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George O. May

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Introduction

On various occasions when the question has arisen, I have been impressed by the uncertainties and misconceptions shown to exist concerning accounting bases for determining income for tax purposes and in regard to the significance of such terms as "the cash basis" and "the accrual basis" commonly employed in tax practice. It has therefore seemed to me to be worth while to devote some time to a consideration of this subject and in so doing to go back over the developments affecting it since the passage of the corporation-excise-tax law in 1909.

As a preliminary to such consideration it seems necessary to inquire to some extent into the nature of taxable income, but I do not propose to go into this very large subject except in so far as may be necessary to an intelligent discussion of the accounting bases for determining income. To allay still further any anxiety created by the comprehensiveness of the title of this paper, I will add that I shall confine myself to commercial income, which constitutes the major part of the taxable income of the country and presents the more difficult problems and I shall not discuss personal, professional or investment income.

In income taxation, the first problem is to define income and the second to allocate income in respect of time. The question of allocation to sources geographically arises in some cases and presents some difficulties, but this question affects only a restricted field.

The problem of definition resolves itself mainly into a choice between several different concepts of the nature of the income and, though important, is relatively simple. The more serious difficulties are encountered in determining when income emerges from the complicated business transactions of modern commerce so as to be properly taxable.

The accounting bases employed in determining income affect the time when income becomes taxable rather than the amount of income ultimately taxable and this paper therefore has to do

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mainly with the time element in taxation. This is conspicuously a case where "time is of the essence". Whether an amount is to be deemed taxable in a year of high war taxes or in some remote future year may be of far more practical importance than whether the whole or only a part is to be finally taxed.

What Is Taxable Income

Since 1913 our income-tax laws have been enacted under the authority of the sixteenth amendment to the constitution, which authorized congress to tax without apportionment among the several states "incomes from whatever source derived".

Now there are numerous theories as to what is income. In one case (*Doyle* v. *Mitchell*) the government argued that the gross proceeds of sale were income. Economists sometimes argue that earnings that are saved are not income, so that what is income is determined by how what comes in is subsequently expended. Apart, however, from any such extreme views, there are two materially different theories of income which are supported by considerable authority: One holds that income is necessarily gain, the other that it may be in part a conversion of capital.

The difference may be illustrated by the case of a man purchasing an annuity. The general public regards the whole of the annuity as his income and this view is shared, I think, by many economists and reflected in the English and probably other tax laws. The actuary and the accountant would, however, insist that only in part is the annuity rightfully called income, a part being a realization of capital.

Congress in 1913 might, I suppose, have adopted either of these theories and if its intent had been clearly manifested the supreme court would hardly have rejected that theory.

This, however, congress did not do. The clauses of the 1913 and 1916 acts purporting to define income or gross income, as definitions, left much to be desired. What are we to infer from the definition of income as including "gains, profits and income" from certain specified sources "or from any source whatever"? Is income something different from gains and profits, and if so, what is the distinction? In section 4 of the act of 1916 congress provided that annuities in so far as they represented returns of premiums were not *taxable income*, but in doing so it in plain language characterized them as income; the 1918 law retained the exemption but avoided the characterization [Sec. 213 (a)].

It might fairly be argued that congress, taking the acts as a whole, indicated an intention to tax only gains. This view is supported by the provisions above mentioned and by those allowing depreciation and depletion. On the other hand, the fact that these items were allowed by way of deductions from income or gross income in arriving at taxable income, the limitation of the deductions in purely arbitrary ways, and the language of section 4 of the act of 1916 above alluded to, might be claimed to support the view that congress intended to assert the right to tax as income what might be in part a conversion of capital, but not to exercise its rights to that extent.

However this may be, the supreme court presumably settled the matter when in the case of *Eisner* v. *Macomber* it defined income as the gain derived from capital, from labor, or from both combined.

This decision, for the reason that it contained the definition I have referred to and held that congress had attempted to tax as income what was not income, is of great importance and it may be worth while to discuss it briefly. Many passages from the opinion are of interest to accountants but I will quote only one paragraph:

> After examining dictionaries in common use (Bouv. L. D.; Standard Dict.; Webster's Internat. Dict.; Century Dict.), we find little to add to the succinct definition adopted in two cases arising under the corporation tax act of 1909 (*Stratton's Independence* v. *Howbert*, 231 U. S. 399, 415; *Doyle* v. *Mitchell Bros. Co.*, 247 U. S. 179, 185)—"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, to which it was applied in the Doyle case (pp. 183, 185).

