Journal of Accountancy

Volume 28 | Issue 4 Article 4

10-1919

Relation of Invested Capital to Excess Profits Tax

Stephen G. Rusk

Follow this and additional works at: https://egrove.olemiss.edu/jofa

Part of the Accounting Commons, and the Taxation Commons

Recommended Citation

Rusk, Stephen G. (1919) "Relation of Invested Capital to Excess Profits Tax," *Journal of Accountancy*: Vol. 28: Iss. 4, Article 4.
Available at: https://egrove.olemiss.edu/jofa/vol28/iss4/4

This Article is brought to you for free and open access by the Archival Digital Accounting Collection at eGrove. It has been accepted for inclusion in Journal of Accountancy by an authorized editor of eGrove. For more information, please contact egrove@olemiss.edu.

Relation of Invested Capital to Excess Profits Tax*

By Stephen G. Rusk

Since the enactment of the revenue laws of 1917 and 1918, especially those sections thereof that pertain to the taxation of so-called excess profits, the subject of invested capital has been one of conspicuous interest and concern. The excess profits tax, being based upon invested capital (and the government's interpretation of what comprises invested capital as a basis of taxation), has been the cause of this lively interest and anxiety.

Policy of Conservatism

It has not been an unusual practice among business men to conduct their enterprises in an ultra-conservative manner with respect to a showing of assets or the capitalization of expenditures which wholly or in part represented capital outlay rather than expenses. Their apparent aim seemed to be a desire to build up reserves to tide the business over the shoals of unprofitable years and to provide against stringent financial periods. Too often little or no attempt was made to have the financial records always kept so as to show the cost of the acquisition of assets, the amounts of depreciation and other data necessary to a full and accurate view of the precise financial status at any given date.

This policy of conservatism was and is a sound one; but because the accounting records have not shown the true conditions nor the consecutive steps that have been taken to give effect to this policy, many taxpayers feel that they are now being penalized for having pursued what they rightfully deemed to be praiseworthy methods in the conduct of their financial affairs. They do not recognize that the penalty they now are paying arises from the lack of proper records of the methods by which these reserves were created rather than from pursuing a commendable and conservative policy.

Importance of Adequate Records

However, many are thinking more clearly with respect to this matter and are beginning to realize the importance of clear, com-

* A paper read at the annual meeting of the American Institute of Accountants, Cincinnati, Ohio, September 17, 1919.

prehensive and accurate bookkeeping in the conduct of their business.

It is a dearly acquired lesson to many who, by reason of improper accounting, now find themselves obliged to pay a much higher tax than they would have had to pay were they now able to trace their financial history and prove to the satisfaction of the treasury department that their book showing of invested capital is erroneous, and to what extent it is erroneous.

The government has immensely strengthened the accountant's long maintained position that the books of account should show all the facts and that, when it is found necessary partly to estimate values, the manner and amount of such estimate should be clearly written into the accounting history of the enterprise.

How often, since early in the year 1918, have we heard from the lips of an outraged taxpayer quotations from section 210 of the 1917 law, to the effect that his is

> "an exceptional case in which the invested capital cannot be satisfactorily determined"?

How often have we heard the reasons given in support of this assertion that

> "through defective accounting or the lack of adequate data, it is impossible to accurately compute the invested capital"?

quoted from the particularly apt language of section 210, article 52, of regulations 41 covering the 1917 law.

Again we have heard them insist that their condition could be likened unto that described in the following language:

> "Long established business concerns which by reason of ultra conservative accounting and the form and manner of their organization would, through the operation of section 207, be placed at a serious disadvantage in competing with representative concerns in a like or similar trade or business."

These taxpayers usually arrived at a comprehension of the above quoted conditions when they discovered that (again quoting article 52)

> "the invested capital is seriously disproportionate to taxable income."

Accountants generally have discovered how often the taxpayer was truly picturing his own conditions. What delving into old and musty records there has been to discover the evidence to convince the treasury department the quoted language exactly fitted a particular case.

All accountants know how often they have been called upon to face just such a situation for their clients, and particularly how often there has been every presumption that the taxpayer was in possession of a much greater invested capital than could be proved from his books or other available data, until finally he was compelled to rest his appeal, under section 210, solely upon the bald and unsupported assertion that "the invested capital was seriously disproportionate to the taxable income."

Similar situations were met in computing the taxes under the 1918 law, but while the latter law has been more carefully drawn than the 1917 law and has given some additional latitude to taxpayers and has eliminated some of the obstructions, there are still many cases that require relief under sections 327 and 328 of that law.

