Domestic Corporate Tangible and Intangible Invested Capital

Frederick M. Thulin

DOMESTIC CORPORATE TANGIBLE AND INTANGIBLE INVESTED CAPITAL

WITH a tax law on the statute books that fixes a moderate flat rate of taxation on business income, no question of invested capital need be considered. The income tax laws of 1913 and 1916 and the flat rate or normal tax section of the 1917 law and the proposed 1918 law bear out this statement.

With a tax law on the statute books that fixes a high levy on business income, equitable principles of taxation cannot be maintained unless an element is introduced that negatives the flat rate method of computing the amount of income tax a business should pay.

As an elementary principle of business finance, it may be stated that a certain amount of capital is necessary to operate any business. Furthermore the owners or contributors of such capital are entitled to a reasonable compensation for the risk assumed in allowing the capital to be used in the prosecution of a business enterprise. If this were not true, capital would find no encouragement to stay in or to seek business channels.

With the foregoing thought in mind, one can perceive that a high flat tax rate on business income in many instances will be equivalent to allowing very little compensation to the contributors of capital. On the other hand, many business enterprises will be able to compensate fairly the contributors of capital.

It is therefore with the object of not discriminating between contributors of business capital, that there was interpolated into the 1917 and 1918 tax laws the element of invested capital. An amount of income representative of a certain percentage of such invested capital, plus an arbitrary sum of $3,000.00, is deemed to be fairly measurable of the compensation that the business owes to the contributors of such capital, and is the amount of corporate earnings fixed on as absolutely exempt from the higher taxation. The remainder of the income is subject to varying rates of taxation.

Invested capital is therefore the most important element to be considered in the present taxing program of the United States. Invested capital not only fixes on the amount of income absolutely exempt from taxation but also governs the amount of the groups of income taxable in excess of the fixed exemption. The latter fact is often overlooked in considering invested capital.

TANGIBLE PROPERTY AS INVESTED CAPITAL OF DOMESTIC CORPORATIONS[1]

There seems to be considerable misunderstanding on the subject of tangible property as invested capital.

The law itself, applicable to 1917, was somewhat doubtful but has been cleared up in an excellent manner by the treasury decisions and regulations. The 1918 proposed law, in the major points of the definition of invested capital, follows the 1917 law and regulations.

The misunderstanding in regard to tangible property seems to be largely due to the position taken by some appraisal companies that appraisals are now in order to accurately determine invested capital.

Tangible property[1a] as related to corporations and as defined by the law and regulations, is classified as follows:

I. *Choses in possession,* i. e., *physical* property, such as:
  A. Fixed physical property
    1. Land
    2. Buildings
    3. Machinery, equipment, tools, etc.
    4. Office furniture
    5. Miscellaneous
  B. Current physical property
    1. Inventories
II. *Choses in action:*
  A. Accounts, notes and bills receivable—trade
  B. Accounts, notes and bills receivable—Non-trade.
  C. Investments—bonds and mortgages
III. *Leaseholds.*
IV. *Capital holdings,* i. e. stock investments.
V. *Treasury securities,* i. e. stocks and bonds..
VI. *Reserves.*
VII. *Dividend deductions.*
VIII. *Additions to Capital Liability.*

The first point therefore to clear up is the status of physical property as invested capital.

---

[1] Limited partnerships which provide for limited liability of all the partners, such as the Pennsylvania type of limited partnerships, are classified as corporations. The limited partnership of the type that has one or more partners unlimitedly liable takes the status of a partnership. Treasury Decision No. 2711. The Massachusetts or common law trust is classified as a corporation. Item 10—Excess Profits—Letter No. 3 handed down February 21, 1918. See also section 1 of the new act.

[1a] A most logical change was made in interest deductibility. Interest under the new proposed act is deducible in full and is not measured by an amount of the capital

I

A. CHOSES IN POSSESSION—FIXED PHYSICAL PROPERTY.

The fixed physical property under the law is acquired in one or more of the following ways:

1. *By the Payment of Cash.*

Under the law applicable to 1917 and 1918, the property so purchased is held at cost, less, if any, the depreciable elements of wear and tear that may have taken place up to the beginning of the taxable year, and also any junking that may have taken place and which has not been recorded.[2]

The initial *cost price* of the *land* is usually ascertainable accurately. Any additions to the cost such as special assessments also are easily ascertainable.

The *cost price* of the *buildings* in many instances is not readily ascertainable because of the work, materials and overhead expense that may have been expended by the business itself in constructing the buildings or additions thereto. When such is the case, the only practicable way to arrive at approximate cost is—the appraisal valuation of the building and additions, when erected.

The *cost price* of machinery likewise is often difficult to ascertain for the same reason, viz: much of the machinery and equipment may be constructed by the corporation itself and no record kept of overhead, direct labor or material expenditures used in constructing such machinery and equipment. The only practicable way to arrive at the valuation is to appraise the machinery and equipment now on hand as of the value of the *date acquired.*

The *cost price* of office furniture and fixtures is easily ascertainable and does not therefore become any problem. This asset because of the smallness involved, will not give any trouble.

