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Invested Capital Under the Revenue Law

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Invested Capital Under the Revenue Law of 1916

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Invested Capital is the sum of—(Valued according to the law)

- I. Payments for stock or shares.
  - A. Cash.
  - B. Property other than cash.
    - 1. Tangible Property.
    - 2. Intangible Property
      - A. Prior to Mar. 3, 1917.
      - B. On or after Mar. 3, 1917.
- II. Other matters affecting invest-capital. ed capital.
  - A. Paid in Surplus.
  - B. Earned Surplus or Undivided Profits.
- III. Adjusted for Inadmissible Assets.

INVESTED CAPITAL UNDER THE REVENUE LAW

The invested capital of a corporation in many cases determines very materially the amount of excess or war profits tax which the corporation is obliged to pay under the Revenue Act approved February 24th, 1919, called the Revenue Act of 1918. It is not intended in this article to explain the nature of the relation between the tax and the invested capital, but it is intended to give in some detail an analysis of this one step leading to the ultimate determination of the tax, viz., determination of the invested capital. Only the normal method of determining invested capital, which is prescribed in Section 326 of the law, will be considered. Cases where the invested capital cannot be determined according to Section 326, or where relief is given on account of abnormal conditions as provided in Section 327, and cases of reorganizations after March 3d, 1917, as provided in Section 331, will not be considered. The adjustment for changes in invested capital during the taxable year[1] is also excluded.

The words "Invested Capital" have a technical meaning under the law, and the invested capital seldom if ever corresponds to the capital invested in the corporation as the term is ordinarily understood. Neither does invested capital necessarily or even usually correspond to the fair market value of the capital stock, which is the measure of the capital stock tax.[2] The failure to make these distinctions is the source of endless confusion among taxpayers.

The preceding remarks have in view the effort to arrive at invested capital as provided in the law and as interpreted by the Treasury Department. There remains the further question, which will probably be litigated, whether the law levying the tax based on invested capital as so computed is constitutional. The present law purports to be an *income tax* and must be justified in its present shape, if at all, by the sixteenth amendment to the constitution of the United States. As will be hereafter explained, the Act in most instances disregards appreciation of capital assets for purposes of invested capital, and this gives rise to the question whether such a tax is an income tax within the meaning of the amendment, particularly with reference to appreciation occurring prior to March 1st, 1913, when the amendment became effective. It has also been sug-

1. Section 326 (d). (Hereafter all references to sections will refer to the Act of 1918.)
2. Section 1000.

gested that appreciation up to the beginning of the taxable year must be taken into account. Certain industries which are greatly affected have arranged to contest these questions, but at the present writing it is believed that no decision has been reported.

Invested capital, according to the Revenue Act, is primarily an historical proposition. It is necessary to determine what was actually put into the corporation at the beginning and also to review all of the changes that took place in the capital from the original incorporation to and through the taxable year. The chart accompanying this article shows an analysis of invested capital according to the class of asset. This article will treat of the various classes in the order in which they appear on the chart. The order in which they are mentioned in the law is somewhat different, as the arrangement of the law is not logical in all particulars.

I. PAYMENTS FOR STOCK.

A. CASH.

The law reads: "actual cash bona fide paid in for stock or shares."[3] Amounts paid in by shareholders after the shares were received, for instance pursuant to an assessment, would also be included in invested capital but not under this class, as such payments would not be paid in *for stock or shares* but rather paid in surplus under Section 326 (a) (3).

Ordinarily it is a simple matter to determine whether cash has been paid for stock or shares, but where stock is issued as a bonus in connection with the sale of bonds of a corporation, the price covering both stock and bonds, it has been ruled[4] that such bonus stock may be included in invested capital only where the corporation proves to the satisfaction of the Commissioner that the issuance of the bonus stock enabled the corporation to secure a higher price for the bonds. Such excess may be treated as amounts paid in for stock.

Where amounts paid in for stock have been directly or indirectly liquidated or returned to the stockholders, such amounts no longer are computed as invested capital.[5] Such a return of capital should be distinguished from an operating deficit resulting in impairment of capital or surplus actually paid in, which is not considered as reducing the invested capital.[6]

If the corporation, either directly or indirectly, as through a trus-

3. Section 326 (a) (1).
4. Article 832. (Hereafter all references to articles will refer to Regulations 45 Revised).
5. Article 860.
6. Article 860.

tee, acquires its own stock, deduction of the cost thereof must be made from invested capital, since the money so paid out is no longer employed in the business of the corporation.[7] The justification of the ruling last mentioned must be by implication of the statute, as no direct provision of the law is found.

