1929

1. TAX COMMISSIONER—BALANCE SHEET FILED IN CONFORMITY WITH BOOKS OF ACCOUNTS BY BANK OR FINANCIAL INSTITUTION—PURPOSE OF TAXATION—STATUS OF "RESERVES," "SURPLUS RESERVES," "RESERVE FUND"—TAX BASE COMPUTED—SECTION 5412 G. C.

2. STATE OR NATIONAL BANK—BOOKS SHOWING VALUATION OF CAPITAL, SURPLUS, RESERVES AND UNDIVIDED PROFITS—SEPARATE CLASSIFICATIONS—LIABILITY SIDE OF BALANCE SHEET—RESERVE FOR CONTINGENCIES OR GENERAL RESERVES—TAX BASE COMPUTED.

3. STATUS RESERVES FOR CONTINGENCIES OR GENERAL RESERVES SHOWN ON LIABILITY SIDE OF BALANCE SHEET—TAX BASE COMPUTED BY TAX COMMISSIONER—ASSESSMENT OF TAXABLE SHARES.

SYLLABUS:

1. Where, on the balance sheet filed in conformity with its books of account by a bank or financial institution with the Tax Commissioner for purposes of taxation, reserves deducted from the gross book value of the specific assets or specific classes of assets listed therein are shown and the net book value of such specific assets or specific classes of assets are shown on the asset side of such balance sheet and such deductions are designated as reserves against the gross book value of such specific assets or specific classes of assets, such reserves are not surplus reserves and do not constitute a "reserve fund" or a part thereof and should not be added to or included in the tax base computed by the Tax Commissioner under authority of Section 5412, General Code.

2. Where a state or national bank maintains its books of account showing the valuation of its capital, surplus, reserves and undivided profits in separate classifications and showing on the liability side of its balance sheet filed in conformity with its books of account a reserve for contingencies or general reserves, even though allocated on the bank's books of account or records to specific assets or specific classes of assets, all of such reserves for contingencies or general reserves so shown on the liability side of such balance sheet should be added to or included in the tax base computed by the Tax Commissioner in assessing its taxable shares under authority of Section 5412, General Code.

3. Where a state or national bank maintains its books of account showing the valuation of its capital, surplus, reserves and undivided profits in separate classifications and showing on the liability side of its balance sheet filed in conformity with its books of account a reserve for contingencies or general reserves, all of such reserves for contingencies or general reserves so shown on the liability side of such balance sheet should be added to or included in the tax base computed by the Tax Commissioner in assessing its taxable shares under authority of Section 5412, General Code.

Columbus, Ohio, June 22, 1950

Hon. C. Emory Glander, Tax Commissioner of Ohio,
Department of Taxation
Columbus, Ohio

Dear Sir:

Your request for my opinion reads as follows:

> "I respectfully request your opinion with respect to the determination of the book value of shares of a financial institution under the provisions of Section 5408 et seq. of the General Code. That section states that the shares shall be listed and assessed 'at the book value thereof.' Section 5412 requires me to ascertain and assess all the taxable shares of a financial institution 'at the aggregate amount of the capital, the surplus or reserve fund and the undivided profits,' as shown in the report made by the financial institution.

"My difficulty in determining the value of shares under the above sections arises out of the fact that banks maintain different types of reserves in their accounting practices. These reserves seem to fall into three general classes which are as follows:

(1) Most banks maintain valuation reserves which are deducted from specific classes of assets on the asset side of the balance sheet in the banks' published report of condition. The most common of these valuation reserves is probably the so-called 'reserve for bad debts.'

(2) A second type of reserve has substantially the same purpose as the reserve mentioned above under (1), except on the bank's published report of condition it is not deducted from the asset side of the balance sheet, but it appears on that statement on the liability side as all or a part of 'reserves for contingencies' or 'general reserves.' Under this type of reserve there is an allocation on the bank's books to speccific classes of assets.

(3) The third general type of reserve is that part of the 'reserve for contingencies' or 'general reserve' which is not specifically allocated to any assets or class of assets. This reserve is maintained for unforeseen or indeterminate liabilities which are not otherwise reflected on the bank's books.

"Specifically, I would like your opinion as to which, if any, of the foregoing classifications of reserves I may properly include in the book value of the shares of a financial institution.