Books Presumed to Show Invested Capital

Invested capital is a phrase that has come to have importance in every business man's vocabulary, and he is studying the most approved methods of financing his enterprise so that he may get the proper balance between borrowed capital and invested capital. Fortunately for him the limitation as to deductible interest contained in the 1917 law has been eliminated from the 1918 law. This limitation prevented many taxpayers with large amounts of borrowed capital from deducting interest on any but the "maximum principal equal to the amount of the paid up capital plus one-half of the interest bearing indebtedness outstanding at the close of the year" in arriving at their taxable income.

This feature of the 1917 law caused much controversy and, as many have said, was inequitable.

The fact that the government has laid down the rule for determining invested capital that the "books of account will be presumed to show the facts" and "any additional amounts allowed as invested capital must be proven to the satisfaction of the treasury department" has been a potent factor in increasing the taxpayer's respect for his financial accounting records. He now realizes that properly kept accounts should be for him the sole evidence of the amount of his invested capital; the amounts he now has to prove by other forms of evidence are difficult to determine, and he suspects that he has lost track of values of which he should have undoubted records.

ADJUSTMENT OF INVESTED CAPITAL SHOWN BY BOOKS

To the invested capital shown by the books of account may be added such additional assets as may be in the possession of the taxpayer provided adequate evidence can be produced to prove the propriety of their inclusion to the satisfaction of the treasury department. Provision for the inclusion of such additional amounts was made in the 1917 and 1918 returns in the schedule entitled "adjustments by way of additions" and the nature of the items and the proof to be submitted are fully set forth in the regulations.

The adjustment of invested capital described in schedule B, item 2 of the 1917 law, as "value of tangible property in excess of par value of stock issued therefor," is one that caused considerable misapprehension as to the taxpayer's rights thereunder.

Article 63 of regulations 41 of the 1917 law defined cases coming under this head and described the necessary evidence to be submitted to validate the claim.

In order to show the reason for the general misconception of this matter the regulation will first be quoted:

When tangible property may be included in surplus:

> Where it can be shown by evidence satisfactory to the commissioner of internal revenue that tangible property has been conveyed to a corporation or partnership by gift or at a value accurately ascertainable, or definitely known as at the date of conveyance, clearly and substantially in excess of the par value of the stock, or shares paid therefor, then the amount of the excess shall be deemed to be paid in surplus. The adopted value shall not cover mineral deposits or other properties discovered or developed after the date of conveyance but shall be confined to the value accurately ascertainable or definitely known at that time.
>
> Evidence tending to support a claim for paid in surplus under these circumstances must be as of the date of conveyance and may consist among other things of (1) an appraisal of the property by disinterested authorities, (2) the assessed value in the case of real estate, and (3) the market price in excess of the par value of the stock or shares."

Many taxpayers took advantage of the opening seemingly left by this language and sought to increase their invested capital by adding thereto excess value over stock issued for assets acquired by them through a favorable purchase. Many corporations had succeeded to property held in receiverships and had for a comparatively small amount of capital stock acquired property of a value greatly in excess of the par value of the stock given in pay-

ment therefor. Without question they adjusted their invested capital by adding this excess value to their book showing of invested capital.

They were much surprised when such adjustments were disallowed and it was explained to them this provision of the law was intended to cover cases where there had been no substantial change of beneficial interest in the property paid in to the corporation.

Article 836 of regulations 45 of the 1918 law is much more explicit upon this matter than was article 63 of regulations 41 of the 1917 law, and the taxpayer cannot fail to distinguish his case from cases in which paid-in surplus will be allowed and can readily determine whether or not he has a valid claim under this heading.

The requirements to submit balance-sheet showing the taxpayer's financial status at the beginning and end of the pre-war period and at the beginning and end of the taxable year; the schedules in which is shown the invested capital at the beginning of each of the pre-war years; the schedule in which are shown all changes in outstanding capital stock from the end of the pre-war period to the beginning of the taxable year, together with the analysis of surplus from December 31, 1910, down through the taxable year, makes the path anything but smooth for one who would attempt to increase his invested capital in ways that are contrary to the regulations.

Intangibles

The government's regulations in regard to the exclusion of certain intangible asset values has also been the source of much thought and controversy. It will be remembered that intangible assets, consisting of patents, goodwill, trade names, etc., can only be included in invested capital to the extent that the amount represents actual cash outlay, or to a limited extent if the intangible was acquired in payment for stock of the corporation prior to March 3, 1917. This method of valuation takes no account of the developed value, no matter how far from the present the latter may have accrued.

