Relation of Accounting Principles to the Solution of Federal Income Tax Problems

By Dr. Joseph J. Klein, C.P.A.

I—PRELIMINARY OBSERVATIONS

As you will note from the mimeographed outlines which have been distributed, I intend to discuss with you a number of cases, some of them recently decided, which will illustrate the application of accounting principles in the determination of taxable net income. The number of cases which will be analyzed and discussed will depend on the time required to present a number of essential preliminary topics. Aside from some introductory observations, these preliminary topics include discussion of "accounting principles," "income" both as an accounting and as a federal income tax concept, and deliberate legislative deviations from sound accounting practices in the determination of taxable income.

(1) Basic problem: "Accounting income" versus "tax income."

Fundamentally, every income tax problem involves, aside from Constitutional and procedural questions, an amount of tax—payment or refund thereof. In the determination of the federal tax on incomes—and we are not dealing tonight with any other phases of taxation—the amount subject to tax is frequently found through the help of bookkeeping or accounting. This is surely true of the income of business enterprises. As we shall soon see, "taxable income" and "accounting income" are by no means identical. Nevertheless, Congress must have intended that accounting principles, to a much greater extent than is actually the case, should govern the determination of taxable income.

(2) Interaction between accounting principles and income tax decisions.

Manifestly, tax law has influenced accounting principles, but as accounting does not function in a vacuum, it has been influenced by other factors as well, among which are law in general, business management, credit seeking, and requirements and mandates of governmental agencies. See, for example, *Sources of Accounting Principles,* by Professor Roy B. Kester, in the Journal of Accountancy for December, 1942. But just as accounting does not function in a vacuum, neither does it travel a one-way street. It influences taxation. Roswell Magill, in his *Taxable Income,* points out that "there is likely to be a gradual cross-fertilization between the in-

Dr. Joseph J. Klein, C.P.A., has served two terms as President of the Society since his admission in 1911, as well as on the Board of Directors and as Vice President. He is a member of the Council of the American Institute of Accountants and also a member of the Bar Association. Dr. Klein is well known as the author of books on accounting and taxation and is Associated Professor of Taxation at the College of the City of New York.

Presented May 24, 1945 for the Course on Current Problems in Accounting for Lawyers given by the Practicing Law Institute in cooperation with the American Institute of Accountants and the New York State Society of Certified Public Accountants.

come tax decisions and accounting principles, as each group of specialists comes to know the other's theories and results."[1]

(3) Inevitable effect of high income tax rates.

The pressure of income tax accounting on business operations is indisputable; the effects of the pressure are manifest in many ways, directly and indirectly, including the form selected in which to conduct business. The activities and operations of a business are undeniably influenced by net results,—profits *after* taxes. In the presence of a federal taxing statute with rates at almost a confiscatory level, which claims 95% of corporate net income (with a post-war refund provision of 10% thereof) and as much as 94% of non-corporate net income, no wonder that accounting for taxable income has come to be recognized as of primary significance. It is to be expected that honest taxpayers will seek accounting practices which result in avoidance of unnecessary exposure to taxation, and in postponement of such exposure as long as possible. When tax accounting deviates from financial accounting, it becomes of the utmost importance that such deviations be absolutely justified under the Constitution and in the statutes. Resistance is natural to any tax administrator's interpretation which seeks unjustifiably to increase taxable income or attempts too early precipitation of tax liability.

(4) Static definition of "income" not to be expected.

Neither the concept of accounting income nor that of tax income is static; as accounting principles and practices develop, the concept of accounting income is modified and changed; with each amendment of the Internal Revenue Code the statutory definition of tax income changes.

Under the Constitution, the term "income" will not be put in a straitjacket by a definition which will for all time confine it to a fixed connotation. The courts will, from time to time, in dealing with specific cases, give earlier definitions greater preciseness, expand where necessary or expedient, but no static definition is to be expected.

(5) British vs. American philosophy of tax administration.

The British income tax administrator has a degree of discretion vested in him that the American legislator appears to regard as practically unthinkable. That is why the British income and excess profits tax statutes are so short, while our taxing laws are so long, detailed and complicated, and, perhaps, why they are so frequently amended. The British tax administrator is intended to administer the law in a *quasi*-judicial spirit; the American counterpart is expected to be "Treasury" minded. Rare, indeed, is the official who seeks justice only and who really does not care "where the chips fly." Fortunately, there are some such officials in key positions in the Revenue Bureau, both in Washington and in the field. An Attorney General has advised the Treasury that revenue laws should be interpreted so as to favor the revenue.[2] An opinion of a later Attorney General is more consonant with the rule that reasonable doubts as to taxable income are to be resolved in favor of taxpayers.[3] Many

[1] Rev. ed. (1945), p. 20.
[2] 18 Op. A. G. 246.
[3] T. D. 3754 (IV-2 C. B. 37).

field agents act as though they had been brought up on 18 Op. A.G. 246; fortunately, fewer higher Bureau officials are uninfluenced by *Gould* v. *Gould*,[4] *Smietanka* v. *First Trust & Savings Bank*[5] and *U. S.* v. *Merriam*."[6]

II—ACCOUNTING PRINCIPLES

In the determination of business income, it is recognized that important as is the application of sound and accepted accounting principles to the elements and factors with which the accountant deals, it is of at least equal importance that such principles should be consistently applied. Such two-fold criterion is embodied in the certified public accountant's report or certificate based on his audit or examination:

> "In our opinion, the accompanying balance sheet and related statements of income and surplus fairly present the position of Company at , 1944, and the results of its operations for the year then ended, *in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.*" (Italics supplied for emphasis)

As Mr. George O. May, in his lecture on "Distribution of Profits," or Mr. Carman G. Blough, in his talk on "Effects of S. E. C. and Treasury Department Policies on Application of Accounting Principles" may have told you, an "accounting principle" is neither the philosopher's "fundamental truth" nor the mathematician's "axiom." An accounting principle is really a "convention" or a "rule" derived empirically. Thus:

> ". . . Initially, accounting rules are mere postulates derived from experience and reason. Only after they have proved useful, and become generally accepted, do they become principles of accounting. But in discussion the word is often invested with an aura of sanctity, arising out of its more fundamental meanings, thus leading many to attribute to the rules of conduct called principles a greater force and a more universal and permanent validity than most of them were ever intended to have."[7]

In this presence, it may be most helpful to liken an accounting principle to a principle of law which stems out of decisions of the courts. But such court decisions frequently present conflicting principles. It then becomes your job and mine to try to find the principle which applies most aptly to the specific facts of a particular case. In a similar sense, we speak of an accounting principle—no more, no less sacrosanct, fixed, immutable, than a principle of law. In both fields the principle is helpful for it satisfies practical needs.