"I may further explain that the above mentioned 'reserve for bad debts' has become important because of recent rulings of the Commissioner of Internal Revenue, permitting banks to set aside such a reserve under a prescribed formula based upon previous loss experience of the bank over a twenty year period. Apparently the Federal and State supervising authorities require these reserves to be deducted from the asset side of the bank's balance sheet. Practically all banks have established reserves of this character and they insist that sound, conservative banking requires their maintenance in the light of past experience.

"Many banks for the same reason have also established similar reserves against such classes of assets as 'securities.'

"Your attention is called to two opinions of your predecessors which bear upon this question, but the application of which is not clear to me. I refer to the opinion found in Volume 2 of the Opinions of the Attorney General for 1932, Page 1165, and that in the Opinions of the Attorney General for 1943, Page 336. This latter opinion contains the statement that a reserve, in order to be a proper deduction from book value, must be allocated to a specific item in the balance sheet. My question is whether by this is meant, for example, a specific loan or security, which, of course, is not set forth individually in the balance sheet, or whether a reserve, which is specific in the sense that it is allocated to an individual class of assets such as 'loans and discounts' or 'securities' is the type which may properly be claimed by the bank as not included in 'book value."

The part of Opinion No. 4676 found in Volume II of the Opinions of the Attorney General for 1932, at page 1165, of one of my predecessors, to which you refer, is that summarized in the third paragraph of its syllabus, which reads as follows:

"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."

Opinion No. 6165 found in the Opinions of the Attorney General for 1943, at page 336, of one of my predecessors, to which you also refer, is summarized in its syllabus, which reads as follows:

"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."

The Ohio General Code provides a specific method for the taxation of the property of banks in Sections 5406 to 5414, both inclusive, General Code.

Quoted below are the pertinent sections or the pertinent parts of sections of the General Code.

Section 5407, General Code, reads as follows:

"The term 'financial institution' as used in this chapter includes every person who keeps an office or other place of business, in this state, and engages in the business of receiving deposits, and of lending money, buying or selling bullion, bills of exchange, notes, bonds, stocks, or other evidences of indebtedness with a view to profit. Provided that corporations or institutions organized under the provision of the act of congress, known as the federal farm loan act, approved July 17, 1916, and amendments thereto, and insurance companies, shall not be considered financial institutions or dealers in intangibles within the meaning of this chapter."

Section 5408, General Code, reads as follows:

"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."

Section 5409, General Code, reads as follows:

"The real estate of a financial institution shall be taxed in the place where it is located, in like manner as the real estate of persons is taxed; but the tax provided for in this chapter shall be in lieu of all other taxes on the other property and assets of such institution."

Section 5411, General Code, reads as follows:

"The cashier or other principal accounting officer of each incorporated bank, the secretary or other principal accounting officer of each other incorporated financial institution, the cashier, manager or owner of each unincorporated bank, and the manager, owner or owners of each other unincorporated financial institution, shall return to the department of taxation between the first and second Mondays of March, annually, a report under oath, 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 pertinent part of Section 5412, General Code, reads as follows:

"Upon receiving such report the tax commissioner shall ascertain and assess all the taxable shares of such financial institution, or the value of the property representing the capital employed by such financial institution, not divided into shares, 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."

Section 5324, General Code, reads as follows:

"The term 'deposits' as so used, includes every deposit which the person owning, holding in trust, or having the beneficial interest therein is entitled to withdraw in money, whether on demand or not, and whether evidenced by commercial or checking account, certificate of deposit, savings account or certificates of running or other withdrawable stock, or otherwise, excepting (1) unearned premiums and surrender values under policies of insurance, and (2) such deposits in financial institutions outside of this state as yield annual income by way of interest or dividends in excess of four per centum of the principal sum so withdrawable."

Said Section 5408, General Code, 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 the property representing it." Such section provides that if the bank is unincorporated its "capital employed, or the property representing it," and if incorporated its shares, shall be listed and assessed at the book value thereof and taxed in the manner provided in this chapter. The "in the manner provided in this chapter" is provided for in said Section 5412, General Code. Said Section 5411, 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 said report. Said Section

5412, General Code, in so far as incorporated financial institutions are concerned, provides that:

> "Upon receiving such report the tax commissioner 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 the Tax Commissioner "shall ascertain and assess * * * the value of the property representing the capital" in a similar manner.