The Department has ruled[8] that where stock has originally been issued or exchanged by the corporation for tangible or intangible property and is returned to the corporation as a gift or for a consideration substantially less than its par value, the stock so returned shall not be treated as a part of the stock issued or exchanged for such property. It is submitted that this regulation should be rewritten. The regulation is almost an exact copy of Article 54 of Regulations 41, which it will be remembered were compiled in great haste to interpret the War Revenue Act of October 3d, 1917. It probably aims at the practice of turning physical or intangible property in for stock of a corporation at an inflated value, and then remedying the inflation, so far as the other stockholders are concerned, by a donation of part of the stock back to the corporation or a sale to the corporation at value less than the par value. This procedure would result in an inflation of the invested capital to the extent of the overvaluation of the property turned in. However, the terms of the Act sufficiently provide against inflation of property turned in for stock, and it does seem that the situation would be fully met by a provision that such subsequent dealing with stock will be regarded by the Commissioner as evidence that the original valuation of the property exchanged for stock was excessive The ruling at all events is too broad in that it includes subsequent surrender of stock which was paid for by cash, for cash is tangible property under the Revenue Act.

The preceding remarks concerning retirement and liquidation of stock, although occasioned by the treatment of subdivision I-A "Cash Paid in For Stock or Shares," apply as well to payments of property other than cash for stock or shares.

B. PROPERTY OTHER THAN CASH.

1. Tangible Property.

The law reads: "actual cash value of tangible property, other than cash, bona fide paid in for stock or shares, at the time of such payment, but in no case to exceed the par value of the original stock or shares specifically issued therefor, unless the actual cash value of

7. Article 862.
8. Article 861.

such tangible property at the time paid in is shown to the satisfaction of the Commissioner to have been clearly and substantially in excess of such par value, in which case such excess shall be treated as paid-in surplus."[9] Note the use of the words "actual cash value" as distinguished from "fair market price or value" used elsewhere in the income tax law.[10] It is not known whether these phrases are absolutely equivalent. Promissory notes are tangible property as defined in the law.[11] The Department has ruled[12] that enforceable notes or other evidences of indebtedness of the subscriber, received by a corporation upon a subscription for stock, may be treated as tangible property for invested capital to the extent of the actual cash value of such notes or evidences of indebtedness at the time when paid in, but only (a) if such notes or other evidences of indebtedness could under the laws of the jurisdiction in which the corporation was organized legally be received in payment for stock, and (b) if they were actually received by the corporation as absolute and not as conditional payment for stock. The fact that the security is non-interest bearing is not material. Presumably a note due at some future date will be deemed "enforceable." The ruling also seems to contemplate that the subscriber giving the note has other assets sufficient to pay the note, as otherwise it would not be enforceable. The matter is further conditioned on permission of the state corporation laws. But with all of these qualifications it still seems that an opportunity is given figuratively to "lift one's self by one's bootstraps." For instance, let a man who has $10,000 pay it into a corporation which he is forming and the invested capital will be only $10,000. But let the man pay in $10,000 receiving stock which will presumably be worth $10,000, and then let him subscribe for $10,000 more par value of stock, paying in his note therefor. The note will be enforceable as the maker will own the other $10,000 par value of stock, presumably worth par. The note might be made for a long maturity and without interest so that it would not prove embarrassing. The result would be invested capital of $20,000, making two dollars of invested capital "grow where one grew before." It would seem possible, therefore, that the Department will be compelled to recede from the ruling above mentioned, and it does seem that the law could properly be held to mean notes of third persons, as these are property in a sense different from one's own note, which is a mere promise.

9. Section 326 (a) (2).
10. Section 202 (a).
11. Section 325 (a).
12. Article 833.

The section of the law under discussion does not require that the tangible property paid in shall be what is called "admissible assets."[13] The deduction for inadmissible assets, as will be hereafter explained, is not dependent on the status when paid in but the status on the date as of which invested capital is determined.

Since different rules apply to payments of tangible and intangible property for stock, it is necessary to make an apportionment when a mixed aggregate of tangible and intangible property is paid in for stock and for bonds or other evidences of indebtedness. The ruling[14] is merely the statement of a prima facie presumption of evidence in such a case in the absence of satisfactory evidence to the contrary, it being presumed that the bonds were issued for tangible property and the stock was issued for the balance of the tangible property, if any, and for the intangible property. The exact meaning of this ruling is not clear.

As it is customary to have the par value of stock at least as great as the fair value of the property exchanged therefor, it is provided in the first instance that such value for purposes of invested capital shall not exceed the par value of the stock specifically issued therefor. At the same time it is recognized that on account of peculiar circumstances property is often turned in for stock at a value admittedly less than its true value. Various motives induce such action. For instance, it may be done to secure lower assessments for local taxes or to reduce the franchise fee on incorporation, or merely to be ultra-conservative. The law permits the corporation to show that the actual cash value of such tangible property was (1) clearly and (2) substantially in excess of such par value, and upon so doing to include such actual cash value as invested capital. The Commissioner has indicated[15] the nature of evidence which may be submitted in connection with the valuation and has stated that generally allowable claims will arise out of transactions where there has been no substantial change in the beneficial interest in the property paid in to the corporation.

