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1. BANK, STATE OR NATIONAL — WHERE ACCOUNTING RECORDS SHOW VALUATION OF CAPITAL, SURPLUS, RESERVE AND UNDIVIDED PROFITS IN SEPARATE CLASSIFICATIONS SHOWING RESERVES FOR DESIGNATED CONTINGENCIES, ALL OF SUCH ITEMS MUST BE INCLUDED IN TAX BASE COMPUTED BY TAX COMMISSIONER — ASSESSMENT — TAXABLE SHARES — SECTION 5412 G. C.

2. WHERE FINANCIAL INSTITUTION FILES WITH TAX COMMISSIONER BALANCE SHEET WHICH SHOWS DEDUCTIONS FROM BOOK VALUE OF SPECIFIC ASSETS—ITEMS DESIGNATED AS RESERVES AGAINST VALUE OF SPECIFIC ASSETS—SUCH ITEMS NOT RESERVE FUND — SHOULD NOT BE INCLUDED IN TAX BASE COMPUTED BY TAX COMMISSIONER.

SYLLABUS:

1. When a state or national bank maintains its accounting records showing valuation of its capital, surplus, reserve and undivided profits in separate classifications showing reserves for designated contingencies, all of such items must be included in the tax base computed by the Tax Commissioner in assessing its taxable shares under authority of Section 5412 of the General Code.

2. Where, on the balance sheet filed by a financial institution with the Tax Commissioner for purposes of taxation, deductions from the book value of the specific assets are shown and such items are designated as reserves against the value of such specific assets, such items do not constitute a reserve fund and should not be included in the tax base computed by the Tax Commissioner under authority of Section 5412 of the General Code.

Columbus, Ohio, June 21, 1943.

Hon. William S. Evatt, Tax Commissioner of Ohio,
Department of Taxation,
Columbus, Ohio.

Gentlemen:

Your request for my opinion is as follows:

"You are respectfully referred to an opinion of your office appearing in Opinions of the Attorney General for 1932, Volume II, page 1165 and those following, in which the Attorney General in commenting upon the provisions of Section 5408, General Code, as applicable to banks, construed such section as requiring the then Tax Commission to deduct from the investment assets of any bank as assessed by the Tax Commission, those reserves which have been ordered by the Superintendent of Banks to be set up on the books of the bank, under the provisions of Section 710-111, General Code, for the purpose of reducing such asset value where he finds that such value does not exist.

It has come to our attention that various banks, both State and National, set up on their books, as liabilities, certain reserves for contingent or potential future loss as applicable to loans, investments, real estate and other assets. It is our understanding that, in the interest of establishing a more conservative policy relative to bank accounting, it is the policy of the Superintendent of Banks to recommend to the banks that such reserves be established and that, relative to National Banks, the Comptroller of the Currency is committed to a like policy.

Your opinion is respectfully requested, applicable to both State and National Banks relative to the following question: Under the provisions of Sections 5408 and 5412 of the General Code, may a bank which maintains its accounting records as required by law, in determining the book value of its taxable shares, or the value of the property representing the capital employed by such financial institution, not divided into shares, as the case may be, deduct from the capital, the surplus or reserve fund and the undivided profits, reserves for contingent or potential future loss when such loss has not occurred and when such reserves (1) have not been ordered or approved by the official regulatory authority (2) when such reserves have been ordered or approved by the official regulatory authority?"

The part of the opinion of my predecessor to which you refer is that summarized in the third paragraph of its syllabus, which reads:

"3. When a bank maintains its accounting records as required by section 710-111, General Code, such corporation in determining the book value of its shares, may not deduct from the capital and surplus reserves for taxes, whether due and payable, but when it has set up a reserve at the direction of the Superintendent of Banks, who had directed that a certain sum be either deducted from its assets or a reserve be set up equal to such sum, such item of reserve should be considered and deducted from the value of the bank's investment assets in determining the book value of the shares of the bank for the purposes of taxation."

The General Assembly of Ohio has provided a specific method for the taxation of the property of banks in Sections 5406 to 5414 of the General Code. Thus:

1. Section 5409 of the General Code provides that the real property of a financial institution shall be taxed by the same method as that owned by individuals.

2. Section 5408 of the General Code provides a method for the assessment of "all the shares" of such institutions.

3. Sections 5406, 5411-1 and 5412 of the General Code provide for the assessment of "deposits" in financial institutions.

The definition of "financial institutions" contained in Section 5407 of the General Code includes "banks", whether organized under state or federal laws, within such term and whether incorporated or unincorporated. Section 5408 of the General Code, referred to in your request, reads:

"All the shares of the stockholders in a financial institution, located in this state, incorporated or organized under the laws of the state or of the United States, the capital stock of which is divided into shares, excepting such as are defined as 'deposits' in Section 5324 of the General Code, and all the shares of the stockholders in an unincorporated financial institution, located in this state, the capital stock of which is divided into shares held by the owners of such financial institution, and the capital employed, or the property representing it, in a financial institution the capital of which is not divided into shares, or which has no capital stock, located in this state, shall be listed and assessed at the book value thereof, and taxed in the manner provided in this chapter."

