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Some Notes on Comparing Tax Accounting and General Accounting

*by Arthur R. Cerio**

MANY PROBLEMS of taxation are caused by the differences between tax accounting principles and generally accepted accounting principles.[1] Despite years of extensive litigation, the question of the timing of income or deductions is difficult to determine.[2] Usually no additional revenue is realized by these conflicts in principles; they merely cause a shift of revenue between the years.[3]

Clarence F. Reimer presents three main categories which are responsible for the differences:[4]

> "The first main cause is obvious. The Sixteenth Amendment gives Congress the power to tax gross income. * * * Congress can and has caused many of the present differences in income for accounting and tax purposes by not taxing certain types of income, by disallowing certain types of expenses as deductions, and by allowing deductions for non-expense items * * *."
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> "The second main cause for differences is the interpretation given to tax statutes by the Treasury Department in its Regulations, Treasury Decisions, and Opinions, and by the courts in their decisions on tax problems. This category of differences is composed primarily of differences in the year of incidence of income or deduction * * *."
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> "A third cause of some of the current differences between net income for accounting and for Federal income tax purposes is the necessity to avoid taxing of income earned or accrued prior to March 1, 1913 * * *."

The "generally accepted accounting method" employed by the taxpayer should solve the question of when an item is income or a deduction. However, the solution to this question will depend on the limitations of the statute, particularly in the case of de-

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1 Seghers, *Tax Accounting Compared with Recognized Accounting Principles,* 27 Taxes 145 (Feb. 1949).

2 Helvering v. Horst, 311 U. S. 112 (1940).

3 Lasser, *Tax Accounting Incongruities,* 83 J. Accountancy 221 (March 1947).

4 Reimer, *Differences in Net Income for Accounting and Federal Income Taxes,* Ch. III, pp. 25-28 (1949).

ductions, and in the case of income, on the broad concepts evolved in recent years by Bureau rulings and court decisions.[5]

The question of "when" is extremely important in the field of accounting; yet, the income tax statutes are usually silent on this point.[6] In the absence of express provisions in the statutes, sections 41, 42, and 43 of the Internal Revenue Code should apply.[7] These sections seem clear and simple and their application equally so. They indicate that if the procedure used by the taxpayer is correct accounting practice, taxwise the taxpayer should properly report as income the amount thus computed. However, the Commissioner and the courts have not been inclined to follow this interpretation.

No uniform method of accounting can be used by all taxpayers and this fact is accepted in "tax law." The regulations contemplate that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his

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5 2 Merten, Law of Federal Income Taxation, Sect. 12.01.

6 Exceptions are Code Sections 23(p) and 24(c). The first section deals with contributions of an employer to an employees' trust or annuity plan and compensation under a deferred-payment plan. The latter deals with unpaid expenses and interest.

7 Internal Revenue Code, as amended to January 7, 1952.

Part IV—Accounting Periods and Methods of Accounting.

"Section 41—General Rule.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) 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. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year. * * *"

"Section 42—Period in Which Items of Gross Income Included.

(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—Period for Which Deductions and Credits Taken.

The deductions and credits (other than the corporation dividend paid credit provided in section 27) 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. * * *"

purpose.[8] The two principal methods of accounting recognized for tax purposes are (1) the cash receipts and disbursements basis, generally called the cash basis, and (2) the accrual basis. In some instances a hybrid method of accounting has also been recognized. Generally speaking, the cash method computes income by deducting actual cash expenditures for the accounting period from actual cash receipts,[9] while the accrual method allocates receipts and disbursements to the accounting period in which earned or consumed, regardless of the time of receipt or payment.

The Internal Revenue Code sections 41, 42, and 43 form the foundation of sound tax accounting. In reading these sections, the inexperienced taxpayer or tax practitioner may think that tax law, complicated as it may appear, is in harmony with any sound system of accounting being used by the taxpayer.[10] However, it is submitted these sound statutory provisions are often the subject of misconstruction by the Internal Revenue Bureau and the courts, although some relatively recent decisions give us hope for better recognition of "any sound system." The cases of *Towers Warehouses, Inc. vs. Commissioner*[11] and *Millar Brainard et al. vs. Commissioner*[12] may be used as examples.

In the first case, the taxpayer was engaged in a storage business and charged shippers in advance for handling costs both in and out of its warehouse. In accordance with a long established practice, it excluded from income each year a portion of the handling charge which it estimated represented the actual cost of out-handling of shipments remaining in storage at the end of the year.

In most prior instances, the Commissioner and the courts had not been so willing to defer the taxation of dollar receipts. If for such dollar receipts a service had to be rendered in the future, the dollars in whole or part returned, or an expenditure incurred, the deduction could only be taken at the time of the

[8] U. S. Treas. Reg. 111, Sect. 29.41-3 (1943).