The proposed law for 1918[3] while the same as the 1917 law is more explicit on the subject of appraisals; it states—the surplus shall be only *earned* surplus and shall not include the increase in the value of any asset above the original cost until such increase in value is actually realized by sale. On the same hypothesis no drop in the market value is deductible from invested capital until realized by actual sale.

2. *By the payment of stock.*

Such a case would arise where a corporation purchases property

stock plus one-half of the interest bearing indebtedness. No part of the indebtedness of a corporation therefore can be included as invested capital. Section No. 234, House Bill.

[2] Article 42—Excess Profits Regulations.

[3] Section No. 326—Paragraph No. 3, House Bill.

and specifically pays for such property in shares of stock. To illustrate:

> Smith turns over certain land to the Jones Company and receives as payment therefor 100 shares of stock par value $10,000.00.

Under the 1917 law and regulations the property, if acquired *prior* to January 1, 1914, is valued as of January 1, 1914, up to the par value of the stock issued for the property.[4] Thus:

> If the land was worth $8,000.00 when acquired and was worth $15,000.00 on January 1, 1914, $10,000.00 is the maximum amount that can be used. If the land was worth $10,000.00 when acquired and was only worth $5,000.00 on January 1, 1914, the maximum amount that can be used is $5,000.00.

Under the 1917 law,[5] where the property is acquired *subsequent* to January 1, 1914, the *actual value* of the property governs; and, not the par value of the shares. Thus:

> If the land acquired in 1915 for $10,000.00 par value stock were actually worth $25,000.00 the $15,000.00 can be credited to a "Special Surplus" if desired. Should the property in 1915 be worth only $5,000.00 in 1915, $5,000.00 is the amount that can be used.

Under the proposed 1918 law,[6] the *actual value of the asset when acquired* governs; measured as a maximum by the par value of the shares given for the asset *at the time acquired.* Thus:

> Certain land is sold in 1913 to the Jones Company for $10,000.00 par value stock. This land is worth $9,000.00 at that time. The $9,000.00 is the beginning amount that governs for 1918. If the land were worth $15,000.00 in 1813, the par value of the stock, $10,000.00, would govern for 1918.

3. *By the Payment of Stock in a Reorganization Consolidation, etc.*

Such circumstances would ordinarily show that no specific stock were apportioned to each asset, but that the assets were taken over at book value or some other arbitrary amount. Thus:

> The Jones Company, a partnership on January 1, 1913, reorganized on a corporate basis, with a capital of $125,000.00. The assets were taken over at book value, the difference being thrown into good will.

---

[4] Article No. 55—Excess Profits Regulations.
[5] Article No. 55—Paragraph No. 2—Excess Profits Regulations.
[6] Section No. 326—Paragraph No. 2—Excess Profits Regulations.

The treasury department[7] for 1917 has formulated the following rules applicable to reorganization, viz., the assets are deemed to be paid for in par value stock in a certain order, at the *valuation of the time acquired.* Thus:

The assets taken over were as follows:

Land	$15,000	and is deemed to have been paid in par value stock	$15,000
Buildings	45,000	and is deemed to have been paid in par value stock	45,000
Equipment	15,000	and is deemed to have been paid in par value stock	15,000
Inventories	25,000	and is deemed to have been paid in par value stock	25,000
Cash	15,000	and is deemed to have been paid in par value stock	15,000
Goodwill	10,000	and is deemed to have been paid in par value stock	10,000
	$125,000		$125,000

If the fixed assets were acquired prior to January 1, 1914, the value of January 1, 1914, if *lower* than the values noted, will be taken; if the valuation for January 1, 1914, is *higher* than the values noted above then the values noted are taken.

Where such reorganizations took place *subsequent* to March 3, 1917; the point to determine is the percentage of control carried over from the old organization to the new organization. If such percentage is 50% or more the new organization will not take a higher valuation than the preceding business could take. While the law is not specific on the point of the continuance of the control, if the control is not 50% or more, *when the taxable year ends,* consider the control as *not* being 50% or more for the year in which the return is made. If such control is not 50% when the business is reorganized the valuation principle illustrated above is the principle to apply.[8]

The control is illustrated as follows:

> The Jones Company partnership is composed of A, B, C, and D. On March 15, 1917 the Jones Company is reorganized and on December 31, 1917 C and D owned 90% of the

[7] Article No. 59—Excess Profits Regulations. Item 27, Letter 5—Excess Profits Tax Series.

[8] Article No. 50—Excess Profits Regulations.

stock, they having purchased the interests of A and B. The new control is still deemed to be the continuation of the old control. If on December 31, 1917 E and F owned 50% or more of the stock, impliedly the percentage of ownership provision is not operative for 1917.

