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THE INTERNAL REVENUE CODE AND ITS RELATIONSHIP TO GENERALLY ACCEPTED ACCOUNTING PRINCIPLES*

JOSEPH E. TIERNEY, JR.**

Introduction

The Internal Revenue Code requires that taxable income be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.¹

The Code itself, however, excludes from the computation of taxable income many items of income for book purposes and items which are proper expenses for book purposes; for example, interest on certain governmental obligations, income from the discharge of indebtedness, expenses and interest relating to tax-exempt income, and certain types of entertainment expenses.

A 1962 congressional amendment results in a substantial distortion of book income by providing a credit against the federal income tax liability.² This investment credit granted a reduction of the federal income tax liability of taxpayers to the extent of a percentage of the cost of certain types of assets purchased. This, in effect, changed a portion of a capital expenditure (the purchase of an asset) into a reduction of an expense (provision for federal income taxes).

The investment credit caused many differences of opinion among accountants and financial analysts as to the proper method of reflecting the credit in the financial statements. This conflict was minimized by a 1964 amendment to the Code which removed the requirement that the income tax basis of property subject to the investment credit was to be reduced by the amount of the credit.³ The federal income tax effect of the investment credit is permitted to distort the income of many companies in the current year and in succeeding years.

In addition to the differences caused by statutory enactment, courts have created additional differences by holding that an item of income or expense is to be treated a certain way for federal income tax purposes regardless of the proper accounting for that item. A recent and very important example of such a decision is *Schlude v. Commissioner*,⁴

* This article is based on a lecture given at the Fourteenth Annual Marquette University Institute on Taxation.

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¹ INT. REV. CODE OF 1954, §446(a).

² INT. REV. CODE OF 1954, §38.

³ Revenue Act of 1964, §203(a), 78 Stat. 19.

⁴ *Schlude v. Commissioner*, 372 U.S. 128 (1963).

which was the last of a series of cases decided by the United States Supreme Court. These cases are regarded by many as overruling the statutory requirement of section 446(a) of the Internal Revenue Code of 1954: "*General Rule*—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books."

These differences result in the shift of the federal income tax effect of a transaction into financial periods other than those in which the transaction occurs.

In order to correctly reflect the current year's earnings in the financial statements, a series of adjustments under the general heading of income tax allocations is required to be made.

In summary, this article will discuss the differences between income tax accounting and generally accepted accounting principles, the impact of the *Schlude* case and the other cases on this difference, and the accounting precept which requires the adjustment of financial statements to reflect the federal income tax effect in the fiscal periods to which they properly apply under generally accepted accounting principles.

*General Accounting Principles v. Federal Income Tax
Accounting Requirements*

The differences created by statute are many and have substantial effects on the financial statements. The following examples list types of income exempt from taxation, types of expenses not deductible for income tax purposes, and items which cause a transfer of the income tax effect of a transaction from one fiscal period to another :

- (1) Exempt income from
 - (a) state and municipal obligations,
 - (b) discharge of indebtedness where the basis of the related property is adjusted,
 - (c) recovery of bad debts where the deduction did not give rise to a tax benefit,
 - (d) exchange of property specifically held to be nontaxable, and
 - (e) portions of dividend income from certain securities.
- (2) Expenses not deductible include
 - (a) federal income taxes,
 - (b) expenses incurred in obtaining tax-exempt income, and
 - (c) certain entertainment expenses.
- (3) Items which cause transfer of the income tax effect from one fiscal period to another are
 - (a) net operating loss carry-forwards,
 - (b) deductibility of research and experimental expenses, either in the year incurred or over a five-year period,

- (c) accelerated depreciation which transfers depreciation deductions into the early portion of an asset's life, and
- (d) organization expenditures amortizable for tax purposes over a period of not less than sixty months.