Said Section 5412, General Code, requires 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."

Section 710-1, General Code, pertaining to banks, reads in part as follows:

> "The following definitions shall, except as otherwise specifically provided, be applied to the terms used in this act:
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> "The term 'capital' means the aggregate par value of the outstanding shares of all classes of an incorporated bank, and the capital actually paid in and remaining in the possession of an unincorporated bank, bona fide, as its property, for the sole purposes of the bank.
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> "The term 'stock' or 'capital stock' shall include both common and preferred stock.
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> "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.
>
> "The term 'undivided profits' means the credit balance of the profit and loss account of any bank or trust company.
>
> "* * * The term 'unincorporated bank' shall include every unincorporated person, firm or association transacting banking business in this state; * * *."

Section 710-37, General Code, pertaining to banks, reads in part as follows:

> "* * * No bank hereafter incorporated shall begin to transact business until it has a surplus equal to at least twenty per cent of its capital. * * *"

Section 710-30, General Code, pertaining to banks, reads as follows:

> "The board of directors of every bank whose capital shall have become impaired by losses or otherwise, shall, within thirty days after receiving notice from the superintendent of banks assess the deficiency in such capital, to be paid in in cash, upon the stockholders pro rata for the amount of capital stock held by each. Notice of the amount so assessed upon each stockholder and that, if the same is not paid within the time herein limited, a sufficient amount of his stock will be sold as herein provided, shall be given to him by registered mail. If any stockholder of such bank neglects or refuses to pay such assessment within sixty days after receipt of such notice, it shall be the duty of the board of directors to cause a sufficient amount of the stock of such stockholder to be sold at either public or private sale, to make good the deficiency, and the balance, if any, shall be returned to such delinquent stockholder. If any bank shall fail to cause to be paid in such deficiency in its capital stock for ninety days after receiving such notice from the superintendent of banks, the superintendent of banks may forthwith appoint a conservator therefor.
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> "A sale of stock as provided in this section shall effect an absolute cancellation of the outstanding certificate, or certificates, evidencing the stock so sold, and shall make said certificate, or certificates, null and void, and a new certificate, or certificates, shall be issued by the bank to the purchaser of such stock.
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> "In lieu of enforcing such order of assessment as herein provided, the board of directors may execute or cause to be executed to such bank a bond in such sum and with such surety or security as may be approved by the superintendent of banks, conditioned that the deficiency in its capital be paid in in cash on or before the date fixed in such bond and approved by the superintendent of banks. If a conservator be appointed for such bank, or it be closed as provided in section 710-90, General Code, at or before the date so fixed in said bond, the same may nevertheless be enforced by appropriate action to be instituted by the superintendent of banks for the benefit of the depositors and creditors of such bank.
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> "Whenever the capital of an unincorporated bank shall have become impaired as herein set forth, the superintendent of banks shall forthwith upon learning of such fact cause notice thereof

to be directed to any one or more of the owners of such unincorporated bank, notifying such owner or owners to cause the deficiency in such capital to be paid in, in cash, by the owners of such bank. If the deficiency in the capital of any such unincorporated bank is not so paid in within the time specified by the superintendent of banks in such notice, which in no event shall exceed thirty days, the superintendent of banks may forthwith appoint a conservator therefor.

"As used in this section with respect to incorporated banks, the terms 'capital stock' and 'stock' shall mean only outstanding common stock. The terms 'capital notes' and 'debentures', as so used mean and include obligations of a bank which by their terms are subordinated, in the event of the liquidation of such bank, to the claims of depositors and other creditors, and which have been issued by such bank and paid for at the full face amount thereof.

"The capital of a bank shall be deemed 'impaired' within the meaning of said term, as so used, whenever the losses sustained by such bank exceed the aggregate amount of the following (a) its surplus; (b) its undivided profits; and (c) its capital notes or debentures to an amount not in excess of fifty per cent of its capital."