In the dictionaries cited, both of the views of income above mentioned are set forth; the definition coming closest to that adopted by the court is found in Bouvier's *Law Dictionary*.

Reference to the decision in *Stratton's Independence* v. *Howbert*, in which the definition was first used, discloses that in that case the court was at pains to point out that, as at the time of the passage of the 1909 law congress had no power to levy a general income tax without apportionment, the theoretical distinctions between capital and income were of little value to the court in interpreting that statute. Curiously enough also, the case was one in which the court sustained the taxation as income of the proceeds of gold mining without any provision for the exhaustion of the capital represented by the mine. In *Doyle* v. *Mitchell*, arising under the same act, the court adopted the same definition in a decision in which it ruled that the proceeds of lumbering could not be taxed as income without a deduction for the capital value of the timber exhausted. However, these decisions being rendered under the excise-tax law, have no necessary bearing on the present question; and in *Eisner* v. *Macomber* which was decided under an income-tax law, none of these special features was present.

Just how far reaching the effect of that decision is in law is a question for lawyers. The supreme court decisions under the excise-tax law of 1909 rather suggest that congress can levy an excise tax *measured by income* without availing of the sixteenth amendment and in so doing can define income as it pleases without regard to the views of the supreme court or any one else. So long, however, as it levies a tax *on income* it apparently can not tax as income what the supreme court does not consider to be income.

The point is largely academic and congress has not shown any disposition to disagree with the general interpretation of income adopted by the court. The two bodies have, it is true, differed on the question whether stock dividends are income; but dividends constitute a special problem and are, both under the acts and under court decisions, an exception to the rule that there is no income unless there is gain. If an investor buys $100 shares of a company which has a surplus equal to its capital stock for $200 a share and if the next day the company pays a dividend of $100 a share and its shares fall to par, the dividend is not gain to the investor whether the dividend is paid in stock or cash. Dividends are however, in general, income and it is so manifestly impossible to provide for treatment thereof varying according to the circumstances surrounding the holders' acquisition of the stock on which the dividend is paid, that purchasers of stocks of companies having large earned surpluses may reasonably be expected to realize that in making such purchases they not only acquire the prospects of dividends out of profits earned prior to their purchase but also assume the burden of any tax on the dividends they may receive. It was for this reason that Mr. Justice Pitney in the *Phellis* case said the hardship in the case of such purchasers was more apparent than real. It is on similar grounds that supporters of the English system justify its treatment of the proceeds of an annuity or of mining and similar operations as taxable income without any deduction for exhaustion of capital. In this connection it is pertinent to point out that the English income tax has been levied continuously since 1842 and that therefore the great expansion of industry and corporate enterprise has taken place mainly with notice of the burdens in the form of income tax to which it might be subject.

Other similar cases may arise where something which is not gain is taxed as income. It would probably be a fairly accurate statement to say that the general test of the existence of income is whether there is gain, but that items which ordinarily constitute gain and are commonly regarded as income may be taxed as such even though in exceptional cases they may not result in a gain to the recipient.

As regards commercial operations there are probably few exceptions to the rule that income must be in the nature of gain.

Gain in commercial business is, however, usually not a separate item but a difference between items on opposite sides of the account. On the one side are the proceeds of sale, on the other the costs involved in producing the sales. Frequently also the gain is the result of a series of transactions or a gradual process extending over two or more distinct tax periods. If a taxpayer buys raw materials in one year, manufactures finished goods therefrom in another, sells those goods in a third and collects the proceeds in a fourth year, the ultimate gain is obviously not attributable wholly to any one of these four years nor is there any way of allocating portions of the gain to the operations of the several years which can be said to be the scientific and only proper way. In one such series of transactions the main factor contributing to the gain may be cheapness of buying, in another low cost of manufacture, in another advantageous selling and so on. Further, the transactions of a taxpayer are frequently so interrelated that we can not ascertain the profits of any given series separately. Commercial profit is in fact, as an eminent English judge puts it, necessarily a matter of estimate and opinion.