There are two sections of the Internal Revenue Code of 1954 which are designed specifically to conform federal income tax accounting to generally accepted accounting principles with respect to the treatment of a specific item:

- (a) Section 455 provides that prepaid subscription income is to be included in taxable income in the year in which the taxpayer has a liability to furnish or deliver a newspaper, magazine, or periodical.
- (b) Section 456 permits the inclusion in taxable income of prepaid dues in the taxable year during which the taxpayer has a liability to render service. This section is represented as being a specific answer to the decision of the United States Supreme Court in the case of *American Auto. Ass'n v. United States*.⁵ In that case, such prepaid dues income was held to be taxable income in the year received regardless of the fact that the Association had contracted to render a service to the subscriber in a subsequent fiscal period.

Investment Credit

The accounting treatment of the income tax benefit resulting from the investment credit has been the subject of a great deal of conflict in the accounting profession.

The credit, which directly reduces the federal income tax otherwise payable, was first enacted in the Revenue Act of 1962 and provided in substance that to the extent that a taxpayer invested in certain depreciable property, a percentage of that investment created an investment credit.

For income tax purposes, the taxpayer was required to reduce the basis of the property by the amount of the credit, and the indicated congressional intent was to encourage investment in capital assets by reducing the cost of such investment.

Immediately, a conflict developed as to the proper accounting for the tax benefit of the credit. The American Institute of Certified Public Accountants resolved this conflict by stating that the tax benefit should be amortized over the life of the asset required.

The Securities and Exchange Commission permitted the treatment required by the American Institute of Certified Public Accountants, but it also recognized as an alternative the so-called "flow-through"

⁵ 367 U.S. 687 (1961).

method which resulted in realizing the entire tax benefit in the year the credit arose.

The position of the American Institute of Certified Public Accountants was based on the expressed congressional intent; that is, a reduction of the cost of qualified property acquired. The American Institute's position was that that cost reduction should be prorated over the life of the asset and not recognized in the first year. To do otherwise would be to allow the managers of a business to increase the net income of that business by the simple expedient of buying property. It seems unusual that any credence could be given to a practice which permits such manipulation of the net income.

In section 203 of the Revenue Act of 1964, Congress removed the requirement that the basis of the property (giving rise to the credit) be reduced. This amendment was retroactive to the extent that depreciation for the year 1964 and succeeding years is to be computed on the entire cost of all qualified property, including that property acquired in 1962 and 1963, the basis of which had been reduced by the investment credit for federal income tax purposes.

After the 1964 amendment, the American Institute, while expressing its preference for the deferred tax method of accounting for the investment credit, retreated to the extent that it will now accept as "in accordance with generally accepted accounting principles" either the flow-through method or the method which recognizes the tax benefit throughout the life of the property. However, it requires that whichever method of accounting is adopted, full disclosure be made of the method followed and of the amounts involved, where material.

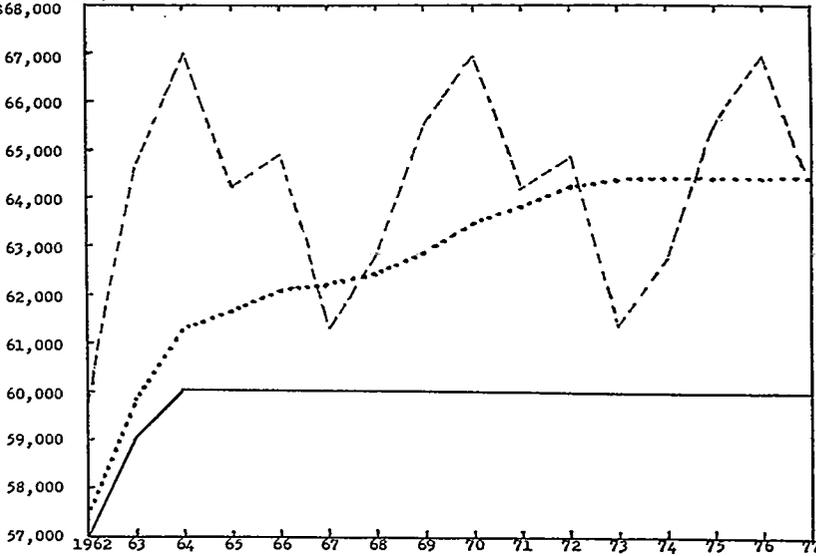
The following charts indicate the violent fluctuations of income caused by the flow-through method of accounting for the investment credit. It will be noted that using the deferral method, the net income is relatively stable, rising slightly over a period of years to reflect the tax benefit of the investment credit. These charts are based on a net income before investment credit in all years of \$60,000,000, an assumed life of qualified property of twelve years, and a six-year program of acquisition of property qualified for the investment credit under which the same amount is acquired each year as was acquired six years earlier. The acquisition program includes purchases of \$100,000,000, \$60,000,000, \$70,000,000, \$20,000,000, \$40,000,000, and \$80,000,000.

