1946

Role of Accounting in the Taxing Process, An Address before the National Tax Association, June 6, 1946

Carman G. Blough

THE ROLE OF ACCOUNTING IN THE TAXING PROCESS

An Address before the National Tax Association, June 6, 1946

by

Carman G. Blough
Director of Research, American Institute of Accountants

Accounting as it is commonly understood is the art of recording, classifying, summarizing and interpreting transactions and events which are, in part at least, of a financial character. The roles which the art of accounting plays in taxation are both varied and important. Only the most elementary estimates of revenue needs can be made unless they are supported by comprehensive accounting classifications of expenditures by the taxing unit for a period of prior years together with similar classifications of the estimates of its current needs. It is not uncommon for tax assessors to base their conclusions with respect to the value of commercial and industrial buildings, equipment and stock in trade upon information obtained as a result of the taxpayer's accounting process, and in the field of valuation of enterprises on a unit basis, such as in the assessment of railroads and public utilities, complete accounting analysis of the condition of the corporate enterprise and the results of its operations is essential to intelligent assessment. In controlling and reporting upon the collection and disposition of public revenues, accounting is, of course, a commonplace.

But it is in the field of income taxation, the revenues from which play such a dominant part in the financial programs of the Federal Government and of many of the states, that the role of accounting in the taxing process attains its greatest importance. Without accounting, the administration of an income tax program would be impossible. At the same time it is in the field of income taxation that public taxing policy has its greatest impact upon business and thereby upon accounting, for to an ever-increasing extent tax considerations enter into the determination of business decisions which must, in turn, be reflected in the accounts.

The selection of income as a basis of taxation poses a variety of questions, the most important of which are of an accounting nature and involve accounting principles. What is income? How is income--or better, how are the elements of revenue and expense that determine income--to be allocated to time periods? These questions have broad economic, social and philosophical implications, but their business or commercial answer is made in the language of accounts--stated in terms of the concepts and conventions of accounting.

In commercial practice, income is recognized as the gain or increase in assets which arises from business operations. Such gain is to be measured by the excess of the revenues derived from sales of goods or services over the expenses or costs incurred in obtaining such revenues. As business operations are continuous so are the processes by which revenues, expenses, and income arise. A final and complete determination of income may be made only when the business enterprise ultimately dissolves. However, tentative periodic measurements of income can be made by matching the elements of revenue arising during a particular period with the costs or expenses which are related to that revenue. The principles and procedures designed to fairly allocate revenues to fiscal periods and to match them with the expenses properly attributable to them make up a large proportion of accounting theory and practice. It is well recognized in accounting and commercial practice that such allocations and matchings are based on estimates and may require subsequent adjustment, modification, or correction, but it is important to note that such subsequent changes are the result of being able to substitute facts for estimates and are not based upon changes in accounting procedures.

Accounting concepts recognize that there are various acceptable procedures for the allocation of revenues and expenses in the measurement of income, and that there may be a different pattern of periodic income when different methods are used. For example, depreciation may be allocated on the straight-line basis, the fixed percentage on diminishing balances basis, the sinking fund basis, the units of production basis, etc., and inventory costs may be allocated on the first-in, first-out basis, the last-in-first-out basis or the average cost basis. It should be observed, however, that these concepts do not approve whimsical shifts from one method to another. Consistency in the application of a method is itself a basic accounting principle. Whatever alternative method is selected, the sum of the annual incomes over the life of the enterprise will always be the same. A greater income of one year will be offset by a smaller income of a later period if one method is used, whereas a smaller earlier income would be offset by a larger later income under another.

It is within the framework of business practice and accounting convention that tax laws and tax rules must be put into effect. Thus, to the extent that concepts and conventions of income taxation reflect or may be easily reconciled with accounting principles, they are commonly understood and accepted by the business community. To the extent that other concepts and conventions prevail, tax rules and laws are found to be novel and unrealistic in terms of common commercial practice and experience, and those accustomed to the usual procedures of business are confused and resentful. The legislative and judicial history of income taxation is full of conflicts between those forces which strive to narrow the area of difference between accounting and tax concepts of income and income measurement and those which attempt to inject into the tax program procedures and objectives which are foreign to common business practice and produce results which appear to the taxpayer to be both capricious and unreasonable.

