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CHAPTER 1

Major Differences between Taxable and Business Income Concepts

THE DIFFERENCES BETWEEN THE CONCEPTS OF TAXABLE AND business income, important though they are, can easily be exaggerated. Indeed, by focusing attention on the differences rather than on the essential similarities of the two concepts, this study will almost inevitably give an exaggerated impression of the significance of the differences. In an effort to counteract such an impression, this chapter begins with a brief but emphatic statement of the common heritage of the two concepts. Attention can then be concentrated on the points at which they diverge with less danger of overemphasis on the differences.

The tax law has long recognized the fundamental dependence of the concept of taxable income upon approved accounting practices. The basic provision of the Internal Revenue Code with respect to accounting methods lays down the following general rule (Sec. 41):

"The net income shall be computed upon the basis of the taxpayer's annual accounting period . . . *in accordance with the method of accounting regularly employed in keeping the books of such taxpayer;* but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income." (our italics)

A substantially identical statement was first enacted as Section 212 (b) of the Revenue Act of 1918 and has remained in the income tax law ever since.[1]

The dependency of the concept of taxable income upon approved accounting practices gradually became recognized between 1909 and 1917. The hastily drawn 1909 act read as though it required all taxpayers, regardless of the nature of their business, to compute their taxable income on a cash basis. This totally unworkable requirement was circumvented by Treasury regulations which reached such remarkable (but useful) conclusions as that the words 'paid' and 'actually paid' did not necessarily mean disbursement. Gradually, between 1909 and 1917, the provisions concerning accounting methods were clarified and in 1918 a new statement was formulated.

Although these statements and Mr. May's historical foreword clearly indicate that tax and business accounting are closely related, it would be incorrect to conclude that the former has simply adapted itself to the latter without influencing approved accounting practice. On the contrary, in many instances tax requirements and incentives have greatly influenced approved accounting practice and, perhaps even more so, the way business firms keep their books.

The authorization for a five-year amortization of emergency facilities during World War II is a recent example of the effect of tax practice upon business accounting. Many companies charged off new plant and equipment over an abnormally short period on their own books as well as for tax purposes. As a result, at the end of the war the American Institute of Accountants found itself confronted with exceptionally difficult problems in its effort to prescribe proper postwar accounting procedures for fully amortized emergency facilities which had a substantial continuing postwar usefulness. Its Committee on Accounting Procedure recommended in substance that such facilities be restored to the books at a reasonable value, usually

[1] See the Historical Foreword by George O. May for a discussion of this crucial formative period of the tax law.

less than cost reduced by normal depreciation, and be redepreciated. The Committee was divided, and the recommendation, although necessary to provide a 'correct' statement of postwar income, was a modification of previously accepted accounting canons. An incidental effect of the recommendation will be to create a continuing divergence between business and taxable income, since depreciation of the same assets more than once would obviously be inappropriate for tax purposes.[2]

The last-in first-out method of inventory valuation is a second illustration of the effect of tax provisions and incentives on business accounting practices. Since it was authorized for tax use in 1938 and 1939, many companies have adopted it for both tax and business purposes.[3] At the time of its recognition for tax purposes it was regarded, even by its most ardent proponents in the accounting profession, as of very limited scope, appropriate only for companies with large investments in a substantially uniform raw material whose cost constitutes a major portion of the value of the finished product.[4]

Its extensive adoption in recent years, not only in a wide variety of manufacturing companies but even in department and specialty stores, seems rather clearly to have had in large degree a tax motivation. Mr. May has succinctly stated the influence of the tax advantage:

[2] See Accounting Research Bulletin 27, Emergency Facilities (1946). This Bulletin was adopted by a vote of 15 to 6 (1 assenting member of the Committee on Accounting Procedure attached qualifications).

[3] The taxpayer is required to use the 'elective method'—a modified last-in first-out method—of inventory valuation in his business reports if he uses it in computing taxable income.

[4] M. E. Peloubet, Last-in First-out Once More, *Journal of Accountancy,* Vol. 69, p. 447 (June 1940). See also: M. E. Peloubet, Problems of Present Day Inventory Valuation, *NACA Bulletin,* Vol. 18, p. 741 (March 1937); Statement by the Committee on Federal Taxation of the American Institute of Accountants, The Last-in First-out Inventory Method, *Journal of Accountancy,* Vol. 66, pp. 310-14 (Nov. 1938). This statement is less specific than Peloubet's in prescribing the exact conditions necessary to justify last-in first-out accounting but clearly implies that the method would be appropriate for relatively few basic manufacturing industries.

