PART ONE

The general objective of this volume is perhaps best summarized by Wesley C. Mitchell’s statement in the Twenty-first Annual Report of the Director of Research of the National Bureau (1941).

"The aim is to lay the foundation essential for building public policy with respect to the taxation of business and also for subsequent studies of federal and state income taxation policies. The revenue from and the burden of taxation upon business and individuals depend in large measure upon the legal definition of taxable income. With tax rates as high as they are now and are certain long to remain, the significance of changes in the definition of income is greatly augmented. If a tax structure is to be framed wisely, it must be founded upon clear knowledge of all differences between income as defined for ordinary and for tax purposes."

Mr. Mitchell emphasizes the limited objective of this study. As originally conceived by the Conference on Research in Fiscal Policy, it was intended “to lay the foundation”—or more conservatively, to lay some of the building blocks in the foundation—needed for determining public policy on tax matters and for the intelligent use of business and tax income statistics in other areas of analysis. Subsequent research projects at the National Bureau and elsewhere may well have occasion to develop the implications of the findings to a much greater degree and apply them to other areas of economic analysis, such as national income.

The intended coverage may, perhaps, be further clarified by one or two illustrations. In the area of tax policy, for instance, proposals have frequently been made to the general effect that the Treasury Department should accept for tax
purposes net income as determined and reported by business concerns. In accordance with National Bureau practice, the authors have refrained from formulating a definite policy recommendation on this issue or on other comparable issues. They hope, however, that the information and analysis here presented will provide some of the 'foundation blocks' needed by anyone interested in appraising the merits of the above proposal—or of comparable proposals.

In estimating national income, data from federal income tax returns are used extensively. For the years when tax data are available, estimates of corporate profits and of major segments of capital consumption are derived largely from information reported on the federal corporation income tax return. In estimating corporate profits for current years, on the other hand, the Department of Commerce must rely on information from a sample of published reports of corporations, inasmuch as tax data are not available currently. In appraising national income statistics compiled partly from tax data and partly from records kept by business firms for their own purposes, information with respect to the relation between the two sets of data is clearly necessary for a full understanding of their implications. It is, for instance, important to know to what degree taxable income differs from book profit as reported to the public or to what degree depreciation allowances claimed on tax returns differ from those taken on the corporation’s books.

Despite the importance of these questions, little material has been published that would provide answers. The authors hope and believe that their statistical findings, although obviously subject to serious qualifications in several respects, will be useful in filling in part the major gaps in our knowledge in this area of national income statistics. In view of the limitations on the scope of this project, however, no attempt is made to spell out the implications of the findings for national income statistics; this task is left for specialists.

One other aspect of the coverage should be stressed. The
analysis of income concepts which comprises Part One is not intended to present new material to professional specialists in their own fields. It is, however, hoped that the volume will be helpful to, say, legal or accounting specialists in formulating the reasons for diverging concepts and points of view advocated by specialists with different backgrounds. For instance, it is hoped that legal specialists may obtain some additional insight into the various business conditions and requirements that cause business income to diverge from taxable income. Conversely, some accounting specialists may derive a more sympathetic appreciation of a pattern of logic running through the legal concept of taxable income. Economists, unversed in the intricacies of either law or accounting, may find an underlying logic in each, instead of the combination of arbitrary positions each may seem to represent to the uninitiated.

Consistent with this approach, the more typical situations rather than the obscure borderline situations are the chief object of attention. Many of the intriguing special cases, which would be of great interest to specialists in their own fields but confusing to nonspecialists, have been deliberately omitted. Likewise, the authors have deliberately refrained from including extensive documentation of a sort likely to be of interest to the specialist in his own field rather than to the general reader. Such documentation is readily accessible in technical studies, the tax services—and law and accounting journals—with which this volume has no intention of competing.

The study is divided into two parts, the conceptual and statistical. From some points of view they may be regarded as substantially independent. Readers interested in the concepts of income, as such, may be almost exclusively concerned with Part One. On the other hand, specialists in national income statistics will probably find the quantitative treatment in Part Two of major interest. In other respects, however, the two parts are quite closely related. Part One may be regarded as a presentation of the reasons underlying the quantitative divergences reported in Part Two.
PART ONE

PURPOSE AND SCOPE OF PART ONE

Part One is designed to describe the differences underlying the concepts of book profit and taxable income. The individual chapters cover the chief reasons for divergences between the two income concepts, but they do not in any sense constitute complete presentations of either concept. They are designed rather to give an over-all view to the general reader. They indicate the extent to which the differences in the two approaches are, on the one hand, erratic and, on the other, to be explained by logical and consistent patterns running through the two concepts.

In preparing this study the authors have convinced themselves, at least, that it would be altogether incorrect to conclude that of the two concepts one is 'right' and the other is 'wrong'.

Certain fundamental principles differ and these differences are manifested in various ways. Any attempt at a reconciliation of the two income concepts, as far as reconciliation is desirable, should start with an understanding of the differences and the reasons for them rather than with any tacit assumption that one or the other concept is correct. Part One is therefore designed to present a pattern of logic with a reasonable amount of perspective on the development of the income concepts treated.

