed period, no partner has the right to withdraw before the end of the period, but he has the power to do so and may exercise this power, even in the absence of right, and so dissolve the partnership, rendering himself liable for damages.

A corporation, on the other hand, continues its existence without regard to the condition or personnel of its stockholders, until it is terminated by expiration of the period for which it was incorporated, by voluntary dissolution, by judicial action or by forfeiture of its charter.

(c) Legal entity. The law does not recognize the existence of a partnership as an entity apart from the partners who compose it. Therefore in suing or being sued, the partners must be treated as individuals doing business under a firm name. Since a partner cannot be both plaintiff and defendant in the same suit, a partnership cannot sue one of its partners, nor can a partner sue the partnership. A corporation, being a separate legal entity, can sue or be sued in its own name, either by outsiders or by its own stockholders.

(d) Availability. The holder of shares in a corporation can readily dispose of them by sale or will, without the consent of the other holders, except in the case of a pooling agreement. He can also use them as collateral for loans without prejudice to the business. A member of a firm can realize on his investment only by winding up the business, or by obtaining the consent of the other partners to a sale of his interest.

(e) Larger capital. The use of the corporate form provides for increased capital by the sale of shares to outside investors, who may be willing to risk definite sums but would not be willing to assume the indefinite risk involved in a general partnership.

(f) Ease of management. In a partnership, unless the rule is modified by agreement, all partners have a right to equal participation in the management of the business, and there is no well defined method of enforcing the will of the majority. Hence there is liable to be dissension and

dispute, and, in the case of an even number of partners, there may be a deadlock which it will be impossible to break. Each partner has implied legal authority to bind the partnership in matters within the scope of the partnership business, and this authority has frequently operated to the disadvantage of a firm.

Stockholders have no authority to bind the corporation. Their only control lies in the election of a board of directors and a review of its activities. The corporation is managed by the directors, who meet periodically to outline the general policy of the business, and in the meantime delegate the actual conduct of affairs to a president and other officers with definite powers, their action being subject to supervision by the stockholders at their annual meeting. This delegation of definite authority tends to eliminate the friction and the hazard which prevail in partnership management.

Disadvantages of incorporating. Some of these are:

(a) Less freedom of action. In case of a contingency arising when prompt action is necessary, partners can decide on what should be done without any delay, while in a corporation it may be necessary to call a formal meeting of the board of directors after due notice to each member.

(b) Restrictions as to character of business. A corporation is restricted to the kind of business which it was given authority under its charter to carry on, while a partnership can conduct any legal business and can change from one business to another without consulting the state officers.

(c) Restrictions as to capital. A partnership may change its capital at will by investments and withdrawals, the drawing of profits being accomplished without restriction or formality. A corporation can increase or decrease its authorized capitalization only after compliance with the legal requirements of the jurisdiction in which it is incorporated. Division of assets among stockholders during the life of the corporation can be made only from accumulated profits and not from invested capital, and the distribution of profits must be preceded by a formal declaration of dividends.

(d) Restrictions as to investments. In some states it is illegal for one corporation to invest in the stock of another corporation, or to acquire and hold its own stock as treasury stock, or to own real estate which is not required for the operation of its business.

(e) Taxes and reports. The federal and state governments have been inclined to require corporations to make compensation for their peculiar privileges by the payment of special taxes, among which are the organization and franchise taxes, stock transfer taxes and the federal corporation tax. Moreover a close supervision has been maintained over corporate activities through the medium of extensive reports.

Question 8:

There is a confusion in the minds of many people between statements of "revenue and expense" on the one hand and of "receipts and payments" on the other hand. Discuss the distinctive features of such statements showing wherein they differ.

Answer:

Revenue, or income represents a clear gain in value, whether received at present or to be received in the future, provided its eventual receipt is reasonably certain. It includes the gain from all sources, whether collected or not, even if accrued only but not yet due. Expense includes everything which tends to reduce value or create loss, whether paid or not, even if accrued but not yet due, or only estimated, as in the case of depreciation for which allowance is made.

Receipts include only those items which have been collected in cash. Not only may they include items of a capital nature which have no effect on profits or losses, but also items which do not belong to the period for which the accounts are being made up and are merely the collection of items which have come over from a previous period. In the same way payments may represent disbursement of cash for capital assets and for expenses which are for the benefit of a subsequent period. Neither receipts nor payments include items that are accrued only, nor those which are estimated.