"Altogether, the method [LIFO] has less usefulness than many of its adherents claim for it, and it is doubtful whether it would have gained its recent popularity but for the prospect of using it to reduce taxes in a period in which prices and tax rates were rising and the law was unjustly insistent on the false concept of each year as an entirely separate taxable unit. Now that the law has been amended so as to recognize the essential continuity of business and of the process of profit earning, and contains provisions for carrying losses forward or backward, the tax appeal of LIFO is greatly reduced and further extension of its use is not so probable as it seemed before these changes were made." [5]

While the concept of taxable income clearly rests in fundamental respects on business accounting practices, tax considerations in turn have exercised an important influence on approved business accounting practices.

One might erroneously conclude from the general statutory requirements and Treasury regulations with respect to acceptable accounting methods that taxable and business income are substantially identical. The differences between the two concepts, however, are both numerous and important. Most of them may be grouped into three broad categories: differences in the timing of various income and expense items; differences arising from the use of surplus charges and credits for business purposes which are not accepted for tax purposes; and miscellaneous differences arising from policy decisions to accord special treatment to certain types of income or expense; e.g., capital gains and losses, percentage depletion, or the limitation on deductible charitable contributions. Some of these differences are no greater than those which inevitably arise from the exercise of judgment in dealing with complex situations; e.g., in setting depreciation rates. Others involve tax rules directly contrary to accepted accounting procedures.

A Differences in Timing

The differences between taxable and business income that

[5] *Financial Accounting, A Distillation of Experience* (Macmillan, 1943), p. 176.

originate in different emphasis on timing have a broad range. At one extreme is the tax requirement that prepaid rent received must be included as income in the year when received, even for a taxpayer on an accrual basis, though the rent is a single payment covering several years' use. Similarly, taxpayers are not permitted to make any allowance for the future payments when containers (such as bottles or barrels) are returned to them for refunds, even though there is an accurate statistical basis for determining in advance the extent of future returns and refunds. If these rules were applied by companies on an accrual basis in preparing public reports for other than tax purposes, the reports would be grossly misleading and unacceptable under professional accounting standards.

At the other extreme is the disallowance for tax purposes of charges to establish precautionary and contingency reserves. Such reserves represent the best judgment of management on possible or probable future losses, and accordingly are of great use to investors and others interested in appraising the status and prospects of a company. But by their very nature their basis is seldom one to assure a high degree of probability that they will be required to meet the specified contingency. In this respect they differ from a bad debt reserve or a reserve for refunds on the return of containers. Since precautionary reserves are in considerable degree subjective with respect to both their timing and size, their recognition for tax purposes would open the way to great abuse by taxpayers attempting to shift income into years when rates were presumed to be relatively low or when they had suffered offsetting losses. The justification for the distinction between taxable and business income arising from different treatments of precautionary reserves has been quite generally recognized.[6]

Between these two extremes the different emphasis on timing in the determination of taxable and business income be-

[6] See G. O. May, Taxable Income and Accounting Bases for Determining It, and A. A. Ballantine, Taxable Income, *Journal of Accountancy*, Vol. 40, 1925, pp. 252-3 and 353-4.

comes apparent in many income and expense items when there is doubt as to which of two or more periods they might more properly be attributed. The traditional conservatism in business accounting requires the postponement of doubtful income items and the inclusion of doubtful expense items to avoid any charge of overstating the immediate income. For tax purposes conservatism quite logically calls for an exactly opposite treatment. To maximize the immediate revenue, and to minimize any risk of subsequent unavailability of a taxpayer or his assets, tax law and administrative policy may require the inclusion of income items at an earlier date than accounting practice would generally sanction. Expenses, on the contrary, are typically not recognized until the amounts involved can be determined accurately.

Much of the controversy and litigation over taxable income revolves around 'which year?' or more simply, 'when'. Professional accountants increasingly deplore the accounting fiction that annual periods are separate and distinct entities. But since income taxes are levied annually, income too must be calculated for a year. The skepticism appropriate for business purposes does not exist for tax purposes, and an inclination so to decide debatable matters as to maximize income and the immediate tax revenue is altogether understandable.

