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Norman C. McLaren

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The Influence of Federal Taxation upon Accountancy

BY NORMAN L. MCLAREN

FIFTY YEARS ago the public accountant had virtually no concern with Federal taxation. It was not until 1894 that there was launched on the sea of legislation a craft of new design which to the far-seeing accountant gave promise of a valuable cargo. True, the income-tax law of that year, proving to be of faulty construction, was condemned and scuttled in the following year. Nevertheless, considerable resentment was expressed by the liberal leaders of political thought, because in their judgment the Supreme Court had based its adverse decision on reasoning which smacked of the covered-wagon era rather than the enlightened horse-and-buggy days of the gay 90's. It does not seem to have occurred to President Cleveland or his advisors—this all happened before the discovery of a perpetual national emergency, but during a national depression of unprecedented severity—that a simple solution would be to pack the Supreme Court. On the contrary, the proponents of income taxation quietly, and perhaps with a smile, laid their plans to secure the orderly passage of a constitutional amendment which, when ratified by the required number of states, would permit of the same form of taxation as that which had proved practical and equitable in Great Britain and other nations. It can be stated with assurance, however, that in the early days of the present century no one could foretell that the defective little sloop of 1894 would be the forerunner of the super-dreadnaught of today, and it is certain that public accountants had not the slightest intimation of the part they would be called upon to play as navigators and occasionally as life savers.

In order to appraise with any degree of accuracy the influence of Federal taxation upon our profession, it is necessary to start with a trial balance of accountancy as it appeared in the early days of the present century. Most of the native-born public accountants in the United States who had attained positions of

NOTE.—This paper was presented by Mr. McLaren on October 21st at the fiftieth anniversary celebration of the American Institute of Accountants, the Waldorf-Astoria, New York.

responsibility were graduates from the ranks of bookkeepers. Their progress was retarded by lack of professional education and legal recognition. No examinations were required of public accountants anywhere in the United States until 1896, and as late as 1905 only two universities in this country were equipped to give adequate training in accountancy. Before the close of the first decade of this century, however, rapid strides were made in the enactment of state laws which gave official sanction to and prescribed for the regulation of certified public accountants. Moreover, considerable progress had been made in the development of courses of study in schools and colleges designed especially for the embryo certified public accountant.

It is fitting to acknowledge the contribution of many British chartered accountants engaged in practice in this country during the formative period of our profession. Their willingness to share with their American brethren the practical knowledge born of wider professional experience and a more thorough cultural and technical education undoubtedly made for a far more rapid recognition of accountancy as a profession than would have been the case if the field of public accountancy had been left wholly to our own citizens.

Thirty years ago, the principal functions of the American-trained public accountant were the disentanglement and interpretation of complicated and debatable financial records and the investigation of business transactions with the object of detecting dishonesty. In addition he was engaged occasionally to suggest improvements in the accounting system, but the less said of the efforts of some of our pioneer accountants in this connection, the more flattering we will be to their memories. In the good old days, many highly reputable accountants took the position that work of this character should be left to stationery salesmen. Yet if a client insisted that his auditor install a system of accounts, dignity was unselfishly sacrificed and an attempt made to comply with his wishes. One case is on record of a large industrial concern, still existent, for which four successive firms of well known accountants were engaged to devise and install a cost system, each in turn being discarded and the client finally returning to the one first installed.

In the accounting department of the run-of-the-mill client, records were kept in minute detail, but system, as we think of

that term today, was conspicuously absent. The old merchandise account, which was a conglomeration of purchases, sales, discounts and expenses, together with opening and closing inventories, supplied in one figure the result now determined by elaborate analyses. Depreciation and depletion were curious animals whose figures bore a close resemblance to the chameleon. Any attempt to determine logically the proper depreciation charge at the end of the fiscal period was complicated by the well-nigh universal practice of treating as a current expense—if the earnings permitted—all plant additions and replacements. As a corollary to this procedure, depreciation was seldom reflected in current operations except in prosperous years. Proud indeed was the bank—and there was usually one or more in every large community—which could boast in its published statements that the bank premises and fixtures were carried on the books at $1.00. Another account upon the books of a myriad of business organizations was entitled "suspense." Doubtful items were thrown with abandon into this account, and sometimes the suspense was terrific.