There is a point to observe in regard to reorganizations, consolidations, etc., that is extremely important:

> That if the business taken over and paid for in stock is practically a defunct i.e. an unprofitable organization,[9] in reality the assets are purchased and taken over and not the business. If such be the case the *valuation of the assets when taken over* probably is the governing factor and not what the value was to the defunct or unprofitable prior organization. Such would be true in principle although the reorganization took place *subsequent* to March 3, 1917, and 50% of the ownership of the old organization were continued to the new organization.

The proposed law[10] for 1918 on the question of reorganizations and as affecting tangible property is practically the same as the regulations and law of 1917 with one exception; the value of the asset when acquired is the governing factor and its value as of some subsequent date say January 1, 1914 is not taken in account. Thus:

> The Jones Company incorporates on January 1, 1913, for $100,000 and takes over the partnership assets. Land is worth $15,000 and is deemed to be paid for in par value stock $15,000 and so on with the other assets. If the land is worth $10,000 on January 1, 1914 the invested capital as a beginning is still deemed to be $15,000.

4. *By Gift.*

Tangible physical property ordinarily is acquired by gift in two instances.

First, by an outright or conditional gift such as the case of building sites given by a municipality to induce locations in the town.

When the gift is *completed* the value of the property *as of that time* is considered invested capital.

Secondly, by an excess of valuation over the purchase price,[11]

---

[9] This principle is important and may be overlooked if not specifically called to one's attention.

[10] Section No. 331 and Section No. 326—Paragraph No. 2, House Bill.

[11] Article No. 63—Excess Profits Regulations.

readily ascertainable at *the time the asset was acquired.* A subsequent rise in value is not taken into consideration. Thus:

> A certain corporation acquires on January 1, 1913, a tract of land for $30,000 payment being made therefor in cash. An appraisal of the land as of January 1, 1913 showed the valuation to be $40,000.

For the year 1917 the excess valuation $10,000.00 can be carried as invested capital on the books of the company.

It is desirable to show this amount as "Surplus created in conformity with Article 63, Regulations 41."

The same rule would be true if the $30,000 were paid for in $30,000 par value stock, $30,000 par value treasury stock or $30,000 par value bonds.[12]

Whether or not the provision set out in Article 63, Regulations 41 will govern for 1918, under the new law, is a question of doubt; probably it will be retained. The recital in the new bill that nothing shall be included as surplus unless realized by a sale is a very strong provision and one which may constrain the treasury department to overrule Article 63.

5. *By an Exchange of Property.*

Such a transaction is comparatively rare. The value of the property given in exchange for the property received is the governing factor. Thus:

> The Smith Company has land for which it paid $10,000 on January 1, 1913. On January 1, 1917 this land was worth $25,000 and was exchanged on that day for land worth $25,000. The new acquisition can be held at $25,000 *the amount on which the depreciation charge is based.*

DEPRECIATION

There is some misunderstanding on the subject of the basic amount on which to compute the percentage of depreciation. The basic amount on which the percentage depreciation is computed may or may not be the amount which is the beginning point of invested capital.

The point of difference as established by the Treasury Department[13] is: Whether or not the asset subject to physical wear and tear had been acquired prior to March 1, 1913.

[12] But this would be true also by virtue of Article 55 of Excess Profits Regulations—where the property is acquired subsequent to January 1, 1914. Article No. 55, paragraph 2 applies to property purchased after January 1, 1914.

[13] Treasury Decision No. 2754.

Where the asset had been acquired *prior* to March 1, 1913, the rule seemingly formulated for the computation of depreciation is expressed in the following illustration:

> A building was purchased in 1909 at a cost of $50,000.
>
> During 1909, 10, 11, 12, 13, 14, 15, 16, and 17 a depreciation rate of $2,000.00 annually is taken based on the estimated life of the building, the total depreciation reserve on January 1, 1918 being $18,000.00.
>
> If the same building had been erected on March 1, 1913 the cost thereof would have been $60,000. The depreciation on this valuation would be $2,400.00 annually.
>
> For 1918 therefore the depreciation charge is $2,400.00, and on January 1, 1919 the total depreciation reserve for tax purposes is $24,000.00.

The valuation of March 1, 1913 may prove beneficial in the event there has been an increase in value in the property since it was acquired. If there has been a decrease in the value of the property on March 1, 1913, the *cost* price is the one to use and not the valuation of March 1, 1913.

The tangible property acquired *after* March 1, 1913 will be depreciated on the basis of its cost price.

Neither the law nor treasury decisions specifically define what constitutes the *cost* for purposes of depreciation computation except in a few instances.

The expenditure of cash and its equivalent and the giving of a primary obligation for an asset is a clear basis. Where stock is given the case is not so clear—presumably the fair value of the property when acquired whether or not in excess of the par value of the stock given is the depreciable basis. There is a possibility that in some cases the depreciation written off on a certain valuation has taken up completely the valuation of the asset used as a beginning point for invested capital. In such a situation a certain portion of the depreciation reserve may or may not be considered invested capital. To illustrate:

> A building was acquired in 1900 and carried on the books at $100,000. The offset thereto was capital stock of $100,000, which had been given in payment therefor.
>
> The depreciation for 17 years was at the rate of 5% per annum or 85% which accordingly showed a balance in the depreciation reserve of $85,000.00.
>
> The building *when* acquired was worth no more than $75,000.00 which amount is considered the beginning point of the computation for invested capital.

