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Taxable and Business Income

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FISCAL POLICY SERIES

NUMBER TWO

Taxable and Business Income is the second book published on the initiative of the National Bureau's Conference on Research in Fiscal Policy. Other reports are *Fiscal Planning for Total War*, by W. L. Crum, J. F. Fennelly, and L. H. Seltzer, published in 1942, and *Occasional Paper 25*, Recent Developments in Dominion-Provincial Fiscal Relations in Canada, by J. A. Maxwell, published in 1948.

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Preface

This comparative study of the concepts and statistics of taxable and business income was originally planned on a very comprehensive scale. After many delays and changes necessitated by the war activities of the participants, it is now released in a greatly modified form. The first arrangement, agreed upon in 1940, called for a joint authorship representing the legal, the accounting, and the economic points of view, with the hope that balanced professional judgments could be made on the various income concepts pertinent to the comparison of taxable and business income. Bishop C. Hunt, Randolph Paul, and Dan T. Smith, as chairman, constituted the original committee. J. Keith Butters was employed to work on the statistical part of the study; in fact, he initiated and carried out virtually all the compilation and analysis for Part Two.

Wartime activities diverted the attention of all participants from the study. Grateful acknowledgment is made to W. L. Crum, the chairman of the Conference on Research in Fiscal Policy, and to officers of the National Bureau of Economic Research, for the gracious manner in which they allowed this project to be completely immobilized for more than three years. Work on the manuscript was resumed by Messrs. Smith and Butters early in 1946, and the manuscript was submitted to the National Bureau for review and publication in July 1946.

Part One is a combination of material written in 1942 with new material, prepared primarily by Mr. Smith, designed to give the manuscript reasonable coverage. The few sections regarded as nearly complete in 1942 have been severely edited to bring them down to a scale commensurate with the rest of the volume. Considerable portions of the legal sections of Part One are derived from manuscripts originally written by Mrs. Joyce Stanley under the supervision of Mr. Paul, whose research assistant she was. The concepts underlying the considerations of bad debts and depletion represent our own summarizations of much longer sections on these subjects originally prepared by Mr. Hunt.

The authors find themselves in the somewhat delicate position of trying to give full recognition to the great contributions of their earlier associates to Part One without in any way charging them with responsibility for the final product.

Part Two represents a reworking of various interim reports made by Mr. Butters to the Treasury Department and to the Securities and Exchange Commission. The very generous cooperation and provision of clerical assistance by both agencies rendered the entire statistical portion of the study possible.

The authors wish to express particular appreciation to W. L. Crum for his constant interest and thoughtful consideration of innumerable problems, both general and detailed, which they have raised with him throughout the study. C. A. Heuser and D. R. Hopkirk of Price, Waterhouse & Co. assisted in the early research and prepared material on reorganizations and installment sales. Willard Arant, now with Swift and Company, and H. B. Woolley assisted in early phases of the research. Grateful acknowledgment is also due the splendid cooperation of members of the Treasury Department, the Bureau of Internal Revenue, and the Securities and Exchange Commission, in the compilation of the data. Roy Blough and Louis Shere of the Treasury Department, T. C. Atkeson of the Bureau of Internal Revenue, and R. W. Goldsmith and R. C. Parmelee of the Securities and Exchange Commission, were especially help-

ful, as were their associates, too numerous to name. After the manuscript was submitted to the National Bureau, helpful reviews were made by a committee of accountants including George O. May, P. F. Brundage, and L. G. Sutherland of Price, Waterhouse & Co., M. E. Peloubet of Pogson, Peloubet & Co., and C. H. Towns of Loomis, Suffern & Fernald; by two legal experts, Dean E. N. Griswold of the Harvard Law School, and Professor W. L. Cary of the Northwestern Law School; and by Professor James C. Bonbright of Columbia University. Various members of the National Bureau staff made helpful suggestions; those of Geoffrey Moore were especially detailed and complete. Martha Anderson was generous with her time in the tedious task of editing a manuscript as technical as this. The manuscript has been substantially improved as a result of the criticisms of these individuals, to each of whom the authors express their gratitude. The authors, however, assume full responsibility for the content.

