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CHAPTER 8

Miscellaneous Divergences in Deductions

A EXPENSES HELD TO BE DISTRIBUTIONS OF PROFITS

THOUGH CORPORATE TAXABLE INCOME IS NOT SUBJECT TO THE many borderline problems that arise in individual income tax matters in connection with deductions for business expenses, even the phrase 'ordinary and necessary expenses' has led to considerable controversy. In the case of small or closely held corporations, for example, certain elements of interest or executive compensation may be deemed, for tax purposes, to be distributions of profits rather than expenses. The temptation to reduce taxes by making distributions that can be deducted as expenses is obvious. Increases in salaries and bonuses have been disallowed as deductions, especially when they are in proportion to stockholdings. Various sorts of unusual securities have also been issued at times, under conditions and with provisions that appear to place them on the borderline between profit participation and bona fide debt obligations. The deductibility of payments on them has been contested by the Treasury with varying degrees of success.

Though it is beyond the scope of this study to attempt to pass on the merits of controversies of this type, we must recognize that, in an attempt to prevent flagrant abuses through large and unreasonable bonuses, administrative policies may be carried to the point where altogether reasonable amounts are disallowed. In a company owned and managed by a family, the determination of proper compensation is subject to so many considerations as to leave a wide range for honest differences of opinion. Both the motives for abuse by taxpayers and

the suspicions of the revenue authorities may be expected to be stronger when corporation taxes are higher. It is sufficient here to point out this possible cause of divergences and to note that even though disallowed for tax purposes, salary or interest deductions may still be shown as such for business purposes.

The disallowance of a deduction for any part of a salary that is held to constitute unreasonably high compensation is applied generally under Section 23(a)(6) of the Regulations, whether or not the employee owns stock in the company. Thus, part of a salary may be disallowed even if payment could not be considered a device to distribute profits to the owners of a corporation in the form of salaries rather than dividends. The logic behind the extended disallowance of unreasonably high salaries is less apparent than when the employee is also a stockholder. By analogy, similar disallowances would seem equally appropriate for unreasonably high costs of raw materials or professional services. The special treatment of salaries suggests either a presumption of some indirect profit distribution although the employee is not a stockholder or a social policy directed against high incomes.

B Royalty and Leasehold Expense

Divergences between the taxable and business income concepts arise also in the highly specialized field of leaseholds and royalties, especially in connection with oil and mining properties. Any satisfactory analysis would be disproportionately detailed in view of the extremely technical legal problems and subtle differences in leasehold contracts. Though in the determination of corporation income the problem is complicated enough, it is even more complicated in the allocation of income between individuals and trusts.

C Surplus Reserves and Other Disallowed Deductions

In Chapter 1 the reluctance of tax authorities to recognize expense and deduction items until they are clearly determinable was cited as a major reason for the differences between taxable

and business income. The results of this reluctance are especially apparent when such subjects as surplus or contingency reserves are considered. The Internal Revenue Code does not provide for them, and they are consistently disallowed in practice. Here we need only explain the reason for their appearance in business records.[1]

The purpose of surplus and contingency reserves is to anticipate losses or expenses that have not yet arisen and may not arise and whose size is often unknown. Though only future events can determine the time and exact amount of the losses, reserves are typically not set up unless there is a real expectation that the losses will be incurred. Their main purpose is not merely to smooth income fluctuations, though they are likely to have that effect. Losses on inventory after a price rise, possible losses on the termination of major contracts (as government contracts at the end of a war), and losses on lawsuits are among those which justify attention in advance. One effect of reserves is to reveal more fully the best judgment of management on the condition of a company as a long-term going concern. When the reserves are taken from income, they typically smooth fluctuations in it by avoiding some of the fictions of annual accounting periods. Thus, a reserve to cover a decline in inventory values would be created by a special charge to income in what was believed to be a period when inventory prices were rising temporarily. The reserve would absorb the loss during the subsequent decline.

The advantages of avoiding excesses of optimism and pessimism on the part of management, investors, and the general public are too familiar to require elaboration. Surplus and contingency reserves, properly handled, can contribute significantly in limiting these excesses by reducing stated income during and immediately after periods of price increases, thereby rendering unnecessary additional reduc-

[1] The general theory of surplus reserves, and problems arising during and immediately after the war, are discussed in Accounting Research Bulletin 13, Accounting for Special Reserves Arising Out of the War (1942).

tions in income when prices decline. Contingency reserves for other purposes may well be established by charges to income or appropriations from income when unfavorable developments are foreseen. Reserves for postwar reconversion and contingencies have been common examples.