[9] *See* U. S. Treas. Reg. 111, Sect. 29.42-2 (1943). An exception to this rule occurs where the taxpayer may be taxable prior to the time of actual receipt in accordance with the theory of constructive receipt.

[10] *Supra* note 3.

[11] CCH 6 T. C. M. 59 (1947), Dec. 15,587(M).

[12] 7 T. C. 1180 (1946).

outgo of money or the accrual of an actual liability.[13] Under recognized accounting practices, the Commissioner's position would not fairly reflect actual income. The Bureau, under these circumstances, would succeed in taxing income received but not earned.

The Court's decision in this case supported the doctrine of recognition of a system of accounts shown to have been of many years standing and consistently followed. This decision also evidences a trend in the tax field leading to a closer determination of income as followed in the commercial and business fields.

In the *Towers* case, the court observed:

> "* * * The addition to reserve by Warehouses [the petitioner] was disallowed by respondent on the ground that the liability had not yet been incurred by the Warehouses. It is evident that respondent had in mind Warehouses' liability to its laborers who had not yet performed the services for which Warehouses had been paid. He overlooks the fact that Warehouses had incurred a very definite and fixed liability to its customers to perform, at no additional cost to them, this service no matter what it should cost and had been paid in full by its customers for such services.
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> It should be kept in mind that we do not have here a contingent liability which, of course, would not be subject to accrual. This liability was fixed. The fact that the exact amount which it was later necessary to pay could not be determined does not preclude the accrual of the liability in an amount estimated with reasonable accuracy * * *."

The court recognized the error in forcing the inclusion in income of gross collections without fair provision for cost of fulfillment or performance.

This treatment brings to mind that approved by the Commissioner of Internal Revenue in I. T. 3369[14] in which lump sum payments for multiple period subscriptions were permitted to be taken into income ratably over the fulfillment periods. It should be pointed out, however, that this I. T. is applicable to only the specialized industry of publishing. In I. T. 3369 the gross receipts and hence the profits were reported as income in the period earned. Under the *Towers* decision the profits were all reported in the period of receipt and only the cost for the performance of the contract was deferred.

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13 E.g., Brown vs. Helvering, 291 U. S. 193 (1934) (overriding commissions on one, three and five year fire insurance policy); Your Health Club, Inc., 4 T. C. 385 (1944) (contract for personal services extending beyond the taxable year); South Tacoma Motor Co., 3 T. C. 411 (1944) (coupon books

The theory of I. T. 3369 would seem to reflect accepted accounting concepts of allocating to each period all of the relative income and cost factors and thus present a true picture of the operations of that period. The Commissioner's stand in the *Towers* case clearly distorts the taxable incomes of both periods. Reversing the Commissioner in this case, the court attempted to compromise between two of the Commissioner's theories—the immediate taxation of dollar receipts and that of allocating to each period the income earned. The revenue is secured by taxing the entire profit in the period in which the gross income is received and the administrative dislike for deferment of income for tax purposes is met. The distortion caused by the treatment of gross receipts of one period and cost of goods sold as a deduction of the following period is avoided.

In the *Millar Brainard* case, the taxpayer, who had been a large scale stock-trader, ended up after the 1929 crash with indebtedness of over a million dollars and practically no property. He entered into an agreement with his creditors to pay 4% interest on the indebtedness and pledged what little property he had as collateral to secure the performance of his undertaking to pay the interest and principal on the debt. The taxpayer carefully, and under direction, kept his books of account and filed his returns on an accrual basis. In each year he deducted the interest accruing for that year; however, he did not pay the interest and paid no Federal taxes since his other income was more than offset by the annual interest accrual. In 1941 the Commissioner directed a change over to a cash basis which, of course, he refused to do.

The issue before the Tax Court was whether the Commissioner had the authority to change the taxpayer from an accrual to a cash basis.[15] The Tax Court refused to rule on this issue

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entitling the purchaser to services to be performed after the year of sale); Edward A. Renwick et al. Trustees vs. U. S., 87 F. 2d 123 (1937) (advance rentals on ninety-nine year lease); Pioneer Automobile Service Co., 36 BTA 213 (1937) (fees paid for services to be rendered during lives of automobile owners for which reserves were set apart on the books); Automobile Underwriters, Inc. 19 BTA 1160 (1930) (receipt of membership fees for services to be rendered over a three year period).

14 1940 INT. REV. BULL. 46.

15 "While the statute leaves much to the discretion of the Commissioner, he is not entirely free to act capriciously or arbitrarily, and he may not, in deciding what clearly reflects the income, sacrifice the facts to theory or fiction." See Hyams Coal Co. vs. U. S., 26 F. 2d 805, 809 (1928); Reynolds Cattle Co., 31 BTA 206, 209, 211 (1934). The Supreme Court has suggested that the Commissioner is "vested with wide discretion," in deciding whether

made by the parties, but sustained the deficiency on the ground that the interest was not deductible since "there was no reasonable prospect of payment." In other words, tax-wise it was improper to accrue definite, fixed and legally binding liabilities for the payment of interest unless there is a reasonable prospect that payment will be made. Accounting-wise, however, and under the accepted accrual method of accounting, this liability would be proper irrespective of the prospect of payment.

