

Michigan Law Review

Volume 33 | Issue 7

1935

CORPORATIONS-STATE PRIVILEGE TAXES-VALUATION OF PROPERTY TO DETERMINE SURPLUS

Follow this and additional works at: <https://repository.law.umich.edu/mlr>



Part of the [Business Organizations Law Commons](#), and the [Tax Law Commons](#)

Recommended Citation

CORPORATIONS-STATE PRIVILEGE TAXES-VALUATION OF PROPERTY TO DETERMINE SURPLUS, 33 MICH. L. REV. 1074 (1935).

Available at: <https://repository.law.umich.edu/mlr/vol33/iss7/7>

This Comment is brought to you for free and open access by the Michigan Law Review at University of Michigan Law School Scholarship Repository. It has been accepted for inclusion in Michigan Law Review by an authorized editor of University of Michigan Law School Scholarship Repository. For more information, please contact mlaw.repository@umich.edu.

CORPORATIONS—STATE PRIVILEGE TAXES—VALUATION OF PROPERTY TO DETERMINE SURPLUS—Various bases have been evolved in this country for computing corporation privilege taxes.¹ Of special interest is the fact that seven states² have made corporate surplus together with capital the basis for such taxes—Louisiana, Michigan, Mississippi, Missouri, North Carolina, Ohio, and Texas.³ The statutes of these states adopt either the gross value or the net value of the assets of corporations as the foundation of the tax, depending upon whether or not liabilities may be deducted. In fixing the amount of such a tax, some valuation of corporate property to determine the corporation's surplus is necessary.

The Michigan Supreme Court recently gave what is apparently the first judicial interpretation as to the method to be used in figuring surplus under such a statute. The Michigan act provides that the privilege tax is to be assessed on paid-up capital and surplus, the latter being defined as the net value of the corporation's property less its outstanding liabilities and paid-up capital.⁴ The General Corporation Act requires an annual report, including, among other things, "A complete and detailed statement of the assets and outstanding liabilities of the corporation . . .,"⁵ and such other information as the secretary of state may demand and need for the purpose of computing the tax.⁶ A Michigan corporation on its balance sheet, sent to creditors and stockholders, set up under the item "Marketable Securities" the original cost of the securities less reserve, with a footnote indicating a considerably smaller figure as the actual market value. However, in its report sent to the secretary of state, only the figure representing the smaller amount was given. The corporation computed its tax from the surplus computed upon this basis, but the secretary of state refused to accept it. The court held that the statute did not require the corporate balance sheet to be included in the report, and that the tax was to be computed

¹ For an enumeration of the different bases for such taxes, see Tobin, "State Franchise Taxes," 10 *Tax Magazine* 366 (Oct. 1932).

² Illinois uses paid-in surplus, which is merely the consideration received for its capital stock less stated capital. Ill. Rev. Stat. (Cahill 1933), c. 32, § 132, as amended by Laws of Ill., Spec. Sess. 1933-34, p. 154 ff.

³ La. Laws 1932, Act No. 8, § 1, as amended by Laws 1934, Act No. 18, p. 95; Ex. Sess. Laws 1934, Act No. 25, p. 72; Third Ex. Sess. Laws 1934, Act No. 20; Mich. Comp. L. 1929, § 10140, as amended by Mich. Pub. Acts, Ex. Sess's. 1933-1934, Act No. 13; Miss. Laws 1934, c. 121, §§ 2, 6; Mo. Rev. Stat. 1929, § 4641; N. C. Laws 1933, c. 445, § 210, p. 737; Ohio Gen. Code (Page 1926), § 5498, as amended by Laws 1933, p. 589; Texas Stat. 1928, art. 7084, as amended by Tex. Laws 1931, c. 265, § 1 (Tex. Stat., Supp. 1931, art. 7084).

⁴ Mich. Comp. L. 1929, § 10143.

⁵ Mich. Pub. Acts 1931, Act No. 327, § 82 (m).