The question here is practically analogous to the situation where excess depreciation was taken. The excess depreciation for the years 1900 to March 1, 1913, can be resurrected to "Surplus." The excess depreciation for 1913, 14, 15, and 16 cannot be resurrected to "Surplus" except under the conditions already noted.

Obsolescence is strongly emphasized as being an element that should be taken into consideration in computing invested capital. The term obsolescence means nothing more than junking and as long as buildings, machinery, etc., are substantially used or usable, no deduction can or need be taken because such assets are somewhat out of date.

When such assets are practically junked, the depreciation reserve plus the residual value deducted from the original cost of the asset will give the amount deductible from surplus, if such deduction had not already been made. To illustrate:

> An asset was acquired for $15,000.00 in 1910 with an estimated physical life of 15 years. Depreciation was charged from 1910 to 1917 inclusive at the rate of $1,000.00 per annum. In 1918 the asset was junked and had at that time a residual value of $100.00.
>
> The amount chargeable to 1918 income is $6,900.00.

If an under estimate had been made in computing the depreciation or if no depreciation had been taken, the amount chargeable to 1918 would be the same, the depreciation of former years being made up by an amended return. To illustrate:

> The depreciation in the foregoing case was charged in at $500.00 per annum. An amended return can be filed for 1917, 16, 15, 14, and 13 for a refund, on the amount of depreciation which could have been taken but which was not taken.

6. *Resurrection of Excess Depreciation Which Has Been Charged Off.*

There seems to be a general misunderstanding on the point of the resurrection to invested capital of excess depreciation that has been charged off on buildings, machinery, equipment and other depreciable property. The following is an illustration of the manner in which the question arises:

> The Jones Company in 1910 acquired a building at a cost of $75,000.00. During 1910, 11, 12, 13, 14, 15, and 16 the depreciation charged off was at the rate of 6% per annum or $31,500.00. The Jones Company wishes to reconstruct the asset on the basis of a depreciation charge of 3%, i.e. restore

$15,750.00 to surplus and charge the building account $15,-750.00. The Jones Company furthermore, purposes to make amended returns for 1913, 14, 15, and 16 on the basis of the 3% annual depreciation rate.

The Treasury Department[14] specifically states:

> "Whenever a corporation after March 1, 1913 has claimed a deduction in computing its income tax and the treasury department has allowed the deduction, the item upon which the deduction is based *shall not be restored to surplus account,* nor included in the invested capital."

In our illustrative case therefore, only the excess depreciation represented in 1910, 11, and 12, $6,750.00 can be reconstructed. Obviously if the treasury department objected to the depreciation rates charged in 1913, 14, 15, and 16 and asked for an amended return the excess depreciation for these years can be restored to surplus.

As a matter of practical procedure the proper step to take is to file an amended return thus impliedly calling the department's attention to the excess depreciation taken. Accompanying the return should be a letter of the following tenor:

> "The attached amended returns or statement cover the years ——— and are a correction of excess depreciation charges taken in error in computing the income for the aforementioned years.
>
> The excess depreciation was due to errors in estimating the life of the assets noted in the attached memo.
>
> If your office does not wish us to make the corrections, please return our remittance. We enclose stamped envelope."

Attached to the amended returns and to the letter should be a schedule showing the deduction or rate of depreciation taken on buildings, machinery, equipment, tools, etc., and the rate of depreciation that should have been taken. But until such amended returns have actually been accepted and the tax payer not placed in the position of volunteering payment, there is no ground for holding that an amended return *of itself* will give the right to reconstruct the excess depreciation written off.

B. CHOSES IN POSSESSION—CURRENT PHYSICAL PROPERTY.

The only items of importance in the current physical property are the inventories. The rule[15] on this point is—

Inventories are to be taken at:

---

[14] Article No. 64, paragraph No. 3—Excess Profits Regulations.

[15] Treasury Decision No. 2609. Also No. 2649 and No. 2744.

I. Cost price
II. Cost price or market price whichever is the lower.

Thus, if cost is used on *all items* the cost governs as the method to be used for the next period. If the cost or market price whichever is the lower is used, that is the method to be used for ensuing periods.

Where similar materials, etc., have been purchased at varying prices, the internal revenue department has not formulated any rules. Therefore until such rules are formulated, the average cost, first in first used, or last in last used methods, whichever method is used is correct.

If the inventory includes damaged or unsalable goods, a deduction can be taken for such goods, but not unless a supplementary statement accompanies the inventory showing cost of goods, value at which inventoried and their present condition.[16]

The inventory certificates taken in an audit should conform to the principles outlined by the internal revenue department; set out that the inventory was taken by one of the two methods noted, that it conforms to the previous method used and that no unsalable or depreciated goods are included except as noted by the attached memo. The memo, should set out the facts as noted.