Taxpayers frequently contend that much pointless bickering takes place over the timing, for example, of depreciation deductions; doubtless, in numerous instances these complaints are well founded. But it can by no means be concluded that disputes over the timing of income and deduction items uniformly reflect intransigence on the part of the revenue agents.[7]

[7] As a legal reviewer of the manuscript has emphatically reminded the authors: ". . . there might well be some reference here to the tendency of businessmen to try to take advantage of the Treasury. The Treasury's attitude does not arise because Treasury officials are mean and grasping, but is in fact in considerable part due to their experience with taxpayers, many of whom, small and obscure, *sometimes*, but also *occasionally* large and important, try to 'get away' with a good deal. In order to meet this situation, the Treasury has no alternative but to establish some rather rigid rules. It seems to me that this should be recognized in the discussion of accounting methods established for tax purposes."

The emphasis on the timing of income and deduction items by both the Treasury and taxpayers has undoubtedly been accentuated by the relatively short statute of limitations, usually three years. Before 1938 the problem was further complicated by the doctrine established in an early case by the Board of Tax Appeals concerning the timing of income and deduction items.[8] Under the Board's ruling a taxpayer who successfully claimed a deduction for specified expenditures was not barred from claiming the deduction again in later years, after the statute of limitations had run, if the "true facts" on review indicated that the expenditures were properly chargeable to the later year. This doctrine, pushed to its logical conclusion, suggests that a taxpayer could refrain from claiming all possible deductions and postponing all debatable items of income only at his peril; likewise, the Treasury, only at its peril, could refrain from questioning any items that might subsequently turn out to be debatable.

The danger of double inclusion or complete omission of items was partly mitigated in 1938 by the addition of Section 3801 to the Internal Revenue Code.[9] This Section provides that, under certain circumstances when either a taxpayer or the Commissioner shifts his position on the treatment of any of certain classes of items, the other party shall not be barred with respect to retroactive adjustments for such items by the statute of limitations or by any previous closing agreement. Though the Section is applicable in only a few situations, it should go

[8] Appeal of Goodell-Pratt Company, 3 B.T.A. 30 (1925). The Board stated that the possibility of an option in the treatment of expenditures (as between current expense and capital expenditure to be written off later) was "entirely repugnant to the principles of accounting", and that once the facts are known, the question of opposite options "never arises and never can arise". For an example of administrative attitude arising in connection therewith, see Aubrey R. Marrs, *Reflections of a Revenuer* (Commerce Clearing House, Inc., 1948), pp. 39-45.

[9] For a discussion of this section see A. H. Kent, Mitigation of the Statute of Limitations in Federal Tax Cases, *California Law Review,* Vol. 27, p. 109 (1939); Maguire, Surrey, and Traynor, Sec. 820 of the Revenue Act of 1938, *Yale Law Journal,* Vol. 48, pp. 509 and 719 (1939); Editorial note, Sec. 820: Equity in the Administration of the Revenue Act, *Columbia Law Review,* Vol. 39, p. 460 (1939).

far to eliminate double deductions or double taxation of the same elements of income. The wide variation in tax rates since 1938, however, has rendered the choice of years for inclusion of income and expenses of great importance to both the Treasury and taxpayers, and has probably kept the new provision from having as much effect as might have been expected under a more stable rate structure.

The emphasis on timing has had one important corollary. Various income and expense items, if not included at the proper time, may not be taken into account later. Bad debt losses and allowable depreciation, for example, if not recognized at the proper time may not be included in later years, nor may prior years be adjusted retroactively except during the period allowed by the statute of limitations. Accordingly, despite the very broad definition of taxable income, a set of books kept according to tax requirements might not balance out over the years.

One important modification of the emphasis on timing and the independence of individual years arises from the so-called 'tax benefit' doctrine. Its substance is that if, in specified situations, certain deductions in prior years have not had the effect of reducing taxes, subsequent developments arising from them will not be deemed to increase taxable income in later years. This principle is significant primarily for bad debt recoveries and refunds of prior taxes.[10] When it was being developed during the middle 'thirties, the possibilities of very broad application aroused great interest.[11]

B Differences arising from the Use of Direct Surplus Charges and Credits for Business Purposes

A second category of differences consists of items that are carried directly to surplus for business purposes but are included

[10] Internal Revenue Code, Sec. 22(b) 12.

