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Pressures for Tax Conformity, AICPA Spring Council Meeting, Boca Raton, Florida, May 3, 1972

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Report of Robert G. Skinner
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It is a privilege to appear at this meeting of Council on behalf of the Institute's Division of Federal Taxation. It is a privilege that I assure you I do not take lightly--for I know I am following the footsteps of other Tax Division Chairmen who have represented our professional tax practice ably and with distinction over the years. These exceptionally capable leaders include Bill Barnes and Don Burns who are here as members of Council.

My report to you centers on a matter of major significance to our profession today--a matter that all of us need to understand more fully, in order to be able to react to it appropriately as members of a profession dedicated to public service. This matter involves the policy and judgment question of the desirability and extent of conformity that should exist between tax and financial accounting. It is my purpose to explore this question with you in summary fashion this morning. In so doing, I hope to put this matter in perspective by explaining how I think it got started, where it stands now, and where it is going.

The current position of the Institute on conformity of tax and financial accounting was adopted by the Board of Directors in October last year. This position is generally that there should be greater conformity of tax accounting to generally accepted accounting principles, but that neither the Treasury Department nor the Congress should impose any requirement that financial reports for creditors, stockholders and others must conform to tax accounting as a prerequisite for the use of a tax accounting method.

I think it is unfortunate that this financial statement eligibility test has been phrased in terms of a "booking requirement," because it has been widely misunderstood--even by CPAs. The Board of Directors has indicated that a test, which either in fact or in effect provides that an accounting method may be adopted or used for tax purposes only if the same method of accounting is used for financial reporting purposes may serve as a deterrent to changes in accounting principles considered desirable by the accounting profession.

This is the essence of the Institute's policy which the Tax Division has now presented, as forcefully as it could, on two recent occasions. The first of these occasions was 6 weeks ago at the Internal Revenue Service hearings on proposed regulations regarding accounting for long-term contracts, and the second was just two weeks ago when we submitted our written comments on proposed regulations regarding the valuation of inventories. In both these situations, new financial statement eligibility tests were proposed. These two areas are vitally important in our professional practice, since they both involve basic cost accounting concepts of particular significance to manufacturers and construction contractors. I have to believe that our testimony--oral and written--has had an impact on the Treasury Department. Fred Hickman, Deputy Assistant Secretary of Treasury for Tax Policy, chose the occasion of the plenary session of our Tax Division's spring meeting last week to announce that the twice-proposed revised regulations on accounting for long-term contracts were being withdrawn, and that because the Treasury Department agreed with many of the comments submitted on the proposed new inventory regulations, these proposed regulations were also being withdrawn--to be revised and reproposed in several months. To me, this represents progress--but it should not be understood to mean the end of the tax accounting-financial reporting conformity policy considerations facing our profession and the tax authorities.

At this point, I think it would be time well spent to review the developments that have led us to where we now stand on the conformity issue.

In light of the fundamental nature of this matter, it may not be so surprising that concern about conformity of tax accounting rules with generally accepted accounting principles (or good accounting practice) goes back to the time of the enactment of the Income Tax Law of 1913. For example, the 1913 law did not contain any reference to accrual accounting; income was determined solely on the basis of receipts and disbursements. It soon became apparent that the complexities of business could not be adequately reflected on a cash basis, and at the urging of the Institute (then the American Association of Public Accountants), regulations were adopted by the Commissioner of Internal Revenue permitting taxpayers to use the accrual method of accounting even though this was contrary to the express provisions of the law.

The Revenue Act of 1916 recognized the principles of accrual accounting that were written into the regulations under prior Revenue Acts, and permitted taxpayers to prepare their returns on the basis used in keeping their accounts. The permissive language of the Revenue Act of 1916 was made mandatory in the Revenue Act of 1918.

From this beginning emerged the current provision of the 1954 Code that "taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." A literal reading of this provision might suggest that Congress intended to adopt generally accepted accounting principles for Federal income tax purposes. However, much transpired between 1916 and 1954 which led very nearly in the opposite direction. For one thing, the Revenue Act of 1918 added an important qualification to the 1916 law concerning "clear reflection of income." The Commissioner was then given the right to change the taxpayer's method of determining net income if, in his opinion, the taxpayer's method did not clearly reflect his income. During the same period, the tax law also came to be used more and more for social and economic objectives, in addition to its basic revenue-raising purpose.