⁶ Mich. Pub. Acts 1931, Act No. 327, § 82 (o).

on the actual value of the corporation property, rather than on the book value as set up on the balance sheet.⁷

The Michigan legislature has not set out specifically the method by which figures for fixing the surplus item are to be obtained. Accordingly, in construing the statute and determining the method, reference may be had, first, to the form of the laws in states having a similar basis for franchise taxes; second, to the nature of the tax; third, to other sections of the Michigan corporation act dealing with valuations of corporate property; and fourth, to the policy factors involved in tax collection. Actually, just two methods of figuring surplus come into question: (1) balance sheet, and (2) actual valuation.

I.

As indicative of legislative thought on the subject, we may consider the statutes in the states which have made specific provision for computing the surplus. In Louisiana,⁸ Mississippi,⁹ and Ohio,¹⁰ corporate property is specifically to be taken at the valuation at which it is carried on the books of the corporation; in North Carolina,¹¹ the basis is to be the annual report and balance sheet submitted to the state. In all jurisdictions the valuation is subject to modification for fraud and gross negligence, and possibly in some other situations. The tax officials' scrutiny is to be directed to the corporate books, with the necessary discretionary power to deal with false valuations. Thus, whenever a legislature has expressly laid down the method for fixing the amount of surplus for the franchise tax, the valuation made in good faith by a corporation has been accepted.

Even in the states where the method of valuing property is not expressly laid down, the practice apparently has been to accept the amount of surplus shown by the corporate balance sheet.¹² The acquiescence of corporations in the appraisals put upon their property without judicial determination makes it appear that some method mutually satisfactory to the states and their corporations has been evolved in the practical administration of the tax. The only way likely to reach such

⁷ Appeal of Hoskins Mfg. Co., 270 Mich. 592, 259 N. W. 334 (1935).

⁸ La. Laws 1932, Act No. 8, § 1, as amended by La. Laws 1934, Act No. 18, p. 95; Ex. Sess. Laws 1934, Act No. 25, p. 72; Third Ex. Sess. Laws 1934, Act No. 20.

⁹ Miss. Laws 1934, c. 121, § 7.

¹⁰ Ohio Gen. Code (Page 1926), § 5497.

¹¹ N. C. Laws 1933, c. 445, § 210, p. 737.

¹² For cases where the valuations on a balance sheet report submitted to the state were apparently accepted as a privilege tax basis, see *State ex rel. Mo. Pac. R. R. v. Danuser*, 319 Mo. 799, 6 S. W. (2d) 907 (1928); *State ex rel. Marquette Hotel Inv. Co. v. State Tax Com'n*, 282 Mo. 213, 221 S. W. 721 (1920); *In re Oklahoma Nat. Life Ins. Co.*, 68 Okla. 219, 173 Pac. 376 (1918).

a result involves the acceptance of the valuation uniformly put and carried by corporations upon their own property.

The Michigan court was informed that the appraisal of property on corporate books had been accepted by the tax department for fourteen years.¹³ These figures were shown regularly on the corporation's balance sheets and did not involve any footnoted changes. Corporations have had their tax fixed on the basis of the value of property which they themselves so represented they were carrying on their books. The state was furnished with a ready-made valuation of property by which the tax was to be measured, which would be consistent with the requirements of the statute. In the great majority of cases this valuation would be more accurate than the resources of the tax department or the amount of the tax to be collected would allow the state to make.¹⁴

2.

The nature of the tax is important as determining the sort of property valuation which the legislature might require. Privilege taxes are generally held not to be property taxes requiring an exact appraisal,¹⁵ but excise taxes levied by the state for privileges accorded to the corporation.¹⁶ The tax usually consists of a more or less arbitrary sum having little or no connection with actual asset value.¹⁷ However, such a tax, even when an excise, may be measured to some extent by the amount of property or earnings of a corporation.¹⁸ The legislature may

¹³ Appeal of Hoskins Mfg. Co., 270 Mich. 592, 259 N. W. 334 (1935).

¹⁴ The difficulties in arriving at an accurate valuation of corporation property for balance sheet purposes are nowhere better illustrated than in the depreciation items. On this point see 33 MICH. L. REV. 783 (1935).

¹⁵ The importance of the distinction is due partly to the constitutional provisions in many states requiring property taxes to be uniform and according to value, and forbidding double taxation. See 1 COOLEY, TAXATION, 4th ed., §§ 269, 156, 232 (1924).