[11] See Pittsburgh Brewing Company v. Comm., 107 F (2d) 155 (1939), for a temporary application of the principle to adjustments of basis for excessive depreciation taken and allowed; also Virginian Hotel Corporation of Lynchburg v. Helvering, 319 U.S. 523 (1943).

in income calculations for tax purposes. In determining taxable income substantially all gains and losses as well as income and expense items are taken into account. Though certain types of gain and loss may be treated in special ways, the tax law does not distinguish between what accountants call true income items and items that may be considered as affecting surplus accounts directly. The subtleties and refinements so important in business accounting in connection with decisions about surplus adjustments or income and expense credits and charges thus have no direct counterpart in tax accounting.

The distinction between business and taxable income arising from the disallowance of surplus credits and charges for tax purposes influences many individual income and expense items. The reasons for the difference in treatment are stated in general terms at this point so they will not have to be repeated each time the subject recurs. For book purposes the chief reason for making surplus, and in extreme cases even capital, adjustments is to keep stated income for current and subsequent years from being distorted by the effects of past or unusual contemporaneous events. Even this simple statement indicates the difficult problems of judgment practice demands. The distinction between past and contemporaneous events is by no means always clear, nor is that between the ordinary and the unusual. Decisions on the acceptability of any surplus charges and credits, and of the extent to which they should be made, depend upon the main objective of the accounting records.

The implications of the choice between surplus and income charges for items that have developed over more than one year may be stated very simply. If such items are charged to the current year as an expense, the net income for the year will be reduced because of events not properly attributable to it. This distortion of the income of a single year may lead to confusion in appraising the company's status and prospects by those who place great reliance on annual income figures and charges. The alternative is to consider that income of preceding years was overstated because events in the making were not recognized.

Since the accounts of individual past years are closed, the charge to the surplus account is appropriate. However, it will overstate aggregate income for the entire period and will be misleading to anyone especially concerned with aggregate or average income. The charge to the income of the year in question has the merit of at least showing a total income over a period of years that reflects the charge.

Current items not attributable to past years are ordinarily carried through the income account for book as well as for tax purposes. Nonrecurring items so large that they would seriously distort the income of a given year may, however, be charged or credited directly to surplus. This treatment will give a more significant statement of current income but only at the expense of a less precise reporting of the aggregate income earned over a period of years. Another possible treatment, but much less frequently used, is to set up a nonrecurring item as a deferred charge to be written off against income in subsequent years.

Manifestly, none of the above treatments is thoroughly satisfactory. The problem is simply not susceptible to a neat solution. Hence, reports for recent years have used a procedure which, through full disclosure, renders the exclusion or inclusion of various items from income much less important. Many companies publish a combined income and earned surplus statement with special charges or credits clearly indicated and carefully explained. Anyone can then easily make whatever adjustments are appropriate for his purposes. The approval given the combined income-earned surplus statement by the American Institute of Accountants in 1941 should go far in extending its use.[12]

Moreover, in recent years the Institute's Committee on Accounting Procedure has been exerting increasing pressure against direct charges or credits to surplus, although it still recognizes them as acceptable practice in some circumstances.

[12] Accounting Research Bulletin 8, Combined Statement of Income and Earned Surplus (1941).

With respect to direct surplus charges there is considerably greater divergence between the calculations of taxable income and the practices actually employed by companies in their public reports, especially in the years covered by Part Two, than there is between taxable income procedures and current formulations of preferred accounting practice.

The changes up to 1948 in the attitude of the accounting profession towards surplus adjustments in the treatment of extraordinary charges and credits of material amount were reviewed in an editorial, 'Sharpening' Net Income, in the *Journal of Accountancy* for January 1948. The first change noted became apparent some thirty years ago and arose from the increased use of corporate reports by 'noninsiders' who were not in a position to have an informed independent judgment about the significance of income figures. The uninitiated were misled by the earlier practice of charging nonrecurring expense items to surplus but carrying similar credits to income.[13] The first change in practice was to go to the other extreme and adopt all-inclusive income statements which made full disclosure in one place of all events bearing on income. Currently, this editorial notes, the tendency is to approve the exercise of judgment by management and professional accountants in segregating and excluding from income items that "would impair the significance of net income". In this way, the net income figure may presumably be most effectively sharpened.[14]

The preceding paragraphs have presented the subject of surplus or income charges in the abstract because the facts of a

[13] M. H. Stans, Weakness in Financial Reporting Caused by Improper Use of Reserves, *Journal of Accountancy*, Vol. 85, pp. 190-5 (March 1948). W. A. Hosmer, The Effect of Direct Charges to Surplus on the Measurement of Income, *Business and Modern Society*, ed. by M. P. McNair and H. T. Lewis (Harvard University Press, 1938), pp. 113-51.

