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CHAPTER 7

Miscellaneous Divergences in Income Items

EVEN A CASUAL PERUSAL OF ANY OF THE TAX SERVICES WILL suggest a long series of causes for divergences between taxable and business income. Since this study is designed to explain the reasons for the major differences rather than to present an exhaustive collection of all differences, it suffices here to mention briefly some of the remaining lesser but recurring causes of divergence. This chapter summarizes some of the miscellaneous divergences primarily affecting income items. The next chapter will cover miscellaneous expense items.

A TAX-EXEMPT INTEREST

The exemption from income taxation, complete or partial, accorded the interest on different types of government securities is perhaps the most widely recognized single factor making taxable income differ from business income. No problems of accounting theory are involved in this distinction between the tax and business treatment of income from government securities. Certain forms and degrees of tax exemption have developed as a result of constitutional restrictions and as matters of public policy; statement of that fact is all that is necessary in this study.

Though a review of the arguments on the merits of tax exemption is inappropriate here, the probable future limitations on tax exemption should be recognized. As tax rates rise, the advantages of exemption to taxpayers have become greater.

The interest that must be paid on new tax exempt issues is reduced by the growing value of the tax exemption. States and municipalities may be expected to oppose the removal of tax exemption more strenuously as the differential becomes bigger through rising rates. The general reduction in interest rates is an offsetting factor.

Against such objections to change is an increasing awareness of the inequity and social and economic undesirability of a large flow of tax exempt income. During the last fifteen years, the arguments for the removal of tax exemption have been reinforced by the desire to encourage venture capital. Upper bracket individual taxpayers must feel assured of a very high rate from taxable investments to make them as attractive as tax exempts. Other investigations of both the income and estate tax returns indicate that wealthy individuals have not shifted into tax exempt securities to the extent that would seem justifiable if they were concerned solely with maximizing net income after tax. But the underlying discouragement to putting capital into business ventures arising from high tax rates is accentuated by the existence of numerous tax-free investments.

The removal of tax exemption from new issues of federal securities, and the imposition of a surtax instead of simply a higher rate on corporate income, suggest a line of action that will partly eliminate the difference between taxable and business income due to tax exemption. By the surtax, income even from outstanding federal securities is made subject to part of the corporation tax. The taxation of interest from state and local securities will have to await more fundamental legal changes. Any reduction in tax exemption will bring taxable and business income closer together.

B Receipts from and Premiums Paid on Life Insurance Policies

The treatment of receipts from and premiums paid on life insurance policies on corporation executives by which the corporation is the beneficiary leads to a difference between taxable and business income whenever such insurance is carried. The statutory requirement in the Code is specific:

Sec. 24 *Items Not Deductible*

a) General Rule. In computing net income no deduction shall in any case be allowed in respect of . . .

4) Premiums paid on any life insurance policy covering the life of any officer or employee, or of any person financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy.

The phrase "indirectly a beneficiary" has been construed broadly.

If the executive, rather than the corporation, is the beneficiary, the premiums paid are considered additional compensation, and as such deductible by the corporation and taxable to the executive. It has been suggested that in the unusual case in which stockholders, rather than the corporation or the insured individual, are the beneficiaries, the premiums paid might be held to constitute a distribution of earnings.[1]

The required tax treatment is not satisfactory for a company's own accounting records. Cash funds are given up by the corporation which receives in return a policy that may have a present value measured by its cash surrender value. This cash surrender value may properly be shown as an asset, and the difference between the premium paid and the increase in cash surrender value must be considered an expense of the period.[2] The distortion that would be produced by keeping books on the tax basis is especially clear in the case of term insurance with no cash surrender value. If the premium paid were not charged as an expense, some other asset would have to be set up to take the place of the cash paid. This would probably be in the nature of a special deferred charge, but to accumulate it year after year would lead to a gross misstatement of income

[1] R. H. Montgomery, *Federal Tax Handbook 1940-1941* (Ronald Press, 1940), Vol. 1, p. 430.

[2] R. H. Montgomery, *Auditing Theory and Practice* (5th ed.), pp. 242-4.

and assets because the actual realization is in no sense certain and the amount realized would not be in proportion to the number of years the insurance had been carried. If premiums for three or five years were paid at one time, as in fire insurance, the total payment should be spread over the period of effective insurance, but to carry any sort of debit balance beyond the expiration date would be unjustifiable. In the case of insurance that has a cash surrender value, that amount represents the asset to be shown on a balance sheet, since realization of a larger amount is contingent upon many uncertain factors.