As a single illustration of a firmly established accounting principle, I offer the well established practice or rule:

> The revenue of a given accounting period shall be charged with, and offset by, all costs and expenses fairly attributable or applicable to such revenue.

I shall not add another illustration, but I do refer you to the distinction between income and capital, recognized both by the accountant and the economist. The accountant's recognition of the distinction finds expression in a principle or rule or practice.

---

[4] 245 U. S. 151 (1917).
[5] 257 U. S. 602 (1922).
[6] 263 U. S. 179 (1923).
[7] Report of Committee on Terminology, Amer. Inst. Accts, Accounting Research Bul. No. 7.

"Approved standard methods of accounting," the expression in the Treasury Regulation,[8] is quite synonymous with "generally accepted accounting principles," the statement in the independent accountant's report or certificate and with "good accounting practice."

III—APPLICATION OF GOOD ACCOUNTING PRACTICE TO INCOME TAX PROBLEMS

The essential task of accounting, in its relation to the solution of the type of income tax problem with which we are dealing, is to aid in determining the *quantum* of income and the taxable period to which it belongs. The problem itself involves differentiation between "accounting income" and "federal income tax income." Aside from those distinctions which are statutory,—and we shall refer to such differences shortly,—I should, in passing, remind you that income is determined by the facts and not by mere bookkeeping entries.[9] This is as it should be.

My good friend, Judge J. Gilmer Korner, Jr., while Chairman of the United States Board of Tax Appeals, embraced the opportunity to philosophize about accounting.[10] What he wrote makes interesting and pleasant reading, but it is probably undeservedly complimentary.

IV—"INCOME" AS AN ACCOUNTING CONCEPT

When an accountant speaks of "income" he has in mind "net income," or, at least, he frequently employs the terms synonymously. So do the business man and the economist.[11] Quite frequently, the accountant uses interchangeably "income" and net "earnings and profits."[12]

Robert H. Montgomery has suggested an acceptable definition of net income:[13]

> "The net income of a business is the remainder of the earnings and profits from all sources after providing for all costs, expenses and allowances for accrued or probable losses."

In 1941, the Committee on Terminology of the American Institute of Accountants reported that the definition of income in *Eisner* v. *Macomber*[14] "conformed closely to the accounting concept, and is, therefore, appropriate for adoption by accountants for general use as well as for tax purposes":[15]

> "Income may be defined as the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets . . ."

It has often been observed that the accountant's concept of income is a conservative one, and that it discloses the influence of credit grantors who had learned, through sad experience, that anticipated profits frequently were not realized while the possibility of future losses was often regarded too optimistical-

[8] Reg. 111, Sec. 29.41-2.
[9] *Doyle* v. *Mitchell Bros.*, 247 U. S. 179 (1918).
[10] *Goodell-Pratt Co.*, 3 BTA 30 (1925).
[11] Seligman, *The Income Tax*, (1914), p. 19.
[12] The expression "earnings and profits" has a special statutory meaning. See Reg. 111, Secs. 29.115-11 to 29.115-14.
[13] *Auditing Theory and Practice*, Sixth Ed., p. 421.
[14] 252 U. S. 189 (1920).
[15] Accounting Research Bulletins, No. 9 (Special).

ly. Hence the injunction: anticipate no future profits, but show possible future loss.

Because income is measured in money, and because in modern business the calculation of the *amount* of income for a year involves many transactions recorded through the bookkeeping process which, at least to many lawyers, appears not only mysterious but *mathematical,* an "aura of sanctity" has frequently been impressed—especially by attorneys—on the end results shown in the balance sheet and in the income statement. In sober truth, much of the conclusions expressed in such financial statements is based on estimate. This is inescapable, because these statements merely express the *opinion* of management as to values, overlapping income, expenses in incompleted transactions, etc. And when the certified public accountant reports on such statements, as a result of his audit, he likewise expresses his opinion on the opinion of management, which alone is responsible for the substantial correctness of the representations implicit in such statements.

Accountants recognize two fundamental bases for determining net income of a period: the cash receipts and disbursements basis, and the accrual basis—itself really a number of different bases. The first basis is of very limited application; the latter is necessary for most trading and all manufacturing enterprises. The regulations recognize these bases, although, at least until quite recently, some officials appeared to regard the accrual basis as *one* distinct method. In reality, there is *the* cash basis, approved for those not in business and, to a very limited extent, for some others; and then there is the approved accounting method or procedure of business organizations which, while they must employ *an* accrual basis in order to determine (approximately) correct income, cannot have their accounting procedure identified with sufficient definiteness by saying that they are on *the* accrual basis, and nothing more. The accrual basis, when used by traders and manufacturers, involves the use of inventories. Inventories require determination of quantity and value. Certain types of business have developed special inventorying methods and procedures, and these constitute recognized accounting practices. The law[16] and the regulations[17] recognize and approve such established practices.

Where the statute refers to the taxpayer's "method of accounting," Congress undoubtedly had in mind methods of accounting in accordance with recognized professional practices grounded in approved accounting principles.[18]

Taxpayers must use either the cash basis *or* an accrual basis. Taxable income, in general, is not to be calculated on a hybrid basis.