D.T.S.
J.K.B.

February 1948

Relation of the Directors to the Work and Publications of the National Bureau of Economic Research

1. The object of the National Bureau of Economic Research is to ascertain and to present to the public important economic facts and their interpretation in a scientific and impartial manner. The Board of Directors is charged with the responsibility of ensuring that the work of the National Bureau is carried on in strict conformity with this object.

2. To this end the Board of Directors shall appoint one or more Directors of Research.

3. The Director or Directors of Research shall submit to the members of the Board, or to its Executive Committee, for their formal adoption, all specific proposals concerning researches to be instituted.

4. No report shall be published until the Director or Directors of Research shall have submitted to the Board a summary drawing attention to the character of the data and their utilization in the report, the nature and treatment of the problems involved, the main conclusions and such other information as in their opinion would serve to determine the suitability of the report for publication in accordance with the principles of the National Bureau.

5. A copy of any manuscript proposed for publication shall also be submitted to each member of the Board. For each manuscript to be so submitted a special committee shall be appointed by the President, or at his designation by the Executive Director, consisting of three Directors selected as nearly as may be one from each general division of the Board. The names of the special manuscript committee shall be stated to each Director when the summary and report described in paragraph (4) are sent to him. It shall be the duty of each member of the committee to read the manuscript. If each member of the special committee signifies his approval within thirty days, the manuscript may be published. If each member of the special committee has not signified his approval within thirty days of the transmittal of the report and manuscript, the Director of Research shall then notify each member of the Board, requesting approval or disapproval of publication, and thirty additional days shall be granted for this purpose. The manuscript shall then not be published unless at least a majority of the entire Board and a two-thirds majority of those members of the Board who shall have voted on the proposal within the time fixed for the receipt of votes on the publication proposed shall have approved.

6. No manuscript may be published, though approved by each member of the special committee, until forty-five days have elapsed from the transmittal of the summary and report. The interval is allowed for the receipt of any memorandum of dissent or reservation, together with a brief statement of his reasons, that any member may wish to express; and such memorandum of dissent or reservation shall be published with the manuscript if he so desires. Publication does not, however, imply that each member of the Board has read the manuscript, or that either members of the Board in general, or of the special committee, have passed upon its validity in every detail.

7. A copy of this resolution shall, unless otherwise determined by the Board, be printed in each copy of every National Bureau book.

(Resolution adopted October 25, 1926 and revised February 6, 1933 and February 24, 1941)

Historical Foreword

by

George O. May

At the outset it is desirable to consider the fundamental causes which tend to create similarities or dissimilarities between income tax accounting and general financial accounting in the first instance, or to narrow or widen the differences in the course of the gradual development of practice.

Dissimilarities between tax accounting and financial accounting might result from difference in concepts, as for instance, on the question whether capital gains and losses are elements in the determination of income, or they might be a reflection of different views as to the time when revenues or expenditures should be brought into the accounting. They might be the result of the adoption of materially different codes or of gradual departures from an initial common standard.

The corporate excise tax law of 1909 rejected commercial practice and provided that cash receipt or payment should determine when items should be brought into account. But the proposal was so impracticable that it was never put into effect in measuring business income. Its only contribution to our system of taxation was a confusion of ideas that still exists.

During the present century the interest of the Federal Government in the financial accounting of corporations has been recognized in various ways. Beginning with the railroads in 1907, Federal Commissions have been given power to regulate the accounting of all public utilities engaged in interstate business. The Securities Acts of 1933 and 1934 conferred extensive jurisdiction over accounting of other corporations whose securities are required to be registered. The accounts prescribed under these powers had to be suited to the needs of the owners of the corporation as well as to those of the government. The forces making for acceptance of the corporations' own accounts (assuming that they conformed to prescribed or accepted standards) as the norm for income tax accounting were irresistible.