When a policy matures by the death of the insured, the amount received is not taxable to the corporation. This procedure is consistent with the disallowance of the premium expense. The net effect of the disallowance of the expense and nonrecognition of the receipt will be an unrecognized gain or loss, depending on whether the total payments fall short of or exceed the amount received from the policy. If term insurance is carried to cover a period when the executive's services are particularly vital or when the withdrawal of his capital would be particularly onerous, or even for the entire period up to his own retirement, then allowed to lapse before his death, there is of course no cash recovery and the total amount paid is permanently disallowed in the computation of taxable income.

For book purposes, upon maturity of the policy because of the death of the insured, there is a gain equal to the difference between the cash surrender value at which the policy was carried as an asset and the face amount of the policy. This gain may be shown as income in the year the insured dies or part of it may be set up as deferred income to be credited to income over the period when the services of the insured were expected to be especially valuable to the company and when, presumably, because of his premature death, income will be less than it otherwise would have been.

C Dividends Received

The tax treatment of dividends received, like tax-exempt income, is covered by rules that have no possible counterpart in business accounting. In the Act of 1909, establishing the excise tax on corporate income, the Conference Committee excluded from taxable income dividends received on the stock of other corporations. Apparently the theory was that any other procedure would impose discriminatory double taxation upon the parts of corporate income that were passed on from one corporation to another. This policy was continued until 1935, with various amendments to restrict the exclusion for tax purposes to dividends received from corporations subject to the federal corporation income tax. Dividends received by individuals were similarly exempted from the normal individual income tax.

In 1935, following a suggestion by the President, the deduction was limited to 90 percent of dividends received from domestic corporations subject to taxation. This inclusion of a portion of intercorporate dividends in the tax base was proposed to discourage corporations from forming many interlocking corporations in order to avoid the new graduated tax. In 1936 the deduction was changed, for various technical reasons, to a credit against income, and in 1938 the percentage credit was reduced from 90 to 85, the figure first stipulated in the Senate Finance Committee Report in 1935.

This feature of corporate income taxation is obviously connected with various other items of legislation restricting holding companies. In fact, the House Ways and Means Committee rejected the President's proposal in 1935, but indicated a willingness to consider the proposal "on its merits in connection with discouraging chains of holding companies".[3] It is one of the many factors making extremely complex the calculations about the relative desirability of forming a single corporation

[3] House Report 1681, 74th Cong., 1st Sess., Report of the Ways and Means Committee on the Revenue Act of 1935, p. 7.

or operating with one or more subsidiaries. With a 38 percent tax rate, as in 1949, the tax penalty on intercorporate dividends is 5.7 percent, which applies regardless of motive or attending circumstances.

In any general discussion of taxable income, the distinction between dividends paid from earnings and profits and those constituting a return of capital would be a subject of major importance. Under the tax law neither the wording of the dividend declaration nor the nature of the book entries reflecting the payment determines the tax status of distributions. Section 115(b) of the Internal Revenue Code provides that a dividend for tax purposes is any distribution from earnings and profits of the taxable year or those accumulated after February 28, 1913; and that every distribution is presumed to be made from earnings and profits to the extent thereof. Thus though a dividend may be charged to surplus, it is not taxable unless the surplus represents earnings and profits of the current year or those accumulated since February 28, 1913. On the other hand, even though no surplus of any sort is shown, a distribution may be deemed to be from earnings and profits if, for example, past accumulated earnings had been capitalized. Two further complications arise in that (a) the definition of earnings and profits is itself involved and corresponds to neither taxable income nor book profit, and (b) earnings and profits may be carried forward from one company to another in the case of certain reorganizations.

These features of the law introduce a higher order of complexity into the influence of intercorporate dividends on the comparison of taxable and business income. Since, however, the statistical evidence indicates that the divergences arising from intercorporate dividends are relatively small, the higher order of complexity is of a lower order of importance for this study and need not be explored at length. The distinction between taxable income and earnings and profits will probably become increasingly significant in connection with Section 102 cases.

In 1936 an additional cause of divergence between taxable and business income was introduced by the provision that a distribution was to be treated as taxable income to the recipient if it was from earnings and profits of the taxable year, even though there was an accumulated deficit in the surplus account. This new provision was a reasonable corollary of the undistributed profits tax adopted the same year; it has remained as a further complicating feature in the calculation of taxable income.

For business purposes, the most reasonable procedure is to treat dividends on investments as income, in the absence of some strong ground to do otherwise. Surely the 1913 date is of no significance in determining the income status of dividends. Some corporate distributions are designated by the companies making them as returns of capital or from the proceeds of profits on the sale of capital assets. These present special cases which may justify crediting the investment asset account or surplus for the amount of cash received. In general, both past reorganizations and capitalizations of surplus will be recognized as established facts and no attempt will be made to look through them to find evidence for modifying the apparent nature of any distributions.