In the determination of income for commercial purposes the best practice is to be governed by considerations of conservatism. Profits are not taken except when and to the extent that they are received or at least reasonably assured. Losses that are foreseen are provided for even though not actually sustained or measured. The legislature naturally approaches the question from a rather different point of view. On the first point it may be questioned whether congress has power to tax profits not actually received.

On the second, if it allows actual losses as deductions it can hardly be expected to allow deductions for potential future losses to be made at the discretion of the taxpayer.

It should be said at once that congress has shown no disposition either to tax income not received or to deny losses actually sustained. Indeed in at least one important instance it has deliberately allowed the anticipation of potential losses. The provision in the 1918 act that inventories shall be taken on the basis conforming to the best trade practice was enacted with the knowledge that one of the best trade practices was to value inventories at cost where cost was less than market and at market where that was less than cost, thus anticipating a loss wherever market might be below cost. This recognition of one of the best established of those trade practices which find their justification not in logic or scientific considerations, but in conservatism and practical wisdom is very significant. In 1921 also the law was amended to permit deduction of a reasonable reserve for bad debts instead of only debts ascertained to be worthless, thus recognizing another well established trade practice.

Whether the deductions permitted for depreciation and depletion are properly regarded as provisions for anticipated losses is difficult to say. From the accounting standpoint the provisions for depletion and depreciation of manufacturing plant are elements of cost, which must be provided for before there can be said to be any gain. The decisions of the supreme court on this branch of the subject are not altogether easy to reconcile either with one another or with the court's general definition of income. Quite apart from the decision in the *Stratton's Independence* case, under the 1909 law, the significance of which may be lessened by the fact that the claimants were asserting that all the proceeds of mining were capital, the court has approved under an income-tax law a purely arbitrary limitation on the depletion allowance which it would seem could hardly have been sustained except on grounds which would have applied equally to the total denial of any deduction. This in turn would seem to mean that depletion is not a factor necessarily taken into account in determining the gain.

One other point may be noted. In general our laws have taxed the income of the taxpayer from his business, which may be less than the total gain from the business to the extent of the portion of the economic gain which the taxpayer may be required to pay over to others in the form of interest, rentals and other participations. In this respect ours has differed from the English system, which assesses against the taxpayer carrying on the business the entire gain from that business without regard to any such distributions, leaving the equitable adjustment between taxpayers to be effected by a system of deductions by the taxpayer when making the distributions, and refunds by the revenue to the distributees if they should be exempt from tax. In the act of 1909 and the income-tax acts up to that of 1918, however, the interest deduction allowed to corporations was arbitrarily limited and the limitation was sustained by the courts. Here again the power to impose purely arbitrary limitations on the deduction would seem necessarily to imply power to deny any deductions whatever. In the cases which came before the court the objection urged was apparently that the limitation was discriminatory and the decisions may, therefore, not be authority for the proposition that congress has the power to tax all that is economically income in the hands of the person who realizes the income, even though it is not all income to that person. The point might become important, for a tax so levied without some provision for the proper adjustment of the burden between the ultimate beneficiaries of the gain might easily result in a tax on a person receiving the income greater than the portion thereof which he might be entitled to retain. In the year 1917 the limitation on interest deductions undoubtedly worked some hardship, and would have caused gross injustice but for the action of the commissioner in allowing, without any very obvious warrant in the law, the capital sum corresponding to the interest disallowed to be treated as invested capital.

While the arbitrary limitations to which I have referred, and which are now fortunately removed, were blemishes on the earlier acts, criticism of the methods of determining taxable income established by those acts must be directed mainly at their lack of precision and clarity and their failure to recognize business methods and considerations of practical convenience.