This position was first clearly recognized by the Congress in the Revenue Act of 1918 which was drafted by the Treasury with the aid of a singularly fortunate combination of technical advisers of great ability and vision, brought together by the Commissioner of Internal Revenue in the first instance to assist in solving the almost insoluble problems created by the Revenue Act of 1917.

The triumvirate which directed the formulation of the Act of 1918 and the regulations thereunder, which may be said to have created a new body of doctrine "income tax accounting", were a distinguished economist and former tax administrator, an outstanding accountant and a brilliant young lawyer.[1]

The fundamentals of the new body of doctrine were embodied in two sections of the law which have remained virtually unchanged ever since. Section 212 (b) of the Act of 1918 says in part:

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year as the case may be) *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 *upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income.* (Now Sec. 41 of the code.)

Section 213 of the Act of 1918 provides, after enumerating the items to be included in gross income, that:

1 T. S. Adams, J. E. Sterrett, and Arthur A. Ballantine.

The amount of all such items shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivision (b) of Section 212, any such amounts are to be properly accounted for as of a different period; . . . [Now part of Sec. 42 (a).]

Article 22, of Regulations 45, reads in part:

The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. (Now Reg. 111, Sec. 29.41-1.)

Article 23, of Regulations 45, begins with the statement:

Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income.

It was, of course, necessary to reserve to the Commissioner the right to reject methods of accounting which did not reflect income, but the spirit in which he was expected to exercise his discretion was made very clear in the section relating to inventories, one of the major and most difficult problems of income determination. Section 203 of the law provided that:

Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income. [Now Sec. 22 (c).]

The regulations are as significant and of as much historic interest as the Act itself. They were the product of the same minds and, together with the law, form an organic whole. These regulations included an outline of accepted accounting methods then recognized. In the course of time they have come to be regarded by some as a code of legal rules for determining income distinguishable from general accounting practice. But in origin and purpose they were merely an implementation of the intent of the law as above quoted for the benefit of those who were not familiar with current accounting standards.

No adequate account of this important episode in the history of income taxation appears to have been published. Passages from the testimony given by Dr. Adams in 1925 were quoted in a recent article of mine in the *Columbia Law Review*.[2] The occasion of the testimony was action of the Board of Tax Appeals which Dr. Adams regarded as a departure from the general intent of Congress. Some of these passages are reproduced here:

I happen to be unusually familiar with the entire development of these provisions authorizing something other than a so-called receipts and disbursements accounting. I have been interested in it for years, interested in it before there was any federal income tax.

I know that on the part of the experts who framed the legislation in the first instance, they recommended it to Congress, recommended it to the several legislative committees interested in it, and explained what they had in mind with respect to the reporting of gross income to give the widest elasticity to the Commissioner of Internal Revenue, in the belief that the differences of business practice and business necessity required such elasticity.

Nothing was further removed from the minds of those who worked on Sections 212 and 213 of the Revenue Act of 1918, than the thought that just two systems of accounting could be recognized, one a so-called accrual method. . . .

On the contrary the exactly opposite belief existed, the belief namely that even the experts were at variance concerning the implications of the so-called cash and accrual methods, that the conditions of modern business required the most elastic adjustments to their necessities and needs, that within the bounds of reason accounting should be permitted to adjust itself to those needs. And thus it was that the phraseology was adopted in the 1921 law, that the taxpayer should make returns upon the basis regularly employed in keeping his books, provided it clearly reflected the net income, that if it did not clearly reflect net income the Commissioner should prescribe a method which would reflect the correct net income. . . .