Question 9:

Can you suggest any circumstances in which goodwill would appear in the books of a partnership?

Answer:

Goodwill may appear on the books of a partnership when one partner retires from the firm and is paid a sum in addition to the book value of his interest. This additional amount may be charged to goodwill as representing the amount actually paid, or it may be taken as a measure of one partner's share and each of the remaining partners may be credited with a similar amount, which would also be charged to goodwill. The latter is seldom done as it puts too large an undesirable asset on the books. In fact, it is better to charge the amount paid to the retiring partner against the capital account of the remaining partners in their profit-sharing ratio, and avoid the use of goodwill entirely.

It may also appear when a new partner is taken into a firm, the old partners being allowed a goodwill for the business they have built up. It should be credited to the old partners' capital accounts in their profit-sharing ratio, before the new partner pays in his capital.

It may also appear when a firm sells its entire business to another firm or to a corporation for more than its book value. In order to divide the proceeds of the sale equitably between the partners, it is necessary to put the excess price on the books of the partnership, crediting the partners in their profit-sharing ratio, and thus reaching a basis for the division of the cash or stock received for the business.

Question 10:

A company makes machines of a highly technical nature which it rents out, but refuses to sell, to its customers. These machines, if kept in good order, are calculated to last almost indefinitely, but say for at least 20 years. They are, on the other hand, liable to be superseded at any time

by new devices or methods. How would you treat the original capital value on the books of the company? (Assume that two years' rental would, in each case, liquidate the first cost.)

Answer:

Owing to the danger of supersession, the safest plan would be to credit all the rental from each machine to a reserve account for two years, so that its cost would be entirely taken up, and after that to credit all rental to profit and loss. This would result in the company's showing a deficit equal to all its expenses above manufacturing cost for two years on each successive lot of machines, before it would have any profits against which to charge these expenses, with a margin gradually to reduce the deficit. This treatment would be too drastic to be satisfactory. It would be better to set up a reserve only after the expenses had been provided for, thus avoiding the deficit, but not allowing for any surplus for the first two years at least plus the time that it takes to overtake the general expenses. That is, if the general expenses were one-third of the manufacturing cost, it would take three years' rentals to clear the cost of a machine from the books. After the first set of machines was thus paid for, the subsequent output would be half paid for on the average, if the output was always steady. It is almost certain that, even if better new machines were devised at any time thereafter, this company would still be able to keep enough of its own machines rented to enable it to get out a good deal more than merely clear of loss. Because it would take time for competition to develop, the company would be safe in declaring dividends, even before payment for the first machines had been completed.

Question 11:

What are the present requirements of the federal reserve banks in regard to the verification of the accounts of companies whose paper is submitted by member banks for rediscount?

Answer:

The requirements seem to differ in different districts. In one district the reserve bank does not require a copy of the statement furnished by the borrower to the member bank at the time the loan is made. This is subject to certain modifications when there is any particular reason for making a more thorough investigation. It is left to the member bank to exercise discretion because of its liability as an endorser when the rediscount is made.

In another district the reserve bank requires a statement of the borrower's condition prepared by a certified public accountant.

When not endorsed by a member bank, a trade acceptance or bill of exchange is not eligible for purchase by the reserve bank unless a satisfactory statement of one or more of the parties thereto has been furnished. However, this is beside the question, as paper submitted by member banks would be endorsed by them.

The application made to the reserve bank by a member bank for rediscount of paper contains a column headed "Have you statement on file?" and a provision that the reserve bank reserves the privilege of asking for copies of financial statements where they are on file. Such statements

must be on file with respect to all notes which have been purchased from others than a depositor or a member bank. A blank form of statement is furnished to be used when required by the member bank or by the reserve bank but it is nowhere stated that this statement should be prepared or verified by a professional accountant. This is true in at least one of the federal reserve districts, whatever may be the practice in others.

Reply to Joseph Robinson.

Since The Journal of Accountancy has given seven pages to Mr. Joseph Robinson in the December, 1918, number devoted to criticisms of this department, we feel that silence on our part might be construed into a confession that his strictures are just and that his arguments are well founded.

The first subject he treats of is the celebrated Safety Razor Company and its subsidiaries. One of the peculiarities of this problem is the frequency with which persons who reason only from superficial analysis insist, like Mr. Robinson that the goodwill in the consolidated balance-sheet is $1,630,000, or $100,000 more than the goodwill allowed by us, corroborated by the excellent authority of A. E. Anderson and David Himmelblau.