As you are already aware such section provides for the taxation of the shares of the financial institution in the event it is incorporated; and, if not incorporated, for the taxation of the "capital employed or property representing it". Such section provides that if the bank is unincorporated its "capital employed or property representing it", and if incorporated the shares, shall be listed and assessed at the book value thereof and taxed as otherwise provided in this chapter. The "in the manner provided in this chapter" is contained in Section 5412 of the General Code. Section 5411 of the General Code requires that each financial institution file annually with the Department of Taxation a report "exhibiting in detail, and under appropriate heads, the resources and liabilities of such institution at the close of business on the thirty-first day of December next preceding" the filing of the report. Section 5412 of the General Code then, in so far as incorporated financial institutions are concerned, provides that:

> "Upon receiving such report the tax commission(er) of Ohio shall ascertain and assess all the taxable shares of such financial institution, * * * at the aggregate amount of the capital, the surplus or reserve fund and the undivided profits as shown in such report, * * *. Such amounts shall be assessed in the name of such financial institution * * *. In the case of an incorporated financial institution all of whose shares constitute deposits as defined in section 5324 of the General Code such assessment of shares shall exclude the capital stock thereof as so shown but shall include the surplus or reserve and undivided profits so shown."

and that with respect to unincorporated financial institutions he "shall ascertain and assess * * * the value of the property representing the capital" in a similar manner.

You will observe that the General Assembly, by the enactment of Section 5412 of the General Code, has directed you, as Tax Commissioner, to ascertain and assess the shares of an incorporated financial institution "at the aggregate amount of the capital, the surplus or reserve fund and the undivided profits, as shown in such report".

The term "capital" or "capital stock" as applied to corporations is generally understood to be the value of the property or means contributed by the stockholders as the fund for the conduct of the enterprise for which the corporation is created.

Iron Railroad Company v. Lawrence Furnace Co., 49 O. S., 102

Bradley v. Bauder, 36 O. S. 28

State, ex rel. v. Jones, 51 O. S. 492

Lee, Treas. v. Sturges, 46 O. S. 153

The term "surplus" as applied to corporate accounting, when used in its broadest sense, is that sum which represents the difference between the value of the assets of the corporation and its capital and liabilities. Bennett, Corporate Accounting, 93. If the corporation originally sells its shares at more than par the amount received therefor in excess of the par value thereof constitutes a paid-in surplus. Section 8623-23, General Code.

Guthmann, Analysis of Financial Statements, 32

Finney, Principles of Accounting, Chap. 7, page 14

A surplus may also arise through the operations of the corporation.

However, in Ohio, for the purposes of the banking law, the term surplus is defined in Section 710-1 of the General Code as follows:

> "The term 'surplus' means a fund created pursuant to the provisions of sections 710-37 and 710-130 of the General Code by a bank or trust company from its net profits."

Section 710-37 of the General Code requires each bank to have a paid in surplus at least equal to 20% of its capital. Section 710-130 of the General Code requires each bank semi-annually to set aside from its net profits into a surplus account 10 percentum thereof until such surplus equals 100 percentum of its capital. Similar provision is made with respect to a trust company in Section 710-167 of the General Code. It would, therefore, seem that for the purposes of the banking act a somewhat narrower meaning is given to the term "surplus fund" than the broad definition above set forth. However, with respect to building and loans, I find no such statutory definition of a surplus.

In Ohio the building and loan statutes authorize "reserve funds" to be created. In accounting practice when, from the excess of the assets of a corporation over its capital sums are reserved or set aside for a particular purpose and specified funds or property are set aside or invested or permitted to remain with the company but earmarked to meet such purpose or contingency, a reserve is said to have been created. Bennett, Corporate Accounting, page 323, Section 282; 2 Finney, Principles of Accounting, Chap. 46, page 1; Section 8623-38, General Code. The term has been defined as "amounts set aside from the surplus account for specific purposes". Guthmann, Analysis of Financial Statements, Revised Edition, page 37. In Section 9659 of the General Code building and loan associations are authorized to create a "reserve fund" for the payment of contingent losses and an "undivided profit fund". Section 9671 of the General Code further defines a building and loan association reserve fund. Such section reads:

> "The amount to be set aside to the reserve fund, for the payment of contingent losses shall be determined by the board of directors, but in all permanent or perpetual association, at least five per cent of the net earnings shall be set aside each year to such fund until it reaches at least ten per cent of the total assets. All losses shall be paid out of such fund until it is exhausted. When the amount in such fund falls below ten per cent of the assets as aforesaid, it shall be replenished by annual appropriations of at least five per cent of the net earnings as hereinbefore provided until it again reaches such amount. Provided, that if the reserve fund of an association which has deposits greater than the aggregate amount of stock credits, reserve, and undivided profits, exceeds at any time three per cent of the total assets of the association, and thereafter declines to three per cent of such assets, whenever, and as long as, such reserve fund amounts to less than three per cent of such total assets, the association shall pay no dividends on its stock."