The "executive discretion" concept and the changing objectives of the tax law are largely responsible for the build-up of administrative rulings and judicial interpretations that have created sharp divergencies between tax accounting and generally accepted accounting principles.

Perhaps the strongest effort made by the Institute to conform tax and financial accounting more closely was made in the early 1950's during the development of the 1954 Code. In 1950, Council adopted a resolution, pointing out that variations between the tax law and generally accepted accounting principles caused unnecessary expense and uncertainties about tax liabilities, resulting in inequities and hardships for taxpayers. Council resolved that the Committee on Ways and Means of the House of Representatives should adopt the legislative proposals made by the Institute's Tax Committee. The first of these proposals specifically sought greater conformity between tax accounting and financial accounting, with emphasis on the treatment of prepaid income and reserves for estimated expenses.

Early in 1953, following an invitation from Congressman Reed, who was then the Chairman of the House Ways and Means Committee, the Institute's President appointed a special committee to present recommendations which would reduce the deviations in tax accounting from GAAPs. On December 10, 1953, the report of this special committee was submitted to Mr. Reed. This report made a number of specific recommendations and concluded that generally accepted accounting principles should be restored as the basic standard for tax accounting. It recognized that the tax law contained special provisions which reflected Congressional policy decisions influenced primarily by social, economic and political factors, with the consequence that taxable income must inevitably differ from financial net income.

The Institute's report was so persuasive that it resulted in the enactment of almost all of its main recommendations--in the form of the ill-fated 1954 Code Section 452 (prepaid income) and Section 462 (reserves for estimated expenses). Shortly after enactment of these two provisions, the Secretary of the Treasury requested their repeal on the ground that the revenue loss appeared to be much greater than had been anticipated. They were both retroactively repealed in 1955.

Following the repeal of these provisions, the Tax Division has consistently and repeatedly urged the enactment of similar legislation in its biennial booklet "Recommendations for Amendments to the Internal Revenue Code." In addition, since 1958 the Tax Division has recommended legislation to permit deductions for the amortization of good will and other intangibles.

The conformity issue was in limbo from 1955 to 1970. This may have been the proverbial calm before the storm. Facing the increasingly difficult task of auditing more numerous and more complicated tax returns, the Treasury Department and the IRS undertook to facilitate its return examination processes by attempting to cut down on the number of reconcilements necessary to convert financial net income into taxable income. They were encouraged to do this administratively, apparently with the mistaken assumption that the Institute, long on record as favoring greater conformity between tax and financial accounting, would back them as they sought at the same time to correct some bad law, provide greater precision and uniformity, and simplify the tax accounting area for taxpayers and Revenue Agents alike.

During the past 21 months, the Treasury Department has either adopted or proposed "financial statement eligibility tests" in one form or another in seven areas of tax accounting. Prior to August 7, 1970, this type of technical requirement existed only with respect to the use of the LIFO method of inventory valuation. This was a statutory restraint imposed virtually on a "take it this way or not at all" basis, and the financial statement conformity requirement was intended to discourage widespread adoption of LIFO, notwithstanding its basic purpose of limiting the taxation of inflation.

This is what has happened in this connection in the past 21 months:

1. Advance Payment for Goods and Services. On August 7, 1970, notice of proposed rule making regarding advance payments for goods was published in the Federal Register. The proposed regulations provided that with certain exceptions and limitations,income from advance payments for goods may be reported in the taxable year in which properly accruable under the taxpayer's method of accounting. No reference was made at that time to a "financial statement eligibility test." However, when these regulations were finalized on March 23, 1971 they provided that the accrual method of reporting advance payments for goods may be used only if it is in accordance with the method used for financial reporting purposes.

On July 22, 1971, new proposed regulations were published with respect to payments for goods. They retained the financial statement eligibility test in a different form. These proposed regulations are still under consideration by the Treasury Department.

On August 31, 1970, an administrative pronouncement--a revenue procedure--was issued liberalizing the treatment of advance payments received for services. This procedure in its original form and as modified and superseded on July 12, 1971, permits an accrual-basis taxpayer, in specified and limited circumstances, to defer the reporting of payments received for services to be performed by the end of the next succeeding taxable year. The amount of any payment permitted to be deferred cannot be greater than the amount deferred by the taxpayer for his financial reporting purposes.