The accounting for the investment credit clearly indicates the need for income tax allocation, and the charts, following the wide swings in net income where the flow-through method is used, graphically portray the error of this method. The income of the hypothetical company used in these charts should in fact be stable, since it is predicated upon the same assumed level of operating income in each of the years involved. Obviously, in order properly to inform the investor of the income pat-

ABC COMPANY

Net Income
(In Thousands)
\$68,000

Investment Credit Continuing

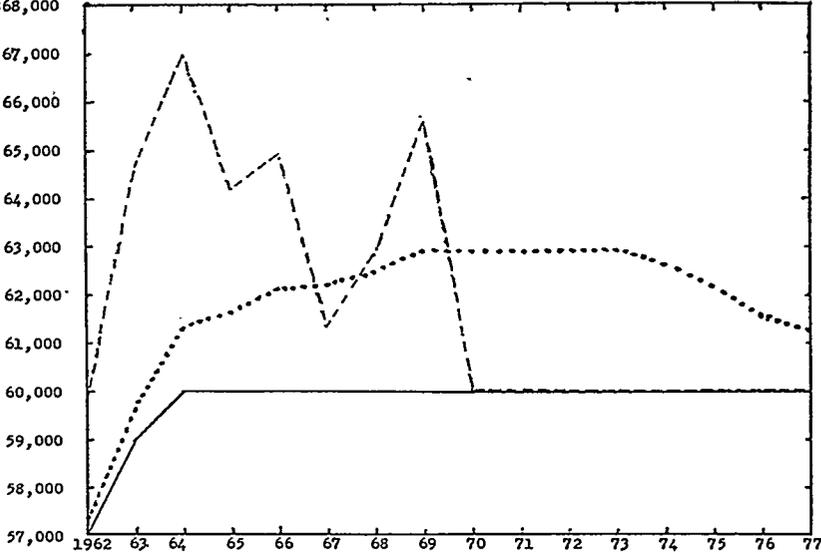


— Net income before investment credit
 - - - Net income with "flow-through" of investment credit
 Net income with deferment of investment credit

ABC COMPANY.

Net Income
(In Thousands)
\$68,000

Investment Credit Discontinued After 1969



— Net income before investment credit
 - - - Net income with "flow-through" of investment credit
 Net income with deferment of investment credit

tern of this company, the tax benefit of the investment credit should be deferred and recognized over the life of the assets which gave rise to this tax benefit.

One of the most serious effects of the failure to recognize the tax benefit over the life of the property is that the resulting distortion of net income directly affects the purchase price of securities issued by the company in question. Uninformed investors are being misled into assuming that the operating income of a company is substantially higher than it is in fact, because of the manipulation caused by "flowing through" the tax benefit of the investment credit.

Schlude v. Commissioner

The case of *Schlude v. Commissioner*⁶ was the last of a group of cases decided by the United States Supreme Court on issues which revolved around generally accepted accounting principles and the right of a taxpayer to continue to use an accounting system admittedly in accordance with generally accepted accounting principles and consistent with the system used in prior years.