The treatment of distributions on investments in subsidiaries is a special problem which is scarcely reflected in Part Two. Actual earnings, rather than distributions, may be taken up on the parent company's books and shown as a special asset account or as an increase in the investment account; subsequent dividends merely involve a shift to cash from this other asset account. Any detailed discussion of this subject would carry us into one of the most complex aspects of consolidated statements.

It suffices to note that the partial inclusion of dividend income in computing taxable income could not in any conceivable manner be followed in business reports. The extent to which it is included for tax purposes seems itself to be the result of a compromise among various objectives, most of them considerably removed from corporation income tax problems. A requirement of consolidated returns, or an authorization to use them without a tax penalty, would substantially reduce differences between taxable and business income arising from the treatment of dividends in cases of parent companies and their subsidiaries. The divergence in the two income figures is inevitable in cases involving dividends from investments other than in subsidiary or affiliated companies, unless the law were changed to include all dividends in income subject to taxation, as is now done with individuals. Such a change would impose a discriminatory burden of multiple taxation on income passing through more than one corporation. The divergence might, in fact, be greater than it is, if ulterior motives had not brought about the partial inclusion and taxation of intercorporate dividends. The percentage inclusion of dividends is an altogether arbitrary compromise with no possible analogy in business practice, and the definition of taxable distributions based on earnings and profits since 1913 rests on distinctions that are altogether irrelevant for ordinary corporation accounting. Continued divergences between tax and business procedures appear inevitable.

D Capital Gains and Losses

The special treatment of capital gains and losses, by applying directly or indirectly different tax rates and otherwise distinguishing them for tax purposes, has no exact counterpart in business accounting. A somewhat analogous distinction is made for business purposes between income and expense items and direct charges and credits to surplus and capital. In the business treatment, however, individual items are included in the income statement or they are excluded; there is no partial or fractional inclusion. Accordingly, divergence between taxable and business income is virtually inevitable whenever capital gains or losses arise in taxable income and are subject to special treatment. These divergences, furthermore, will not wash out over longer periods.

Though corporate gains and losses have not been subject to the frequent radical changes in tax treatment applied to capital gains and losses of individuals, they have been changed fundamentally at various times. Before the 1921 Act, the capital gains of both individuals and corporations were taxed in full as ordinary income. Capital losses were, under the 1918 Act, deductible in full.[4] Corporate capital gains and losses continued to be treated as ordinary income until the 1932 Act. Applicable to both corporations and individuals, this Act provided that losses from the sale or exchange of stocks and bonds held two years or less were allowable only to the extent of the gains from the sale or exchange of such assets.[5]

Under the 1934, 1936, and 1938 Revenue Acts, Section 117(d), capital losses of corporations were allowed only to the extent of capital gains plus $2,000. These various limitations are, however, the only instances prior to the 1939 Act where the treatment of corporate capital losses and of ordinary losses differed. Throughout the period, capital gains were taxed in full, at the same rates as other income. One objective of the special treatment of capital gains of individuals was to offset the penalty arising from applying highly progressive tax rates to gains developed over a period of years but realized in a single year. The absence of progressive corporation income tax rates during most of this period is one reason for the lack of special treatment of corporate capital gains.

The 1939 Act modified the method of taxing corporate capital gains and losses, treating them more nearly like the gains and losses of individuals. A distinction was drawn between short- and long-term gains and losses. Long-term gains and losses were included in full, and treated in the same way

4 Prior to the Revenue Act of 1918 there were certain limitations upon the deductibility of capital losses sustained in transactions not connected with the taxpayer's trade or business; see Revenue Act of 1916, Sec. 5(a).

5 Revenue Act of 1932, Sec. 23(r). These would not be strictly capital losses, because the 1932 Act limited the definition of capital assets to property held more than two years. However, under the present Code definition, these losses would be capital losses if the assets were held more than six months.

as ordinary income. Short-term gains were taxed in full while short-term losses were allowed only to the extent of short-term gains with a one-year carry-over of any net short-term loss. In the Revenue Act of 1942 (Sec. 150) the present provision, which in effect imposes a maximum tax of 25 percent on the excess of net long-term capital gain over net short-term capital loss, was established. A five-year carry-over of net capital losses was allowed, and the holding period necessary to bring an asset into the long-term category was reduced from eighteen to six months. Net short-term capital gains are still taxed at ordinary rates.

The foregoing review of the concept and treatment of capital gains and losses for purposes of income taxation shows the varying content of taxable income figures and the technical distinctions that at one time or another have been important. No need exists for a point by point comparison of tax and business accounting procedures. Surplus charges and credits were discussed briefly in Chapter 1 as one of the three principal reasons for differences between taxable and business income; they are referred to in more detail in the chapters covering income and expense items which sometimes involve surplus directly.