2. Changes in Accounting Methods. Early in 1971, the IRS on its own initiative adopted a new policy for changes in tax accounting methods. This new policy was explained to representatives of the Institute's Tax Division at a meeting with Treasury officials on February 11, 1971. The Treasury representatives stated that except for changes involving Code sections enacted to provide incentives for taxpayers, and except for situations where a regulatory agency requires a different method of accounting, approval of a change of tax accounting method will not be granted unless the taxpayer agrees to use the new method for financial reporting purposes.

On April 14, 1971, the IRS issued an information release requesting comments from interested parties regarding provisions to be included in any proposed regulations that might be issued requiring conformity of tax accounting and financial reporting as a condition for the approval of a requested change in a tax accounting method. No such regulations have yet been issued. However, the new policy is now being implemented administratively without regulations.

3. Long-Term Contracts. On March 24, 1971, a notice of proposed rule making regarding accounting for long-term contracts was published in the Federal Register. There is no Code provision dealing with this matter specifically, but the regulations for more than 50 years have provided an option to use either the percentage-of-completion or the completed contract method of accounting for long-term contracts for tax purposes. The proposed regulations restricted the option previously provided by stating that henceforth income from long-term contracts may be reported under the completed contract method only if the income is reported on the same basis for financial statement purposes. At the IRS hearings on these proposed regulations held on May 11, 1971, I appeared on behalf of the Tax Division to oppose these government proposals.

On December 15, 1971, these proposed regulations were withdrawn and new proposed regulations in this area were exposed for comment. These reproposed regulations also contained a financial statement eligibility test and, once again, I represented the Tax Division at the IRS hearings on March 21 of this year in opposition. As I mentioned a few moments ago, I am pleased to report to you that the Treasury Department has decided to withdraw these reproposed regulations, pending further study.

4. Inventory Valuation. December 15, 1971 was a jackpot day. In addition to the publication of reproposed long-term contract regulations on that date, extensive new proposed regulations were released on the valuation of

inventories. Sweeping technical and practical rules and procedures were proposed, some good and some bad. Once again, financial statement eligibility tests permeated the new administrative proposals. Two weeks ago, the Tax Division submitted 43 pages of comments on these proposed regulations. Hearings were scheduled to be held on them in Washington yesterday but, as I mentioned a short time ago, these hearings were called off while the Treasury Department incorporates some of the written suggestions into a new set of proposals. I expect our Tax Division to be called to consult with the Treasury Department in this connection before new inventory regulations are reproposed.

5. ADR System. On January 27 this year, proposed regulations were issued on the Class Life Asset Depreciation Range System. These proposed regulations use a "financial statement eligibility test" to determine whether an expenditure should be treated as a repair for purposes of the repair allowance. We opposed this provision in our written comments on these proposed regulations.

6. Vacation Pay Accrual. We understand that a Bill, soon to be reported by the House Ways and Means Committee, dealing with vacation pay accruals, will contain a financial statement eligibility test. This Bill, when it was originally introduced on October 12 last year, did not contain this test. We intend to object to the financial statement conformity requirement in this Bill if and when it reaches the Senate Finance Committee.

7. Accounting for the Investment Credit. In a perverse way, the new investment credit accounting provision adopted in the Revenue Act of 1971 represents a form of financial statement eligibility test. While optional

accounting treatment of the investment credit is authorized and assured by legislation, the method of accounting selected must be used for both tax and financial reporting purposes.

I suggested earlier some of the factors that I thought motivated the Treasury Department to take the offensive almost 2 years ago in the battle for greater conformity between tax and financial accounting. Although this involves some speculation, I would like to elaborate a bit more fully on what appears to be behind this policy push.

In 1970, Treasury representatives of this Administration concluded that taxpayers and the government would both benefit if tax and financial accounting could be conformed more closely. They observed that the Institute had been advocating closer conformity of tax and financial accounting for many years--although not necessarily with the formalities of a financial statement eligibility test. It was at least understandable that the Treasury policymakers expected the Institute to support this effort.