2 Accounting and the Accountant in the Administration of Income Taxation (Vol. 47, pp. 377-97; April 1947).

It is clear that in 1918 the Congress intended that there should be the closest possible harmony between tax accounting and general business accounting and the later statutes contain no evidence of any change of attitude on this point. Indeed, the provisions which in 1938 authorized what is known as LIFO inventory accounting (perhaps the most important annotation that has occurred in tax accounting) made its acceptance for tax purposes conditional on its use also for the general accounting purposes of the taxpayer [Sec. 22 (d)].

I turn next to consideration of the extent of the differences between tax accounting and general financial accounting which have developed during the 30 years that have elapsed since 1918 and of the way in which they have arisen.

The most important differences undoubtedly have resulted from the introduction into law of a constantly increasing number of provisions which modify the general concept of income underlying the statute, in order to give relief or for other reasons of a policy character. The rules governing deductions for depletion are perhaps the most notable instance of this practice. In such cases, it is sometimes difficult to distinguish clearly between the allowance based on concepts of income and the deduction based on policy.

Apart from these the divergencies have been relatively unimportant in the amounts involved and have been the result of a few causes that can readily be traced. These causes include:

A Constitutional limitations.

B Differences in attitude towards merely potential losses or expenses.

C Semantics—especially in relation to the words 'accrue', 'reserve' and their derivatives.

D Difference between the legal and the accounting approach to certain questions.

E The human craving for the supposed certainty of a definite rule.

The most important constitutional point of difference originally was that which required the exclusion from income of amounts which were a realization of values that existed at the date of the constitutional amendment which authorized the tax (March 1, 1913). Contemporary discussion reveals also uncertainty whether income could be held to arise before there was a realization in cash.[3] This was resolved by adoption of the doctrines of the completed transaction and equivalence to cash.

The underlying consideration of constitutionality, as well as the general intent to recognize accepted accounting practice, may have led the Congress in 1921 to overrule the Commissioner's denial of recognition for reserve for bad debts which was itself apparently of semantic origin. It may be noted that a fortiori the revenue from sales should have been permitted to be measured by the amount of cash or other values that would have discharged the debt at the end of the taxable period and that reserves for discounts and for return of the nominal sale price of returnable containers should have been allowed on this ground.

The framers of the law of 1918 were clearly concerned with the distinction between deductions from gross sales to arrive at gross income and deductions from gross income to arrive at taxable net income. During the year 1918 the Supreme Court, in the case of Doyle v. Mitchell, had emphasized this distinction and had pointed out that the taxpayer's right to the first-mentioned deduction was absolute and not dependent on any express provision of the statute. This distinction has often been ignored in the presentation and hence in the decisions of later cases, particularly by the Board of Tax Appeals. Many decisions have remained uncorrected either because counsel for the taxpayers themselves overlooked the point, or because the cost of securing a reversal would have been greater than that of accepting the decisions and accommodating oneself to them by changes in business procedure.

Obviously the law could not go as far in the direction of

[3] See paper by T. S. Adams, When is Income Realized? (Columbia University Press, 1921).

allowing provisions for possible losses not yet measurable as might be prudent for the taxpayer, and difficult questions arose as to just where the line should be drawn. Quite naturally the Court held that reserves for purely contingent losses could not be deducted [4] and a rule of thumb was then adopted that 'reserves' were not deductible; the fact that a reserve was merely the technique, not the substance, was not recognized. Reserves for depreciation are described as not true reserves and reserves for bad debts as exceptions to the general rule expressly authorized by the Congress.

The confusion caused by varying uses and interpretations of the word 'accrue' would afford subject matter for a volume. It may be attributed largely to the retention in 1918 of that word in the listing of deductions as set forth in the preceding law. Other expense deductions were to be allowed when "paid or incurred", interest and taxes "when paid or accrued". True, it was provided in the Act of 1918 that each of these terms was, in the language that is retained in the present Sec. 43(c) of the Code, to be "construed" according to the method of accounting upon the basis of which the net income is to be computed under this part.[5] The intent clearly was that they should be brought into account in the period in which they were properly included according to the method of accounting accepted or prescribed by the Commissioner in the individual case. This point appears to have been frequently overlooked.