The Commissioner discussed, in I. T. 3635,[16] the deductibility of interest on the old debt structures of railroads in reorganization where plans provided for a new debt structure of lesser amount and lower interest cost. It was clear that there was "no reasonable prospect of payment" of the larger interest accrual on the old debt structure. However, the Commissioner stated the full amount of interest accrued was deductible from gross income for the respective years of accrual and the doubt as to collectibility of such interest is not such a contingency as postpones the accrual of the liability until the contingency is resolved.

It is not so much the narrow field of interest accrual deductions which is affected by this theory; it is a distortion of a basic accounting concept. The Tax Court refused to consider the real issue but instead applied a new income test to determine the cash or accrual basis. What the court did was to accept a general accrual system but, thereafter, subjected a single item or transaction to a new test. Where the liability is definite in amount and admitted to be due and has come into full maturity, all of the heretofore stated definitions of accrual are met.[17] In this case, the Tax Court applied a further test, namely, "is there reasonable prospect of payment." Failing this, the single item or transaction out of this general accrual system goes over to a cash basis system. This results in a hybrid system and a mixed cash and accrual reporting which has been specifically rejected in other cases.[18]

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to permit a change of accounting method and has said that "it is not the province of the court to weigh and determine the relative merits of systems of accounting." See Brown vs. Helvering, *supra* note 13. See also Code Section 41, *supra* note 7.

[16] 1944 INT. REV. BULL. 101.

[17] Cf, e.g., Security Flour Mills Co. vs. Comm'r., 321 U. S. 281 (1943); Burnet vs. Sanford & Brooks Co., 282 U. S. 359 (1931); Dixie Pine Products Co. vs. Comm'r., 320 U. S. 516 (1944); The Baltimore Transfer Co. of Baltimore City vs. Comm'r., 8 T. C. 1 (1947).

[18] Cf. e.g., Massachusetts Mutual Life Insurance Co. vs. U. S., 288 U. S. 269 (1933); Hygienic Products Co. vs. Comm'r., 37 BTA 202 (1938); aff'd., 111 F. 2d 330 (1940), cert. denied, 311 U. S. 665 (1940).

The resultant basis of tax reporting is neither cash nor accrual, is at variance with the method employed by the taxpayer in maintaining his books and records, and is apparently contrary to the Commissioner's construction of Section 41 and other applicable provisions of the Internal Revenue Code.

The government, of course, has no monopoly on the confusion which exists between general accounting and tax accounting. Some years ago, several small law and accounting firms conceived the idea that any corporation which was subject to renegotiation of war contracts should not be considered to have accrued taxable income on account of such contracts until the renegotiation proceedings had been terminated. For example, if a corporation were subject to renegotiation for any of the years 1940 to 1945 (being excess profits tax years) these accountants or attorneys took the position that no taxable income accrued with respect to the renegotiable portion of the business until 1946 or thereafter (when excess profits taxes were no longer in effect) upon final settlement with the renegotiation authorities. They recommended the filing of claims for refund on such basis and solicited the work on a contingent basis, usually one-third of the savings with a certain minimum fee.

A number of suits were brought in the United States Court of Claims involving this principle. The Court of Claims in the *Holmes Projector Company case*[19] in rendering a decision for the government and against the taxpayer held that the income is taxable on the accrual basis in the year earned despite the fact that the company might be subject to renegotiation in later years. The court in this current case followed "good accounting."

The taxpayer and his advisors in this case were clearly attempting to violate one of the basic principles of accounting.[20] If the Commissioner of Internal Revenue and the courts are expected to adhere closely to generally accepted accounting principles, the taxpayers and tax practitioners must likewise follow the same principles.[21]

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19 2 CCH 1952 Fed. Tax Ref. P. 9404 (U. S. Ct. Cl. 1952).

20 Finney, "Principles of Accounting—Intermediate," 3rd Edition, pages 196-197 (Revenues should not be regarded as earned until an asset increment has been realized, or until its realization is reasonably assured).

21 Sydney A. Gutkin and David Beck in their article "Tax Accounting v. Business Accounting—The Emasculation of Section 41" make these comments:

"The average person has not been reared in an environment conducive to accounting consciousness. Included in this group is the lawyer. He has been trained to cope with legal concepts and has, in this connection, been taught to present facts in such a manner that legal conclusions most favorable to him will be delivered therefrom. Understandably, no attention has been directed by him to the finer points of accounting concepts involving cash receipts and disbursements, accruals, methods of reporting income, reserves created to reflect liabilities, and the like. * * *"

"* * * the legal profession has been, and still is, responsible for the introduction, presentation, and perpetuation of confusion and error in cases involving the interpretation of accounting principles. * * *"