II

Choses in Action—Trade Accounts, Notes and Bills Receivable

There is no difficulty in handling items of the foregoing nature as invested capital.[17] As a matter of fact, no debt of this character, unless actually written off and a deduction taken in computing the income tax, need be excluded from invested capital.

(See the discussion on reserves.)

Choses in Action—Non-trade Accounts, Notes and Bills Receivable

The question of non-trade accounts, notes and bills receivable, arises in three ways:

I. Temporary indebtedness of officers or employees which *are made* with the expectation that such indebtedness will be paid in cash.

---

[16] Article No. 162, Regulations 33 revised.

[17] Section No. 325—1918 House Bill, which confirms the Treasury Decision on this point.

II. Indebtedness of officers or employees which are *not made* with the expectation that such indebtedness will be paid in cash but that liquidation will be made by a dividend to be applied against such indebtedness.

III. Loans to outsiders.[18]

Under items I and III there is no doubt that such items can be considered as invested capital. Item II while not so clearly "invested capital" is nevertheless an asset of the corporation and included in invested capital because if the corporation should go into liquidation before the dividend is declared and credited against such advance, the stockholders who had received the advance would be compelled to return the funds in the same manner as any other debtor.

CHOSES IN ACTION—INVESTMENTS IN BONDS, MORTGAGES OR NOTES.

Investments[19] in bonds, mortgages, etc., are classified as follows:

I. Bonds or other securities of *private* entities.
   a. Corporate
   b. Partnership
   c. Individual
   d. Trustee

II. Bonds or other securities of public entities.
   a. United States government and quasi government obligations.
      1. Certificates of indebtedness.
      2. War Savings Stamps.
      3. Bonds—war and prewar.
   b. Obligations of political subdivisions of the U. S.: U. S. territories, state, county, city, etc.
   c. Obligations of foreign governments.
   d. Federal Farm Loan Bonds.

The investments in the first class are included in invested capital because the income thereof is income subject to taxation. The investments are held at *cost* less any amortization of premium that

[18] Item 62, letter 10, issued March 15, 1918, covers the point of notes given for stock. Such notes are invested capital if *bona fide* given and are not merely colourable.

[19] Dealers in investment securities consider securities as merchantable commodities and under the regulations inventory the securities at cost or market whichever is lower and not at cost, or, cost or market whichever is lower.

Item 68, Letter No. 11, issued March 19, 1918, Article 45 of the Excess Profits Regulations and Item 78, Letter No. 12, dated March 22, 1918, set out the status of tax exempt bonds when held by dealers in securities.

may have taken place. Any discount that is amortized from time to time, is set up as income accruing, or if it is not desired to accrue the discount, wait until the investment is paid or sold and return the discount in full as income in the year the investment was matured or sold.

The investments in the second class, public securities, sometimes are and sometimes are not invested capital. All United States government securities,[20] prewar or war, *are* invested capital whether or not a certain portion of the income is exempt from income taxation. The obligations of political subdivisions that have been issued prior to the passage of the 1918 law are *not* invested capital, because the income is not subject to the federal income tax. From present indications, the obligations issued subsequent to the passage of the 1918 law likewise will not be invested capital because income from such securities will be free from taxation.

The bonds or other primary obligations of foreign governments are considered invested capital, because the income from such securities is subject to federal taxation.

Federal Farm Loan Bonds are not invested capital in that the income therefrom is *not* subject to taxation.

The question sometimes arises as to the effect on invested capital of the pledging of nonadmissible bonds as security to a loan; whether the funds received from such pledging can or cannot be substituted for the securities pledged.

Where the pledging is the ordinary collateral transaction, the pledging *will not make* the proceeds of the loan invested capital.

Where the pledging takes the form of a sale with a condition subsequent, the pledging will make the proceeds invested capital. To illustrate:

> The contract form for a loan of $5,000.00 for 90 days at 6% would roughly read as follows:
>
> $5,000.00 Chicago, Illinois, Sept. 1, 1918.
>
> For value received, towit: The sum of four thousand nine hundred and twenty-five ....dollars. We hereby transfer, sell and assign to the
>
> NATIONAL BANK OF CHICAGO
>
> $6,000.00 par value 3½% Bonds of the City of Chicago.
>
> Nos...........
>
> It is provided that if the sum of five thousand dollars is tendered to the National Bank of Chicago on November 29,

[20] Section No. 325—House Bill.

> 1918, in legal tender or by a certified check or other primary obligation of some reputable bank of Chicago which is also a member of the Chicago Clearing House, the aforementioned securities or securities corresponding thereto in kind, value and interest rate, shall be surrendered to the ....Co.
>
> If tender is made subsequent to November 29, 1918 but beyond ...., the tender must be accompanied by interest from November 29 to date of tender at 7% per annum on the sum of $5,000.00. ....Co.

Whether or not a bank will take such an agreement in lieu of the ordinary collateral note is not clear; if it would do so its position would be fully secured. The entries in this case would be:

Interest	$ 75.00	Securities	$6,000.00
Bank	4,925.00		
Contingent Rights under Contract	1,000.00		

The contingent rights would not constitute invested capital. The coupons maturing during the period of the loan should be detached by the borrower.