For example, we have seen instances where a patent was the most valuable asset held by a taxpayer and without it his invested capital was very seriously disproportionate to his taxable income,

although his accounting records were proper. As a result the taxpayer was obliged to appeal to the treasury department to have his tax assessed under the provision of section 210 of the 1917 law or under sections 327 and 328 of the 1918 law.

This course leaves the whole matter of his taxation to the treasury department in these particularly difficult instances, and it is assumed the taxpayer will obtain relief from the department after it has given his case special consideration. Whether or not the tax is equitable, when determined by the proper authorities, depends upon the taxpayer's ability to describe his situation clearly and comprehensively, so that when understood it may be compared with others of similar nature. Adequate relief also depends on the ability of the department to find cases fairly comparable to his. In view of the large number of returns that have appeals attached asking to be assessed under these relief sections of the 1917 and 1918 laws, it would seem to devolve upon someone to formulate a ruling that would give recognition to bona fide cases of developed value of intangible assets. Of course, it can readily be seen that this regulation must be most carefully drawn in order to exclude all but intangible assets of definitely provable worth, because it takes no stretch of the imagination to conjure up a view of the number who would set up claims of values attaching to patents, goodwill, trade-marks, formulae, contracts or other intangible assets, wholly beyond the limits of any reasonable valuations. Nor is it difficult to foresee the almost insurmountable obstacles in the way of deciding what would be and what would not be fair values for these intangible assets.

Where a corporation has actually invested either cash or its capital stock in intangible assets, the question is comparatively simple, and it may have been the part of wisdom to limit the admission of intangible assets to those so acquired.

Actual Outlay Versus Value at March 1, 1913

The theory that invested capital, as uniformly construed throughout the acts and the regulations of 1917 and 1918, represents actual values paid in by the stockholders (and "paid in" also includes actual capital earned and left in by the stockholders) and not the value of the net capital assets as at March 1, 1913,

has caused much controversy. The arguments in favor of determining the present worth of invested capital at March 1, 1913, are too well known for enumeration here.

If the theory of determining the worth at March 1, 1913, were accepted and written into the regulations, it would relieve the auditors and inspectors in the treasury department, who are now engaged in solving the many knotty problems contained in section 210 of the 1917 law and sections 327 and 328 of the 1918 law, from considerable responsibility and labor.

Personal Service Corporations

The exact meaning of section 209 of the 1917 law and section 200 of the 1918 law, defining personal service corporations, has puzzled many taxpayers whose business required simply a nominal capital and whose income flowed directly from the combined efforts of its stockholders. Many taxpayers apparently coming under the provisions of the above mentioned sections have been surprised to find that their returns could not be assessed thereunder.

In the 1918 law the distinction between those properly belonging in that category and those not so belonging is more clearly defined* than it was in the 1917 law.

All the stock holders of a corporation may be active in the conduct of its affairs; the profits may be primarily attributable to the activities of the stockholders; such a corporation may only have a nominal capital stock—but if the employment of capital appears as an essential to the business, it will be ruled not to be a personal service corporation. Besides having the attributes of rendering a personal service for compensation, the employment of capital, whether borrowed or invested by the stockholders, must not be more than incidental. If it can be successfully argued that the employment of capital is essential to the conduct of the business, the corporation cannot be considered a personal service corporation.

In the consideration of such a case before a committee in the treasury department having the responsibility of determining whether or not a corporation's taxes should be assessed under the provisions of section 209 of the 1917 law, a certain corporation

* See articles 1523 to 1532 of regulations 45.

was denied the right to be assessed under that section because it had advanced sums of borrowed money, or funds arising from its own undrawn profits, to one of the principals for whom it acted as selling agent.

This corporation was one commonly classified as a close corporation, where its profits were directly attributable to the activities of its stockholders. Its capital stock was nominal. It acted as selling agent for several manufacturers. Its contractual relations with one of its principals compelled it to make advances to the principal on partly completed work. This money it sometimes borrowed and sometimes drew from its own funds. It did not handle the product it sold, that being shipped directly from the factory of the principal. The billing, however, was done by the corporation as agent, at a higher price than was paid to the principal. The corporation collected from the purchaser and settled with the principal. It was held, because the agent advanced funds to the principal, that the agent assumed responsibility for the collection of the accounts and hence the conduct of the business required capital.