The term "undivided profits" in its broadest sense is almost synonymous with the broad meaning of "surplus" above set forth, except that it does not include paid in surplus. Paton's Accountants' Handbook, Second Edition, page 154. However, in modern accounting it usually refers to that portion of the surplus of the company which has not been set aside or earmarked for particular purposes or contingencies. As stated in Paton's Accountants' Handbook, Second Edition, page 154:

> "In the case of the corporation a considerable group of accounts is often used to display the stockholders' equity. In the first place is the capital stock account (one for each class or type of stock), an account which controls the ledger of stockholders' accounts? In the case of par-value stock it is customary to credit par to the capital stock account proper, which necessitates—where

the stock is issued for more or less than par—the use of special supplementary accounts for premium or discount, as the case may be. In some instances the total authorization is set up in the capital stock account and this practice requires the use of a special contra account for unissued stock, if any. Stock purchased by the corporation is sometimes charged to a special treasury stock account for a time, instead of to the main account, and this special account is another example of an offset for contra account. 'Donated' stock is often similarly handled. See Section for discussion of capital stock.

In the second place is the surplus or undivided profits account (often called the profit and loss account) in its various manifestations. In banking, both general titles are employed, surplus to designate premiums originally paid in and earnings definitely accumulated (although not formally capitalized) either as a result of statutory requirements or of the policies of the board of directors, or both, and undivided profits to indicate the amount of earnings not appropriated and hence available for dividends. Outside of the banking field, however, this practice is seldom found."

In Sections 5408 and 5412 of the General Code it would seem that the General Assembly, in prescribing the tax base upon which the property tax is levied, has decreed that the aggregate book value of all proprietary accounts of a company shall constitute such base; that is, the tax base includes the capital—the value of property contributed by the stockholders in exchange for their shares, the surplus fund—whether required by statute as an addition to capital or otherwise, the reserve fund—surplus earnings set aside or earmarked for particular purposes or contingencies and undivided profits—surplus earnings of the company not yet distributed to shareholders or earmarked on the accounting records of the company to "surplus" or "reserve fund".

In ordinary accounting the reserve fund of a corporation may be broken down into many different items depending upon the purposes for which it is created as "sinking fund reserve", "reserve for depreciation", "reserve for depletion", "reserve for bad debts", "reserve for contingent losses", "reserve for self-insurance", etc. In Guthmann, Analysis of Financial Statements, page 38, the author tersely classifies reserve items shown on the balance sheet as follows:

"For the proper understanding of reserves, it is necessary to classify them according to their relation to the other three classes of accounts in the balance sheet. They fall into three groups, although the analyst will find borderline cases which will be difficult to classify. The groups are:

1. Reserves that offset assets.

2. Reserves that are actual liabilities.

3. Reserves that are surplus."

It would appear that the General Assembly, in the enactment of the tax statute under consideration, has fixed the tax base for financial institutions as the value of its capital and of its surplus fund as that term is used in its broadest meaning, including the undivided profit fund, reserve fund for contingent losses and other reserve funds by whatever terms denominated. Such being true, it would seem that whether such funds are created by order of the superintendent of banks, building and loans, or otherwise, they must be included by you in computing the tax base of financial institutions.

You will observe, however, that in Section 5412 of the General Code the General Assembly, in defining the tax base, uses the terms surplus fund and reserve fund. It would, therefore, appear that unless the reserve shown on the balance sheet is a reserve fund against which certain charges are to be made in the event of the happening of a contingency, there has been no attempt on the part of the General Assembly to include it as a part of the tax base. In accounting practice the term "reserve" is used not only as designating reserve funds, but also to specify deductions from the book valuation of specific assets. Thus, in preparing the statement of the assets of a corporation the book value of the assets may be reflected and also on the asset side of such report immediately thereunder will appear an item sometimes designated a "reserve" which is subtracted from the book value of such asset in order to cause the total value of the assets to reflect the true value, rather than the book value which has not yet been reduced to the true value. In other words, such charge appearing on the asset side of the statement of assets and liabilities would indicate that the loss has already been charged against the reserve fund and the book loss taken on the specific asset.

I am informed that when the superintendent of banks or the comptroller of the currency upon examination of the affairs of a bank has found that the book value of an asset is excessive and he has determined the true value and has ordered a mark-down of specific assets and that in some instances the return may be made for purposes of taxation by the financial institution before such deduction has been made upon the books of the bank against the book value of specific assets, it would appear to me that such type of a reserve does not constitute a fund and, therefore, could not be a "reserve fund" such as mentioned in Section 5412 of the General Code.

Specifically answering your inquiry, it is my opinion that:

1. When a state or national bank maintains its accounting records showing valuation of its capital, surplus, reserve and undivided profits in separate classifications showing reserves for designated contingencies, all of such items must be included in the tax base computed by the Tax Commissioner in assessing its taxable shares under authority of Section 5412 of the General Code.

2. Where, on the balance sheet filed by a financial institution with the Tax Commissioner for purposes of taxation, deductions from the book value of the specific assets are shown and such items are designated as reserves against the value of such specific assets, such items do not constitute a reserve fund and should not be included in the tax base computed by the Tax Commissioner under authority of Section 5412 of the General Code.

Respectfully,

THOMAS J. HERBERT,
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