The leading case was *American Auto. Ass'n v. United States*,⁷ involving the Association's method of accounting for dues. In accordance with generally accepted accounting principles, the Association recognized as income a ratable portion of the dues which it received over the period during which the Association was required to render service to the members who paid those dues. For example, if the Association received the annual dues of a member on December 1, 1955, it included one twelfth of those dues in its income for the calendar year 1955 and eleven twelfths of those dues in the calendar year 1956.

The Court held that this method did not clearly reflect its income; and consequently the Association was required to include, as in our example, the entire amount of the dues received in December 1955 as income of 1955.

In a case entitled *Milwaukee & Suburban Transp. Corp. v. Commissioner*,⁸ the taxpayer, following generally accepted accounting principles, set up an accrual at the end of each year to recognize its liability resulting from accidents involving its vehicles during the year. The United States Court of Appeals reversed the Tax Court and held that the taxpayer, following a method of accounting which clearly reflected its income, was entitled to keep its books in that manner and to record that accrual. The Supreme Court upset that decision and returned to a much narrower definition of accrual than is recognized under generally accepted accounting principles.

Schlude case has been described as completing the mutilation of the

⁶ 372 U.S. 128 (1963).

⁷ 367 U.S. 687 (1961).

⁸ 367 U.S. 906 (1961).

accrual method of accounting for federal income tax purposes. In that case, a dance studio received cash payments, notes, and contracts receivable for dancing lessons to be given at the request of students in future fiscal periods. In accordance with generally accepted accounting principles and in an effort to match revenues and expenses, the taxpayer deferred the income into the periods in which the lessons were given or the contracts were cancelled.

The statutory provisions of the Internal Revenue Code of 1954 which appear to require that a taxpayer follow for federal income tax purposes the method of accounting which he regularly uses in keeping his books are the following:

Section 446. *General rule for methods of accounting.*

- (a) *General Rule*—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.
- (b) *Exceptions*—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.

Section 451. *General rule for taxable year of inclusion.*

- (a) *General Rule*—The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount to be properly accounted for as of a different period.

Section 461. *General rule for taxable year of deduction.*

- (a) *General Rule*—The amount of any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

The Court in the *Schlude* case recognized these sections and posed the question for decision as follows:

Was it proper for the Commissioner, exercising his discretion under §41, 1939 Code, and §446(b), 1954 Code, to reject the studio's accounting system as not clearly reflecting income and to include as income in a particular year advance payments by way of cash, negotiable notes and contract installments falling due but remaining unpaid during that year?⁹ (Footnotes omitted.)

The Supreme Court then stated its decision as follows: "We hold that it was since we believe the problem is squarely controlled by *American Automobile Association*."¹⁰

The Court advanced the following points in support of its decision:

⁹ 372 U.S. at 133-34.

¹⁰ *Id.* at 134.

- (1) The repeal of section 452 permitted the Commissioner to reject accounting systems deferring prepaid income. The Commissioner rejected the *Schlude* accounting method and, since Congress intended to leave that jurisdiction in the Commissioner except for one specific enactment dealing with the prepaid subscriptions,¹¹ the Court refused to intervene.
- (2) The *Schlude* case accounting method suffered from the same difficulty as did the accounting in the *American Auto. Ass'n* case, since the apportionment of income was artificial because the advance payments related to services which were to be performed without relation to fixed dates in the future.

The American Institute of Certified Public Accountants, in its brief filed as amicus curiae, made the following points in stating its position:

- (1) The *American Auto. Ass'n* decision permits taxpayers to defer income if by such deferral there is an accurate and precise matching of income with the costs of services performed in a particular year.
- (2) In the *Schlude* case, under the method of accounting used, income was picked up in direct relation to the costs of lessons given each student, a clear matching of costs and revenues.
- (3) Distinguish the *Schlude* case, where the revenues were matched with the direct cost of services to each individual student, with the deferral in the *American Auto. Ass'n* case, where revenues were apportioned based on estimates of the services which the Association would be called upon to render to its members. These estimates were based on prior years' experience.