The larger manufacturing companies were, of necessity, somewhat more advanced in matters of accounting technique. Nevertheless, the principal attribute which their accounting methods had in common was utter lack of uniformity. A most interesting study of industrial corporation balance-sheets by John Noone appears in the August and September, 1910, issues of THE JOURNAL OF ACCOUNTANCY. The analysis deals with the published balance-sheets of six representative industrial corporations for the five year period ended December 31, 1909. The following excerpt demonstrates the varying depreciation policies of large companies during the period under review:

"A comparison of the methods of providing for depreciation is likewise of interest. National Biscuit Company allows annually a fixed sum—$300,000.00—although depreciation can scarcely be said to go on uniformly and irrespective of changes in the amount of the permanent investment. American Car and Foundry Company charges against 'earnings from all sources,' for the year, 'renewals, replacements, repairs, new patterns, flasks, etc.,' but makes no specific reservation for depreciation. The Midvale Steel Company employs rates per centum based upon diminishing value. The New Home Sewing Machine Company apparently pursues a course similar to American Car and Foundry Com-

pany. The method used by The Butterick Company is not disclosed, but in one of the years the amount was so small as to seem palpably inadequate. Of course, the allowance for depreciation should never be contingent upon profits. International Paper Company's reports make no reference to the subject beyond the statement of the president, that the plants have been 'carefully maintained'."

Similar originality is found in the balance-sheet treatment of goodwill, patents, franchises and trade-marks. The National Biscuit Company, for example, included "plants, real estate, machinery, patents, etc." in a lump sum; the New Home Sewing Machine Company showed "patent rights, trade marks and goodwill" as separate balance-sheet item; the Butterick Company listed as a single item "patents, goodwill, contracts, copyrights, trade-marks, etc." Mr. Noone states that the balance-sheets of the American Car and Foundry Company, which followed the practice of lumping all fixed assets and intangibles under "property and plant account," was reputed to own more than three hundred patents, "some of which are doubtless of great value, since it is claimed they afford protection in every detail of car construction," and adds naively, "Very likely, in part at least, the patents have been capitalized." No goodwill appeared on the balance-sheets of the International Paper Company for the period under consideration except in negligible amount, but it is not unreasonable to assume that the caption, "mill plants and water powers," which embraces almost seventy per cent. of the total assets, may have included a modicum of water, as well as water power. The author comments upon treatment of intangible assets by the Midvale Steel Company, as follows: "Goodwill is not carried upon the company's books as an asset, but is a calculation of the certified public accountants who act as auditors for the company, and represents two and one-half times the average annual profits for a period of five years. At the time the estimate was made, therefore, the average profits were in excess of $1,000,000.00 annually, although, as will be noticed, they were materially less than this amount in 1908 and 1909. Since goodwill is shown upon the company's balance-sheets, but not upon its books, the surplus which appears upon the balance-sheets is in excess of the amount shown by the ledger by the valuation put upon the goodwill."

So much for the vagaries of accounting technique in the days before income taxation. Business enterprises, with the exception of banks and public-service corporations, were in a position to maintain their accounts with utter freedom from outside interference and complete disregard of the newfangled theories of master bookkeepers. It was a virtue, thirty years ago, to create hidden reserves by the understatement of profits in prosperous years, and brave indeed was the public accountant, if any, who insisted upon a qualified certificate under these circumstances. Despite the inconsistencies in procedure and practice, however, there was much to be said for those days from the point of view of our brethren. Fees were small, but staff salaries were smaller, and office overhead was guarded with a hawk-like eye so that hard-earned profits could be retained. The appearance of the office bore not even the remotest resemblance to some of the palatial establishments of today—and why should it? Conferences with the client almost invariably took place in his office. In the good old days, the average business executive would no more think of calling at the office of his accountant than he would upon his plumber. The gloomy appearance of the accountant's office had the added advantage of frightening solicitors away. No one tried to sell him a new "must" service every day. The detailed audit was the rule and not the exception, and the balance-sheet audit had not yet been devised to plague us with rush seasons and slack periods. Temporary staff was practically unknown, and the junior accountant could be kept reasonably busy on unending detail where, if he did not accomplish much good, he could at least do little harm.

