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Income Tax Accounting Versus Accounting Theory

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Accounting is a mirror, a continuing mirror in dollars, of the financial data of a business, compiled to meet the needs of management, investors and the public. Should this mirror be distorted by tax accounting laws, or should it remain a clear picture of the operation, based on what are known in the profession as "generally accepted accounting principles?"

Most will agree that Congress intended to have tax laws conform to generally accepted accounting principles, but many changes have been made since its inception.

The January 1954 issue of the Journal of Accountancy published the full text of a report which the American Institute's Committee on Accounting Principles for Income Tax Purposes had directed to the Committee on Ways and Means of the House of Representatives, which was preparing the 1954 amendments to the Internal Revenue Code.

In this report the committee pointed out various problems then in existence on which it desired consideration for members of the profession and the business community as a whole. This report placed emphasis on the fact that the majority of differences in tax accounting and generally accepted accounting principles were in the area of *when* certain types of revenue and expenses are recognized in tax accounting in contrast to *when* they are recognized in accounting theory. The result of this difference was that business organizations either had to keep, in effect, two sets of books or make elaborate reconciliations between their accounting records for tax purposes and those used for general business purposes.

Certain of the suggestions commented upon in that report were alleviated by the 1954 amendments, and others have been affected by later amendments and interpretations of the Code. However, many of these differences still exist.

In this year, 1962, the American Institute of Certified Public Accountants, in the Accounting Research Study Number 3, entitled, "A Tentative Set of Broad Accounting Principles for Business Enterprises," noted on the cover page: "This research study is published for discussion purposes. It does not represent the official position of the American Institute of Certified Public Accountants." In the August 1962 issue of the Journal of Accountancy, the president of the Institute, Mr. John Queenan has called on the profession to consider this research study and Study Number 1 "The Basic Postulates of Accounting" critically but constructively and offer their views and criticisms in a constructive manner.

Accounting principles are a growing, constantly evolving body of knowledge of the profession which will continue to change as the economy of our country and the world changes. This growth and change is a practical and purposeful thing. What would this profession, or any profession, be if it could not, or would not, change. Yet, just because we as a profession do not have a "permanent" set of accounting principles, it should not mean that the principles by which we and the other taxpayers of this country compute our taxes should not conform as nearly as possible to those principles that *have* been established by the accounting profession.

Many of the principles and pronouncements of our profession have been formed because of the solutions which accountants have had to devise to solve certain requirements of business transactions which have been affected by Federal income tax interpretations. Today significant and material business transactions cannot possibly be undertaken without careful preliminary study of the impact of Federal taxation.

For example, Dr. Sidney Simon in a recent article regarding the Lease-Option Plan concluded that many problems arise from failure on the part of parties to the contract to comprehend the hazards which exist and which can be avoided by careful consideration of the plan before it is put into effect.[1]

Accounting and taxable income are not the same, and due to certain economic, social or political factors they may never be the same. Accounting income results from a comparison of revenue and expense, and is significant by its comparison with other firms and other accounting periods within the same firm. Agreed, taxable income is similar, with recognition given to certain, "awards and deterrents" as authorized by our tax laws. The pressures

[1]Simon, Sidney L. "The Lease-Option Plan—Its Tax and Accounting Implications," The Journal of Accountancy, April 1962, P. 38-45.

placed upon Congress by court interpretations, certain income or political groups, and by deference to the demands of the economy of these modern times has often counteracted the changes that have been created in an attempt to bring about conformity of these "similar" recognitions of the result of business operations.

Many of these differences result from acceleration of income or delaying of expenses for tax purposes. By this method the government does not receive any more revenue, it just obtains the revenue earlier. In a period of increasing tax rates, these differences would result in a lower tax payment by the taxpayer, and vice versa in a period of decreasing rates. The differences in income tend to fall into four classifications as follows:

1. Items which constitute taxable income which are not included as income in the income statement.
2. Items included as income in the income statement which do not constitute taxable income.
3. Charges made against income in the income statement which are not deductible for tax purposes.
4. Items deductible for tax purposes which are not shown as a charge against income in the income statement.[2]

Now, let us look at some specific examples of the differences in the application of principle and tax accounting law that are common in many income tax returns prepared today.

The Institute Accounting Terminology Bulletin Number 2, dated March 1955, defines revenue as follows: "Revenue results from the sale of goods and the rendering of services and is measured by the charge made to customers, clients, or tenants for goods and services furnished to them. It also includes gains from the sale or exchange of assets (other than stock in trade), interest and dividends earned on investments, and other increases in the owners' equity except those arising from capital contributions and capital adjustments."