¹⁶ Pacific Co. v. Johnson, 212 Cal. 148, 298 Pac. 489 (1931); Cincinnati, Milford & Loveland Traction Co. v. State, 94 Ohio St. 24, 113 N. E. 654 (1916); Gulf States Utilities Co. v. State, (Tex. Civ. App. 1932) 46 S. W. (2d) 1018; Gray v. Central Florida Lumber Co., 104 Fla. 446, 140 So. 320 (1932); Spokane International R. R. v. State, 162 Wash. 395, 299 Pac. 362 (1931); Thomson Elec. Welding Co. v. Commonwealth, 275 Mass. 426, 176 N. E. 203 (1931); State v. Pierce Petroleum Corp., 318 Mo. 1020, 2 S. W. (2d) 790 (1928).

¹⁷ Newark v. Tunis, 81 N. J. L. 45, 78 Atl. 1066 (1911); California v. Cent. Pac. R. R., 127 U. S. 1, 8 Sup. Ct. 1073 (1887).

¹⁸ The Michigan privilege tax is construed as an excise; the reference to paid-up capital and surplus in the statute is merely for the purpose of fixing a fair price for the privilege of doing business. In re Detroit & Windsor Ferry Co., 232 Mich. 574, 205 N. W. 102 (1925); Michigan Trust Co. v. People of State of Michigan, (C. C. A. 6th, 1931) 52 F. (2d) 842. See generally, Phoenix Carpet Co. v. State, 118 Ala. 143, 22 So. 627 (1897); American Uniform Co. v. Commonwealth, 237 Mass. 42, 129 N. E. 622 (1921); People ex rel. U. S. Aluminum Printing Plate Co. v. Knight, 174 N. Y. 475, 67 N. E. 65 (1903).

fix the value of the franchise at any sum it chooses;¹⁹ and if the tax has a reasonable relation to benefits granted, it will be upheld.²⁰ Although the tax is measured by the amount of a corporation's paid-up capital and surplus, it is clearly not a tax upon the property of the corporation, but is levied for the privilege of doing business in corporate form.²¹ Where the tax has not been clearly unreasonable, the assessment of non-existing values has never deterred the courts from declaring franchise taxes constitutional.²² If a corporation purports to be doing business with a certain amount of capital and surplus, and so represents to the public, it would seem wholly logical and in accord with the probable intent of the legislature to assess the tax on this basis. The corporation certainly could not object, since the tax would be in line with the privileges granted.

3.

In discussing other sections of the Michigan corporation act dealing with valuation of corporate property, a word regarding the requirements of the annual report is necessary. The position of the court that a corporation is not required by the statute to submit its balance sheet to the secretary of state seems difficult to justify.²³ As already stated, the statute requires "A complete and detailed statement of the assets and outstanding liabilities" as of the close of business of the preceding calendar year.²⁴ This coincides with the ordinary business understanding of the function of a balance sheet.²⁵ In any event, since the secre-

¹⁹ *New York, Philadelphia, & Norfolk Tel. Co. v. Dolan*, 265 U. S. 96, 44 Sup. Ct. 450 (1923); *Ohio River & W. R. Co. v. Dittey*, 232 U. S. 576, 34 Sup. Ct. 372 (1913); *Southern Car & Foundry Co. v. State*, 133 Ala. 624, 32 So. 235 (1902); *State v. Boston & M. R. R.*, 123 Me. 48, 121 Atl. 541 (1923); *Southern Realty Corp. v. McCallum*, (D. C. W. D. Tex. 1932) 1 F. Supp. 614.

²⁰ *People of State of New York v. Latrobe*, 279 U. S. 421 at 427, 49 Sup. Ct. 377 (1929).

²¹ *In re Detroit Properties Corp.*, 254 Mich. 523, 236 N. W. 850 (1931); *In re Detroit & Windsor Ferry Co.*, 232 Mich. 574, 205 N. W. 102 (1925). See *Educational Films Corp. v. Ward*, 282 U. S. 379, 51 Sup. Ct. 170 (1930).