[14] For an authoritative statement along the same line by a leading accountant see G. D. Bailey, The Increasing Significance of the Income Statement, *Journal of Accountancy*, Vol. 85, pp. 10-9 (Jan. 1948). See also ibid., pp. 20-5, for reprints of Accounting Research Bulletin 32, Income and Earned Surplus (1948), and comment by E. C. King, Chief Accountant, Securities and Exchange Commission.

particular situation may indicate an overwhelming advantage for a specific procedure. The need for choosing between surplus and income charges arises in such dissimilar circumstances as the retirement of equipment before the expected date because of unforeseen technical developments, the loss of foreign assets because of a war, the retirement before their due date of bonds previously issued at a discount with a substantial deferred charge in the form of bond discount still to be written off, or the discovery of a defalcation not covered by insurance extending over several preceding years. Some of the situations reflect past incidents that should have been but were not recognized, some are of past incidents that could not have been anticipated, others are present events so unusual and of such magnitude that to handle them as routine current expenses would badly distort the income of a single year. A similar diversity of situations exists with reference to gains and income items unusual or partly attributable to preceding years.

In the sections dealing with individual items of income and expense, the problem of surplus adjustments will be discussed in more detail. Here it is necessary to point out only that the circumstances justifying or requiring surplus adjustments in business income accounts have few counterparts in the American income tax concept. Both the statutory and court definitions of income are very broad, including "gains or profits and income derived from any source whatever", and "growing out of the ownership or use of or interest in . . . property".[15]

In conclusion, differences between tax and business practices with respect to surplus adjustments are entirely reasonable and may be expected to persist. Situations will continue to arise in which management may reasonably decide that the best overall results will be obtained by carrying some items directly to surplus. As a general rule, however, there is little justification for a comparable tax treatment. Tax equity ordinarily requires that all items be carried through the income account in order that aggregate income over a period of years will be correctly

[15] Internal Revenue Code, Sec. 22(a).

stated. It must be recognized, though, that this policy sometimes has the effect of concentrating abnormally large amounts of income or deduction items in a single year, thereby creating tax inequities of a different nature. Some of the special tax requirements discussed in the next section represent attempts to mitigate the inequities that otherwise would result from concentrating large income and deduction items in a particular year.

C MISCELLANEOUS DIFFERENCES

Another series of differences between taxable and business income arises from direct legislative action to provide special treatment for certain types of income or for certain industries in the computation of taxable income; for example, the requirement that only specified percentages of capital gains and losses be included in taxable income,[10] the limitation on capital loss deductions, the partial or complete exemption of the interest on certain government bonds, the limitations on the deductibility of charitable contributions, the partial credit for dividends received by corporations, and the extraordinarily generous discovery-value and percentage depletion allowances. The provisions for the carry-back and carry-over of net operating losses should perhaps also be mentioned.

Congress has been motivated by various considerations in authorizing special treatments of such items as those just listed. Interest on government bonds, for instance, has been exempted from taxation partly because of the dubious legality of taxing it as far as state and municipal indebtedness is concerned. Capital gains have been granted special treatment partly to alleviate the inequities that would otherwise result from the taxation in a given year of the entire amount realized, even though the gain had accrued gradually during a long period. Special depletion allowances have been granted, ostensibly to promote the exploitation of mineral and petroleum resources.

[10] This requirement did not apply to corporations in the years to which Part Two applies.

For purposes of this study detailed treatment of the above items is inappropriate, though critical analyses of the degree to which the public interest is served by these special tax treatments are proper subjects of separate studies. The pertinent point here is that they do not have any counterpart in business accounting, nor do they arise as inherent elements of any underlying broad concept of taxable income. On the contrary, they represent deliberate Congressional decisions to adopt for tax purposes rules based on criteria other than a correct determination of income in any usual sense of the word. Thus, unless Congress reverses its attitude, these special provisions will continue to be a source of divergence between business and taxable income.

A final group of miscellaneous differences arises from constitutional limitations, notably in the treatment of interest on securities issued by states and localities. Also various events influencing subsequent income are treated differently depending upon whether they occurred before or after March 1, 1913, the effective date of the 16th Amendment, authorizing federal income taxation. The latter distinctions too rest on constitutional grounds, at least as the constitution was interpreted when the tax provisions were enacted. These special constitutional differences have no business counterpart and need be described only briefly in the appropriate places.