Mr. Justice Stone, in the *Anderson* case (joined with *U. S.* v. *Yale & Towne Mfg. Co.*),[19] pointing out that the Revenue Act of 1916 must have contemplated the accrual method of accounting and that the true income for the year "could not have been determined without deducting from its gross income . . . the total cost and expenses attributable to the production of that income," stated:

> "It was to enable taxpayers to keep their books and make their returns according to scientific accounting principles, by charging

[16] I. R. C. Sec. 22(c).
[17] Reg. 111, Secs. 29.22(c)-1 to (c)-8.
[18] I. R. C. Secs. 41, 42, 43.
[19] 269 U. S. 422 (1926). But see later contra holding in *Lucas* v. *American Code Co., Inc.*, 280 U. S. 445 (1930).

against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period."

Here is Clear Recognition of the Accrual Basis of Accounting.

In the *Anderson* case, the issue involved the deductibility of the munitions tax which was based on the business of 1916, but not paid until 1917. It was not until the latter year that the amount of the tax was known or paid. In effect, a reserve for the tax was allowed in the computation of the taxable income for the year 1916. The *time* of the deduction was found to be 1916, to which the deduction applied and in which year the revenues were reported, and not the later year of payment.

While we are now dealing with the accountant's concept of income, a very brief word regarding the economist's concept is in order. Economists quite universally define "income" as, in effect, the succession of pleasurable sensations imparted to us by things or services. They regard wealth as the fund or stock of such goods.

For practical purposes, we must use a yardstick — money — to evaluate such satisfactions, *i.e.*, income, "Money income" refers to the time of receipt (or its equivalent on an accrual basis), rather than to time when the money is spent for psychic pleasures or satisfactions. Hence, Haig's often-quoted definition:[20]

> "Income is the money value of the net accretion to economic power between two points of time."

Seligman would add to Haig's definition:[21]

> " 'Separation,' that is, a separation of the accretion from the fund by 'realization.' "

Upon analysis, Haig's and Seligman's definition are not radically different from the, one sponsored by accountants.

V—"INCOME" AS A (FEDERAL INCOME) TAX CONCEPT

In the very nature of things, accounting principles and practices will influence determination of taxable income through tax legislation, through tax administration and through judicial interpretation *but the statute remains supreme.* Accounting principles, when persuasive (with notable exceptions), guide the courts; when so-called principles are arbitrary or illogical, and especially when not generally accepted, they are ignored by the courts.

Taxable net income is what the statute says it is. But the statute vacillates and changes altogether too frequently. And at any moment of time there are a number of different statutory "net incomes." Thus, this very evening, the Internal Revenue Code (as amended to date), defines "net income" in a number of different ways. I shall mention a few of them:

(a) Normal tax net income (for corporate and other taxpayers) —see Sec. 21(a)

(b) Surtax net income (for corporate and other taxpayers)—see Sec. 12(a)

(c) Declared value excess-profits tax net income (for corporations)—see Sec. 602

(d) Excess profits net income (for corporations) (i) on earnings basis—see Sec. 171(a)(1); (ii) on invested capital basis —see Sec. 711(a)(2)

I have had occasion to refer to the

[20] *The Federal Income Tax* (Col. U. Lectures, 1920), p. 27.
[21] *Are Stock Dividends Income?* (American Economic Review, Sept., 1919).

fact that "income" and "earnings and profits" are different concepts. Dividends, as per statutory definition, are distributions out of "earnings and profits"[22] rather than out of "income." The former, when reduced to "net," is much more akin to the accountant's net income.

In *Com'r* v. *Wheeler*,—*U. S.*—(March 26, 1945), the Court stated:

> "But 'earnings and profits' in the tax sense, although it does not correspond exactly to taxable income, does not necessarily follow corporate accounting concepts, either. Congress has determined that in certain types of transaction the economic changes are not definitive enough to be given tax consequences, and has clearly provided that gains and losses on such transactions shall not be recognized for income-tax liability but shall be taken account of later. §§ 112, 113. It is sensible to carry through the theory in determining the tax effect of such transactions on earnings and profits."

The courts regard "income," undefined in the Sixteenth Amendment, according to the layman's conception of the term, rather than that of accountant, economist or lawyer. Its meaning is "not to be found in its bare etymological derivation. Its meaning is rather to be gathered from the implicit assumptions of its use in common speech."[23]

It is appropriate to conclude our discussion of the federal income tax concept of income, by referring to three Supreme Court decisions.[24]

As early as 1913, the Court defined income "as the gain derived from capital, from labor, or from both combined."[25] About five years later, the same Court extended the definition so as to include the profit gained through a sale or conversion of capital assets.[26] Finally, in 1920, the Court[27] found "little to add to the succinct definition adopted" in the two earlier cases, but it did emphasize "separation"—Seligman's contribution:

> "'*Derived — from — capital*'; 'the *gain—derived—from—capital*', etc. Here we have the essential matter; *not* a gain *accuring* to capital; not a *growth* or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value, *proceeding from* the property, *severed from* the capital, however invested or employed, and *coming in*, being *'derived'*—that is, *received* or *drawn by* the recipient (the taxpayer) for his *separate* use, benefit and disposal —*that* is income derived from property. Nothing else answers the description.
>
> "The same fundamental conception is clearly set forth in the Sixteenth Amendment—'incomes, *from* whatever *source derived*' . . ."

VI. THE INTERNAL REVENUE CODE RECOGNIZES THE PLACE AND FUNCTION OF ACCOUNTING IN THE DETERMINATION OF TAXABLE INCOME.

The real forerunner of the present series of federal income tax statutes was the corporation excise tax act of 1909.[28] Its language contemplated

[22] See Sec. 115(a), (b), (e), (h), (l) and (m); Reg. 111, Secs. 29.115-3, 29.115(12)-29.115(14).
[23] Judge Learned Hand in *U. S.* v. *Oregon-Washington R. & Nav. Co.*, 251 Fed. 211 (C.C.A. 2, 1918).
[24] Klein, Federal Income Taxation, pp. 49-51.
[25] *Stratton's Independence, Ltd.* v. *Howbert*, 231 U. S. 399, 415 (1913).
[26] *Doyle* v. *Mitchell Bros. Co.*, 247 U. S. 179, 183, 185 (1918).
[27] *Eisner* v. *Macomber*, 252 U. S. 189, 207.
[28] Act of Aug. 5, 1901 (36 Stat. L. 13-8, C. 6).

the determination of net income on the basis of cash receipts and disbursements. This was found to be impracticable and, consequently, in the administration of the Act, established accounting practices were recognized. By January 8, 1917, such recognition was formal.[29]

We have no need, and there is no time, to trace the evolution of the present Code provisions relating to computation of net income and recognition of sound accounting methods in such determination. Sec. 41 of the Code approves the taxpayer's method of accounting if it clearly reflects income:

> "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 . . ."