A forerunner of the present tax law, the Corporation Excise Tax of 1909, provided for the measurement of taxable income in terms of cash-receipts and cash-disbursements as defined by "income received" and "expenses actually paid." The 1913 Act provided the same basis of income measurement. These laws made no provision for matching revenues with their related costs, but it was soon recognized that even though a "cash" basis of income measurement may be convenient for tax assessment and collection, in a modern economic society it is generally not realistic--it is not descriptive of the common modern business practice. The Revenue Act of 1916 gave statutory recognition to this fact and provided that other bases of income measurement are appropriate. The terms of that Act were permissive. A taxpayer not on a cash basis could make a tax return on the basis employed in its accounts unless such basis "does not clearly reflect its income." As interpreted by the Supreme Court*, the purpose of that feature of the 1916 Act "was to enable taxpayers to keep their books and make their returns according to scientific accounting principles, by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period...".

The present mandate that net income be computed according to the method of accounting regularly employed by the taxpayer was first given in the Revenue Act of 1918. The language of that Act is contained in later Revenue Acts and is repeated in Sections 41, 42 and 43 of the Internal Revenue Code. The Code states:

---

*U. S. vs. Anderson

(Section 41) "The net income shall be computed upon the basis of the taxpayer's annual accounting period ... 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 in accordance with such method as in the opinion of the Commissioner does clearly reflect the income ..."

(Section 42) (a) "General Rule --- The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period ..."

(Section 43) "The deductions and credits ... provided for in this chapter shall be taken for the taxable year in which 'paid or accrued,' or 'paid or incurred,' dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. ..."

These provisions of the tax law would seem to provide an adequate basis for a reasonable and consistent measurement of income and the equitable assessment and collection of taxes upon such income. Moreover, they indicate that generally accepted accounting principles and practices that are regularly employed should be recognized as proper for the determination of income for tax purposes. However, the administration of the tax law has produced some rather weird results. On the one hand, taxpayers who have consistently used a cash basis of income determination have been required, for tax purposes, to take deductions for expenses on an accrual basis; for example, deductions for insurance premium payments have been required to be spread over the life of the insurance policy and a bonus payment required to obtain a mortgage loan has had to be spread over the life of the loan even though the taxpayer's accounts and tax returns were on the cash basis. On the other hand, persons keeping their accounts on the accrual basis have been required to report receipts as income on a cash basis; for example, one who contracts to perform future services by making sales of coupon books has been required, for tax purposes, to report as income the entire proceeds from those contracts in the period in which the coupons are sold, and advance rentals have been held to be income in the year of their receipt notwithstanding the fact that the taxpayer's accounts and tax returns were on the accrual basis.

It is, of course, to be recognized that in some areas accounting practices do not provide a simple basis which would make possible the convenient administration of a tax program. This is particularly true with respect to those expenses or losses which are provided for in advance of their final determination, such as provisions for warranties or recognition of losses on securities or other investments before their disposal is consummated. However, in relation to the whole field of accounting and taxation, such areas are relatively unimportant and should not be given undue emphasis. When tax rates vary from year to year and when "ability to pay" is reflected in graduated tax rates, the timing of the recognition of revenues and expenses might, of course, make important differences in the amount of taxes to be payable if income could be readily shifted between years. Other reasons also impel taxing authorities to seek positive criteria whereby revenues may be taxed as soon as possible and deductions delayed as long as they can be. For example, insolvency or bankruptcy may prevent or defeat tax collections if such collections are postponed after the cash has been received, or a statute of limitation or a doctrine of estopel may provide undue advantages if tax assessments are deferred. The force of these considerations in the establishment of a tax program is generally recognized, but it frequently appears that exaggerated importance is given to this line of argument in the determination of the tax assessment of a particular period. Such emphasis may increase the tax collections of a single year, but year-in and year-out will result in little advantage to the taxing authority. Tax administrators would do well to recognize that taxation, like business, is a "going concern" and that a single separate tax period is not the climax and end of the taxing process. Why, for example, should so much of the time of taxpayers and taxing officials be taken up by revisions of depreciation rates? If a corporate management fixes a depreciation schedule based upon rates that are within the realm of reason and follows it consistently what gain is there to the taxing authority to require a different rate for tax purposes? As a matter of fact it is probably safe to assert that the Federal Government has received millions of dollars less revenue over the past decade because of the enthusiasm of its agents for reducing depreciation rates during the 1930's. The wheel of fortune is uncertain and no one is foresighted enough to determine what procedures of allocating revenues and expenses to fiscal periods will, in the long run, produce the greatest revenues to the taxing authority. Then why confuse and complicate the taxing process and multiply the accounting problems of business by trying to do so?