2. Intangible Property.

a. Prior to March 3d, 1917.

Having treated of tangible property paid in for stock, we come to intangible property paid in for stock which may be (a) prior to March 3d, 1917, or (b) on or after March 3d, 1917. March 3d, 1917, was the date of approval of the first excess profits law, and is fixed

13. Article 834.
14. Article 835.
15. Article 836.

on the presumption that transactions prior to that date were not influenced by considerations of invested capital. The portion of the law applying to this situation is:

> "Intangible property bona fide paid in for stock or shares prior to March 3, 1917, in an amount not exceeding (a) the actual cash value of such property at the time paid in, (b) the par value of the stock or shares issued therefor, or (c) in the aggregate twenty-five per centum of the par value of the total stock or shares of the corporation outstanding on March 3, 1917, whichever is lowest;"[16]
>
> "Provided, that in no case shall the total amount included in paragraphs (4) and (5) exceed in the aggregate twenty-five per centum of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year;"[17]

In contrast to the ruling in case of tangible property, the limitation in the law of the value of intangible property paid in prior to March 3, 1917, is conclusive. It will be of no avail to show that such intangible property was of greater value than the par value of the stock or shares issued therefor, nor to show that the value exceeded in the aggregate twenty-five per centum of the par value of the total stock outstanding on March 3, 1917. The regulations indicate the nature of evidence desired relating to the value of intangible property.[18] Probably, the severe limitations on intangible property were induced by the fact that such property is difficult to accurately appraise, and overvaluation of it is hard to deduct.

b. On or After March 3, 1917.

The portions of the law applying to intangible property paid in for stock or shares on or after March 3, 1917, are as follows:

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

16. Section 326 (a) (4).
17. Section 326 (a) (5).
18. Article 851.

five per centum of the par value of the total stock or shares outstanding at the beginning of the taxable year."[19]

The remarks under intangible property exchanged prior to March 3, 1917, apply also to the present class. It would appear that the only purpose served by making two classes is to apply the twenty-five per cent limit on March 3, 1917, as to intangible property exchanged for stock prior to that date. This would hardly be a sufficient reason for such a complication, but an examination of the legislative history of the revenue bill of 1918[20] shows that the bill as introduced into the House of Representatives would have excluded all kinds of intangible property exchanged for stock on or after March 3, 1917, excepting only patents and copyrights. This was changed by the Senate Finance Committee by broadening the latter provision instead of rewriting the two provisions into one. This is only one of the many instances where unnecessary complexities in the law have arisen out of the legislative history of the bill.

The foregoing discussion concludes the treatment of the first principal division of the chart entitled "Payments for Stock or Shares."

II. OTHER MATTERS AFFECTING INVESTED CAPITAL.

To the sum of the payments for stock valued according to the regulations must be added the other matters affecting invested capital.

A. Paid-in Surplus.

The law reads: "paid in * * * surplus and undivided profits not including surplus and undivided profits earned during the year;"[21] The regulation states:[22]

> "Where it is shown by evidence satisfactory to the Commissioner that tangible property has been paid in by a stockholder to a corporation as a gift or at a value clearly and substantially in excess of the cash or other consideration paid by the corporation therefor, then the amount of the excess shall be stated to be paid in surplus."

While only tangible property is included in the regulation, the law would seem to authorize inclusion as well of cases where intangible property was paid in.

Where cash has been paid in there will be no question unless it appears that a dividend has been paid out of current earnings and then

19. Section 326 (a) (5).
20. H. R. 12863.
21. Section 326 (a) (3).
22. Article 837

the stockholders have paid back all or a substantial part of such dividend. As this would be a subterfuge resulting, if permitted, in adding part of the current year's earnings to invested capital, it is provided[23] that such amounts so paid back cannot be included in invested capital unless the corporation shows by evidence satisfactory to the Commissioner that the dividends were paid in good faith and without any understanding, express or implied, that they were to be paid back.