Bases of Accounting for Income Historically Considered

It is perhaps not surprising that at the outset receipt or payment in cash should have been adopted as the general basis for inclusion of items in income-tax returns. Legislation is framed and interpreted largely by lawyers, and lawyers apparently seek to atone for the bewildering complexities they have introduced into their own sphere of activity by insisting on the utmost simplicity in other spheres. The legal mind that distrusts simple interest and regards compound interest as wholly pernicious is naturally suspicious of any account more complex than a cash account. In Great Britain, the home of the income tax, this tendency has been manifest but in regard to commercial income it has been counteracted by another principle of judicial action, the principle that in commercial affairs the established practices of business men are a better guide than rules framed by theorists. Consequently the courts there have always held that the determination of income from business was a business problem and that in the absence of express statutory provision to the contrary, established trade practices must be followed even though to the revenue authorities or even the court those practices might seem theoretically unsound or illogical.

An excellent illustration is found in the methods of valuing inventories, the English courts having sustained both the "cost or market" basis and the "basic stock" method where a practice in the trade was shown to exist and there was no statutory prohibition.

In our case, however, the tendency towards the cash basis was perhaps strengthened by the accident that our first income tax was enacted in the guise of an excise tax.

The law of 1909 was framed so as to provide that corporations should return income actually received and expenses actually paid. As soon as this became known the accountants vigorously protested to the attorney general that such a basis ignored the nature and practices of modern business and would entail inconvenience that would be more burdensome than the tax. The attorney general, however, remained unmoved by their protest, said that the straight cash basis was adopted advisedly and retorted that he had too much confidence in the ability of the accountants to think that they would find the difficulties of complying with the law unsurmountable.

The attorney general's confidence was apparently justified for with the assistance of accountants the secretary of the treasury issued regulations which certainly presented no special difficulties to taxpayers.

Some have thought that the authors of those regulations found their inspiration where so many others have found inspiration, in the works of W. S. Gilbert. Certainly when one reads the provisions to the effect that the term "actually paid" does not necessarily contemplate that there shall have been an actual disbursement of cash or even its equivalent and that an item is paid as soon as a taxpayer recognizes that it has to be paid one is irresistibly reminded of Koko's explanation to the Mikado of his statement that Nanki Poo had been executed when in fact he was still alive.

> When your Majesty says, "let a thing be done," it's as good as done,—practically it is done,—because your Majesty's will is law. Your Majesty says, "Kill a gentleman," and a gentleman is told off to be killed. Consequently, that gentleman is as good as dead, practically, he *is* dead, and if he is dead, why not say so?

It is, however, quite possible to find a more logical justification for the method of determining net income established by the regulations at least in the main, though this justification I admit does not extend to the language in which the method is prescribed and ostensibly justified.

The act of 1909 provided that the "net income" which was subjected to tax should be determined by deducting "from the gross amount of the income . . . received within the year from all sources."

> First. "All the ordinary and necessary expenses paid within the year out of income in the maintenance and operation of its business and properties including all charges such as rentals or franchise payments required to be made as a condition to the continued use or possession of property."
> Second. "All losses actually sustained within the year and not compensated by insurance or otherwise, including a reasonable allowance for depreciation of property if any."
> Third. "Interest actually paid within the year" subject to specified limits.
> Fourth. All sums paid within the year for taxes.
> Fifth. Dividends from other companies subject to the tax.

The regulations regarding commercial income apparently ignored the word "received" just as fully as the word "paid". It was not necessary that proceeds of sale should have been received in order that there should be taxable income therefrom. The regulation treated income from sales as received when the goods were exchanged for an account or note receivable or cash. This was, in ordinary cases, an obviously convenient rule (and in considering the almost complete acquiescence these regulations secured it must always be borne in mind that the tax was so small as to make it not worth while to fight a reasonably convenient rule) but whether if challenged it would have been sustained is open to question. The courts have pointed out that the expectation of gain in the future is not present income and have been reluctant to sustain a tax where nothing had been received out of which the tax could be paid. The justification of the regulation would have had to be found in the argument that something equivalent to cash had been received, and in many classes of transactions the recognition of the principle of cash equivalence must be conceded to be practically essential to an effective income-tax administration. Once this principle is adopted, however, it has to be admitted that in measuring the gain the proceeds must be reduced to a true cash equivalent.

This would mean bringing provisions for the cost of collection, for discounts and for credit risks into account at the same time as the sale itself, which it may be noted the regulations did not permit.