Sec. 42(a) of the Code recognizes that receipts of a given year may represent income of another year:

> "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 . . ."

Sec. 43 of the Code relates to deductions and parallels Sec. 42(a):

> ". . . deductions . . . 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 . . . should be taken as of a different period . . . "[30]

The Code contains other instances of recognition of accounting practices. Thus, in Sec. 22(c), dealing with inventories, it is provided that in businesses where the use of inventories is necessary to determine income, the Commissioner may prescribe the basis for the taking of the inventory

> "conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."

The regulations of the Commissioner interpreting the Code are quite in accord with the sections from which I have quoted. Thus, Sec. 29.41-3 of Reg. 111 provides:

> "Methods of Accounting. — It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his true income. He must, therefore, maintain such accounting records as will enable him to do so."

Again, Sec. 29.41-2 of the same regulations recognizes standard meth-

[29] T.D. 2433. See George O. May, "Taxable Income and Accounting Bases for Determining It." 40 Journal Accountancy 248 (1925).

[30] This section, in dealing with decedents, refers—I recall no other place in the statute—to "the accrual method of accounting."

ods of accounting and the need of consistency in the application of accounting principles:

> "Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency."

The statute provides protection for the revenue where there is manipulation of income[31] or where there are corporate acquisitions primarily for the purpose of evading or avoiding tax.[32]

VII. CONGRESS HAS DELIBERATELY DEPARTED FROM THE CONCEPT OF "ACCOUNTING INCOME" IN ENACTING SPECIFIC PROVISIONS FOR INCLUSIONS, EXCLUSIONS AND DEDUCTIONS.

A person otherwise unfamiliar with the Internal Revenue Code would be justified in assuming, as a result of reading the sections of the law and regulations quoted in the immediately preceding division of this lecture, that taxable net income would be determined in accordance with approved accounting methods consistently applied. The conclusion would be true but for the fact that Congress has seen fit, from time to time, to provide what might be called "exceptions" to sound accounting practice. Some of these exceptions favor taxpayers, others favor the Treasury, and still others favor the taxpayer or the Treasury, depending on circumstances and subsequent events.

These "exceptions" limit the generality of the application of accounting principles to the solution of federal income tax problems. This is so because, regardless of sound accounting practice, the mandate of the statute governs.

We have no time to analyze the various exceptions, ascertain the motivation which induced their enactment, or pass critical judgment on them. It must suffice, in passing, merely to mention some of these exceptions.

Among those which now come to mind, as intended to favor taxpayers, are certain earnings for personal services rendered outside of the United States[33], which are not subject to tax. Then there is partially exempt income in the form of ordinary dividends received by a corporation, only 15% of which is subject to income tax[34] (and none to the excess-profits tax)[34a]. Then, recently, those in the military services have been favored by exemption of the first $1,500 of income from such services[35]. There is, also, the exemption from income tax of the proceeds of insurance payable at death[36], as well as the exemption of sickness and accident insurance and compensation for injuries[37]. Another recent exemption, in the form of a special deduction, is the allowance of "extraordinary" medical expen-

---

[31] See Sec. 45 of the Code and Sec. 29.45-1(c) of Regulations 111.
[32] See Sec. 129 of the Code (amendment added by Sec. 128(a) of the 1943 Act).
[33] Sec. 116(a). Interest from state and municipal obligations (Sec. 22 (b)(4)) and distributions out of capital (Secs. 115(b) and (d)) are exempt on Constitutional grounds.
[34] Sec. 26(b).
[34a] Sec. 711(a) (1) (F).
[35] Secs. 22(b) (13) and (14).
[36] Secs. 22(b) (1), (5).
[37] Sec. 22(b) (5).

ses[38]. I suppose I should mention, in the present connection, the exemption from liability for tax of the lessor because of improvements made on his property by the lessee[39]. Not so long ago the value of such improvements was income to the lessor. The statute now provides that, under certain circumstances, discharge of indebtedness does not result in taxable income to the favored debtor[40]. Quite recently Congress amended the Code so as to provide for exemption from income tax of bad debt recoveries, prior taxes and so-called "delinquency amounts" to the extent that there had been no prior tax benefit[41]. I suppose that it is proper to include among statutory deviations from accounting principles and practices, favorable to the taxpayer, the carry-back and carry-forward provisions of the statute, which apply both to net operating losses[42] and to unused excess profits credits[43]. Exceptions to the general rule that depreciation, obsolescence and depletion, based on cost, may be deducted from gross income is found in connection with oil, mining and other extractive industries with respect to which specially favorable deductions are allowed on the basis of "discovery value"[44]. Finally, I refer to the provision that only 50% of net long-term capital gains are to be treated as gross income[45]. There is a somewhat similar provision with respect to sales of oil or gas properties[46].