Because of the special rules for the allocation of revenues and expenses for tax purposes many business transactions are timed with a view to obtaining the best tax results and many transactions that would be highly desirable from an economic or social point of view are never consummated because of the tax effects. Sound public policy should minimize the influence of the tax laws over the ordinary conduct of business. Certainly the recognition of accepted accounting procedures as a basis for allocation of income would not remove all of the barriers to desirable commercial transactions but there are various ways in which it would have that effect to a significant extent.

Accounting is a practical art. Within its utilitarian framework there is ample room for the adjustments and modifications necessary to provide a reconciliation of the concepts and procedures of the determination of annual income for accounting purposes with the principle of measurement required for an effective administration of a tax program. Similarly, there should be room in the administration of a tax program which will permit the adjustment or modification of tax concepts and procedures to reconcile with sound business practice. This is not a novel idea. Such reconciliations have been made from time to time. For example, income from sales on account may now be determined in the light of expected losses from uncollectable accounts and inventory costs may be allocated upon a last-in, first-out basis. Much of the inequity resulting from the divergence of tax rules and accounting principles has been removed by the carry-forward and carry-back provisions of the present Federal tax law as it relates to corporations, but it should also be recognized that these provisions have also removed many of the reasons which legislators, courts and taxing officials have relied upon to justify their advocacy of such deviations.

By law and by precedent the taxation of income cannot avoid a dependence upon accounting--upon accounting concepts and procedures. From a business view, it is unfortunate that so many of the legislators and judges were not, and are not, more thoroughly acquainted with commercial practice and with the accepted accounting procedures for recording business transactions and events. Business generally recognizes the need for, and the importance of, a sound tax program. But to avoid an unwarranted burden upon the taxpayer, both from the standpoint of the tax to be assessed and the cost of maintaining useful tax and accounting records, that program should permit a common understanding of its concepts and those concepts should reflect the principles and procedures used by the economic community to which the program is to apply. Corporate investors and the public generally are confused by the anomalous situation of a corporation reporting substantial net income to its investors but being subject to no income tax or reporting a net loss while at the same time being required to pay a substantial income tax. Time was when the keeping of two sets of books was viewed with alarm as a breach of business morality but the ever-increasing divergence between tax accounting, as required by our income tax laws, and generally accepted accounting principles, as required for the presentation of financial data to investors and creditors, has made multiple records a necessity. The economic waste inherent in such procedures is, in itself, justification for serious study to determine whether they are really necessary costs of the taxing process, but when, in addition, they lead to confusion, misunderstanding and taxpayer resentment and resistance they are indeed worthy of a most exhaustive effort toward their elimination.

It is to be hoped that the future will bring intelligent and thorough-going revisions of many of the present tax laws which will permit a material narrowing of the areas of difference between tax and accounting concepts, will permit the establishment of a common and consistent basis for a tax program, and will permit variations in governmental revenues to be made from time to time by changing the tax rates only.

These objectives warrant thoughtful consideration. Solutions to the social and economic problems of our time are not facilitated when the public confusion and misunderstanding of the nature of business operations and the purpose of tax rules and regulations make possible the publicity given such charges as "the government is paying to break the strike," "the tax law makes the public subsidize business to the detriment of labor," etc., etc. Part of that confusion is understandable. Tax laws, regulations and decisions providing new concepts, changed procedures, and variations in interpretations flow out in constantly increasing volume. The income tax program has been an ever-changing patchwork embroidered in patterns designed to symbolize the economic, social or financial philosophies of the moment. It is time to develop an understandable and a consistent tax structure realistically integrated to modern commercial practice. The principles and procedures of accounting have been molded through the years to properly reflect the results of business as it is done. Only to the extent that they are recognized by the tax laws and regulations can there be hope for reconciliation between income taxation and business practice and a removal of the major sources of irritation and resentment by business men toward income taxes and their administration.