²² *Phoenix Carpet Co. v. State*, 118 Ala. 143, 22 So. 627 (1897); *Kaiser Land & Fruit Co. v. Curry*, 155 Cal. 638, 103 Pac. 341 (1909); *Blackrock Copper Min. & Milling Co. v. Tingey*, 34 Utah 369, 98 Pac. 180 (1908); 42 *YALE L. J.* 967 (1933).

²³ *Appeal of Hoskins Mfg. Co.*, 270 Mich. 592 at 597, 259 N. W. 334 at 336 (1935).

²⁴ Mich. Pub. Acts 1931, Act No. 327, § 82 (m).

²⁵ 19 FLETCHER, *CYCLOPEDIA OF CORPORATIONS* 475 (1933), "A balance sheet is a statement of the assets and liabilities of the corporation as they exist on a certain date." SUNLEY and PINKERTON, *CORPORATION ACCOUNTING* 156 (1931), "The balance sheet would . . . be called a statement of assets and liabilities." See also HATFIELD, *ACCOUNTING* 3 (1928); CONYNGTON, BENNETT and PINKERTON, *CORPORATE PROCEDURE* 1356 (1922).

tary of state is given authority to require such other information as may be necessary in computing the tax, an administrative regulation requiring each corporation to submit its balance sheet as part of its report would seem clearly within the power granted.

Valuation of assets and liabilities is also required under the Michigan corporation act to determine surplus from which dividends may be paid.²⁶ Many states fix surplus, or some portion of it, as one of the sources from which directors may declare and pay dividends.²⁷ In Michigan, the amount is ordinarily confined to earned surplus,²⁸ the statute expressly provides that the judgment of directors in determining what is earned surplus is to be conclusive in the absence of bad faith or gross negligence.²⁹ The directors ascertain the amount of the corporation's surplus by referring to the balance sheet, and it seems that the legislature must have understood that such a method would be used. However, if a new valuation of corporate property is to be required to determine "surplus" for the purpose of the tax, then the intent of the legislature may have been that directors should revalue such property each time a dividend is declared. The value at which corporations carry most of their assets and liabilities, including charge-offs, are necessarily approximations which at best can only approach the actual value of the items carried at any given time. A re-appraisal could only result in a somewhat closer approximation being reached. Such a construction of the dividend statute would clash with the method universally used by directors to determine the position of a corporation for dividend purposes, and would place an onerous duty upon corporations in the ordinary conduct of their businesses.

The use of the word "surplus" as referring to a balance sheet item has found support in accounting authorities.³⁰ And in *Edwards v. Douglas*,³¹ the United States Supreme Court said, "The word 'surplus'

²⁶ Mich. Pub. Acts 1931, Act No. 327, § 22.

²⁷ See Ballantine and Hills, "Corporate Capital and Restrictions upon Dividends under Modern Corporation Laws," 23 CAL. L. REV. 229 (1935).

²⁸ Mich. Pub. Acts 1931, Act No. 327, § 22, provides that dividends upon capital stock may be paid from earned surplus or net earnings, but that dividends upon preferred stock may be paid from any surplus if notification of the source is given.

²⁹ Mich. Pub. Acts 1931, Act No. 327, § 22.

³⁰ "... 'surplus' . . . in itself means little. It is merely the valuation the officials of the company put upon the corporate business and property in excess of the par value of the capital stock — or book value if the capital stock has no par value — plus any unencumbered reserves." CONYNGTON, BENNETT and PINKERTON, CORPORATE PROCEDURE 913 (1922). See also SUNLEY and PINKERTON, CORPORATION ACCOUNTING 100 (1931); HATFIELD, ACCOUNTING 297 (1928); PATON, ACCOUNTING 726 (1926).

³¹ 269 U. S. 204 at 214, 46 Sup. Ct. 85 (1925). See *Phillips v. United States*, (D. C. W. D. Pa. 1926) 12 F. (2d) 598 (1926).

is a term commonly employed in corporate finance and accounting to designate an account on corporate books. . . . The surplus account represents the net assets of a corporation in excess of all liabilities including its capital stock." The courts themselves have adopted what is known as the "balance sheet" method in determining whether a corporation has a surplus available for dividends.⁸²

