When Does a Tax Accrue?

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The question of when a tax accrues is important, not only for the purpose of determining when it should be deducted from taxable income, but also for the purpose of determining invested capital under federal income-tax laws for those years in which the profits taxes apply. The statutory invested capital of a corporation is affected by the payment of dividends within the first sixty days of the taxable year under the revenue acts of 1918 and 1921, and it may also be affected under those acts by the payment of dividends after the first sixty days and under the revenue act of 1917 by the payment of dividends at any time during the taxable year when the amount distributed is in excess of the available current earnings at the date of payment. Article 857 of regulations 45 provides that, for the purpose of ascertaining the amount of current earnings available for distribution, accrued federal income and profits taxes for the taxable year shall first be deducted.

In computing the amount available for dividends under article 857 of regulations 45, the usual practice of the income-tax unit has been to deduct the income and profits tax on the entire year's income and then to pro-rate the balance in determining the amount available at a particular date. This method is varied when the taxpayer can show that the earnings at the dividend date were in fact greater than the year's income pro-rated. (A. R. R. 2839, Bul. II-16-1003).

It was pointed out in Kixmiller & Baar's Consolidated U. S. Income Tax Laws (C. C. H.), p. 906, that the practice of prorating the current income and profits tax over a period prior to the passage of the law under which the tax is assessed is open to question. It does not appear, however, that these adjustments of invested capital have been contested in the courts, although they have been contested in the bureau. The practice of the income-tax unit was upheld by the advisory tax board in T. B. R. 54, 1 C. B. 298. In that case a dividend was paid in March, 1917, and the board sustained the unit in "accruing" at March, 1917, taxes that were assessed under a law passed five months later.
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In A. R. R. 2839 (supra), the committee on appeals and review, in referring to the provision in article 857 for accruing taxes on the current year's income, said: "It was admitted at the oral hearing that until this article was changed the unit's action in following it was correct." But did the unit really follow the letter of the regulations? The first question is, not whether article 857 is wrong in providing for the deduction of accrued taxes, but, What are accrued taxes, and When does a tax accrue?

*Webster's Dictionary* defines the word "accrue" as:

"To come by way of increase; to arise or spring as a growth or result; to be added as increase, profit or damage, especially as produce of money lent."

In 1 Cyc., p. 503, it is:

"To arise; to grow to or to be added to; to occur. In the past tense the word 'accrued' is used in the sense of due and payable; vested; existed."

In 1 C. J., p. 733—

"In the participial form 'accruing' means, resulting, arising; augmenting; becoming due and payable; inchoate, in process of maturing; that which will or may at a future time ripen into a vested right, an available demand or an existing chose in action."

In the case of *U. S. vs. Woodward*, 256 U. S. 632; 545 U. S. *Tax Cases* 58; T. D. 3195, 4 C. B. 153; the supreme court said, in deciding whether the federal estate tax could be allowed as a deduction in the 1918 federal income-tax return of the estate:

"Here the estate tax not only 'accrued,' which means became due, during the taxable year 1918, but it was paid," etc.

But to say that an accrued item is a due-and-payable item would probably fail to meet with approval in the accounting profession. It is possible that the word is used by accountants more often in referring to an item which is not due and payable. And this meaning has also been given to it by the courts. (1 C. J. 734) "Accrued" and "accruing" have been variously defined for the purpose of giving effect to various meanings intended by the use of the words in statutes, contracts, etc. It may be safe, however, to say that an accruing liability or expense is one which is arising, growing or coming into existence; and that an accrued liability or expense may be fully accrued, that is, one which has ceased to grow, but is not due, or it may be only partly accrued and still increasing. And it would seem that an accrual must be
predicated upon some definite condition or event from which the accrual commences; as interest runs from the date at which the debt is created or the date at which an obligation is specified to bear interest; rent accrues from the commencement of the term or rental period; and salaries and wages accrue when the services are rendered. Even in the definition from Cyc., in which “accruing” is said to mean “inchoate * * * that which may at a future time ripen into a vested right,” the verb “may ripen” is used, not because there is any doubt about whether the right has commenced to accrue, but because the uncertainty lies in the possibility that a subsequent event may happen to prevent the right from vesting. “Inchoate” is defined in Black’s Law Dictionary as “imperfect; unfinished; begun but not completed.” There can be little doubt that, in the common every-day use of the word, an accrual, whether of income or expense, conveys the idea of a right or obligation arising out of and resulting from a fact or condition which went before. The idea that “accruing an expense” means to pro-rate it retrospectively, does not seem to be supported by authority.