However, as I have already indicated, all statutory deviations from approved accounting practices are not intended to favor the taxpayer; some are meant to favor the Treasury. Thus, on public policy grounds, there are provisions which disallow deductions for net gambling losses,[47] and where wage stabilization and OPA ceiling violations exist.[48] Then, there are the provisions limiting deductions as in the case of long-term capital losses[49] and charitable contributions[50]. While losses resulting from "wash sales", from the point of view of business or financial accounting, are as fully deductible as any other losses, they are not allowed as deductions for income tax purposes[51]. This is likewise true of income, excess profits and certain other taxes[52], and expenses in connection with certain nontaxable transactions[53]. Beside the "wash sale" provision, to which I have already referred, the Code disallows deductions of losses resulting from transactions between certain members

---

[38] Sec. 23(x).
[39] Sec. 22(b) (11).
[40] Secs. 22(b) 9 and 10; see, also, *Amer. Dental Co.* v. *Helvering*, 318 U. S. 322 (1943).
[41] Sec. 22(b) (12).
[42] Sec. 122.
[43] Sec. 710(c).
[44] Sec. 114(b) (2), (3) and (4).
[45] Sec. 117(b); there is an over-all tax limitation of 25% of the amount of such gain.
[46] Sec. 105 (applicable where the principal value of the property sold was demonstrated through prospecting, exploration or discovery by the taxpayer; the tax is limited to 30% of the selling price).
[47] Sec. 23(h).
[48] Reg. 111, Sec. 29.23(a)-16; CCH War Law Service, par. 41,072-041.
[49] Sec. 117(d) and (e); only 50% of the amount of the net long term capital losses are allowed as deductions, but only as offsets against corresponding gains. In the case of noncorporate taxpayers, $1,000 is the limit of the deduction in any taxable year, but not in excess of the net income; there is a five-year carry-forward provision.
[50] Secs. 23(a), (o) and (q).
[51] Sec. 23(j).
[52] Sec. 23(c).
[53] Secs. 23(a) (2) and (b).

of the "family" and through certain "controlled corporations,"[54] and also if expenses and interest, deducted by a taxpayer reporting on the accrual basis, are not paid to "related persons" within two and one half months after the close of the payor's taxable year.[55] Where an employer pays excessive compensation to an employee, the amount deemed excessive is disallowed as a deduction (although, of course, in business accounting the entire compensation would be treated as a deductible expense).[56] Finally, I should refer to the Code provision which taxes to the grantor of certain types of trusts income of which he has legally divested himself.[57]

I have already told you that some of the statutory deviations from approved accounting practices may, depending upon circumstances and future events, favor either the taxpayer or the Treasury. Time does not permit detailed reference, but see Code Sections 112, 124, 22(b)(2), 733, 23(a)(1)(c) and 24(a)(7).

VIII. LEGISLATIVE DISTORTION OF "ACCOUNTING INCOME"

We have seen that Congress has deliberately deviated from sound accounting practices in the defining of "taxable" income. Within the remaining area, however, it is unfortunate that there has not been stricter adherence to established accounting practices in the determination of net income. Offense is chargeable both to the courts and to the revenue authorities. I shall illustrate my point by reference to a single inter-related field, namely, liability reserves[58] and prepayments. In passing, I might say that with respect to liability reserves, part of the difficulty lies in accounting terminology: "reserves" are used in a number of senses, including the indication of accruals of liability. The statute permits deduction of reserves for bad debts, depreciation and depletion. Because of the specific statutory provisions, and because Congress has repeatedly resisted appeals to extend the use of reserves as deductions in the determination of taxable net income, the Treasury has refused to recognize other than specifically mentioned reserves, when denominated "reserves," even though they are for all practical purposes merely "accruals."[59] In this attitude the courts have generally, but not always, sustained the Treasury.

We have seen that Sec. 43 of the Code recognized accrued expenses as deductions. There is no conflict between the Treasury and the professional accountant as to the meaning of the "accrual basis" or the "accrual method of accounting." Long ago the Treasury recognized that true net income of a mercantile or manufacturing enterprise could not be determined on the basis of cash receipts and cash disbursement. This I pointed out earlier this evening. In speaking to a group of lawyers, perhaps I should not take it for granted that all are familiar with the meaning of "accrual method" and "accrual basis" of accounting, so I shall devote a few moments to the subject.

---

[54] Sec. 24(b).
[55] Sec. 24(c).
[56] Sec. 23(a)(1)(A); Reg. 111, Sec. 29.23(a)-7.
[57] Secs. 166, 167; Reg. 111, Sec. 29.167-1(b).
[58] This discussion contemplates taxpayers other than insurance companies, reserves of which are deductible on a special basis. I.R.C. Sec. 201(b)(c)(2). *Ocean Accident & Guarantee Co., Ltd.* v. *Comr.*, 47F. (2d) 582 (C.C.A. 2, 1931).
[59] *Rogers, Brown & Crocker Bros. Inc.*, 32 BTA 307, 314 (1935); G.C.M. 9571, C.B. X-2, p. 153; Mertens, *Law of Federal Income Taxation*, 1942, vol. 2, sec. 12.67.

The Treasury's attitude toward an understanding of the accrual method of accounting is in accord with the views expressed by judicial tribunals. Thus, in *Spring City Foundry Co.* v. *Commissioner,*[60] the Supreme Court has held that keeping accounts on the accrual basis means that it is the *right* to receive and not the actual receipt that determines the inclusion of an amount in gross income. When the right to receive an amount becomes fixed, the right accrues.

The High Court, in the foregoing case, dealt with gross income. I now cite from a decision of the Board of Tax Appeals, which concerns itself both with income and with deductions on the accrual basis:

> "The basis idea under the accrual system of accounting is that the books shall immediately reflect obligations and expenses definitely incurred and income definitely earned without regard to whether payment has been made or whether payment is due. Expenses incurred in the operations for a particular year are properly accrued in the accounts for that year, although payment may not be due until the following year. Under the accrual system, the word 'accrued' does not signify that the item is due in the sense of being then payable. On the contrary, the accrual system wholly disregards due dates. *Neither is it necessary that the amount of an incurred liability be accurately ascertained in order to accrue it.*"[61] (italics supplied)

As descriptive of the accrual basis of accounting, it may be said that under this method, generally, the important and primary factor is not the receipt or the disbursement of cash, but the incurring or accruing of a right, and the incurring or accruing of an obligation. A sale of goods on credit, for instance, immediately creates an obligation on the part of the customer to pay for the merchandise involved, and the right on the part of the seller to receive the agreed price. When income is computed by the accrual method, consummated sales are deemed to result in income immediately, regardless of the date when payment is due. Likewise, when expenses are incurred, they constitute deductions from income immediately, even though the date of payment is postponed.[62]

A recent decision of the Circuit Court of Appeals for the Sixth Circuit aptly summarized requirements of the accrual method of accounting:[63]

> "The essence of the accrual method of keeping accounts and making returns is that the right to receive and not the actual receipt determines whether an amount should be included in gross income . . . Correspondingly, the right to deduct an expense item accrues when the fixed obligation is incurred, even though the amount may be diminished by subsequent events. Both sides of the ledger must be treated alike . . ."