The problem is too long to reproduce here; therefore reference is made to it as it appears in the December number. The principal point at issue is the time at which the L. W. Company added $100,000 to the book value of 2,000 shares of the Steel Blade Company stock and credited surplus with a corresponding amount. The problem gives no hint as to the time, merely stating the fact that at December 31, 1912, the stock was carried at $400,000, but cost only $300,000. Confining ourselves entirely to the L. W. Company, the net assets which were purchased by the Safety Razor Company on March 31, 1912, were of course, represented by the L. W. capital stock of $400,000, its surplus of $605,000 and the profits since January 1, 1912, of $30,000, a total of $1,035,000. This would be real net assets if the write-up of the Steel Blade stock had not yet been made. Mr. Robinson assumes that it had been made, thereby reducing the actual assets acquired by the Safety Razor Company by $100,000 and consequently increasing the goodwill acquired, since the goodwill is the difference between the actual net assets acquired and the amount paid for the stock.

Since the problem is silent as to the time, the question becomes one of probability. Mr. Robinson says that we have to use our imagination, but we prefer to think that an examination of the probabilities is more trustworthy. He says: "Isn't it against reason that L. W. wrote up the investment between January 1 and March 31, 1912, in the face of S. B. Company's loss of $15,000 during that period?" He then says: "It appears to me that the only logical assumption is that the write-up occurred prior to January 1, 1912, and is included in L. W. Company's January 1, 1912, surplus of $605,000.

Suppose we let our imagination rest awhile and look at the facts. If the write-up of the stock had any justification whatever, it would be found in a large increase in earning power, which would give it additional value

as an investment. There are three periods involved in the problem: that prior to January 1, 1912; that from January 1 to March 31, 1912; and that from April 1 to December 31, 1912. In the first period, the Steel Blade Company had acquired a deficit of $50,000; in the second period it had increased this deficit by $15,000, making it $65,000. There is not much excuse for writing-up the stock to be found in these figures. In the third period this deficit of $65,000 is changed to a surplus of $35,000, which means a profit of $100,000 in nine months, which would be at an annual rate of $133,333 on a capital of $600,000, or more than 22 per cent. Now, if ever, there is a good excuse to raise the valuation of the stock. Mr. Robinson's imagination seems to have become exhausted before he reached this third period, as he ignores it altogether.

Let us now examine the effect upon the L. W. Company. Its surplus at January 1 was $605,000. Before December 31 it paid a dividend of $100,000, reducing its surplus to $505,000. On December 31 its adjusted surplus was $700,000. Therefore its profits for the year must have been $195,000, of which only $30,000 was made during the first 3 months, leaving $165,000 to be earned in the remaining 9 months. While this is by no means impossible, it is much more probable that the profits of the last 9 months were only $65,000 and that the L. W. directors offset the reduced rate of profit by writing up the investment. By itself, this argument would be very weak. Its only value lies in its corroboration of the previous argument.

If Mr. Robinson's contention for a goodwill of $1,630,000 were allowed, the effect would be to increase the consolidated surplus by $100,000. As the common stock is only $1,500,000, the goodwill, even at $1,530,000, represents part of the preferred stock at the time of the purchase. In the face of this condition it would seem as if the smaller goodwill would appeal to the imagination of the conservative accountant, if there is any reasonable ground for adopting it.

But Mr. Robinson has not done with us yet, although he selects only one culprit for discipline. He says, referring to Mr. Walton, "And then he makes a grave mistake. On the books of the Safety Razor Company (the parent company) he credits the $100,000 dividend from the L. W. Company to surplus." He explains that since $30,000 was earned prior to the purchase of the L. W. stock, and that, according to our figures, only $95,000 was earned, there should be a credit to surplus of only $65,000 and that $35,000 should be credited to the investment account. As there is no investment account in a consolidated balance-sheet, the credit must be applied to goodwill.

This is a matter of opinion and the fact that an opinion does not meet the views of Mr. Robinson does not necessarily constitute it a "grave mistake." Whatever may be the British view, it is generally considered in this country that a dividend received is a profit in the period in which it is declared. Therefore, the Safety Razor Company would naturally credit the whole $100,000 as a profit, especially as it had already credited the goodwill with the $30,000 earned by L. W. prior to the purchase, by

adding it to the capital and surplus of January 1, 1912, to represent net assets of $1,035,000, as already shown. Mr. Robinson wishes us to credit this twice.