The next point to be observed is that the proceeds of sale are not income (*Doyle* v. *Mitchell*); only so much as is gain is income. Assuming therefore that the gain is received when the proceeds of sale are received (not necessarily in cash) it follows that all costs attributable to the sale must be brought into account at the same time as the sale itself, whether such costs have or have not been paid. Otherwise on balance something which is not gain will inevitably have been brought into account and taxed as income. It is generally recognized that this is true of the direct cost of the goods sold but it is not so universally understood that it is equally true of the cost of making the sale and the cost of collecting the proceeds. A commission paid in order to effect a sale is as much an element in determining the gain therefrom as the cost of the property sold. This point seems to me to have a most important bearing on the determination of taxable income whether the question be approached from the theoretical, historical, or practical standpoint.

In considering the proper treatment of any item in relation to taxable income the first essential is to decide whether it properly relates to the determination of gross income or to a deduction from gross income. If the former, its treatment is not in any way affected by any limitations of deductions to amounts paid, accrued or incurred, as the case may be, since these limitations apply only to items which are *in fact* charges against gross income after gross income has been determined. As the court indicated in *Doyle* v. *Mitchell* it is immaterial whether there is any express provision allowing elements in the production of gross income as deductions from gross proceeds for until they are deducted there is nothing ascertained which congress can properly tax as income.

This principle would have warranted a regulation that all costs of effecting sales, as well as the costs of producing the goods sold and provisions for the costs of collection, were allowable in the period in which the sales were returned, as a part of the computation of gross income. Only expenses not falling under any of these three heads would have been left to be taken as deductions under the head of "ordinary and necessary expenses actually paid within the year out of income."

Looking back on the problem of 1909 in the flood of light which the developments of the last sixteen years have thrown on the subject one feels that along such lines a solution might have been found that would have been almost as convenient as the one adopted and would have avoided interpreting the words "actually paid" in the Gilbertian manner of the regulation then promulgated. It may be suggested that the language of the provision for deduction for business expenses stood in the way, but this does not seem to be necessarily so. That provision authorized the "deducting from the gross amount of the income all the ordinary and necessary expenses actually paid within the year *out of income.*" Expenditures necessarily made to produce income surely did not fall in any such category. In point of fact expenses of maintenance of the property of the taxpayer were specifically enumerated in the act among the "ordinary and necessary expenses" yet the regulations provided that expenditures for maintenance of manufacturing plant should be included in cost of goods sold in computing gross income and not under the deduction.

The regulations of 1909 did not follow the course I have suggested but treated only cost of goods as a deduction from sales in determining gross income and dealt with cost of selling and collection as "ordinary or necessary expenses" to be deducted from gross income when "actually paid" providing, however, that when such items were duly set up on the books they were "actually paid" within the meaning of the law.

The convenience of the solution is undeniable and it may be that the framers were governed by this consideration. They may well have felt that the solution was so convenient that no one would be likely to challenge it, and that if it were challenged they could readily show that it produced erroneous results only as regards expenses which were not a part of the cost of effecting and collecting the sales returned, the amount of which was in ordinary cases relatively insignificant.

In substance these regulations were sound, convenient and did little real violence to the language of the law. Their form, however, must be admitted to have been defective particularly in its apparent disregard of the language of the law. No doubt if continued interest in the work of administering the law by men of the quality of those who framed the regulations could have been secured, the defects in form would have been corrected, while the advantages of the substance would have been retained. This, however, was not possible and in the event just the opposite result followed. The influence of the defective form has continued long after the advantages derived from the substance have ceased to be felt.

One result of the defective form was that a widespread feeling was created both within and without the department that the regulations were at variance with the law and that any day dissatisfaction with their operation in a particular case might bring the issue into court and cause the whole house of cards to collapse. Another result was that the average taxpayer who was told that when used in connection with expenses the word "paid" did not necessarily mean a disbursement in cash, but that when used in relation to interest or taxes it did contemplate such a disbursement, felt that the law was unreasonable and so far as he was concerned incomprehensible. Still another result, certainly of a most unexpected character, which I shall discuss later in this paper, grew out of the establishment by the regulations of the making of book entries as a criterion of deductibility, a criterion not warranted, either in theory or in the language of the law.