It is patently unrealistic to include in income, under this system of accounting, amounts which the taxpayer's experience indicates will have to be paid over or returned to others,[64] or amounts which have not yet been earned.

I have already directed your attention to a firmly established accounting principle:

---

[60] 292 U. S. 182 (1934).

[61] *H. H. Brown Co.*, 8 BTA 112, 117 (1927). But see *Brown* v. *Helvering*, *infra*, which holds that deductions for accrued liabilities must be predicated on definitely ascertained *amounts.*

[62] Klein, Federal Income Taxation, pp. 106-109.

[63] *Ohmer Register Co.* v. *Com'r*, 131 F. (2d) 682 (1942).

[64] Magill, *Taxable Income*, 1945, p. 209; *of Brown* v. *Helvering*, 291 U. S. 193, 199 (1934).

> The revenue of a given accounting period shall be charged with, and offset by, all costs and expenses fairly attributable or applicable to such revenue.

There is nothing in the statute to justify an assumption that Congress did not intend the foregoing definition to be recognized and applied in the determination of taxable income. Nevertheless, there are instances which demonstrate that taxing authorities are intent upon observing the requirements of the accrual basis with respect to gross income but much less zealous of doing so with reference to deductions therefrom.

A number of rent pre-payment cases will illustrate my point. In the *De Golia* case[65] the Board, and in the *Renwick* case[66] the Seventh Circuit Court, held, with respect to taxpayers reporting income on the cash receipts and disbursements basis, that rent received in advance was taxable in the year of receipt, where no "strings" were attached to the receipt, *i. e.*, the recipient was under no liability to return the advance rent, nor was there any obligation to keep such rent in a special fund for specific purposes, or to apply it to the payment of future taxes on the property. Said the Court in the *Renwick* case:

> "If a taxpayer receives earnings upon property under a claim or right and without restriction as to its disposition, he has received income for which he is required to account."

Even if cash basis taxpayers are held subject to income tax for advance rent, in the year of receipt, there is no accounting excuse for such treatment of taxpayers on the accrual basis. Nevertheless, it was so decided in the *Amusement Company* case,[67] where the Board held that an advance rental "was not merely a deposit as security for the performance of some provision of the lease" and therefore had been received as rent without restriction.

In another case also involving a taxpayer on the accrual basis, the Circuit Court of Appeals for the Fifth Circuit held, properly, that advance rental for the tenth year of the term was a mere deposit and not taxable income at the time of receipt where such advance was given as security for the performance of the lessee's contractual undertakings, even though there was no requirement to maintain a separate fund for the advance rental and the cash in question was intermingled with the lessor's other funds.[68] The prepayment was available as damages in the event of failure to perform, and the lessor allowed interest to the lessee on the amount. In the *Astor Holding Company* case,[69] the same Circuit Court, a year later, affirming a memorandum opinion of the Board, held that a taxpayer, on the accrual basis, was taxable in the year of receipt for advance payment of rental for the tenth year of the term. The Court differentiated the facts in the instant case from those of the *Clinton Hotel* case by emphasizing that in the later case the payment was absolute, whereas in the earlier case there were a number of conditions which might make an advance applicable otherwise than as rent for the tenth year. There is no accounting justification in the case of accrual basis taxpayers for treating as income in the year of receipt, advances of rental for a future period. As I have indicated, however, the Treasury and the courts refuse to follow sound accounting practice except in instances where the advance is subject to such restrictions as those which existed in the *Clinton Hotel* case.

---

[65] 40 BTA 845 (1939).
[66] *Renwick v. U. S.*, 87 F. (2d) 123 (1937).
[67] *H. & G. Amusement Co., Inc.* v. *Com'r*, 46 BTA 1095 (1942).
[68] *Clinton Hotel Realty Corp.* v. *Com'r*, 128 F. (2d) 968 (1942).
[69] *Astor Holding Co.* v. *Com'r*, 135 F. (2d) 47 (1943).

We shall soon see that the attitude toward "accrual deductions" is not always consistent with that shown toward "income accruals." Consider prepayments. Take, for example, payment of commissions for negotiating a lease. We noted in the *Renwick* case that the prepayment of rent was held income in the year of receipt. Nevertheless, the commission paid the rental agent who obtained the lease was held to be *not* deductible in the same year but was to be prorated over the life of the lease!

Unfortunately, rent and lease commission cases are not the only ones in which the Treasury exhibits inconsistency and in which the courts sustain such inconsistency. Perhaps the *South Tacoma Motor Co.* case[70] illustrates, as pointedly as any other, disregard of sound accounting principles. In that case the taxpayer sold service coupon books for cash. As the buyers received service, coupons were delivered; purchasers had the right to have unused coupons redeemed in cash. The taxpayer, on the accrual basis, consistently reported as income that portion of sales represented by coupons collected for services rendered. The Commissioner increased income by adding the deferred portion of the service coupon sales and the Board sustained him. There is no accounting justification[71] for the administrative action and, of course, for the Board's approval thereof. There is no statutory mandate for the Commissioner's action in the *Tacoma* case; none of the statutory provisions which deliberately deviate from sound accounting principles apply to the transaction in question. In fact, not only did the Commissioner ignore sound accounting principles consistently applied, but he substituted therefor a hybrid cash-accrual method of determining income: he accepted the taxpayer's accrual method with respect to all other items of income and deductions but asserted tax on the basis of cash receipts with respect to service coupon sales.