III

THE LEASEHOLD INTEREST

The leasehold interest is of three kinds:

1. The leasehold interest that embodies a straight covenant to pay a certain periodic rent and in some instances to make other payments such as taxes, repairs, erection of buildings, etc., etc.

   Such a leasehold interest does not constitute invested capital and if it is set up on the books at any estimated value, such value is not invested capital.

2. The leasehold interest that has been purchased and also embodies a covenant to pay periodic rent and other miscellaneous covenants. To illustarte:

   > Jones leases certain property to Smith for a ten-year term at a rental of $1,200.00 per annum. Two years later Smith assigns his lease to the A Mfg. Co. for $5,000.00, the A Mfg. Co. assuming the obligations of the lease. The $5,000.00 is invested capital to the A Mfg. Co. and is depreciated 12½% per annum. If, at the time of renewal, any portion of such $5,000.00 remains unwritten off the unwritten portion is prorated over the renewal period.

3. The leasehold interest purchased outright with no covenant for periodic rent.

Such a lease is held at purchase price and depreciated[21] annually on a straight line basis until the lease expires. Thus:

If a 99-year lease is purchased for $5,000.00 and when acquired had 50 years to run, the annual depreciation charge is $1,000.00 per annum.

If, when the lease had run with an unexpired period of twenty years, it was renewed for a period of 25 years for $25,000.00, $45,000.00 would spread over a period of forty-five years.

IV

INVESTMENTS IN STOCK OF OTHER COMPANIES

The stockholdings of a business are of two kinds:

1. Not Controlling.
2. Controlling.

Under the 1917 law this classification made some difference as a 98% control would permit of the consolidated return.

Under the 1918 law, no matter how large the controlling interest may be, each corporate entity is considered by itself and makes a return of its corporate unit.

The 1918 proposed law[22] unlike the 1917 law allows dividends as a deduction from the income of a corporation; the 1917 law merely specified the dividend as a credit. While the net result is the same, the new law places the dividend in a more unequivocal position.

The exclusion of dividends from taxable income also excludes the stock investment from invested capital.

The 1918 proposed law[23] expressly provides for a situation that was not thoroughly understood in 1917, viz; a situation like the following:

Dr. The yearly averaged inadmissible assets (stock, etc.) of a company amounted to...$50,000.00

Cr. The yearly averaged fixed or permanent indebtedness of the company amounted to... 75.000.00

Under such a statement all of the inadmissible assets are deductible from capital and surplus.

---

[21] Buildings and improvements erected on leased premises are depreciated according to the life of the building or the life of the lease whichever period is the shorter.

[22] Section No. 234, House Bill.

[23] Section No. 326—Paragraph c, House Bill.

But: If the inadmissible assets amounted to $75,100.00, the tax payer, if he so desires, may deduct only $100, the excess from capital and surplus. Should the tax payer exercise the option thus given him, 750/751 of the income from inadmissible assets is added to the income subject to taxation. Where the inadmissible assets bear a low or no rate of income, it is of course desirable to exercise this option. If the securities bear a high rate of return, it is better not to exercise the option.

The fixed or permanent indebtedness of a firm is defined to be the indebtedness, which, when created, had a period to maturity in excess of one year from the date incurred.[24]

Stock investments are held at cost. Where such investments have been paid for in cash there is no difficulty in tracing cost. Where such investments have been purchased by stock, the fair value of the corporate stock given for the investment, at the time it was given, is the cost price.

Where the investment is not sold, any amount written off from cost price as a result of the market prices, can be reconstructed to surplus; any amount written up as a result of market price, etc., is deducted from surplus. If the total investment had been written off and charged into profits, such item can be reconstructed as invested capital and an amended return filed for the year the deduction was taken. The credit can be set up as "Surplus Reserve for Investment."

A deduction taken in violation of a rule of law or of a regulation can always be reconstructed. Such a deduction should be carefully distinguished from opinion, i. e., for instance the correct percentage of depreciation to take in a certain instance for physical wear and tear.

V

TREASURY SECURITIES, STOCKS AND BONDS

Treasury securities should be carefully distinguished from unissued securities. The latter type involves no element of invested capital.

Unissued stock, common or preferred, does not become invested capital, although such stock may be pledged to secure a loan. Any loan agreement should be carefully examined to see whether it is called a sale, whereas in fact it may be a loan.

Treasury stock usually finds its way into the treasury of a corporation by

1. A donation credited to "an earmarked surplus."
2. By a purchase.

---

[24] Section No. 326—Paragraph c, House Bill.

Donated treasury stock is not invested capital although it may have a substantial value in the security market.[25] Until such stock is actually disposed of, for cash or other property, no question of invested capital arises. Whatever is received for treasury stock whether or not in excess of the par value, is invested capital. In this respect treasury stock differs from unissued stock in regard to property taken in exchange for stock. Thus:

> The Jones Co. purchases a plant, paying therefor $50,000.00 par value of donated treasury stock. The plant is worth $75,000.00. Twenty-five thousand dollars can be added to a special surplus account and considered as invested capital.
>
> If the plant had been paid for by unissued stock, the limit of inclusion would be $50,000.00, except as qualified by any conception of a gift of the excess.