ANTICIPATING PROFITS.

In the Spencer and Munton joint adventure problem Mr. Robinson criticizes the solution given by us in regard to the only point of any importance in the problem. It is not necessary to examine the whole problem to elucidate this point. Briefly, one item of the venture consists of 100 cases of commodity B, the cost of which has been lumped with that of other goods. Spencer (one of the partners in the venture) "takes 10 cases of commodity B valued at $47.50." Afterwards the remaining 90 cases of B are exchanged for 30 cases of commodity C, which the two partners divide between them. Of course, they should be charged with the goods that they take—the only question is as to the price.

In our answer we claim that since one of the partners was charged $4.75 per case for commodity B, it established an equitable price as between partners, whatever the goods may have been worth on the market. As each partner received the equivalent of 45 cases of commodity B, he must be charged with $213.75.

Mr. Robinson injects into this problem the entirely extraneous idea of unrealized profits. He says:

"Spencer should have taken the goods at or near market value, and very likely he did; but if he did not Munton does not make a profit on the goods he takes, and Spencer does not make a profit on the goods Munton takes, and Munton sacrifices profits on all goods taken by Spencer in excess of his own takings of similar goods.

"If the goods were taken at market value, Spencer is crediting profits on goods taken by himself, and Munton is crediting profits on goods he took, and the goods taken by each are valued at the market price on the books of each, and the anticipated profits on those goods are included in the $106.79 credited by each as their net profits.

"If to Spencer and Munton the goods are raw materials the supposed profits would be considered as profits only for adventure statistics, and should be treated as a reduction of the cost of the material.

"The question of unrealized profits is the most important part of the problem and a solution without a discussion of it ought not to be considered correct."

The reason why Spencer should have taken the goods at market value may exist in Mr. Robinson's imagination, but he has not let it escape. Partners are often allowed to take goods at cost.

The price at which the goods are taken is absolutely immaterial, so long as it was mutually satisfactory. If Spencer could afford to pay a certain price for them, there is no reason why both of them should not afford the same price. It is not necessary that this price should be cost in order to avoid an anticipation of profits. It is only necessary that it should not be more than Spencer and Munton would have to pay in the open market for commodity C, which they evidently can use and they

would have to buy at market price if they did not take their own. It would be a silly thing for them to put up the price of commodity C, so as to show a nominal profit on the venture merely to lose it in their regular business.

Mr. Robinson says: "Undoubtedly the problem was originated for the sole purpose of testing the candidate's knowledge of adventure accounts, and I hazard the guess that the originator had no idea that it raises the question of unrealized profits." Probably because no such idea is admissible.

CLUB INITIATION FEES

Again Mr. Robinson singles out one person for his criticism, when he says:

"Authorities tell us that membership fees and initiation fees are a source of profit to a club, but are not usually considered operating profits. Mr. Seymour Walton goes so far as to say that if a club is sufficiently prosperous to afford it they should not be credited to profits at all but should be considered capital receipts which should be used to pay for the club property or to redeem bonds. He apparently says that the financial condition determines the accounting treatment, but of course he does not mean that. Undoubtedly he will agree that the purpose of the fee determines the treatment. If for the purpose of obtaining money with which to purchase club property or to retire indebtedness or to create a reserve or for other particular purposes, the fees are not operating profits in any sense but are donated surplus. I see no reason at all why the fees do not become operating profits after the particular purpose has been achieved. If property were purchased the repairs, renewals and depreciation would be operating charges and the fees should be treated as operating income to offset those charges."

Mr. Walton says that he does mean exactly that, but calls attention to the fact that the words are "accounting treatment" and not accounting principles. Theoretically the initiation fees are a capital receipt, paid in to give a permanent capital to the club, so that it can invest in fixed assets, even if these fixed assets are no more than furniture in a rented building. Unfortunately, many clubs, after a short period of prosperity in which they are able to pay for part, if not all, of the fixed assets that they need, experience a slump, when the ordinary operating income is not sufficient to pay the expenses, and violent hands have to be laid on the initiation fees. "Necessity knows no law" and accounting principles are apt to be forgotten when the sheriff is at the door. Therefore, the purpose of the fee does not always determine its treatment, although it should do so.