It is significant to note that in the leading case in which the term paid or accrued, as applied to taxes in the 1917 law, was interpreted by the Supreme Court, that body said:

In the technical legal sense it may be argued that a tax does not accrue until it has been assessed and becomes due; but it is also true that in advance of the assessment of a tax, all the events may occur which fix the amount of the tax and determine the liability

[4] Lucas v. American Code Co. 280 U.S. 445; 50 S. Ct. 202.

[5] This provision was and is supplementary to the provision now Sec. 43 that the deductions shall be taken when paid or incurred or paid or accrued *dependent* upon the method of accounting, etc. etc.

of the taxpayer to pay it. *In this respect, for purposes of accounting and of ascertaining true income for a given period, the munitions tax here in question did not stand on any different footing than other accrued expenses appearing on appellee's books.* In the economic and bookkeeping sense with which the statute and Treasury decision were concerned, the taxes had accrued. (Italics mine.)

In general law a tax accrued when it was assessed and became an obligation; by exception interest was "deemed" to accrue from day to day. In accounting practice prior to the initiation of income taxation, an accrued asset or liability was one that had grown up but had not become due. Under the tax law, the term accrued soon came to mean "properly recordable on the books as an asset or liability". The possibilities of confusion thus presented were manifold and they have been exploited to the fullest possible extent in the contest between legal and accounting views of taxable income.

The harmonious cooperation between economists, lawyers and accountants of high quality that produced the law of 1918 seems to have continued between certain groups of lawyers and accountants, particularly where the taxpayer normally engages the continuous services of members of the two professions for services other than tax purposes. In some parts of the field, however, there has been bitter and sometimes unseemly conflict. Attempts have been made by associations of lawyers to bar accountants more or less completely from the tax practice in which they had early established a dominant position. Accountants have attempted to invade the legal areas of tax determinations. A natural feature of this conflict has been attempts by lawyers to make tax practice more and more legalistic and to make nugatory the accounting provisions of the law which have been quoted.

No frontal attack on these provisions has been made but the controlling weight which they originally had has been impaired by multiplicity of special relief provisions and by the laying down of fixed rules on specific questions. This has occurred sometimes at the instance of taxpayers or their legal or accounting advocates, at other times at the instance of the Bureau, which has taken the position that its personnel was not well equipped to administer discretionary powers (as the English Commissioners do). As a result on minor points the lower Courts have rendered decisions which are difficult or impossible to reconcile with the broad provisions of the law. Accountants have complained of them, and rightly, because they are vexatious and perverse. But the number and importance of the points are trivial in comparison with the volume of transaction treated in accordance with accounting rules. It would doubtless be desirable to remove these anomalies which owe their survival to their unimportance. But too little is involved to warrant the expense of securing reversal by the Supreme Court. Some of these decisions may be the result of inadequate presentation by counsel of accounting points with which neither they, nor the Courts, were fully familiar.

Before leaving this question it should be pointed out that in respect of both tax accounting and financial accounting there are important differences between theory and practice. Financial accounts and tax returns are summaries of the results of very large numbers of transactions. To revise the classifications of such transactions is a formidable task. Inventories, which play an important part in determining taxable income, are either accounting records or voluminous listings of items. In the absence of any suggestion of fraud, the revenue agent would seldom be justified in undertaking the work necessary to revise the classification of inventory in order to make it conform more closely to the law where the existing classification is reasonably consistent with that of previous years. As counsel in a recent case involving alleged practice of law by an accountant said: "It is what the cop on the beat thinks that is important to those who live there!" In the same way, the average taxpayer wants to know what the revenue agent or conferee will think about his return, not what the Supreme Court would say about it if he could afford to find out.

New York, N. Y. March 31, 1948

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