A case with facts decidedly analogous to those of the *Tacoma* case is *Your Health Club, Inc.*[72] In that case, the Club sold for cash a year's "gym" service,—a sort of membership privilege. Sales were made continuously, so that during any taxable year there were overlapping service sales: sales of the prior year expired during the given year, while sales during the given year did not expire until the succeeding year. While the arrangement did not expressly provide for refundment in the case of surrender of membership, refunds on a proportionate time basis were made upon request. The taxpayer, during its brief existence, had consistently reported as gross income the portion of membership dues which had expired during the taxable year. The Tax Court, in holdings that the entire cash received for service membership constituted income in the year of receipt, assumed that refundment might never be requested. This is true, of course, but then the cost of rendering the purchased and prepaid services: rent, heat, light, salaries, etc., would inevitably have to be met, to some extent, in the period subsequent to the end of the taxable year in which the "dues" were received.

In response to the taxpayer's arguments in the *Club* case that the inclusion of prepaid amounts in the income of the year in which received "prohibits a correlation of income and expenses incident to the earning of that income," the Court pointed out the rather cum-

---

[70] 3 T. C. 411 (1944).

[71] Melvoin, "Reconciliation of Conflicting Accounting and Tax Concepts of Income" in American Institute of Accountants papers read at 1944 annual meeting; Montgomery, "Administrative Tax Accounting Fallacies in Section 41," 78 Journal of Accountancy, 14; Gutkin and Beck, "Tax Accounting v. Business Accounting—The Emasculation of Section 41," 79 Journal of Accountancy 130.

[72] 4 T. C. 385 (1944).

bersome remedial procedure provided in the regulations[73] to implement Code Section 43 which permits deductions in a period other than the taxable year in which paid, incurred or accrued, if necessary in order clearly to reflect income. Regardless of the extent to which this exception may alleviate the situation, as regards deductions, the fact remains that the inclusion in gross income of the accrual basis taxpayer of receipts as yet unearned does violence to sound accounting principles.[74]

The cases to which I have referred, and many others which reach similar results, frequently cite as authority the case of *Brown* v. *Helvering, supra,* the leading case on the question of contingent liability reserves.

The Supreme Court has acknowledged that the prudent business man often sets up reserves to cover contingent liabilities.[75] A proper interpretation of Code Sec. 41 recognizes such reserves as exclusions or deductions from gross income. But the High Court, in the *Brown* case, disapproving a liberal and realistic decision of the Circuit Court for the Fourth Circuit[76] which had approved deduction of reserves for cash discounts to which the taxpayer's accounts were subject, in an amount determined by past experience with reasonable accuracy at the end of the taxable year, established an unrealistically narrow criterion of deductibility requiring the liability provided against in the reserve to be fixed and absolute as opposed to merely contingent. In the *Brown* case, the so-called contingency consisted of the very strong probability based on previous experience that a general agent of fire insurance companies might be required, because of cancellation of policies, to return a portion of overriding commissions. This contingency was held not to justify the deduction of a reserve set up to meet the obligation to refund. The additional factor in the case that the taxpayer's attempt to deduct the reserve constituted an *inconsistent* method of accounting for which the Commissioner's consent had not been secured, renders the decision sound. That most courts have adopted the alternate basis of decision and rigorously disapproved reserves for contingent liabilities constitutes, it seems to me, a faulty conception of the requirement of Code Section 41 and the rationale of the rule in *U. S.* v. *Anderson, supra.*[77]

It is of course within the province of a court to find upon the facts before it that a liability for which a reserve has been established is not contingent, but absolutely accrued. Liberality in this respect has distinguished a few decisions. Most noteworthy is the line established by *Air-Way Electric Appliance Corp.* v. *Guitteau*[78] in which the taxpayer set up a "Reserve for Contingent Collection Expense" attributable to its liability for distributors' commissions payable as installments of the sales price were paid. Denying that the liability was a contingent one under the rule of *Brown* v. *Helvering,* the Court held that the obligation to pay commissions was absolute and accrued when the right to collect accrued during the taxed years. The "reserve" did not, therefore, constitute taxable income.

To the same effect are the rulings in

---

[73] Regs. 111, Sec. 29.43-1; 103, Sec. 19.43-1.

[74] See I. T. 3740, 1945-11—12050 (p. 3) for a proper application of accounting principles to deductions for prepayment of interest.

[75] *Lucas* v. *American Code Co., Inc.,* 280 U. S. 445 (1930); *Brown* v. *Helvering, supra,* I. T. 2199, C. B. IV-2, 78.

[76] *Virginia-Lincoln Furniture Corp.* v. *Com'r,* 56 F. (2d) 1028 (1932) citing Klein, *Federal Income Taxation,* p. 137.

[77] Montgomery, *Federal Taxes on Corporations,* 1944-45, p. 975. *Cf. Shapleigh Hardware Co.* v. *U. S.,* 81 F. (2d) 697 (C.C.A. 8, 1936); G.C.M. 1342, C.B. VI-1, 177.

[78] 123 F. (2d) 20 (C.C.A. 6, 1941), rev'g. 29 F. Supp. 379.

Ohmer Register Co. v. *Com'r.*,[79] and *Warren Co., Inc.* v. *Com'r.*,[80] wherein the respective taxpayers were held entitled to accrue in the taxable year, as a deductible selling expense, the entire amount of reserves for sales agents' commissions.[81] In the *Ohmer* case, the Court, recognizing that "both sides of the ledger must be treated alike" if the method of accounting adopted was to clearly reflect net income, declared:

> "The fact that the agent might not in the end receive his full commission is no more material than that the petitioner might not receive full payment of the purchase price of the article sold. * * *
>
> "To divide the sale transactions here involved so as to treat them upon an accrual basis with respect to income and upon a cash basis with respect to expense in commissions in making sales from which the income was derived would be as objectionable as the division condemned in Air-Way Electric Appliance Corporation *v.* Guitteau."