The preparation of financial statements from the detailed though defective records called for infinite analysis and, in many cases, the complete recasting of the accounts. This procedure had its merits in that the client could seldom prove the auditor wrong, because to do so he would have to duplicate the work for which he was paying, and even the auditor had difficulty in getting the same answer twice. Who could have imagined in 1877, or even in 1907, that a group of landlubbers engaged in such prosaic undertakings, largely without benefit of legal sanction or public acceptation, would one day be welcomed by business with open arms as master pilots in uncharted oceans.

Into this peaceful if somewhat uninspiring picture came an imposing figure in the summer of 1909; his name was William H. Taft. I quote from THE JOURNAL OF ACCOUNTANCY of July, 1909:

"Out of the hurly-burly of the tariff discussion, to which the people as a whole gave little attention, for they could not understand it, suddenly appeared the President's clearcut proposal for a corporation tax. The President doubtless knows as well as anybody else that his proposal is a most serious one, and that it really ought not to be a matter of legislation until it has been subjected to the most expert criticism the country affords. The tax raises some difficult questions in accounting, public finance and economics, and these questions ought to be well understood in Congress and among the people before the tax is imposed by law. But the situation would not permit the President to wait. Being himself convinced that the tax was a just and lawful one, that the Constitution did not forbid it, and that the Government would need the revenue it would produce, he was tactically justified in hurling his proposal into the tariff debate. Not until after the Federal corporation tax has become a fact shall we know much about its merits and defects.

"We are glad to note, however, that the accounting profession has been quick to perceive its duty and to act accordingly. We print in this number of THE JOURNAL a circular letter addressed to Congressmen, and signed by twelve prominent firms of New York City accountants. This letter, the reader will notice, says absolutely nothing about the corporation tax per se, but calls attention to certain crude accounting errors in the form of the bill. These are such, the letter clearly shows, as to render some of the provisions of the bill 'absolutely impossible of application,' while other provisions of the bill 'violate all the accepted principles of sound accounting.' As a result of this letter, it is quite probable that the bill will be amended as suggested, and the accountants who have signed this letter will deserve the hearty thanks, not only of the perspiring lawmakers at Washington, but also of business men in all parts of the country.

"It is a pity that economists and experts in public finance cannot be heard from with equal promptness."

It now becomes the painful duty of your chronicler to relate that the prognostications of the editor of THE JOURNAL, to the effect that the bill would be amended as suggested, were not borne out. A letter similar to that referred to in THE JOURNAL's editorial was later addressed to Attorney General George W.

Wickersham. One of the prominent accountants received a somewhat inhospitable reply, which was concluded with these words:

"Your further statement 'that as accountants actively engaged in the audit and examination of a number of varied businesses and enterprises, we unhesitatingly say that the law as framed is absolutely impossible of application,' causes me very great surprise. My personal acquaintance with you and a number of the other signers of the letter leads me to the belief that you have underestimated your capacity. Certainly the statement of objections made in your letter is entirely insufficient to support the conclusions which you express."

And after submission of another carefully drawn and highly intelligent response on the part of the prominent accountants, the correspondence was closed by the following letter from Mr. Wickersham:

"In your last letter you set forth in somewhat more detail the following proposition:

"'But no system of accounting can give even approximately the ordinary and necessary expenses actually paid within the year out of income in the maintenance and operation of its business and properties.'

"I think the bare statement of that proposition would be received with very great incredulity by most minds. Certainly, I am quite unable to assent to it. However, it is now too late to attempt to recast the corporation tax amendment bill on the basis of such proposition."