The position taken by the department seems correct, but it also illustrates how narrow is the line between those which can and those which cannot be considered personal service corporations.

Excess Profits Taxes

The term excess profits tax does not accurately describe a tax that is based on 8 per cent. of invested capital. It would seem that the so-called war profits tax could better be described as excess profits tax.

To say that excess profits are being taxed when a corporation's earnings above 8 per cent. are subject to taxation, especially in these days of rising prices and interest rates and falling worth of the dollar, is not a precise statement, because many corporations could not face the hazards of their particular business if the expected return did not exceed a greater percentage on the amount invested.

However, it must also be remembered that the 8 per cent. excess profits credit is based on invested capital and not upon the actual par value of the stock outstanding, and the invested capital

is in almost all cases greater by reason of the accumulation of surplus. Hence, the corporation has an untaxed income usually in excess of 8 per cent. based on its capital stock.

In instances where the corporation's capital has become impaired and there is a present deficit, the ruling that the excess profits credit shall be based upon the capital stock paid in, regardless of the fact that some part of it has been lost, seems to be fair to the taxpayer.

The specific excess profits credit of $3,000.00 has the desired effect of relieving the taxpayers with small incomes from the payment of the excess profits tax. It also admits an element into the law that gives some difficulty in calculating the mathematical relation of invested capital to excess profits tax.

Another consideration in viewing the effects of the excess profits credit must be borne in mind. While 8 per cent. on invested capital, plus $3,000.00 of income, is apparently being exempted from excess profits taxation, the fact may actually be somewhat different because the law does not permit certain legitimate expenses of a business to be deducted. Reference is here made to donations, insurance premiums on the life of an officer or employee where the taxpayer is the beneficiary, the charges to unallowable reserves, etc.

It is not unusual to find a corporation, in which excess profits tax is a high percentage of its actual income, whose percentage of these taxes to taxable income is many points lower.

It would seem that the regulations with reference to donations by corporations could be modified to permit deductions for donations and contributions made to the Red Cross, Y. M. C. A., Y. W. C. A., K. of C., and like benevolences, even though there be no direct benefit therefrom flowing to the donor, without opening the door to evasion of tax.

Taxable Income

One cannot study the present forms for setting forth the facts concerning invested capital and taxable income without a feeling of admiration for the prevision and skill of those who devised it. For the first time many taxpayers have seen a sort of panoramic view of their business by observing the statistics required by the 1918 return. These taxpayers apparently were not aware of the valuable information contained in their books of account, but now

have a greater appreciation of the possibilities for increased control of their financial destiny which proper accounting affords. Many of them also learned for the first time that there is an intimate and precise relation between capital and income; and some things they have said about either or both in former tax returns cannot now be squared with the schedules required in the present forms.

A comparison of the 1917 law and the regulations thereunder with the 1918 law and regulations discovers a very marked improvement in the language of the latter, in that it is more definite and comprehensive.

Numerous defects that were found in the 1917 law and regulations have been eliminated and many puzzling features have been cleared up. This is especially true in regard to depreciation. Obsolescence, which is a definite element of cost in some industries, has been recognized and rules have been laid down for the determination of deductible depreciation that are in conformity with sound business and accounting principles.

The 1918 regulations as to depletion have also been stated more clearly, and the inequities apparent in the 1917 law and regulations have been eliminated. The extension of the base upon which depletion can be taken to include the "fair market value within thirty days after the date of discovery in the case of mines, oil and gas wells, discovered by a taxpayer after February 28, 1913, where the fair market value is materially disproportionate to the cost" is one instance of the elimination of an inequity in the former regulations. Another instance is the extension of the base to permit a lessee to include the fair market value of the lease at February 28, 1913, and the allowing to him of similar values for discovered deposits of minerals, oils or gas.

The article relating to the apportionment of depletion between lessor and lessee removes the cause of much controversy attendant upon administering the 1917 law.

Relation of Invested Capital to Excess Profits Tax

Considering now the thought underlying the subject of this paper brings into view the most important result to taxpayers of the application of the law, though to accountants it has not taken on the same degree of interest.

The taxpayer's interest arises from his desire to know to what extent his net income is to be affected by the application of the excess profits tax.

In the remaining paragraphs of this paper will be taken up the mathematical relationship between invested capital and excess profits tax.

Under the rates of taxation prescribed by section 301 of the 1918 revenue act for the year 1918, the following rule will be found to apply in the determination of the relation of excess profits tax to invested capital, in cases where the invested capital is in excess of $25,000.