Further, while the solution by the secretary of the treasury of the problem presented in the act of 1909 produced immediate benefits in the form of convenience, it stood in the way of efforts to secure a more satisfactory wording when in 1913 the first income-tax law was enacted. Efforts to secure an improvement were made by, among others, the American Association of Public Accountants. The suggestion of a change was met with the argument that the existing law had in practice worked quite satisfactorily and that if such a law could be applied to corporations there was even greater justification for applying it to individuals, most of whom would keep no books and would make returns on a purely cash basis. The law of 1913 thus followed closely the language of the law of 1909. The efforts were, however, continued and in 1916 a modification was effected and taxpayers were given the option of making returns either on the statutory basis or on the basis on which their books were kept, provided the method of keeping the books was such as in the opinion of the commissioner correctly reflected income. For various reasons which it is hardly necessary at this time to discuss, this provision did not work very well, and the regulations under the 1916 act continued to follow very closely those made under the acts of 1909 and 1913.

In passing it may be pointed out that article 126 of regulations No. 33 issued January 2, 1918, strongly suggests that at the time those regulations were issued the line of reasoning which I have put forward above as an alternative to that indicated by the language of 1909 regulations had developed in the bureau. It begins by apparently flouting the language of the statute in the most open and flagrant manner. The first sentence reads "'paid' or 'actually paid' within the meaning of this title, does not necessarily contemplate that there shall be an actual disbursement in cash *or its equivalent*." The next sentence, however, states very succinctly the underlying justification of the results of the regulation which I have suggested. "If the amount involved represents an actual *expense or element of cost in the production of the income* of the year, it will be properly deductible even though not actually disbursed in cash, provided it is so entered upon the books of the company as to constitute a liability against its assets, and provided further that the income is also returned upon an accrued basis."

It will be observed that this regulation does not in terms permit the deduction of any expense which has not actually been paid unless it is "an expense or element of cost in the production of the income". To support such a position it was not necessary to give a forced construction to the words "actually paid" used in the statute. In practice, however, the regulation was applied to all business expenses and the bureau no doubt preferred to retain substantially the language of the regulations under the acts of 1909 and 1913 and to be in a position to invoke the rule that re-enactment of the provisions of an act by congress with a knowledge of the way in which it has been interpreted sanctions that interpretation.

When in 1917 the excess-profits-tax law was passed levying high taxes on the income determined under the 1916 law and regulations the whole question assumed new importance and the need for revision of the law became apparent.

In the 1918 law, therefore, it was provided (in section 212) that returns should be made on the basis on which the taxpayer's books were kept unless that basis did not clearly reflect income, in which case returns were to be made on such basis as the commissioner might prescribe as clearly reflecting income.

In considering this section it is important to bear in mind the provisions of the act that the terms paid or incurred (used in relation to deductions for expenses) and paid or accrued (used in relation to deductions for interest and taxes) should be construed according to the method of accounting used in computing net income.

Even more important, however, is the provision that items of gross income were to be included in returns for the taxable year in which received unless under methods of accounting permitted under section 212 they were properly accounted for as of a different period.

The intent seems clear to give the fullest effect to sound accounting practice in the determination of gross income. It may be conceded that the law gave no authority to the commissioner to prescribe or permit bases of accounting which would result in deductions from the gross income of expenses in periods other than those in which they were paid or incurred or of interest and taxes in periods other than that of payment or accrual. Incurred, however, is a sufficiently broad term and no serious criticism of the rules thus established could be offered by the most ardent advocate of the policy of allowing commercial practice to govern the determination of commercial income. The law certainly authorized the acceptance of well established practices for determining gross income on the basis of the fair present value of the sales price, instead of its face value, in other words the exclusion from the computation of gross income of so much of the nominal sale price as might be necessary to provide for discounts, for the credit risk assumed and the cost of collecting that sale price. It did not permit deduction from gross income of reserves for potential future losses nor for expenditures not yet incurred and not involved in the production of the gross sales reported. From the legislative standpoint such deductions could not reasonably be allowed, however legitimate or even praiseworthy purely precautionary reserves may be from the standpoints of sound finance and business prudence.

To most accountants the act of 1918 seemed to dispose of the vitally important question of accounting bases for determining taxable income in a sound and satisfactory way.