1 Some readers may take exception to this conclusion. For instance, M. E. Peloubet, in reviewing the manuscript, commented as follows on this sentence: “I particularly do not like the statement . . . ‘It would be altogether incorrect to conclude that of the two concepts (taxable income and business income) one is right and the other is wrong.’ The efforts of the accounting profession have been devoted for many years to making proper determinations of income. Income determined under generally accepted accounting principles is objectively determined and is meant to be as nearly correct as possible. It would seem to me that it would be a better approach to make it clear that taxable income is artificial and is not determined from any objective point of view. It is rather arrived at for a specific purpose and is frequently so much in conflict with accepted accounting principles that a figure for taxable income would be regarded as misleading if published to stockholders or the public.” See also J. K. Lasser and M. E. Peloubet, Tax Accounting v. Commercial Accounting, Tax Law Review, Vol. 4, pp. 343-58 (March 1949).
INTRODUCTION

As previously implied, many of the most involved parts of the tax law have been developed to deal with unusual situations, frequently with borderline practices designed to avoid taxation. These increasingly complex aspects of the law are largely ignored in this study. To have discussed them in full would have called attention to many quasi-pathological mutations in business organization and procedure, but would have obscured the more typical and important points.

Nevertheless, to give the reader a 'feel' for the concept of taxable income, it has seemed appropriate to discuss some of the more technical aspects of the tax law with some care. For instance, the discussion of 'basis' in Chapter 2 was undertaken in considerable detail as an illustrative case, as was the tax treatment of bond premium and discount with respect to interest deductions in Chapter 6. Bad debts, depreciation, and inventory valuation are also discussed rather fully. Their suitability to reveal fundamental differences and the desire to minimize repetition account for the relative length of the various treatments. Thus, capital gains and losses occupy a short section because much of the explanation for their varying treatment in tax and business practice is given in Chapter 2, on basis, and in various references to surplus adjustments. When the divergences are absolute and simple, as in the matter of tax-exempt interest, a statement of the required treatment suffices.

Part One includes reference to the significant changes in the definition of taxable income since the last year covered by the statistics. This material has been added both to show the changeable content of data on taxable income and to indicate the respects in which taxable and business income concepts have been modified in recent years. These changes will influence statistical comparisons for later years; the nature and direction of these influences are noted, but their extent cannot be estimated in the absence of detailed figures.

In the treatment of specific income and expense items from the business standpoint, reasonable coverage of alternative procedures has been considered more useful than an exhaustive
presentation of authorities or a nice balancing of conflicting opinions. Limited references are made to some of the most important accounting literature on fundamental issues. The material cited is representative of recent investigations in accounting theory.

The concept of business income itself is not and cannot be precisely defined. Both accounting literature and accepted practice reveal substantial differences in what is regarded as constituting income. Individual authors, to be sure, have formulated their own sets of doctrines, and company or trade association manuals commonly set up procedures for their own areas of interest. But the significant fact remains that authorities differ over what constitutes 'best' practice, and much of the most useful literature consists of appraisals of the relative appropriateness of different accounting methods for specific conditions.

A critical pragmatic approach is characteristic even of the research bulletins of the American Institute of Accountants, the most authoritative source of current professional doctrine. Frequently optional methods are suggested which have radically different effects on annual or even aggregate income figures. Likewise, many of the bulletins are published with vigorous dissents by minority members of the Committee on Accounting Procedure. This study does not, therefore, presume to determine or state any single concept of business income.

One point in particular should be emphasized in this connection. There is often a wide gap between the accounting practices used in computing business income by the companies included in the statistical compilations of Part Two and the current versions of 'best accounting practice' as defined, say, by the Accounting Research Bulletins of the American Institute. For instance, direct charges or credits to surplus are reported by many companies for many reasons in the data, but best accounting practice has restricted the widespread and sometimes indiscriminate use of such charges or credits. By
exerting this pressure the accounting profession has, in this respect, tended to minimize a major source of divergence between book profit and taxable income. The Securities and Exchange Commission also has been a dominant influence in increasing uniformity in accounting practice. In Part Two an attempt is made to differentiate references to business practice as reported in the statistics from references to current interpretations of best accounting practice, when such a distinction is important.

Only taxable and ordinary business income are considered. Other concepts are mentioned briefly to place those studied in their proper perspective. The various regulatory bodies, starting with the Interstate Commerce Commission, have developed rules for income determination which differ from those used both for taxation and for business purposes in other industries. This special treatment has developed in connection with such problems as determining fair returns and establishing rate bases. Retirement accounting for depreciable assets is perhaps the best example of distinctive treatment in the field of regulated industries. Of other equally fundamental but less conspicuous examples only a few are mentioned.

Much of the distinctive treatment of income and expense items in regulated industries goes back to early practices and operating conditions in railroad companies. Attention to the rate base has often been pre-eminent with consequential but unplanned effects on certain aspects of income determination. Comparison of the income concepts of ordinary business and regulated industries would itself be a major study.

Various specialized economic studies also have required the development and use of distinctive income concepts which correspond to neither taxable income nor ordinary business income. No general and universal definition of 'economic income' exists, but specially adjusted income data have been used in connection with:

1) The measurement of aggregates and components in the general area of national income, including gross national product,
net national product, income payments to individuals, and corporate and individual savings. The method of treating capital consumption and other expense and income items in such studies has already been developed at considerable length in various National Bureau studies on income measurement.

2) The measurement of the relative profitability of different forms of business enterprise and industries. Segregation of capital gains and losses, an analysis of surplus adjustments, and the treatment of depreciable assets are all important.

3) Business cycle analysis based on studies of income flows and withdrawals from and additions to income streams. The distinction between income and expense items, on the one hand, and cash receipts and cash outlays, on the other, is important.

4) Studies of price policies and price-cost relations. Cost rather than net income figures are most important. The basis of stating and the method of treating depreciable assets and other expenses may be an important factor in pricing, in plant replacement and expansion, and in competitive positions within an industry.

The subject of this study, the comparison of taxable and business income, is thus merely one part of a much broader whole.