Thus ended the first spirited encounter between the embattled accountants and the minions of the law. Although unproductive of immediate results, this new adventure was to have salutary effects in the succeeding months when it became necessary for the Treasury Department to draft regulations governing the imposition of the new tax. Unquestionably the vigilant efforts of the American Association of Public Accountants, the predecessor of the American Institute of Accountants, had much to do with the final form of the regulations, which were in the main sound and practical, albeit many specific provisions of the law were ignored and extreme violence was done to others.

Contrary to the belief expressed by many intelligent observers at the time of the enactment of the excise tax bill, no strong opposition on the part of corporations generally was encountered,

probably because the rate was only one per cent. of net income and the Treasury Department, in its audit of the returns, followed in the main the liberal policies set forth in its regulations. These factors encouraged income-tax proponents to urge an amendment to the Federal Constitution which would authorize Congress to levy a tax on income without resorting to the obvious subterfuge of continuing an excise tax measured by net income. Thus we find as early as May, 1910, a detailed report in THE JOURNAL OF ACCOUNTANCY of a debate held in New York on March 24, 1910, the subject of which was "Should the pending amendment to the Constitution permitting a Federal income tax be adopted?" The affirmative of this proposition was defended by Senator William E. Borah, of Idaho, and Mr. Lawson Purdy, president of the New York City Tax Board. The negative was supported by two eminent members of the New York bar, Messrs. Austen G. Fox and William D. Guthrie, the latter having been one of the attorneys who, in the celebrated case of *Pollock* v. *Farmers' Loan & Trust Co.*, convinced the United States Supreme Court that the income-tax act of 1894 was unconstitutional. The arguments advanced for the negative side may be characterized as highly legalistic and, therefore, unconvincing. The gentlemen who upheld the affirmative did not contend that our Constitution was of the laymen, by the laymen and for the laymen, but in spite of this omission they seem to have had decidedly the better of the argument.

In the latter part of February, 1913, the necessary number of states had ratified the Constitutional amendment, which led to the enactment of an income-tax law on October 3, 1913, effective as of March 1, 1913. That the American Association of Public Accountants was alive to the importance of the new legislation is evidenced by an editorial appearing in the November, 1913, issue of THE JOURNAL OF ACCOUNTANCY, which announced the creation of an income-tax department. The editorial reads, in part, as follows:

"We have peculiar satisfaction in the permission to make this announcement at this time, for it is indubitable that the income-tax law is to have a more far-reaching effect upon public accountants than upon any other profession or business in the country. Hundreds of men who have never seen the necessity for a correct system of accounting now find themselves compelled to prepare

statements of income and expenditure; and the work in nine cases out of ten will fall upon the shoulders of the public accountants of the several states. The corporation-tax law in its administration vastly increased the labors of public accountants, but the work arising from the enactment of that law was far less than that which will result from the new income-tax act. Accordingly anything having a bearing upon the interpretation of the law will be of vital interest to every accountant in the country and we are confident that in the income-tax department of THE JOURNAL OF ACCOUNTANCY, great assistance will be given to accountants and others."

The new department of THE JOURNAL started modestly enough, but gradually, like the camel in the fable, it commenced to crowd the Arab out of the tent; and deservedly so, because the timeliness of the material and its intelligent presentation proved of inestimable value to those who were struggling with the intricacies of the new law.

In retrospect, we may characterize the years between 1913 and 1917 as the adolescence of the income-tax practitioner, but with the passage of the war excess-profits-tax act of October 3, 1917, the dulcet soprano of youth became a harsh discord of high and low notes, and throughout the transitory period leading to complete maturity and a comprehension of the essential facts, there was great unhappiness in the family. Fortunately, however, our youth showed that he had character and fortitude. He was on the spot, and he held it triumphantly.

Undoubtedly the excess-profits-tax legislation of 1917 was the greatest single force in the elevation of the public accountant from the status of master bookkeeper to member of an honored profession. It has been estimated variously that from five to ten per cent. of the business organizations of this country utilized regularly the services of public accountants before 1917. There is no means of determining the corresponding figures of today, but it is conservative to assume the reverse of the earlier proportion, at least with respect to enterprises of any importance.