Both *American Auto. Ass'n* and *Schlude* were five-to-four decisions. In each case, the dissenting opinion was written by Mr. Justice Stewart. His comments on the *Schlude* case may be summarized as follows:

- (1) The Government's position forces an accrual-basis taxpayer to the cash basis for advance payments, in disregard of the federal statute which explicitly authorizes income tax returns to be based upon sound accrual accounting methods.
- (2) The basis for the majority's decision is the conclusion that the system of accounting used by the *Schlude* taxpayers does not "clearly reflect income." The majority reached this decision by consideration of legislative history and by analysis of the particular system.
- (3) To conclude that the repeal of sections 452 and 462 indicates congressional disapproval of accrual accounting principles "is conspicuously to disregard clear evidence of legislative intent."

¹¹ INT. REV. CODE OF 1954, §456.

- (4) In *Schlude*, there was a clear matching of revenue and expense with respect to the lessons given.
- (5) The taxpayer picked up as income in the year of occurrence the portion of advance receipts applicable to lessons which would not be given because the time specified had elapsed.
- (6) The majority contends this method is arbitrary, and indicates that estimated cancellations should be reported as income in the year advance payments are received.
- (7) This would be subject to precisely the same objection which the majority had to the same type of estimate used by the *American Auto. Ass'n* with respect to requests for services in particular periods.

The effect of the *Schlude*, the *American Auto. Ass'n*, and the *Milwaukee & Suburban Transp. Corp.* cases, and other cases which follow them, results in the transfer of federal income tax effect from the year in which the transaction is recognized under generally accepted accounting practices to another year. Therefore, to the extent of the effect of federal income taxes on the financial statements, an adjustment is required to properly reflect the income of the period in which the transaction is recognized under generally accepted accounting principles and of the period affected under the federal income tax law.

Income Tax Allocation

It is axiomatic that a truly fair determination of net income for a particular period requires an apportionment of costs and revenues. Items of revenue must be carefully matched with related items of cost, and they must also be shown in the income statement to which they both apply. Since income tax is obviously a cost, it too must be apportioned to the financial statements of the period to which the items which give rise to the income tax are apportioned.

The general position of the American Institute of Certified Public Accountants is as follows:

Income taxes are an expense that should be allocated where necessary and practicable to income and other accounts as other expenses are allocated. *What the income statement should reflect under this item, as under any other item, is the expense properly allocable to the income included in the income statement for the year.*¹² (Emphasis added.)

The best-known utilization of income tax allocation results from the use by a business entity of accelerated depreciation for federal income tax purposes and straight-line depreciation for book purposes. The effect of accelerated depreciation is to move its depreciation deductions from the later years of an asset's life into the earlier years. The net

¹² ACCOUNTING RESEARCH BULL. No. 43, ch. 10, §B.

effect, assuming continued taxable income, is to reduce the federal income tax liability in the earlier years and to increase in exactly the same amount the federal income tax liability in the subsequent years, assuming that income tax rates do not vary. There is little difference of opinion as to the need of income tax allocation with respect to this item. It is, however, but an example of literally hundreds of items where, because of the differences between generally accepted accounting principles and federal income tax accounting, the federal income tax effect of a transaction is recognized in a different year from the book recognition of that same item.

The charts included in this article on the investment credit amply demonstrate the effect of failure to allocate income tax liabilities.

The federal income tax rates were reduced in the Revenue Act of 1964. Income tax allocation requires the recognition of the federal income tax effect of transactions which occurred in years subject to a 52 per cent rate of federal income tax but which will be recognized in years subject to a 50 per cent or a 48 per cent rate.

The preferred method of returning the deferred amounts to the income account is based on the tax rate which was in force at the time that the deferral was recorded. That is, the total amount of the tax benefit should be returned to income ratably over the period involved regardless of the change in rates.

Summary

The many differences between book and taxable income caused by statutory enactment and judicial interpretation require adjustment in order to prevent a distortion of book income. Federal income tax allocation requires matching of the tax benefit or detriment with the transaction itself so that each fiscal period's income is properly stated.