It can hardly be said that the expectations entertained have been fully realized. The regulations (reg. 45) seemed to observe the spirit as well as the letter of the law. Article 23, for instance, provided that "approved standard methods of accounting will ordinarily be regarded as clearly reflecting income" and article 24 said "the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose." In such articles as 151 the propriety of computing gross income upon the basis of the cash equivalent rather than the face value of credit sales was recognized. Other articles explicitly recognized approved alternative methods of treating expenditures in the twilight zone between obviously capital expenditure and ordinary operating expense. In administration the law has frequently been construed with less breadth and with less regard for its spirit. In part this is perhaps attributable to failure to realize the nature of the problem of determining the income of a single year.

Accountants realize that income can not with even approximate accuracy be allocated to a particular year, especially in the case of taxpayers carrying on an extensive and complex business. No year is sufficient unto itself—each year's operations are bound up with and dependent on the operations of earlier and later years. Consequently, any attribution of income to a single year in such cases must at best be no more than a very rough approximation based on accepted conventions. Many, however, who have not had much experience in such matters look on the income of a year as a very definite, significant and even a precise thing. They are reluctant to accept the proposition that there can be two ways of determining the income of a given year, which will give substantially different results and be equally admissible and correct. Experience suggests that such reluctance was very general among those in the bureau of internal revenue and when the 1918 act compelled recognition of the principle that there might be more than one legally correct way of computing income for a given year, they apparently resolved at least to limit the number of alternatives. Since the passage of the 1918 act the correspondence and briefs of the bureau have contained constant references to the *two* bases of accounting permitted under the act, these two being described respectively as "the cash basis" and "the accrual basis." Of course, the more experienced members of the bureau realized that there were far more than two bases of accounting possible and recognized under the act, and doubtless many of those who spoke of *the* cash basis and *the* accrual basis used the latter term generically to describe anything other than a cash basis. But to a large number of the employees of the bureau *the accrual basis* has become not merely a significant phrase, but an article of faith. Indeed, one can almost imagine such employees of the bureau scattered over the land turning their faces towards the treasury daily at the appointed hour and reciting their creed, "There is but one accrual basis and the Bureau is its prophet".

"The Accrual Basis"

It may be worth while to inquire just what is meant by "the accrual basis." This is by no means clear nor is it even clear precisely how it differs from the so-called cash basis as applied to commercial income since 1909.

It will be evident from what I have already said that both in theory and in practice cash has very little to do (in the case of commercial enterprises) with the determination of income on the "cash" basis and very little reflection is necessary to a realization of the fact that accruals (in any proper sense of the word) have still less to do with the determination of income on the so-called accrual basis. This fact has been obscured by the practice, which has grown up, of using the word "accrue" in senses hardly dreamed of before the revenue act of 1916 was passed. The bureau, having adopted "the accrual basis" as the only alternative to "the cash basis," has proceeded to term "an accrual" almost everything that is not a cash item. Thus, we find the bureau speaking of taking up an inventory as an accrual and of "accruing accounts receivable from sales" and quite generally using the word "accrue" in a transitive sense as being equivalent to the "setting up on the books" which as I have pointed out was under the regulations of 1909 established as being for tax purposes equivalent to actual payment. Applying Euclidean methods, we may deduce that since setting up on the books is equivalent to actual payment or receipt and is also equivalent to accrual, and since things which are equal to the same thing are equal to one another, accrual is equivalent to actual payment or receipt and the cash basis and the accrual basis are identical. Such use of the word "accrual" could not have been justified from the dictionary nor from common accounting or business practice. Indeed the latest citation in any standard dictionary of the use of the word "accrue" in any transitive sense whatever, that I have been able to discover, is from a work published in 1594.

The fact is, that the word "accrue" is a singularly unhappy choice for use in income-tax practice. One of the great difficulties of income taxation is that income earning is a gradual process and yet the necessities of taxation require that particular portions of income shall be attributed to particular moments in time. It is not feasible to tax income during the period of growth but only when it becomes definite and measurable. Now in its basic meanings, the word "accrual" is ambiguous when applied to such a situation because one of its meanings is to "grow up" and the other is to "spring up" or "fall in," so that it is equally capable of application either to the period of growth or to the moment of falling in of income when it takes a definite form. There is a similar ambiguity in the legal and commercial uses of the word. When the term "accrue" is used in regard to interest, the reference is usually intended to be to the gradual accumulation of interest between one maturity date and another. In regard to taxes, it has repeatedly been held to mean "become due." The use of the word in the recent acts has been sufficiently confusing in that the two deductions in respect of which it has been used in the acts are interest and taxes, two items in relation to which it has quite different meanings. When to such ambiguities is added the further confusion arising from the use of the word by the bureau in the transitive sense as equivalent to "set up," its last shred of descriptive value disappears.