Section 710-111, General Code, pertaining to banks, reads in part as follows:

"* * * Securities shall be charged on books at cost. All securities as enumerated above, having a fixed maturity shall be charged and entered upon the books of the bank at their cost to the bank, and when a premium is paid therefor an annual amortization charge shall be made thereon so as to bring the cost of same to the face value of said bonds at maturity. The superintendent of banks may require the sale of all or any portion of such securities when in his judgment such bank is holding too large an amount of any type or class thereof, or too large an amount in the aggregate of all types and classes in proportion to its deposit liabilities. The superintendent of banks shall have the power to require any security to be charged down to such sum as in his judgment represents its value. The superintendent of banks may order any securities which he deems undesirable removed from the assets of a bank."

Section 9659, General Code, pertaining to building and loan associations, reads as follows:

"To accumulate from the earnings a 'reserve fund' for the payment of contingent losses, and an 'undivided profit fund,' both of which may be loaned and invested as other funds of the association."

Section 9671, General Code, pertaining to building and loan associations, reads as follows:

"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."

I quote below from pages 342 to 344, both inclusive, of said Opinion No. 6165 found in the Opinions of the Attorney General for 1943, at page 336, et seq.:

"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 conributed 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 markdown 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."

I find nothing in Sections 5408 and 5412, General Code, and I find nothing in the above mentioned opinions of the Attorneys General, as I interpret them, requiring the Tax Commissioner to add to or include in the tax base of banks or financial institutions any reserves, sometimes called valuation reserves, which are deducted directly either from specific assets or specific classes of assets and shown on the asset side of the balance sheet prepared in conformity with the books of account of a bank or financial institution. I also find nothing therein requiring the Tax Commissioner to add to or include in the book value of the shares of a bank or financial institution a "reserve for bad debts" or a reserve against "securities," both of which are mentioned in your request for my opinion, provided said reserves are set up and deducted directly from loans and discounts and securities, respectively, on the asset side of the books of such balance sheet of a bank or financial institution so that both the gross book value thereof and the net book value thereof are shown on said asset side of the balance sheet of such bank or financial institution.

"Reserves for contingencies" and "general reserves" are usually and customarily shown on the liability side of a balance sheet of a bank and are often called surplus reserves in private corporation accounting. They are not strictly reserves that offset specific assets or specific classes of assets or the gross book value thereof and they are not reserves that are actual liabilities. I see no reason for you to recognize any allocation thereof on the bank's books of account to or against specific assets or specific classes of assets. The use by the bank of the terms "reserves for contingencies" and "general reserves" and the setting them forth on the liability side of a balance sheet clearly indicate that such reserves are either contingent or general and that they are not so-called valuation reserves and also indicate that they are or should be considered a part of the bank's capital account.

Specifically answering your inquiry, it is my opinion that:

1. Where, on the balance sheet filed in conformity with its books of account by a bank or financial institution with the Tax Commissioner for purposes of taxation, reserves deducted from the gross book value of the specific assets or specific classes of assets listed therein are shown and the net book value of such specific assets or specific classes of assets are shown on the asset side of such balance sheet and such deductions are designated as reserves against the gross book value of such specific assets or specific classes of assets, such reserves are not surplus reserves and do not constitute a "reserve fund" or a part thereof and should not be added to or included in the tax base computed by the Tax Commissioner under authority of Section 5412, General Code.

2. Where a state or national bank maintains its books of account showing the valuation of its capital, surplus, reserves and undivided profits in separate classifications and showing on the liability side of its balance sheet filed in conformity with its books of account a reserve for contingencies or general reserves, even though allocated on the bank's books of account or records to specific assets or specific classes of assets, all of such reserves for contingencies or general reserves so shown on the liability side of such balance sheet should be added to or included in the tax base computed by the Tax Commissioner in assessing its taxable shares under authority of Section 5412, General Code.

3. Where a state or national bank maintains its books of account showing the valuation of its capital, surplus, reserves and undivided profits in separate classifications and showing on the liability side of its balance sheet filed in conformity with its books of account a reserve for contingencies or general reserves, all of such reserves for contingencies or general reserves so shown on the liability side of such balance sheet

should be added to or included in the tax base computed by the Tax Commissioner in assessing its taxable shares under authority of Section 5412, General Code.

Respectfully,

HERBERT S. DUFFY,
Attorney General.