Also influencing the Treasury officials--to a substantial extent, I might add--were the recommendations of a Presidential Task Force. A Treasury spokesman has indicated that the conformity proposals "are in a large part a response to the recommendations" of President Nixon's Task Force on Business Taxation.

Treasury representatives have rationalized and designed their approach in this area generally along these lines:

1. While the principal objective of taxation is to raise revenue equitably, and the principal objective of financial reporting is to present fairly the results of business operations, the determinations of taxable income and income for financial statement purposes are both based on common information regarding transactions and a common objective that the income from these transactions be clearly reflected.

2. Since a close relationship already exists between taxable income and financial income, selective mandatory conformity should result in major administrative simplification by making unnecessary dual determinations of income and by applying uniform principles familiar to both management and the government.

3. Selective mandatory conformity will achieve greater certainty and uniformity in the determination of tax liability (fewer Schedule M adjustments), thereby reducing the effort and cost of tax compliance and administration.

4. Mandatory conformity would not apply to tax provisions intended to achieve special social or economic objectives.

5. A financial statement eligibility test is appropriate and would be beneficial--from a Treasury point of view:

- o Where the test is used as evidence of the existence of a fact. For example, in the now defunct proposed long-term contract regulations, this test would have been used as evidence of the fact that estimates of the cost of completion or the extent of progress toward completion of a contract was or was not reasonably dependable.

- Where only one accounting method for a particular type of transaction has been specified by the accounting profession as appropriate for use in financial reports.

- Where it is considered necessary to protect the revenue. For example, in the case of advance payments for the sale of goods, a financial statement eligibility test should provide at least a mild brake on the use of an advantageous tax accounting method.

- Where the test is used in connection with an application for change in accounting method, the test would assist the Treasury Department in determining whether a particular accounting method change is appropriate.

Will the Conformity Trend Continue? Where Do We Go from Here?

So far, I have attempted to explain how and why we have arrived where we are today with reference to the application of the conformity concept to tax accounting. What further developments are likely in this area?

I wish my crystal ball were clearer. In it, I see further administrative and legislative proposals including financial statement eligibility tests--perhaps with less emphasis, fanfare and rhetorical urgency. Like the war in Viet Nam, I am afraid the problems we see in these tests are not going to go away over night--however much we might like this to happen. These problems are going to still be with us tomorrow morning. However, I am convinced that we have been able to demonstrate to the Treasury Department and to the Internal Revenue Service that tax and financial accounting conformity isn't as simple a solution to business tax problems as it first appeared to them.

I may be overly optimistic, or I may be reading more into some recent indications than I should, but I do want to pass on to you a couple of personal observations. First, during an early informal meeting with Fred Hickman, he indicated that he is not "wedded" to the new Treasury Department conformity policy. To me, this means that he is willing to consider it objectively, fairly and unemotionally on its merits.

Second, I am pleased to report to those of you who haven't yet received the word that 10 days ago the Internal Revenue Service announced that fair value reporting of a LIFO inventory following a tax-free acquisition required to be accounted for as a "purchase" under APB Opinion 16 will not trigger the tax on the LIFO reserve if specified disclosure requirements are met. To me, this represents a flexible bit of interpretation of a very restrictive statutory financial statement conformity requirement on the part of the Treasury Department--an act of accommodation and statesmanship on its part following some passionate advocacy on the part of the Institute's Tax Division and APB representatives. This may be evidence that Treasury-sponsored financial statement eligibility tests in the future will be flexibly proposed to conveniently accommodate evolutionary changes in generally accepted accounting principles and in financial reporting requirements.

Despite the current relaxation of some of the immediate pressure for more conformity between tax and financial accounting, however, don't be too surprised to find more conformity proposals in the next major tax reform package--proposals which might restrict the use of the cash method of accounting, permit amortization of goodwill and other purchased intangibles, and provide for the deductibility of reserves for estimated expenses. Finally, unless my crystal ball is deceiving me, we have not yet seen the end of the tax and financial accounting conformity concept in the inventory regulations which have just gone back to the Treasury Department drawing board.

I hope we can continue to cope with this important concept in a responsible way in the days ahead. We're certainly going to try! I hope also that this brief review of an expanding tax accounting policy has been helpful and informative. I thank you for this opportunity to talk to you about it, and I thank you for your patience and attention.