Treasury stock acquired by purchase is held at the purchase price. Donated treasury bonds seemingly should be set up as special surplus for purposes of invested capital without waiting until such securities are actually disposed of. The amount at which such securities should be held as donated surplus would be measured by the prorata of any property given therefor. When sold, the selling price would be a further addition to surplus.

Treasury bonds purchased in the open market or otherwise are held at purchase price when actually cancelled and applied to the retirement of the bond liability. The discount is a credit to surplus account and the premium paid thereon a charge to surplus. The premium or discount may be a charge or credit to the taxable income in some instances.

VI

RESERVES

Reserves under the federal tax laws are of the following kinds:

1. The depreciation reserve or allowance which is set up to represent the wear and tear that has taken place in physical property—buildings, machinery, equipment, etc.

   Such reserves are not considered as invested capital and cannot be added to the surplus account.
2. The reserve or allowance which is set up to take care of bad debts.

   Such a reserve is an addition to surplus account in that the bad debts are not an allowable deduction until actually written off.

---

[25] Article No. 54—Excess Profits Regulations.

As the bad debts charge is ordinarily made at the end of the taxable year, such a reserve outstanding at the beginning of the year is added in full to the surplus outstanding at the beginning of the year.

The bad debts reserve as invested capital is frequently overlooked.

3. The reserve set up which is in the nature of accrued liability, the accrual for which has not been taken as a deduction in computing the federal income tax.

The reserve of this kind is usually for federal taxes. Such a reserve is an addition to surplus until the taxes are actually paid and charged into such reserve.

A reserve for accrued interest, accrued deductible taxes, accrued wages or other accrued liability is often set up, the charge having been made to a profit and loss account. If the charge is thus made to income subject to taxation, the reserve is not an addition to surplus. Such items should not be called reserves, but accrued interest, accrued taxes, accrued wages, or commission, etc.

As a practical matter it is better not to set up a reserve for federal income and excess profits taxes. When such tax is paid it is charged to a reserve and is only invested capital for five and one-half months. If charged to the current year's earnings (1918) the surplus account would be unimpaired for twelve months.

The amount of the federal taxes could be indicated in a memo fashion.

4. The reserves set up for contingencies.

This reserve is the true type of reserve and is an addition to surplus. The contingencies may be of many kinds, drop in the market price of any investments or inventories, retrenchment due to development necessary after the war, etc.

5. The reserves set up for the retirement of the fixed liability.

Such a reserve is usually offset by a fund of some kind. If such a fund has been used to retire the liability, it has no effect on the reserve which still remains a surplus account.

VII

DIVIDEND CHARGES AGAINST SURPLUS

The status of dividend charges to surplus account as a deduction from invested capital is somewhat misunderstood. The proof of the method outlined by the return can be made by averaging the months and dividing by twelve. To illustrate:

Capital Stock	$50,000.00
Surplus balance January 1, 1918	75,000.00

Dividend declared and paid:

$5,000.00 February 1, 1918
5,000.00 May 1, 1918
5,000.00 August 15, 1918
5,000.00 November 10, 1918

Averaging the payments we have:

January	$125,000.00
February	120,000.00
March	120,000.00
April	120,000.00
May	115,000.00
June	115,000.00
July	115,000.00
August	112,500.00
September	110,000.00
October	110,000.00
November	106,666.66
December	105,000.00
	$1,374,166.66

divided by twelve equal $114,513.88.

The question comes up as to the effect on invested capital, of the recital in the law that dividends are deemed to be paid out of the most recently accumulated surplus, which means the earnings for the current year. While the law impliedly is aimed at a rate of taxation to be paid by the stockholder and is seemingly confined strictly to the income tax feature of the fiscal legislation, yet if the provision of the law is properly taken advantage of, there does not seem to be any reason why the current year's profits cannot be used to take up the dividends so as to leave the capital and surplus as intact as possible.[26]

The suggestion to keep in mind on this point is as follows:

1. The dividend declaration appearing in the minutes of a corporation should read to the effect that such dividends insofar as possible shall be a charge against the profits of the current year.

[26] Article 23, paragraph b and paragraph 2—Excess Profits Regulations. Item 63, Letter 10—Excess Profits tax series.

3. The method of computing is as follows:

The net profits for 1918 is $30,000.00
The dividends paid are:
$5,000.00 February 1, 1918
5,000.00 May 1, 1918
5,000.00 August 15, 1918
5,000.00 November 10, 1918

The $30,000.00 averaged monthly gives a monthly profit of $2,500.00. Therefore:

Twenty-five thousand dollars is a deduction from surplus created to the beginning of the year and $17,500.00 is a charge to surplus created from 1918 profits.