The existence of surplus is a matter depending to a great extent upon a combination of business and accounting judgment.⁸³ Regardless of how carefully accounts are kept and how accurately the surplus and profits are computed, every accountant knows that these do not necessarily represent the true business position and the amount properly available for dividends at any particular time.⁸⁴ Whether the amount of surplus shown is financially available necessitates not only an analysis of the accounts but also a consideration of many uncertain factors and the exercise of judgment upon them. A revaluation of property would not necessarily affect the judgment of the directors in respect to such items. It appears that the directors will be in a better position than outsiders to fix the fair value of corporate property, and a reasonable protection is given by the statute to their determination in the absence of fraud or gross negligence.⁸⁵

The attitude of the legislature towards allowing directors to value corporate property is illustrated in another connection. When a corporation acquires property and issues its own stock in exchange, it is the duty of its directors to estimate the value of the property to ascer-

⁸² "A balance-sheet . . . would shew on the one hand all the assets, and on the other hand all the liabilities of the company; and it was only from that sort of statement that any safe conclusion could be drawn as to the question whether there had been profit . . . or not. . . ." *In re Portsmouth Banking Co. (Helby's, Stokes', and Horsey's Cases)*, L. R. 2 Eq. 167 at 175 (1866). *Shields v. Hobart*, 172 Mo. 491, 72 S. W. 669 (1903); *Richardson v. Buhl & Alger*, 77 Mich. 632 at 649 (1889); *Park v. Grant Locomotive Works*, 40 N. J. Eq. 114 (1885), 45 N. J. Eq. 244 (1888).

⁸³ *Berle and Fisher, "Elements of the Law of Business Accounting,"* 32 *COL. L. REV.* 573 at 576 (1932).

⁸⁴ *DEWING, FINANCIAL POLICY OF CORPORATIONS*, 3rd ed., 604 (1934); *HATFIELD, ACCOUNTING* 297 (1928); *Ballantine and Hills, "Corporate Capital and Restrictions upon Dividends under Modern Corporation Laws,"* 23 *CAL. L. REV.* 229 (1935).

⁸⁵ See *Sparger, "Profits, Surplus and the Payment of Dividends,"* 8 *N. C. L. REV.* 14 (1929). Several recent statutes expressly protect corporate directors from liability for improper dividends if they rely "in good faith on the books of account of the corporation or statements prepared by any of its officials as to the value and amount of the assets, liabilities, and/or net profits of the corporation, or any other facts pertinent to the existence and amount of surplus or other funds from which dividends might properly be paid." *Del. Corp. Law* (1933), § 34; see also *Cal. Civ. Code (Deering 1931)*, c. 65, § 363; *Ill. Rev. Laws (Cahill 1933)*, c. 32, § 42 (h); *Minn. Bus. Corp. Act, Minn. Laws* (1933), c. 300, § 22, p. 411; *Ohio Gen. Corp. Act* (1931), § 123 b, *Gen. Laws* (1933), sec. 8623.

tain what consideration is to be paid by the corporation.³⁶ The Michigan corporation act provides that when property is so obtained, the valuation fixed by the directors is conclusive in the absence of actual fraud.³⁷ If such reliance is placed upon an original appraisal, the legislature might well intend to allow the directors to set a value upon the property at a later date for balance sheet purposes, when the corporation will have had the property in its control, and the result of the bargain will be known with much more exactness.

Thus, it seems reasonable to conclude that whenever the Michigan legislature has dealt with the valuation of corporate property, it has meant to accept the value determined by the directors unless there is serious fault, such as fraud or gross negligence. It would seem also that in none of the type situations indicated above is there any justification for requiring a special valuation of corporate properties for particular purposes. If the privilege tax statute requires an exact valuation of property to fix the surplus, a difficult question is raised as to the method which corporations must follow to determine whether they have surplus available for dividends or not. It would be just as logical for the court to require that in determining surplus for each payment of dividends or each repurchase of stock, the corporation must re-appraise its assets.

4.

In looking at the policy factors involved in requiring either a balance sheet valuation or an actual appraisal of corporate property for the purpose of the privilege tax, the question of the possibilities of fraud is important. Two main objects of the periodical reports of corporations to the state are to afford information to those who are expected to enter into contract relations with corporations,³⁸ and to secure annually for the benefit of all persons concerned a public record of the financial affairs of corporations.³⁹ Reporting a false value on corporate property is a fraud on the part of the directors, for which heavy penalties and damages are available to the state and to interested parties.⁴⁰ In addi-

³⁶ See WILGUS and HAMILTON, MICHIGAN GENERAL CORPORATION ACT 170 (1932).