> When the taxable income is in excess of $3,000 plus 8 per cent. of the invested capital and not in excess of 20 per cent. of the invested capital.
>
> > Multiply the invested capital by three-tenths of one per cent. for each per cent. of the excess over 8 per cent. and from the result deduct $900.
>
> When the taxable income is in excess of 20 per cent. of invested capital
>
> > Multiply the invested capital by sixty-five one hundredths per cent. for each percentage point above 20 per cent.:
> >
> > Add 3.6 per cent. of the invested capital and from the result deduct $900.

The following rule will apply in cases where the invested capital is less than $25,000.

> When the taxable income is in excess of $3,000 plus 8 per cent. of the invested capital
>
> > Multiply the invested capital by sixty-five one hundredths of one per cent. for each percentage point above 8 per cent. and from the result deduct $1,950.

Under the rates prescribed in section 301 pertaining to 1919, the rule is as follows:

> When the taxable income is in excess of $3,000 plus 8 per cent. of the invested capital and not in excess of 20 per cent. of the invested capital

Multiply the invested capital by two-tenths of one per cent. for each per cent. of the excess over 8 per cent., and from the result deduct $600.

When taxable income is in excess of 20 per cent. of the invested capital

Multiply the invested capital by four-tenths of one per cent. for each percentage point above 20 per cent.; add 2.4 per cent of the invested capital and from the result deduct $600.

The following rule will apply in cases where the invested capital is less than $25,000.

When the taxable income is in excess of $3,000 plus 8 per cent. of the invested capital

Multiply the invested capital by four-tenths of one per cent. for each percentage point above 8 per cent. and from the result deduct $1,200.

Limitations of Section 302

The above rules do not apply if the tax upon the taxable income is subject to the limitation provided in section 302.

This section provides that the tax imposed by the 1918 rate contained in section 301 shall not be in excess of 30 per cent. of the net income in excess of $3,000, and not in excess of $20,000, plus 80 per cent. of the net income in excess of $20,000.

It also provides that the tax imposed by the 1919 rates contained in section 301 shall not be in excess of 20 per cent. of the net income in excess of $3,000 and not in excess of $20,000, plus 40 per cent. of the net income in excess of $20,000.

These limitations upon the tax imposed by section 301 present some interesting mathematical problems, the solution of which shows the particular conditions that must be present if section 302 is to be effective, rather than section 301, in the computation of the excess profits tax.

The rules that govern in cases where the taxation is calculated under section 302 rather than under section 301, are as follows:

Under 1918 *Rates*

If invested capital is less than $74,468.09, the taxpayer may be benefited by the limitations of this section.

When the invested capital is between $25,000 and $74,468.09 the rates under section 302 will begin to be effective when the taxable income is 26 6/7 per cent. of the invested capital and will cease to be effective when the said income represents the remainder derived from deducting 62 2/3 per cent. of the invested capital from $66,666.67. The limitation attains its maximum when the income is $20,000. The maximum limitation at this point represents a saving of $7,000 minus 9.4 per cent. of the invested capital.

For invested capital less than $25,000 the limitation will begin to be effective when the taxable income is equal to the sum of 14 6/7 per cent. of the invested capital and $3,000 and will cease to be effective when the income is equal to $59,666.67 minus 34 2/3 per cent. of the invested capital.

The limitation here attains its maximum when the income is $20,000 and this maximum benefit will be $5,950 minus 5.2 per cent. of the invested capital.

Under 1919 *Rates*

If invested capital is less than $71,428.58 the taxpayer may be benefited by the limitations of this section.

When invested capital is an amount between $25,000 and $71,428.58 and the taxable income is in excess of 28 per cent. of the invested capital, the rates prescribed by section 302 will be effective. The saving in taxes effected by the application of section 302 to the computation will be 20 per cent. of the amount by which the taxable income exceeds 28 per cent. of invested capital provided the said income is not in excess of $20,000.

The maximum saving to the taxpayer is attained when the income is $20,000 and the saving remains constant for all income in excess thereof.

The maximum saving is equal to $4,000 minus 5.6 per cent. of the invested capital.

When invested capital is less than $25,000 the saving to the taxpayer begins when his income is equal to the sum of 16 per cent. of his invested capital and $3,000 and the saving is equal to 20 per cent. of the amount by which the income exceeds this limit.

As in the former case the saving becomes a constant when the income has reached $20,000 and is then equal to $3,400 minus 3.2 per cent. of the invested capital.