In the 1962 Accounting Research Study Number 3, previously mentioned, the research committee is still in agreement with this definition with the exception of a distinction between "revenues" and "gains," in that certain items such as gains from the sale of assets, other than inventory, the increase in the current value of inventories and the settlement of liabilities for less than book value are considered as "gains" instead of "revenue."

[2]Johns, Ralph S., "Allocation of Income Taxes" Journal of Accountancy, September 1958, P. 41-50.

Here we find several examples where tax accounting is not in agreement with this definition. For instance, Section 451 of the 1954 Code says, "The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period." You will note, this sections says ". . . method of accounting used in computing *taxable* income," not "method of accounting used in computing income," therefore amounts which are in effect paid for future services without restriction on the use of the funds by the recipient are income when received, notwithstanding the possibility of a refund. An example, an advance rental, royalty or bonus received upon execution of a lease is includible in gross income in the year received when the use of the funds are not restricted, even though the payments are returnable if the terms of the lease are unfulfilled.

An example, in the Harold Bell Co. case, "advances" received by a taxpayer from a related corporation to enable the taxpayer to acquire real estate for the related corporation (lessee) constituted prepaid rental and taxable income in the year received because the taxpayer entered the "advances" as prepaid rentals on its books, and they were not earmarked for any specific purpose and could have been used for any corporate purpose.[3]

Another example, the Supreme Court has ruled that prepaid tuition fees received by a dancing school could not be deferred over the period lessons were taught.[4]

Again from the Institute Terminology Bulletin Number 2, "The terms net income or net profit refer to the results of operations after deducting from revenues all related costs and expenses and all other charges and losses assigned to the period." Here we get into the aforementioned discussion as to *when* items are expense.

Section 462 of the 1954 Code said, "In computing taxable income for the taxable year, there shall be taken into account (in the discretion of the Secretary or his delegate), a reasonable addition to each reserve for estimated expenses to which this section applies."

Section 462 of the 1954 Code was repealed by P.L. 74, 84th Congress in 1955. With

[3]Wakely, Maxwell A. H. Journal of Accountancy, November 1956, "A Re-Examination of the 1954 Code," P. 55-59, Harold Bell Co. TCM 1955-103.

[4]Schlude, M. E. (Sup. Ct.) 61-2 USTC par. 9518.

repeal of this section, the rules applicable under the 1939 Code as to additions to reserves for estimated expenses are now applicable under the 1954 Code. The result of this has been the consistent refusal of the Commissioner and the Tax Court to recognize accounting reserves set up for advertising, anticipated legal expenses, allowances for freight charges, trade discounts, cash discounts on accounts receivable, and reserves for bonuses to officers. Accordingly, when reserves are set up on a taxpayer's records, the expenses and losses may usually be deducted only in the accounting period when they actually accrue and are chargeable to the reserve. Deduction of allowances for bad debts however, are permitted by a special statutory provision under Code Section 166.

Accounting theory has long held that organization expenses of a corporation are a permanent asset since they benefit a concern over its entire life, and the life of a corporation is usually perpetual. The code, however, at Section 248, allows the election to amortize these expenses ratably over a period of not less than 60 months beginning with the month in which the corporation begins business.

In theory, the pricing of an inventory requires the assignment of the proper values to the proper quantities of all inventorial cost elements. The inventory method chosen by a firm, however, often depends upon the tax considerations involved in the various methods.

Depreciation is frequently different for tax purposes than for financial reporting. This difference arises through items capitalized for tax purposes only, amounts disallowed as expense by revenue agents in examination of prior years' returns, and through differences between rates used in computing financial income and those allowable by the Internal Revenue Service.

This difference between depreciation rates used points up a feature in our profession, in which we occasionally do not follow the best professional approach to our own theories. How often we find, since more liberal depreciation policies have been allowed for tax purposes, that companies tend to use these accelerated rates. If management decision, supported by adequate studies of the asset structure and use, can reasonably support the accelerated double declining balance method, or one of the other liberal methods of depreciation, then that method should be used for both financial and tax reporting. However, if previous depreciation methods in use, more clearly portray the "march of assets to the scrap pile," then the financial reports for the company should portray the proper depreciation method.

When different accounting principles are used for financial reporting than are used in accounting for tax purposes, we find ourselves in the field of income tax allocation. In this area there have been recommendations for income tax allocation, partial tax allocation, and for no tax allocation.

There is a long history of this discussion dating from the Institute's Accounting Research Bulletin Number 44 in 1954 and there are still many articles in current accounting publications, each of which carries convincing arguments for each author's interpretations. It appears that there will be much more discussion of this problem before the profession resolves this issue.