³⁷ Mich. Comp. L. 1929, § 9984.

³⁸ Bank of Saginaw v. Pierson, 112 Mich. 410, 413, 70 N. W. 901 (1897).

³⁹ Continental & Commercial Nat. Bank v. Emery, 178 Mich. 612, 617, 146 N. W. 303 (1914); Atlantic Dynamite Co. v. Andrews, 97 Mich. 466, 471, 56 N. W. 858 (1893).

⁴⁰ Mich. Pub. Acts 1931, Act No. 327, § 50, provides that if any report or statement or public notice is made by the directors or officers of a corporation which is false in any material representation, or if the books or records of a corporation are knowingly or wrongfully altered, the directors who knowingly or wrongfully concur in such acts are personally responsible to creditors and stockholders who have entered into dealings with the corporation on the faith of such representations. Section 51 provides a

tion, the Michigan statute provides civil damages to certain classes of creditors for the wrongful valuation of property on the balance sheet in order to show a surplus from which dividends are paid,⁴¹ as well as a fine for misstatements in connection with the privilege tax.⁴²

If the balance sheet valuation be accepted as the basis for the tax, any corporation in publishing its periodical reports and balance sheets would be faced with the dilemma either of making its properties appear less desirable than they really are, or of making a true return to the state. The approval of corporate reports by independent auditors could not be secured if any significant erroneous valuation of corporation property had been made; without such approval the report would lose much of its worth as a statement of condition in the eyes of investors. Finally, the power given to the secretary of state to require further information from the corporation as to the valuation of its property provides a check on wrongful valuation; if any misstatements were discovered, the corporation would be liable not only to the statutory penalties, but also to a possible suspension of corporate powers.⁴³ Against all these risks can be weighed only the chance of a comparatively minor saving to the corporation. Accordingly, the danger of fraud from accepting the corporation's balance sheet valuation seems remote.

If an actual valuation of corporate property must be made, serious difficulties of administration would arise. It may be assumed that the purpose of the state under the statute will be to collect a maximum of the tax available with a minimum of expense. The fact must be considered that only a small percentage of the items on a corporation balance sheet are capable of exact valuation.⁴⁴ In view of the complexities involved in an attempt to fix the exact value of corporate assets and liabilities, and of the great cost involved in such an undertaking, a conscientious effort on the part of the tax department to enforce the tax fairly would lead to frequent litigation. If political considerations were allowed to affect the amounts fixed (and the door is opened by the decision in the principal case to this possibility), an even worse situation might result.

There appears, then, to be sufficient justification for asserting that the intention of the legislature was to have the privilege tax assessed

fine and imprisonment for falsification of corporate books. For a general statement, see Dwight, "Liability of Corporate Directors," 17 *YALE L. J.* 33 (1907); 35 *YALE L. J.* 870 (1926).

⁴¹ Mich. Pub. Acts 1931, Act No. 327, § 48.

⁴² Mich. Pub. Acts 1931, Act No. 327, § 89.

⁴³ Mich. Pub. Acts 1931, Act No. 327, § 87, provides that if a corporation does not file its annual report, its corporate power may be suspended. It seems that a knowingly false report might be construed as the absence of any report at all.

⁴⁴ See Ballantine and Hills, "Corporate Capital and Restrictions upon Dividends

on the valuation at which corporations carry their assets and liabilities on their own balance sheets and books. Such a basis represents a fair estimate of the advantages derived from doing business as corporations, rather than an actual valuation (which in any event could never be exactly determined). In holding that the privilege tax statute requires an actual valuation of corporate property, the Michigan court has placed an extremely heavy burden upon the tax authorities without justification from the standpoint of protection of corporations under the statute.

T. M. D.

under Modern Corporation Laws," 23 CAL. L. REV. 229 (1935); Sparger, "Profits, Surplus and the Payment of Dividends," 8 N. C. L. REV. 14 (1929).