One may wonder why of all the terms used in the acts this term, which is the least illuminating, should have attained the widest use in the bureau. Partly, no doubt, it is due to the fact that of the various terms used such as "paid," "received" and "incurred," "accrued" is the only one from which an adjective is easily formed that is applicable to both sides of the account. Its use therefore achieved brevity, though at a complete sacrifice of significance. However this may be, I venture to suggest that the misuse of the word "accrue" has contributed to the confusion of the income-tax administration in the later stages as much as the artificial solution of the problem presented by the words "paid" and "received" in the act of 1909 occasioned in the earlier stages.

Before leaving the subject, I would like to admit that the accountants are not wholly without responsibility for the confusion that has existed. Our own use of terminology is lamentably inconsistent and reflects too often the idiosyncrasies of the individual rather than the established practice of the profession. I recall a statement put forward over the signature of a well known accounting firm which began with a figure described as "gross income" from which allowances and refunds were deducted to arrive at a figure described as "net gross income." Operating expenses were next deducted and the result described as "net operating income"; the addition to which of net income from other sources produced a so-called "gross net income" which it must be observed meant something quite different from "net gross income." Our treatment of cost of goods, cost of selling and cost of collecting in relation to gross income has too often been determined by habit rather than by logic. Many of us have acquiesced in or even adopted the bureau's unwarranted usage of "the accrual basis." Burdened with so much responsibility, we must be restrained in our criticisms of the bureau which, facing a heavier task and equipped with less experience, has fallen into errors similar to our own.

Conclusion

We may now, I hope, look forward to rates that will be lower and more stable than in recent years with a resulting reduction of the temptation to taxpayers to allow their accounting methods to be influenced by tax considerations. If so, there will be even more reason than in the past why the bureau should carry out the obvious intent of the law and adopt a broad policy towards taxpayers' accounting methods, which will make the law less burdensome in procedure as well as in amount.

In order to accomplish this result some old misconceptions need to be removed and some old truths emphasized anew. It would greatly improve the administration of the income tax if the bureau generally—not merely those who frame regulations but all charged with the administration of the law—would realize that "the accrual basis" is a meaningless phrase; that the choice today is not between a so-called "cash basis" and a so-called "accrual basis" but between the basis on which the taxpayers' books are kept and the basis prescribed by the commissioner as clearly reflecting income; and that as stated in regulations 45, article 24, the law contemplates that "each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose."

They should keep constantly in mind the fundamental difference between the considerations governing the determination of gross income and those governing the treatment of authorized deductions from such gross income. In this connection they should realize that the mention of any class of items among the authorized deductions from gross income does not stand in the way of the deduction of similar items from gross proceeds in the determination of gross income where they are a part of the cost of producing that income.

For instance, the provision that taxes may be deducted either when paid or when accrued does not stand in the way of customs duties accrued and paid last year entering into the determination of the income of this year if the goods imported are sold this year. Similarly the provision that debts actually ascertained to be worthless may be claimed as deductions does not stand in the way of valuing sales accounts receivable at their fair market value at the time when they are created, in determining the gross income from such sales, but merely limits the deduction which may subsequently be claimed for bad debts if the account receivable proves uncollectible.

They should never forget that income is at best a matter of estimate and opinion, and that in its allocation in respect of time, business practice and the treatment adopted in good faith by the taxpayer are entitled to great weight; also that the injustice of taxation of income which has not been received may not be adequately remedied by allowing the amount as a so-called loss against the income from other transactions in a later year. Both the law and business practice warrant conservatism in determining when income is received and is taxable.

These are the practical conclusions which seem to me to emerge from consideration of our subject. I hope you will feel that they give some present value to this paper, which otherwise might seem to have at best only historical interest.