It is only reasonable to acknowledge that you were aware of differences in tax accounting and accounting theory before I started this discussion, and I have, as I stated earlier, only touched upon a portion of these differences. Some discussion as to what the profession can do to assist in the alleviation of these differences will be the conclusion of this subject.

The profession has in the past, and will continue to co-operate with the Internal Revenue Service in the development, and simplification, wherever possible, of the mechanics of the administration of tax laws. Also, the profession will, through its official organizations, continue its efforts to see that the committees of Congress are made aware of the need of conformity between tax law provisions and general accounting theory.

In addition, the American Institute has developed committees within its structure which have worked for years on long-range tax policy. These committees and sub-committees are working not on the mere technical variations between tax law and accounting theory, but are seeking solutions to the philosophy of taxation as a whole.

Individuals in the profession have in the past often quickly adopted changes in the Internal Revenue Code as "generally accepted accounting principles" and the need for adherence to the professional interpretation of these principles is evident. If we do not continue to maintain strict adherence to accounting principles, we will find our profession continuing to be further influenced by tax laws and court interpretations of these laws.

Therefore, we as individuals should by every reasonable means at our disposal, clearly reflect the principles adopted or recommended by the profession, and then make the necessary adjustments to comply with taxation laws.

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age is vital, so that each level of government can design, construct and maintain in operating conditions, systems capable of providing rapid and reasonably accurate estimates of the degree of damage from the attack effects, especially radiological contamination, and what has survived the attack that will be useful for recovery.

Time is not unlimited, and time that passes without plans to insure that preservation of our national economy, should attack occur, only adds to the practical difficulty of achieving national security.

If we do our work well, keep growing, keep the "Fabric" strong; if we do our jobs well; be interested in world affairs; join groups that have voice; if we acquaint ourselves with choosing proper representatives in the government; in the end this will contribute greatly to our surviving.

Survival will be possible if we are prepared. We will be prepared if we plan. So let us plan, prepare and survive.

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the ultimate decision is ignorant of the respective values which each of these two professions have to him?

This training will be the most important contribution an individual can make to the success of his business, be he head of a business, a member of the policy making group, head of a department related to the business's financial structure, or an employee in any of these departments.

An outstanding example of the consequences of effective cooperation between a client and a careful competent counsel may be demonstrated by a comparison of the Agran case which came before the California courts in 1954, and the Zelkin[4] case which was also litigated in California in 1961.

> Agran, a C.P.A., lost his case and was unable to collect his fees from his client. The court held that the services he rendered before the Treasury Department concerning a tentative carry-back adjustment claiming a net operating loss was illegal because such services constituted the practice of law by one not a licensed member of the Bar.
>
> Zelkin, a C.P.A., won his case and was entitled to collect his fee. The court held that the services he rendered in settling with the Treasury Department a tax controversy involving dealers' reserves was not practicing law.

After this case was analyzed in the May 1961 issue of the Journal of Taxation, the article summarized as follows:

> "It would be a mistake to infer that this indicates a change in attitude of the California court from the Agran doctrine since the two cases are clearly distinguishable on their respective facts. * * * Nevertheless, Zelkin does exemplify an appreciation by the courts of the fact that where matters of apparent complexity are involved in negotiations with the Internal Revenue Service their resolution is not presumably to be considered as involving the 'practice of law.'"

With proper coordination between a client's alert tax accountant and competent tax counsel (the latter having sought the cooperation of a competent C.P.A.), millions of tax dollars are saved as a result of proper timing of transactions, proper casting of the form of transaction, and proper assertion of rights which would have escaped attention in the every-day routine.

Another factor not to be overlooked is the subject of privileged information. A lawyer has the legal right of keeping tax files and confidential information out of the Internal Revenue Service's hands. This privilege is not enjoyed by an accountant and is a very important consideration in investigations which smack of criminal charges.

The proper education of the individuals in business as to their tax duties as described above should minimize or eliminate forever the serious conflicts between the professions and should allow more time and energy to be devoted to the application and practice of tax law.

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[4]Zelkin vs. Caruso Discount Corp., *et al.*, No. 704-525, SC L.A. County, Calif., aff'd Dist. Ct. App., 2nd Civ. No. 24663, 186 ACA 875.

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as set forth by the Congress and interpreted by the Courts.

To close I would like to give you a quotation from the article "Accounting as a Social Force," by Arthur M. Cannon in the Journal of Accountancy of March 1955, "Income taxation has been most important in the development of accounting, but the opposite is also true: the development of accounting has been absolutely essential to the development of income taxation."

From a paper presented at the Joint Annual Meeting, New York City, September 1962.