B. Earned Surplus or Undivided Profits.

The law reads: "* * * earned surplus or undivided profits; not including surplus and undivided profits earned during the year;".[24] Numerous questions arise concerning earned surplus and undivided profits.[25] The books of account of a corporation are not necessarily controlling where they do not show the true earned surplus. Adjustments are required in many cases, and in some instances the taxpayer is permitted to make changes in the accounts which materially increase the invested capital and thereby decrease the tax. All losses sustained or expenses incurred must be recognized.[26] It is stated that there can be no earned surplus or undivided profits until any impairment of capital or deficit due to depletion, depreciation, expense, losses or any other cause, has been made good.[27] Depletion must be recognized notwithstanding the limitation or denial of the deduction for this purpose under previous tax laws.[28] Under some circumstances and with minute limitations, additions may be made to invested capital to correct charge-offs, as for excessive depreciation, or patents arbitrarily charged down, or capital items erroneously charged to expense. In many cases accounts have been written down for purposes of ultra-conservatism far below their proper value, and in such cases the regulations should be consulted to ascertain whether the particular change may be made. So far as a general rule is deducible from the rulings on specific cases, it seems to be that *errors* may be corrected, but where an option is given by accounting practice and exercised for the corporation's benefit with respect to the income tax, the accounts may not now be recast granting a greater benefit under the excess and war profits law.[29]

Appreciation of value of capital items not consummated by a sale is not considered as invested capital. But where the appreciation

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23. Article 850.
24. Section 326 (a) (3).
25. Articles 838 to 850 inclusive; Articles 857 and 858.
26. Article 838.
27. Article 838.
28. Article 839.
29. Articles 839, 840 and 841.

is realized it may be included. Accordingly reserves for depreciation or depletion may be analyzed to determine whether they contain any such realized appreciation, and if so, such amount may be included in invested capital.[30] Ordinary reserves for any purpose that is allowed for income tax are not to be included in invested capital.

Whether or not actually made, a reserve for income and profits taxes must be considered in determining invested capital.[31]

The cash surrender value at the beginning of the taxable year of a policy of insurance carried by the corporation for its benefit on the life of an officer or employee may be included in surplus,[32] since the premiums are not an allowable deduction for the income tax.[33]

III. ADJUSTMENT FOR INADMISSIBLE ASSETS.

The invested capital is the sum of the amounts mentioned under I and II, but must be adjusted for inadmissible assets.

The portions of the law governing this adjustment are: "There shall be deducted from invested capital as above defined a portion thereof equal to the percentage which the amount of inadmissible assets is of the amount of admissible and inadmissible assets held during the taxable year."[34] "* * * But where the income derived from such [inadmissible] assets consists in part of gain or profit derived from the sale or other disposition thereof, or where all or part of the interest derived from such assets is in effect included in the net income because of the limitation on the deduction of interest under paragraph (2) of subdivision (a) of Section 234, a corresponding part of the capital invested in such assets shall not be deemed to be inadmissible assets;"[35]

The term "inadmissible assets" means stocks, bonds and other obligations (other than obligations of the United States), the dividends or interest from which is not included in computing net income.[36]

The term "admissible assets" means all assets other than inadmissible assets valued in accordance with the provisions of subdivision (a) of Section 326, Section 330, and Section 331.[37]

The purpose of the deduction for inadmissible assets is to prevent an inequality of taxes which would result were certain classes of assets to be included in invested capital while the income from these

30. Article 844.
31. Article 845.
32. Article 846.
33. Section 215 (d).
34. Section 326 (c).
35. Section 325 (a).
36. Section 325 (a).
37. Section 325 (a).

was exempt from tax. The result would be a correspondingly smaller tax on the income of the corporation derived from other sources. The exception of obligations of the United States in the definition of inadmissible assets was purposely given to increase the value to corporations of Liberty Bonds and other government securities.

It was discovered that the exclusion of assets, the income of which is free from income tax, would work a hardship on dealers in securities and others who made profits from the sale of such tax-free assets, as the profit on the *sale* of such assets is not tax free. It would be possible to state a case where there would be a taxable income from the sale of such assets and no invested capital at all. Therefore it was provided in the portion of Section 325 (a) above set forth that in such case a *corresponding* part of the capital invested in such assets should be included as invested capital.

The "limitation of interest" referred to in Section 325 (a) is interest on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917), the interest upon which is wholly exempt from taxation under title II as income to the taxpayer.

The Department has not as yet ventured to exactly define the "corresponding" part which may be considered invested capital. Montgomery has given his hypothesis,[38] but the matter is by no means clear. In this state of the rulings it is not deemed advisable to treat this class in more detail.

The percentage to be deducted for inadmissible assets where there are not present the complications suggested above, is plain. The admissible and inadmissible assets, properly valued, are added together and the percentage which expresses the ratio between the inadmissible assets and the sum so found is the percentage to be used. Having made such deduction for inadmissible assets, if any, the remainder is invested capital for the date as of which the computations are made.

The law specifically states that borrowed capital is not invested capital.[39] It would not have been included in invested capital even if this specific provision were not present as the computation prescribed would result in its exclusion.

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38. Supplement to Income Tax Procedure, 1919.
39. Section 326 (b)..