The following additional criticism is part of the same topic,

"Mr. Walton incorrectly uses the term 'capital receipts.' Mr. H. C. Bentley correctly defines capital receipts as being money or other evidences of value which are caused by the creation of or addition to fixed liabilities, or the reduction of or realization on fixed assets. Initiation fees are not capital receipts—they are either profits or donated surplus."

A club has no capital stock and it is not operated for profit. But that does not mean that it has no capital with which to operate, nor that it does not make profits or losses in its operations. Without more or less permanent capital it could not own any fixed assets at all. This capital must be either contributed or earned. At first it must be contributed in the form of initiation or membership fees. These are really the payments of the members to a permanent capital, paid only once, and therefore not an item of operating profit, since only regularly recurring items are included in operating profit and loss. The fact that they are credited to surplus or left in initiation fees account, instead of being credited to capital, does not change their nature.

Finally, Mr. Robinson answers his own criticism, when he says that initiation fees may be donated surplus. Undoubtedly; but he forgets that surplus is capital whether in a club or in an ordinary business corporation. As we have seen, it is the only capital that a club can have. As a logical syllogism,

Paid in capital is a capital receipt;
Paid in or donated surplus is paid in or donated capital;
Ergo, donated surplus is a capital receipt.

James Martin has resigned the secretaryship of the British Society of Incorporated Accountants and Auditors, which he has held for thirty-three years and has been appointed advisor to the society's council.

Whittlesey & Wythes announce that F. J. Wilson has been admitted to partnership in the firm, which will practise under the firm name of Whittlesey, Wythes & Wilson, 30 Church St., New York.

Lybrand, Ross Bros. & Montgomery announce that Homer N. Sweet, in charge of the Boston office of the firm, has been admittted to membership in the firm as of January 1, 1919.

Frederick W. Squires and Howard Greenman announce the formation of a partnership under the firm name of Squires & Greenman, with offices at 25 Broad street, New York.

Clinton H. Montgomery & Co. announce the admission to the firm of W. E. Baird in charge of the firm's office 712-714 Scarritt building, Kansas City, Missouri.

Marwick, Mitchell, Peat & Co. announce that they have admitted to partnership Thomas Ritchie, James B. Campbell, and Andrew Stewart.

Edward Owen, formerly commissioner of accounts of the city of New York, died of pneumonia, January 18, 1918.

Haas & Carr announce the opening of offices at 613 Pennsylvania building, Philadelphia, Pennsylvania.

A. F. Wagner announces the reopening of his office at 517 Security building, Minneapolis, Minn.

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Waldron H. Rand.....Massachusetts
H. Ivor Thomas.....California

For one year:

Arthur W. Teele, *Chairman*.....New York
George O. May.....New York
Arthur Young.....Illinois

*A vacancy exists in the membership of council for this term.

Auditors

Henry C. Magee.....New Jersey
Charles Hecht.....New York

COMMITTEES

Executive Committee

The President, *Chairman*.....Massachusetts
The Treasurer.....Pennsylvania
H. S. Corwin.....New Jersey
W. Sanders Davies.....New York
J. E. Masters.....Massachusetts
John B. Niven.....New Jersey
E. W. Sells.....New York

Committee of Professional Ethics

Carl H. Nau, *Chairman*.....Ohio
J. D. M. Crockett.....Missouri
Charles H. Tuttle.....Massachusetts
J. Porter Joplin.....Illinois
T. Edward Ross.....Pennsylvania

Committee on Arbitration

E. E. Gore, *Chairman*.....Illinois
F. A. Tilton.....Michigan
Charles B. Tompkins.....Iowa

Committee on Budget and Finance

E. W. Sells, *Chairman*.....New York
Thomas L. Berry.....Maryland
Charles Hecht.....New York

Committee on Constitution and By-laws

W. R. Mackenzie, *Chairman*.....Oregon
William A. Smith.....Tennessee
Lewis G. Fisher.....Rhode Island

Committee on Education

Herbert F. French, *Chairman*....Massachusetts
F. G. Colley.....New York
Durand W. Springer.....Michigan

Committee on Ethical Publicity

W. Sanders Davies, *Chairman*.....New York
Carl H. Nau.....Ohio
T. Edward Ross.....Pennsylvania

Committee on Federal Legislation

Adam A. Ross, *Chairman*.....Pennsylvania
Harvey S. Chase.....Massachusetts
John B. Niven.....New Jersey