The new and highly complex provisions of the war revenue bills, coupled with undreamed-of rates of taxation, provided the stimulus which the blossoming young profession needed. Happily, our leading practitioners throughout the land, quick to grasp the significance of the opportunity for service, were able to

convince the business public by word and performance that our profession possessed the intelligence and initiative to cope with the new problem.

And, at the same time, the greater opportunities presented to certified public accountants attracted to our ranks a new generation of the highest order of intelligence. Universities and technical schools, recognizing the part which the accountant would be called upon to play in the modern industrial world, readjusted and expanded their curricula to provide intensive training for the student of accountancy. State boards of accountancy, in coöperation with the American Institute of Accountants, elevated their examination standards to the point where the letters "C.P.A." became the hall-mark of unquestioned ability to cope with the new problems. Tangible evidence of the acceptance of our profession at its face value is found in the recognition of attorneys and certified public accountants in 1924 as the only representatives qualified to appear for taxpayers before the United States Board of Tax Appeals.

Business executives, confronted with huge tax bills in the war years, realized the necessity of developing financial records which would reflect more accurately the actual capital invested in their enterprises and make possible the more ready determination of statutory net income. They became for the first time accounting-conscious. The auditor was called with more and more frequency into conferences at which the subject-matter was not the proper treatment of completed business, but rather the best method of handling contemplated transactions. As a consequence, the certified public accountant was soon accepted as the most competent advisor in tax matters and was shortly to be regarded as the professional man best qualified to serve in other important advisory capacities. It is true, of course, that the business counsel of a few outstanding members of our profession had been sought by many clients prior to 1917, but before the war the certified public accountant was primarily an auditor of past transactions.

In reviewing the war period, we find, too, that Treasury officials and Congressional committees in charge of tax legislation were becoming impressed with the desirability of making taxable income conform as closely as possible with accepted accounting principles. Thus, although the 1917 act did not specifically permit of consolidated returns of affiliated corporations, official

sanction was given to Treasury regulations in this respect by a specific provision in the revenue act of 1918. Another noteworthy forward step in Federal tax administration was taken when the Bureau of Internal Revenue liberalized its early regulations in the matter of inventory valuation, with the result that for more than ten years the treatment of inventories has been, in fact, in conformity "as nearly as may be to the best accounting practice in the trade or business." And with the gradual standardization of tax accounting and clarification of most questions by judicial action, there was every reason to believe that the time had come when our people could look forward confidently to but minor changes in our Federal tax laws.

This feeling of confidence has been completely destroyed since the advent of the New Deal. It is significant that, if there is included the abortive tax measure grafted upon the ill-starred national-industrial-recovery act, changes in our Federal taxing statutes of a drastic nature have been made in every year since this country has been turned into a free public laboratory. The limited time at my disposal precludes the detailed consideration of all the backward steps in tax legislation that have been taken in our forward progress toward a more abundant life. It is sufficient, however, to mention the abolition of consolidated returns, the irrational limitation on capital losses, the arbitrary and capricious basis provided for the capital-stock tax and the related excess-profits tax, the tax on unjust enrichment, whose very description smacks of demagogy, the confiscatory gift-and-estate-tax rates, and finally the utterly indefensible surtax on undistributed profits, as among the low lights which have dimmed the brilliance of past accomplishments along the road to equitable taxation and standardized tax accounting. Graphic evidence of the wide variation between statutory income and commercial income is found in the numerous items entering into the reconciliation of book income with taxable income which appear in schedule M of the corporation income-tax return for 1936. Coupled with unsound and unequal legislation, we find a spirit among those who dictate policies of the Internal Revenue Bureau which smacks more of Shylock than of Solomon.