An “accrual” of taxes may be set up before the levy or annual assessment is made; but the justification for calling this an accrual is that the tax is a regular periodic tax, which is reasonably certain, and the amount or rate of the levy can be estimated with reasonable accuracy on the basis of past levies. It appears, however, that some accountants object to calling this an accrual; they say it is a reserve, rather than an accrual. Suppose there is less certainty about the amount of the tax that may have to be paid, and a greater amount is set up than would be warranted solely on the basis of past experience—then there would seem to be less doubt that the amount set up was a reserve for taxes, and not accrued taxes. Or suppose an accountant had been called in on April 30, 1917, to make an audit for a corporation. He presents to the directors a balance-sheet showing a reserve for federal income taxes equal to 50 per cent. of the earnings for the preceding four months and makes this explanation: “Gentlemen, you know we declared war last month. That means the government must have a great deal of money. I foresee that in October of this year congress will repeal the excess-profits-tax law, passed about two months ago, and will enact a new law taxing the incomes of corporations for the entire year as high as 50 and
60 per cent. You must be prepared to meet these taxes. I have, therefore, set up a reserve equal to 50 per cent. of your net income.”

Would anyone say this was an “accrual”—that these taxes were “accrued taxes”? Such a reserve for taxes would no more be “accrued taxes” than a reserve for unknown disasters impending would be “accrued losses.”

But the law is retroactive, it is said. So it is; so also are the state income-tax laws hereinafter cited. A retroactive law attaches new legal consequences to precedent facts. It does not change the facts. To conceive of effect as preceding cause does violence to the first principle of logic.

There is a manifest inconsistency on the part of the bureau in allowing federal income and profits taxes to be included in invested capital for a part of the following year, under T. D. 2791, and, on the other hand, holding that this fund is not available for the payment of dividends in the current year. The advisory tax board questioned the soundness of T. D. 2791, in T. B. R. 17, 1 C. B. 294. But it may well be asked if T. D. 2791 is not more sound than the accrued-tax provision of article 857. Why should not federal income and profits taxes be treated as dividends are treated under article 858—that is, as affecting invested capital only when they are due and payable and not even then if the earnings of the year in which the tax is payable are sufficient to pay it? The tax comes out of the earnings or surplus of the corporation; it has been called “Uncle Sam’s dividend”; in the words of T. B. R. 17 (supra) “it is a sharing of the government in the income of the taxpayer for the taxable year.” In a well reasoned article by Charles F. Seeger, appearing in a recent issue of The Journal of Accountancy, the conclusion was reached that income taxes are a distribution of profits and not expense.

The conclusion reached in T. B. R. 17 (supra) was that article 845 of regulations 45 should not be modified. Article 845 was later modified, however, by T. D. 2931—article 845-(a). This conclusion of the advisory tax board was based on the proposition that “the amount of these taxes for any year cannot, therefore, after conclusion of such year, be considered as a part of surplus, but is rather in the nature of a liability.” In support of this proposition a “single illustration” is used to show that the taxes
are "chargeable" against the income upon which they are computed. But the tax board's illustration is beside the point. The question, under either article 845 or article 857, is not what income the taxes are "chargeable" against, but when they are chargeable. In other words, when does a tax accrue?

The bureau of internal revenue has repeatedly held that a tax is not a liability and cannot accrue before the passage of the law under which it is assessed. In those cases involving the accurability of state income taxes, the bureau has refused to allow as a deduction the state income taxes under a law passed after the close of the taxpayer's federal taxable year. O. D. 505, 2 C. B. 121, N. Y. income tax; I. T. 1498, 1-2 C. B. 95, S. C. income tax; O. D. 1118, 5 C. B. 133, Wisconsin additional surtax; O. D. 387, 2 C. B. 116, Wisconsin bonus tax.