Committee on Meetings

R. J. Beaman, *Chairman*.....Ohio
George R. Lamb.....Ohio
H. A. Keller.....Ohio

Committee on Nominations

J. Porter Joplin, *Chairman*.....Illinois
W. P. Hilton.....Virginia
William H. West.....New York

Committee on Procedure

Hamilton S. Corwin, *Chairman*.....New York
Seymour Walton.....Illinois
Willis B. Richards.....New York
H. B. Fernald.....New York
John F. Forbes.....California

Committee on Publication

J. E. Sterrett, *Chairman*.....New York
William M. Lybrand.....New York
F. F. White.....New Jersey

Committee on State Legislation

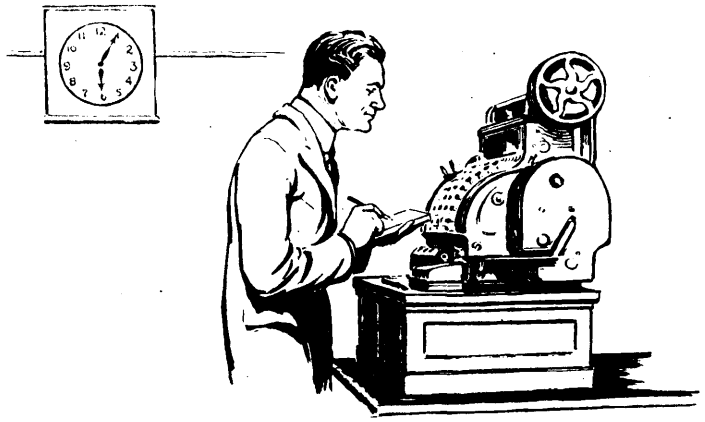
J. S. M. Goodloe, *Chairman*.....New York
R. O. Berger.....Illinois
Edwin J. Bishop.....Minnesota

War Committee

Edward L. Suffern, *Chairman*.....New York
W. Sanders Davies.....New York
Charles S. Ludlam.....New York
Robert H. Montgomery.....New York
Henry A. Niles.....New York
J. E. Sterrett.....New York
Arthur W. Teele.....New York
A. P. Richardson, *Secretary*.....New York

Committee on Administration of Endowment

George O. May, *Chairman*.....New York
Harvey S. Chase.....Massachusetts
E. W. Sells.....New York
Robert H. Montgomery.....New York
Arthur Young.....Illinois



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SITUATIONS WANTED

Situation Wanted Accountant, thoroughly experienced and qualified in the preparation and installation of Cost Systems for Manufacturing plants and Mining Companies. Connection desired with either corporation or firm of accountants. Location in West preferred but not essential. Age 31 years, married.

Address Box 741 c/o Journal of Accountancy

SITUATIONS WANTED

Position Wanted Civil and Mechanical Engineer, C. E. degree, having 6 years' field and office experience, just released from Navy, wishes to start at something new; have been studying accountancy and would like to work in C. P. A. office or firm of Industrial Engineers; location, New York City; salary, anything.

Address Box 749 c/o Journal of Accountancy

C. P. A., (New Hampshire) at present engaged as Chief Accountant for a manufacturing concern, seeks connection with Public Accountants or Corporation; nine years' experience in manufacturing cost, corporation accounting, auditing and office management; location, anywhere; salary, $3,000.

Address Box 750 c/o Journal of Accountancy

Position Wanted Am at present Auditor of Coal Company. To secure educational advantages for children would consider accounting position, paying $2,700 or better, of any nature. First class references, including present employers.

Address Box 740 c/o Journal of Accountancy

Position Wanted Young man, 20, honorably discharged U. S. Army, experienced bookkeeper and accounting student, desires to connect with C.P.A. or large corporation. Industrious and reliable worker. Best references.

Address Box 743 c/o Journal of Accountancy

Accountant C.P.A. residing in New York City desires to become associated with an accountant or small firm of accountants with an established practice in the city.

Address Box 744 c/o Journal of Accountancy

Accountant Young man, 28, single, seven years' experience in accounting with ammunition manufacturer, desires position with a public accounting firm.

Address Box 746 c/o Journal of Accountancy

Accountant University graduate, four years of general public accounting experience, desires connection with a certified firm. Also willing in addition to his services to make a reasonable cash investment in order to acquire an interest in a growing accounting firm.

Address Box 747 c/o Journal of Accountancy

Accountant Young man, 33, married, 17 years' experience, desires position with corporation with chance of promotion. Minimum salary to start $3,000.

Address Box 745 c/o Journal of Accountancy