It is far from edifying to find civil service employees of the United States blandly offering to compromise a tax controversy for the amount deemed to be its "nuisance value." Another ex-

ample of the unfortunate state of mind of officialdom today is found in the efforts of the Bureau of Internal Revenue to enforce the proration of prepaid insurance premiums by taxpayers on the cash receipts and disbursements basis. Happily, judicial disfavor of this fantastic proceeding has been expressed in a recent decision of the Federal district court in Massachusetts. It is apparent, however, that the rebuffs of Federal judges are not having any great salutary effect upon the neo-economists. I have been advised recently that a new test case relating to the Federal estate tax will be instituted shortly by the Internal Revenue Bureau, in which will be presented the identical issue determined against the United States in the Orthwein case, decided by the Supreme Court in the latter part of 1935. But perhaps the most flagrant example of the Treasury Department's opportunism is found in its readiness to take inconsistent positions in tax controversies, urging a proposition in one case where its acceptance would favor the Government, and attempting to refute it in another where the taxpayer would benefit. Yet it must be conceded that in some particulars the Internal Revenue Bureau is approaching its problems in a broad manner. I need only refer to its exceedingly liberal decision in a case involving the assignment of income. It would be unchivalrous to mention the name of the taxpayer involved, but it is refreshing to find that the viewpoint of high Treasury Department officials seems to have become more humane in connection with charitable contributions.

Criticism of an existing order is not helpful unless a remedy for its shortcomings is presented. I believe that not one of the members of our profession disapproves of the efforts of our law makers to close loopholes in the taxing laws which permit of the wholesale avoidance of taxes. I also believe that such devices as inordinately high surtax rates, excessive taxation of capital gains coupled with drastic limitations on capital losses, and the arbitrary tax on undistributed profits cannot be defended as a matter of fiscal necessity, even though they fit perfectly into a scheme of ultimate state socialism. Let those who dictate our legislative policies rather be concerned with a broadening of the tax base, an equitable distribution of the tax burden, a determination of taxable income predicated as far as possible on commercial income. Let us insist upon a stop to endless tinkering with our tax laws. Finally, let the business man of this country,

and I refer to each of your clients, large and small, tell his Congressman that he is tired of being a guinea pig. Surely our profession cannot be charged with self-serving motives when we strive for simplification of our taxing system and a more equitable distribution of the burden, for the more complex taxation becomes, the greater the public requirement for our services.

Today certified public accountants are called upon for income-tax counsel to an unparalleled degree. In times like these, when tax rates approach the point of confiscation and tax administration is unduly harsh, our responsibilities are greater than ever before. It is regrettable that, in order to render the service to which our clients are entitled, we cannot approach the planning of business transactions, the preparation of tax returns, and the representation of taxpayers before the Internal Revenue Bureau from the same objective viewpoint which we must maintain when we undertake audit problems. Consider, for example, the examination of returns under Treasury decision 4422. Shortly after the promulgation of this decision on February 28, 1934, it became apparent that field agents of the department were attempting to fulfill magnificently Secretary Morgenthau's promise that the same practical results which would have followed the flat reduction of 25 per cent. in computed depreciation could be accomplished by more rigid restrictions upon depreciation deduction. Overnight the established rates of depreciation, built up laboriously over many years, which properly gave effect to normal obsolescence, became out-moded and were consigned to the junk heap. Taxpayers and their representatives soon learned that in the great majority of cases the basis of settlement proposed by bureau officials was intended apparently to effect a reduction in the depreciation allowance of at least 25 per cent., regardless of the pertinent facts. Accordingly, accountants throughout the country were compelled to negotiate settlements on the basis of expediency rather than sound principle.

Many other illustrations could be given of adjustments to financial records in conformity with tax settlements which are in violation of accepted accounting principles and which create difficult problems in connection with the preparation of financial statements for other purposes. It is pertinent to inquire whether corporations which are called upon to file statements with the Securities and Exchange Commission are justified in restating

income of past years on the basis of a radical downward revision of the depreciation allowance of doubtful propriety or of other debatable adjustments which produce an increase in net income.

Business today is indeed stifled under a crazy-quilt of governmental regulation, of which one of the ugliest patches is our taxing system. It is a primary duty of certified public accountants to protect their clients to the best of their ability against the imposition of a tax burden in excess of the minimum amount prescribed by law. We cannot countenance deliberate omissions or misstatements of essential facts, nor can we be parties to extra-legal methods and devices. At the same time we can and must afford our clients every protection to which they are entitled and voice earnestly our plea for a return to sound and equitable tax laws and their fair administration.