The Wisconsin bonus-tax law was passed in 1919, imposing a tax on 1918 income. A federal taxpayer sought to deduct the amount of this tax in a return for the year 1918 as a tax accrued in 1918. The bureau of internal revenue refused to allow the deduction. The case was carried to court. The district court gave a decision for the government. Appeal was taken to the circuit court of appeals (Ed. Schuster & Co. vs. Williams, Collector, 283 Fed. 115; 545 U. S. Tax Cases 974; T. D. 3330, I-1 C. B. 133) and that court held that the tax did not accrue in 1918, saying "it did not accrue until it became a liability," and citing the case of U. S. vs. Woodward (supra).

It is interesting to note that, in an Iowa case (Overland Sioux City Co. vs. Clemens, 179 N. W. 954; 545 U. S. Tax Cases 387) the opinion of the state court concerning the retroactive effect of the federal income-tax law is in harmony with the opinion of the federal court in the Schuster case (supra), concerning the retroactive effect of a state income-tax law. In the Iowa case the corporation paid a dividend July 1, 1917, out of its earnings for the preceding six months, leaving a surplus balance which was not sufficient to meet the payment of federal income and excess-profits taxes assessed under the revenue act of October 3, 1917, on net income of the six months ending June 30, 1917. Immediately after the dividend was declared and paid the stock of the corporation was sold by Clemens to another. Recovery was sought against Clemens on the theory that the tax was a liability as of June 30, 1917; that the profits and surplus were overstated.
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in the books; and that the dividend was paid in ignorance of the tax and under mistake. This is just such a case as the advisory tax board had in mind when T. B. R. 17 (supra) was issued. Here is what the Iowa court said:

"But was the dividend or any part of it illegal? No one will so pretend unless it was rendered so by the act of October 3, 1917. That act did not undertake to undo anything which had gone before. * * * It did not require the payment of the excess profits tax exacted from any specified fund or the income of any particular period. * * * Counsel have argued as though the tax must have been paid from the earnings of the company prior to July 1, 1917. "The act contains no such requirement, and as the tax was not payable until nearly a year later, there would be no ground for such an inference. * * * For all that appears the company's earning capacity may have continued as before and have been ample out of which to discharge the tax long before it became payable. * * * As indicated, the act was not retrospective, save as including the income of the calendar year prior to October 3 with that portion following, in making up the net income on which the taxes would be levied and collected, and cannot be considered to have affected in any manner the legality of the dividend or sale of stock."

Our question, When does a tax accrue?, has therefore been answered for us by the courts and by the bureau of internal revenue itself, and it seems clear that the income-tax unit should change its practice in applying article 857, and equally clear that it can do so and still keep strictly within the letter of the regulations.

How about the regulations? If federal income and profits taxes are the government's share of the profits, why not treat them the same as dividends—the stockholders' share of the profits?

For the purpose of collecting the tax, of course, the government is a creditor, and the tax, a liability, or, as has been said, "both are of a higher nature." But for the purpose of determining the income, the government is a partner sharing in the profits, and the government's share of the profits is not allowed as a deduction from income. Why, then, should not invested capital be determined on the same theory? So long as a corporation is able to meet its federal tax payments when they fall due, why should it not be allowed to use its current earnings as it sees fit? Congress undoubtedly intended that it should be allowed to do so. The provision for paying the 1917 tax June 15, instead of when
the return was filed, and the provision in the 1918 law for paying the tax in four instalments are obviously not designed for the convenience of the government, but for the convenience of the taxpayer. It is manifest that the purpose of the law is to allow the tax to be paid out of the earnings of the year in which the tax payments are due. If this were not so, why should not the entire tax be paid when the return is filed? The provision of article 857 which "deems" current earnings to be applied first to the payment of the tax computed on the same current earnings seems, therefore, to be in conflict with the plain purpose of the statute.

There is really nothing in the law even to suggest the purely theoretical set-up of "tentative tax accrual" required by article 857. The law simply provides that "invested capital for any period shall be the average invested capital"; and, while it excludes from invested capital earnings of the current year it contains nothing authorizing the commissioner to regulate the disposition of those current earnings. Certainly there is nothing in the law from which could be inferred a requirement that a corporation shall take a part of every dollar earned during the year and lock it up in a strong box against the day of the tax-gatherer's visit.