A decision on the proper handling of any unusual gains or losses in business accounting requires judgment. In the absence of ironclad rules, it is a matter of opinion how unusual, how nonrecurring, how large, and to what extent related to prior periods, an item must be before it is properly excluded from calculations of income. The distinctions are typically ones of degree. They can best be made only with a full understanding of all the circumstances and an appreciation of how the income figures may be interpreted and used.

The procedure discussed in Chapter 1 which, through full disclosure, renders the actual decision on inclusion or exclusion of various items from income less important is especially appropriate for borderline situations. A combined income and earned surplus statement, with special charges or credits fully disclosed and explained, provides an easy basis for any interested person to make such adjustments as are appropriate for his purposes. It is possible also, and not uncommon in practice, to show unusual charges and credits at the end of the income statement, and net income both 'before' and 'after' such items. The approval given to the combined income-earned surplus statement by the American Institute of Accountants in 1941 should go far in extending its use.[6]

E Installment Sales

Income allocation under installment sales does not apply to a sufficiently large proportion of the country's business to justify elaborate and detailed treatment here. In general, the regulations and the law have been relatively liberal in authorizing reasonable discretion in accepting business practice for these purposes. The installment sales method is optional. Though books must be kept in such a manner as to facilitate accurate computation, reports for tax and for other purposes need not be by the same method. A taxpayer's decision on the installment method will presumably depend upon whether he expects it to minimize his taxes over the years. He will have to estimate future fluctuations in his income and tax rates. There is no reason to suppose that the method which is believed to minimize tax burdens will be the one regarded as preferable for business purposes.

Though the legal provisions have in general been liberal, various technicalities have probably prevented the use of the installment method for tax purposes under circumstances when some method of spreading income over the years was appropriate for business purposes. The principal requirements in the law may be summarized briefly. Until 1926 the law did not mention an installment basis. The Regulations, however, allowed an allocation of profit over the years in which purchase

6 Accounting Research Bulletin 8, Combined Statement of Income and Earned Surplus (1941). Cf. supra.

money was received.[7] The Board of Tax Appeals disapproved the Regulations in 1926, holding to a strict interpretation of the cash and accrual methods. Section 212(d) was accordingly inserted into the Revenue Act of 1926, for the purpose of writing "into the bill the basic principles of the installment method authorized by prior regulations".[8]

Not only dealers in personal property but also sales of realty and casual sales of personal property are covered by the installment method under specified conditions.[9] For realty the initial payments must not exceed 30 percent of the selling price, and for casual sales of personal property the property sold must be other than property included in inventory, initial payments are not to exceed 30 percent of the selling price, and the selling price must be higher than $1,000. There is also a special provision for the treatment of deferred sales—those in which the initial payment exceeds 30 percent—by which a purchaser's obligations are treated as cash to the extent of their fair market value; the difference between face value and fair market value is reported only when and if collected.

F PREPAID RENT INCOME

The treatment of prepaid rent and royalties is a strange anomaly to one familiar with accrual accounting. Legal cases have established the general rule that advance payments of rent or royalties are income in the year received regardless of whether the taxpayer is on the cash or accrual basis.[10] In the Renwick case the Court ruled that brokers' commissions are not expenses in the year paid but are capital expenditures which should be

[7] See the opinion of the Supreme Court in Burnet v. S. & L. Building Corporation, 288 U. S. 406 (1933) for a review of the early history of the regulations and statutory provisions.

[8] House Report 356, 69th Cong., 1st Sess., Report of the Conference Committee on the Revenue Act of 1926, p. 32.

[9] Internal Revenue Code, Sec. 44. Regulations 111, Sec. 29.44-1 to 29.44-5.

[10] O'Day Investment Company v. Commissioner, 13 B.T.A. 1230 (1928). Edward A. Renwick et al., Trustees v. U. S., U. S. D. C., Sept., 1935, affirmed 87 F (2d) 123, (C.C.A.-7th, 1937). See also C. H. Mead Coal Company v. Commissioner, 31 B.T.A. 190 (1934), and W. M. Scott v. Commissioner, 27 B.T.A. 951 (1933).

allocated over the term of the lease. It reviewed accounting procedure for allocating prepaid rent but rejected the method for tax purposes without giving a reason. The inconsistent treatment of income and expense items suggests the possibility of situations in which, if the entire rent had been prepaid, expenses would be allocated to years in which there was no income against which they could be deducted.

For business purposes prepaid rent should be spread over the life of the lease on either a straight-line basis or an actuarial basis. To credit the entire amount to a single year would produce a distortion as between years and would be considered a scheme for improper manipulation. The difference between tax and business practice in this respect is an example of the tendency in tax matters to maximize immediate taxable income and to disregard annual distortions in an endeavor to collect revenues when the taxpayer and his assets are available.