Contingency reserves may be established by direct charges to surplus, thereby relieving both present and future income of any losses which they cover. The purpose is, in effect, to earmark or segregate enough of the surplus to meet the loss, thereby making it unavailable for distribution or capitalization and providing sounder grounds for estimating net worth on a longer-term basis. Also, to the extent that stated surplus and changes in it are the basis for decisions or pressures for dividends, segregation is helpful in balancing dividend distributions over the years.

Reserves of the sort described in this section are frequently referred to as 'surplus reserves', as distinguished from valuation or asset reserves which record the reduction in value or exhaustion of specific assets. They are conceived of as constituting a special element of surplus until the events occur for which they were established. The decision whether they should be included as part of net worth depends on whether an analyst chooses a short- or long-term point of view. On an immediate basis they may be considered part of surplus; on a longer-term approach, they may be recognized as probably subject to dissipation. Their use is consistent with the current emphasis on full disclosure and they are merely an accepted device to record and disclose the management's best judgment about certain types of future developments.

The disallowance of charges to income to establish surplus or contingency reserves is altogether consistent with the general philosophy behind the taxable income concept. Postponement of deductions until they are certain in amount and time protects the immediate revenue. It will increase the revenue in the aggregate to the extent that deductions are deferred to periods when income is such that additional deductions are of no

benefit taxwise, either because of bankruptcy or inadequate loss carry-overs. Until the provisions now contained in Section 3801 of the Code on the extension of the statute of limitations in cases involving inconsistent positions were adopted in 1938, there was also a danger that certain deductions might be taken in whole or in part more than once.

The continued disallowance for tax purposes of deductions for surplus reserves seems probable in view of the latitude within which opinions may differ concerning the need for and size of such reserves. To restrict their use in public reports, however, would deny to stockholders and the public the benefit of the best judgment of management and would be inconsistent with the present emphasis on full disclosure. Continued divergences between taxable and business income in this respect accordingly appear to be both inevitable and justifiable.[2]

The doctrine under which the surplus and contingency reserves discussed above have been disallowed has been applied to other so-called reserves to cover definitely foreseen future expenditures. Accountants have been especially emphatic in their objections to the treatment of the latter charges on the ground that rulings and decisions have frequently been contrary to generally accepted accounting principles. The controversy is perhaps another example of the general confusion that has arisen from the broad application of the word 'reserve' in accounting practice.[3] The charges disallowed have frequently

[2] The justifiable divergence between taxable and business income on this subject is recognized even by strong general advocates of the accounting approach. For instance, George O. May has noted: "The law . . . did not permit deduction from gross income of reserves for potential future losses nor for expenditures not yet incurred and not involved in the production of the gross sales reported. From the legislative standpoint such deductions could not reasonably be allowed, however legitimate or even praiseworthy purely precautionary reserves may be from the standpoints of sound finance and business prudence." Taxable Income and the Accounting Bases for Determining It, *Journal of Accountancy*, Vol. 40, pp. 261-2 (Oct. 1925).

[3] See M. H. Stans, Weakness in Financial Reporting Caused by Improper Use of Reserves, *Journal of Accountancy*, Vol. 85, pp. 190-5 (March 1948), for a detailed criticism of the use of 'reserves' to cover a wide variety of fundamentally dissimilar situations.

been described as establishing reserves, but the reserves really represent amounts that should not properly be included in income at all.

George O. May suggests three "elementary and universally accepted propositions of general accounting" that have been "repeatedly flouted" by the Tax Courts:

"1. A sale accompanied by a burdensome obligation to repurchase on demand at or above the sale price does not produce income.
2. In determining the gain on a sale the credit in respect of the sale price must not be greater than the cash equivalent thereof at the time when the sale was made.
3. A payment in advance for goods or services to be rendered or supplied in the future is not income at the time of the receipt." [4]

Perhaps the best illustration of the first point is the treatment of containers (e.g., beverage bottles) sold at a figure in excess of cost but with an obligation to repurchase at the same price and with the expectation that the obligation will have to be honored in a large percentage of cases. The Board of Tax Appeals ruled in a typical case involving this principle:

"Although there is intended ultimately no gain in the transactions, the title of 'income' ebbs and flows over the dividing lines between the taxable years. We have decided that a reserve is unallowable by way of excluding from income the charges for containers expected to be returned." [5]

May comments on this decision:

"The treatment of floating cooperage that was rejected was at the time of the decision as fully established as the best practice in the trade as any practice that could be cited. There is, however, no reference by the Board to the provisions of the law which permit returns to be made in accordance with methods of accounting regularly employed by the company or to the regulations which

[4] Accounting and the Accountant in the Administration of Income Taxation, *Columbia Law Review*, Vol. 47, p. 388 (1947).