An exception to the narrow formula applied to liability reserves is promulgated in the Regulations[82] for situations where trading stamps and premium coupons redeemable in merchandise or cash are issued for business promotion purposes. The distributor of such stamps or coupons may deduct from gross income the sum necessary to redeem such part issued for the taxable year as experience indicates will be presented for redemption. An unexpended portion of a reserve set up for stamps or coupons is taxable in the year of its transfer to surplus.[83]

For the rest, while it is the rigid rule that a reserve reflecting a contingent liability is not allowable as a deduction or exclusion from gross income, it will be true, as a practical matter, that the taxpayer's method of accounting is not being permitted to "clearly reflect the income."

Unfortunately, the taxing authorities have been amply supported in their distortion of accounting concepts by a judicial, albeit erroneous, distinction between "net income" and "net earnings." Thus, in *South Dade Farms, Inc.* v. *Commissioner*, 138 F. (2d) 818 (C.C.A. 5, 1943), the Court stated that "Section 41 . . . required that the method of accounting should clearly reflect income, not net earnings." Likewise, in the *South Tacoma* case, *supra*, which involved prepayments by way of purchase of service coupon books, the Tax Court found that the taxpayer received its *income* in the year of prepayment, though its *earnings* therefrom might be subject to expenses in a later year[84] (not to mention redemption of unused coupons).

IX. CONCLUSIONS.

If one versed in accounting were to read for the first time the sections of the law and the Commissioner's regulations interpretative thereof, as set forth in tonight's lecture, he could reasonably conclude that sound accounting principles, consistently applied, would be determinative of taxable income. We

[79] 131 F. (2d) 682 (C.C.A. 6, 1942), rev'g. B.T.A. Memo. Dec.
[80] 46 B.T.A. 897 (1942) Acq. 1942—2 C.B. 19, aff'd, 135 F. (2d) 697 (C.C.A. 5, 1943).
[81] *Cf. Reuben H. Donnelley Corp.* v. *Com'r*, 22 B.T.A. 175 (1931) Acq. X-2 C.B. 19, where amounts due for commissions were not credited until payment of the accounts.
See also *Willoughby Camera Stores, Inc.*, v. *Com'r.*, 125 F. (2d) 607 (C.C.A. 2, 1942), rev'g 44 B.T.A. 520.
[82] Reg. 103, Sec. 19.42-5. See also Regs. 101, 94, 86; Art. 42-5; Regs. 77, 74; Art. 335; Regs. 65, 62, Art. 91; Reg. 45, Art. 88.
[83] *The Creamette Co.*, 37 B.T.A. 216 (1938).
[84] *CF.* I.T. 3369, C.B. 1940-1, 46, permitting accrual basis publishers receiving prepaid subscriptions to employ both deferred income and deferred expense accounts in arriving at net earnings.

have seen, however, that Congress has specifically departed from ordinary accounting principles and practices by wholly or partially excluding from income items which the accountant regards as income, by including items not regarded by the accountant as income, by refusing to allow deductions which the accountant would subtract from gross income in the process of determining net income, by allowing certain deductions in a given period which do not really belong to the operations of that period, and otherwise.

We have no special quarrel tonight with statutory inclusions or exclusions, or with postponements and precipitation of income. We merely refer to these matters to focus attention on the fact that taxable income cannot, in many situations, be exactly the same as financial or business income. Nevertheless, in saying this, we wish to emphasize that, aside from statutory differences, Congressional intent is, or at least was, to have sound accounting principles, consistently applied, determine taxable income. We have seen too many instances in which such inference or belief has been ignored; court approval, and sometimes initiation of the trend itself by the courts, have created situations that should never have been permitted to arise and, surely, should not be permitted to continue.

We have seen that accountants are prone to resist recognition of profits until they become certain, and to anticipate expenses and losses. The federal income tax law recognizes only to a limited extent this conservative practice. Inventorying at cost when market is higher, and at market when cost is higher, is a concession to good accounting practice. So is the statutory provision for bad debt reserves. But it is difficult to excuse the deliberate and long-continued refusal to permit reserves for contractual commitments of machinery manufacturers, building and other construction contractors, and others who must guarantee their products. The recent loss carry-back and carry-forward provisions may be interpreted as a species of reluctant confession of past legislative error with respect to reserves for the indicated purposes and for other probable losses and expenses where neither the exact amount nor the precise time of occurrence can be foretold, although experience justifies the conclusion that such expenses and losses will occur. And it is likewise difficult to accept, and quite impossible to excuse, insistence that prepayments for future services should be taxed as income in the year of receipt.

In *Dobson* v. *Commissioner*,[85] Mr. Justice Jackson points out that after thirty years of income tax history, there is no indication, contrary to normal expectation, that tax litigation will subside. He does not refer so much to frequent amendments of the law as the cause, because he knows that some amendments are necessitated by court decisions. The fault lies, he declares, in the fact that tax decisions of the courts are "not based on statute but upon their ideas of right accounting or tax practice." He then continues:

> "But conflicts are multiplied by treating as questions of law what really are disputes over proper accounting. The mere number of such questions and the mass of decisions they call forth become a menace to the certainty and good administration of the law."
>
> * * *
>
> "Whatever latitude exists in resolving questions such as those of proper accounting . . . exists in the Tax Court and not in the regular courts."

We have seen how far the Treasury has departed from accepted accounting principles in the treatment of accruals, of prepayments and other deferred

[85] 320 U. S. 489 (1943).

items. Its action has been encouraged by the courts. The Supreme Court's recognition of the primary judicial status of the Tax Court may inspire that tribunal to re-examine and, at an early opportunity, rectify the type of accounting errors which I pointed out to you this evening. It may be that the remedy lies in legislation. Congress should, at the earliest possible opportunity, restate its views and intendment, in language even clearer than the clear language of Sections 41, 42 and 43. To recognize net income, determined by the application of accepted accounting principles consistently applied, as synonymous with taxable income, save only as the latter is specificially modified by statute, would make for greater clarity and certainty in the law, would avoid much unnecessary litigation, and would probably in the long run not injure the revenue. Lawyers and accountants are familiar with many instances in which the Commissioner's action in ignoring sound accounting resulted in some immediate collection of revenue, offset, however, by considerable more revenue loss in later years.