Where the capital and surplus of January 1, 1918 is $125,000.00; during 1918 it will be $122,708.33.

The capital and surplus beginning of January 1, 1919 will be $135,000.00.

4. Attach a rider to the return stating:

"The dividends paid by us in 1918 were charged against the profits which had been created in 1918 at the time such dividend was paid. The portion of the dividend that was not covered by earnings made when paid was charged to the surplus as it stood at the beginning of the year."

If the resolution in the minutes is not present as in the foregoing sections and if no account is specifically set up as noted, the same general suggestions contained in number three may be applied. The rider to be attached to the return would be phrased somewhat different from that of the rider set out in number four.

> "The dividends paid as in 1918 were deemed to be charged against the profits that had accumulated at the time the dividend was paid."

VIII

ADDITIONS TO CAPITAL LIABILITY

Additions to capital liability ordinarily are of three kinds:

1. New stock issued and paid in by cash, property, notes, etc.
2. Stock issued from "Surplus."
3. Earnings for the current taxable year.

The additions of the first class are prorated throughout the taxable year. To illustrate:

> A company issues $50,000.00 stock and receives payment therefor on July 1, 1918. The addition to the capital and surplus of the beginning of the year is $25,000.00.

A point to observe in connection with the foregoing kind of addition, is that the date or dates appearing on the capital stock account is not conclusive. The dates the subscriptions were paid fixes the beginning date from which to prorate.

The stock paid for by an earned surplus which was in the surplus account at the beginning of the year, is invested capital from the beginning of the taxable period. The stock paid for by a surplus that is earned, i. e., springs into being from an appraisal or some other manner is not invested capital unless the addition to surplus would have been sactioned as invested capital.

The earnings for the current year are not part of the invested capital of a corporation. Thus, if a corporation were to earn $100,000.00 during the taxable year and used such earnings in the business, it nevertheless could not consider such earnings as invested capital for the year.

GENERAL REMARKS

The House Bill for 1918 has specifically provided for the situation whereby one corporation, because of some discriminatory feature of valuation of invested capital is put at a disadvantage when compared with a competing business. For instance, one company may have incorporated prior to March 3, 1917 and thus is enabled to take advantage of good-will, reappraisal, etc., whereas another corporation may have not incorporated or reorganized until subsequent to March 3, 1917. However, the comparison is not to be made if 50% or more of the profits are from government contracts.

The law provides that a comparison of income to capital invested shall be made with representative concerns in the same or similar lines of business in the same general territory where,

1. The invested capital of the business under consideration is materially disproportionate to the net income as compared with representative corporations engaged in a like or similar trade or business.
2. The business is largely run on borrowed capital, particularly on long time borrowing, thus rendering the capital stock and surplus comparatively disproportionate to the actual capital invested.
3. The law also provides that a comparison shall be made with representative and competitive businesses;
   a. Where the data on the cost of the assets cannot be secured or where the dates, etc. cannot be brought out so as to give information for valuation purposes.

The corporation with an invested capital of $25,000.00 or less, after deducting its exemption of $3,000.00, shall pay as a maximum, not more than 35% of its income. The corporation with an invested capital of above $25,000.00 and not to exceed $50,000.00 shall pay as a maximum not more than 40% of its income, after deducting the exemption of $3,000.00. But the foregoing proviso shall not apply to any corporation whose net income exceeds $50,000.00.

The corporation which uses only nominal capital in its business is subject to a 20% flat tax after deducting the exemption of $3,000.00.

Under treasury decision No. 2689 the department outlines the method for computing the tax when only a portion of the year is considered. The decision covers situations:

1. The business which begins operations in the taxable year.

   In a situation like the foregoing the exemption and the invested capital is prorated over the full year. To illustrate:

   A corporation starts business on July 1, 1918 with a capital of $100,000.00. It's exemption for the year is 8% of $100,000.00 plus $3,000.00 or $11,000.00. It's exemption for six months is $5,500.00. Its invested capital is $5,000.00. The income, say of $20,000.00 is then distributed to it's proper taxable divisions.

2. The business which has it's fiscal year ending in the taxable year.

   In a situation like the foregoing the whole year is computed and that equal portion falling within the taxable year is taken as a measure. To illustrate:

   A corporation has a fiscal year ending April 1, 1918. The period from April 1, 1917 to April 1, 1918 is computed at the 1918 rate. One-quarter of this amount is the sum that is picked up. Against this sum is credited the 1917 tax which has already been paid for the three months period.

3. The business which changes it's fiscal year so as to end with the calendar year.

   In a situation like the foregoing the portion of the fiscal year falling within the taxable year is computed as in No. 2. The portion falling within the calendar year after the fiscal year is taxable as in No. 1. To illustrate:

   A corporation has a fiscal year ending April 1, 1918, and in August decides to change it's year back to end on December 31st. The period from January 1st to April 1st is computed as suggested, in No. 2. The period from April 1st to December 31st is computed as suggested in No. 1.

FREDERICK M. THULIN.

Chicago.

(TO BE CONTINUED)