[5] Plymouth Brewing and Malting Co. v. Commissioner, 16 B.T.A. 123, 128 (1929).

hold that generally approved standard procedures will normally be regarded as resulting in a clear reflection of income." [6]

With reference to the second point the tax law was amended in 1921 to allow the deduction of a reasonable addition to a reserve for bad debts in the computation of taxable income. This principle, however, has not been followed in other seemingly comparable situations. To cite one instance, a taxpayer was denied the deduction of an amount representing the Illinois sales tax imposed on the uncollected portion of the sales price of merchandise it had sold during the taxable year. The deduction was disallowed even though the sales price which was taken into gross income included the amount of the uncollected tax. The Board of Tax Appeals supported its decision by the argument that all events fixing the obligations of the vendee, which obligation included the amount of the tax, had been determined at the time of the sale, but that the taxpayer would not become liable to pay the state tax until it had collected from its customers. The liability to pay the tax was therefore contingent on the collection of the outstanding accounts receivable; and "not only is it unnecessary to accrue a contingent liability in order clearly to reflect income, but any system of bookkeeping which accrues such items distorts income".[7]

This dictum is at odds with the basic accounting principle cited above. When the liability was contingent only upon an event so improbable as the failure to collect an ordinary account receivable, a correct statement of business income would require that the amount taken into gross income because of the sale be reduced by the tax accruing, in a business sense, at the time of the sale.[8]

The third principle has been violated frequently by cases involving receipt in one year of income to be earned in several future years, such as prepaid rents or subscriptions for publica-

[6] *Columbia Law Review*, Vol. 47, p. 389.
[7] Swain and Meyers, Inc. v. Commissioner, 42 B.T.A. 306 (1940).
[8] Cf. Roswell Magill, *Taxable Income*, pp. 209-10.

tions to be issued or contracts for services to be rendered over a period extending beyond the taxable year. In these instances the payments are taxable when received even though the services for which they are paid are not rendered until later years.[9]

While the tax requirements cited in the preceding pages do not correspond to approved business accounting standards, this alone is not necessarily sufficient to condemn them as unwise public policy. For tax purposes other factors must be taken into account, such as administrative feasibility and the ability to collect the revenue. The tax requirements with reference to such items as prepaid rents, for instance, enable the Treasury to collect the tax when the taxpayer is likely to have cash on hand rather than later when income may be properly reported in an accounting sense but when there may be no corresponding cash inflow.

Magill summarizes his views on the merits of the present treatment, as follows:

"No controlling administrative reason for this bird-in-hand policy has yet been set forth; the inequities of the present decisions seem to overbalance the probable loss in revenue from some future insolvencies of taxpayers who have prorated these cash receipts." [10]

This statement, made with reference to the treatment of income received in one year but earned in future years, is equally applicable to the other classes of items discussed in this section. Indeed, it is with reference to these classes of divergences that the strongest case can be made for revising tax practice to bring it into closer conformity with standard accounting treatment.

D Research and Development Expense

In addition to charges to establish surplus and contingency reserves, various other charges, such as for research and develop-

[9] The accounting principles involved in the issues discussed in this section are analyzed in detail in the articles by George O. May also referred to in this section. For an authoritative treatment of the legal aspects of the problem see Roswell Magill, op. cit., Ch. 5 and 9.

[10] Ibid., p. 202.

ment, commonly considered business expenses, are or may be disallowed for tax purposes. The Internal Revenue Code does not mention either specifically. They might be deemed to fall under Section 23(a)(1)(A), allowing as deductions all ordinary and necessary expenses, or under the general principle underlying Section 24(a)(2), disallowing deductions for permanent improvements or betterments. The actual treatment for business purposes must depend upon experience and judgment since the facts required for a logical classification of the expenses are often not ascertainable when income must be computed.

The regulations do not deal directly with the problem of research and development expense though the depreciation of patents and copyrights is provided for: costs are to include "development or experimental expenses, etc., actually paid" [Sec. 29.23 (l)-7]. Depreciation of drawings and models is also allowed for: "If a taxpayer has incurred expenditures in his business for designs, drawings, . . . or work of an experimental nature calculated to result in improvement of his facilities or his product, and if the period of usefulness of any such asset may be estimated from experience with reasonable accuracy" [Sec. 29.23(l)-8]. Amounts expended for copyrights are specifically stated to be investments of capital [Sec. 29.24-2].

Despite the absence of specific provisions, the regulations appear to lean toward treating research and development expense as capital expenditures. This is supported by a decision of the Board of Tax Appeals in connection with the cost of experimental work involved in an unsuccessful effort to develop a new process.[11] It was held that such outlays were not deductible as ordinary and necessary expenses, that while hope for success was not unreasonable they could not be deducted as a loss, and that if successful some part of the expenditures would have entered into the cost of the process discovered. How the part not entering into the cost of the process should have been handled was not explained.

[11] Acme Products Company, Inc. v. Commissioner, 24 B.T.A. 194 (1931).

One author of this study had occasion for other purposes to inquire extensively into tax and business practice in the treatment of research and development expenses.[12] He discovered that tax practice was considerably more liberal than might be expected from the regulations and the few court cases on the subject. Companies were found to be allowed to deduct the costs of research as current expenses, when it was carried on regularly. Practice apparently was not uniform in all districts, and taxpayers expressed concern over increasing stringency and a tendency to use the allowances for research expenses as bargaining points on other controversial items.

Among other reasons, business practice varies with the position of a company incurring research and development expense. For new companies, or established companies newly embarking on very large-scale research and development work, it is in no sense unreasonable to defer the charges until the income to which it is expected to lead has been received. Likewise for companies with distinctive models, the preparation of each one of which requires expensive advance work, it is reasonable to segregate special costs to be charged over the life of the model. For mature companies, however, engaging in a variety of research and development work, much of which is not clearly attributable to any specific or definitely foreseeable product or process, it is both extremely complex and unreal to attempt to defer research charges.

A temptation undeniably exists on the part of business to vary the treatment of research costs in such manner as to take them either as current expenses or as amortized deferred charges in the years when the tax benefits are greatest. Relative stability in tax rates and a reasonably long loss carry-over would go far toward removing the grounds for any Treasury suspicions of business motives on this as well as other similar subjects.

12 See J. Keith Butters, Taxation and New Product Development, *Harvard Business Review*, Vol. 23, pp. 451-9 (1945) for an extended discussion of this entire topic.

E Taxes Paid

The deductibility of taxes paid by a corporation is determined by rules that do not necessarily correspond to those by which a company keeps its records. Property taxes are usually considered expenses for both book and tax purposes. Special assessments, financing expenditures that enhance the value of property, are ordinarily capitalized for both purposes, though borderline cases are possible.

The deductibility of state sales and excise taxes depends upon the phraseology of the law imposing the tax. If not deductible as taxes paid by the purchaser, the amounts would swell the cost of purchases, thereby influencing either the current cost of goods sold or the cost of capital assets subject to depreciation. Thus they would, in one classification or another and at one time or another, be treated as expenses. For a company's own books, however, a general rule might be set up that would ignore the artificial distinctions based on legal wording. Sales taxes on machinery purchased, for example, might consistently be regarded as increasing the cost of machinery. During the period covered by Part Two, federal excise taxes also were deductible as taxes paid. They too might have been handled as increasing the cost of goods sold or of depreciable property.

For excise or sales taxes on a company's sales, the company is in a sense acting as a collecting agent for the government. Gross receipts may be shown inclusive of the amounts paid in sales or excise taxes; and the taxes reported as separate deductions or as part of the cost of goods sold; or the taxes may be eliminated from both income and expense. When excises are high, as on liquor and tobacco, their inclusion may seriously distort comparisons between companies. No matter how treated, sales and excise taxes on a company's sales should wash out before the final calculation of net income, but alternative methods may influence intermediate figures significantly.

A further problem in accounting for taxes paid is timing.

For taxpayers reporting on an accrual basis, taxes are deductible in the year they accrue. Accrual accounting for business purposes suggests estimates and allocations of a year's taxes over intermediate periods, but such action would be inconsistent with the tax rule, applicable at least to property taxes, that they are attributable to the precise date on which they accrue in a legal sense, that is, become binding obligations though perhaps still indeterminate in amount.[13] The tax services regularly contain tables showing the date on which various state and local taxes are deemed to accrue.[14] For most property taxes, for many franchise taxes, and for the former federal capital stock tax, the date on which the tax accrued would seldom coincide with the end of a company's fiscal year. Accordingly, a business accrual is not consistent with the allocation of taxes to the tax year in which the date of legal accrual falls. Differences between taxable and business income arising from this source, though frequent and numerous, may be expected to balance out over a period of years.

[13] For a general discussion of problems of allocation and a description of alternative treatments see Accounting Research Bulletin 10, Real and Personal Property Taxes (1941).

[14] For a discussion of doctrine basic in the Treasury's position see G.C.M. 21373, Cumulative Bulletin 1939-2, p. 82.