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Accounting Theory and Taxation

By Mark E. Richardson*

Parallel Growth of Accounting Theory and Income Taxation

A review of the advancements in the field of accounting theory since the turn of the century supports the opinion expressed by many that this period represents a "golden age" in accounting and accountancy. During this period, accountancy has become recognized as a true profession. During this same period, there has been a continuous development and sharpening of concepts and principles of accounting, together with the establishment of more clearly defined standards of performance by which the profession could measure its progress. Concurrently, there has been an increasing awareness on the part of the public of the role that accountancy plays in our national economy. This, in turn, has been reflected by a deeper and clearer understanding of the meaning of accounting information and the principles underlying traditional accounting presentations.

It is not complete coincidence that this growth and development has paralleled so closely the development of income taxation in this country and the development of complementary forms of taxation, such as the estate tax and the gift tax. However, the fact that the field of accountancy and the field of federal taxation have paralleled in growth over the past half century, coupled with the fact that much of the activities of many members of the accounting profession are so closely associated with the field of federal taxation, has led to the mis-

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taken observation that the emphasis in the area of federal taxation has been the direct cause of the remarkable growth in the field of accounting theory.

Similar Parallel in General Economic Growth

Rather than being closely interdependent or interrelated, the growth in accounting theory and acceptance and in income taxation have each paralleled the expansion in our national economy. Accounting, as will be later developed, had its beginnings in the need for the development of a practical method of business communication. As a business economy developed in this country, so naturally did its language, accounting. At the same time, as business activity left the individual form and became the activity of a "business enterprise," taxation of the income of that enterprise has developed. Because accounting has been the language of business, it has necessarily been the cornerstone upon which the taxation of business income has been built.

Clarification of Terms

It is probable that our language does not have, within its total scope, any more confused terms than the words "accounting," "bookkeeping," "accountancy," and "accountants." Despite the sincere and conscientious efforts of many, both within and without the profession, to clarify these terms in the public mind, little progress has really been made. It is not the intent of this paper to take steps toward such clarification, even if it were within the author's abilities to do so. However, within the scope of the subject matter, it seems necessary to indicate the meaning, at least presently intended, in this paper. Accounting, in general terms, is a process, a device, a means of conveying business information. Certain theories of accounting had to be developed in order to effectuate a language, just as has been true in any other need for communication. Bookkeeping, which will not be further discussed now and which has no particular place in the present subject matter, is solely the recording of business transactions in accordance with a method of accounting theory previously determined upon. It may be detailed and may relate solely to minutia of business facts. It may be comprehensive and relate to a complete set of books. It is, of necessity, related to accounting in that it is its application.

Accountancy now seems to have reached the level of an art or science. It includes accounting theory application. It may, and sometimes does, include the preparation of financial statements summarizing and presenting accounting data. However, it goes far beyond such presentation into the fields of interpretation, verification and, under limited and special circumstances, prognostication. Unfortunately for general understanding, but not particularly pertinent to the present subject, is the fact that the term, title, or designation of "accountant" may be applied to one who is truly only a bookkeeper, to one who applies and even develops accounting theories and to one who practices the art or engages in the science of accountancy. With this very lengthy and possibly unnecessary clarification, let us return to the particular subject now involved, that of accounting theory.

Basic Nature of Accounting Theory

As stated previously, it is necessary to recognize the fact that accounting is essentially a tool of commercial management. That is to say, accounting had its beginnings in the need for the development of a practical method of business communication—in the need for summarizing and portraying economic data in such a way that informed, intelligent business decisions might be made. Accounting had to serve to facilitate the evaluation of the management of a business enterprise, both from within and without that enterprise. As these needs became apparent in commerce, so development and change in accounting theory took place.

Actually, accounting theory in one form or another is practically as old as history itself. At least limited thinking embodying the basic concepts of accounting theory has been necessary as long as commerce has been carried on between individuals and a record thereof important. Written references to accounting theories and concepts are found in the writings of the ancient Greek philosophers and references to accounts, as such, are found in more ancient civilizations. Biblical references to accounting systems, related even to taxation at that time, are so numerous as to clearly indicate a venerability even in those times.

Accounting theories and processes, as we presently know them, more particularly as they are recorded through the process known as "double entry bookkeeping," had their modern beginnings in the period of the renaissance when there was an emergence of civilization from what we now call "the dark ages." This period, for the first time, saw a real growth of commercial activities among people in different localities. As the types of problems which were encountered in commercial ventures became more complicated and as the separation between the proprietorship interest in business ventures and the actual operation of the ventures became more distant, the need for adequate financial records became acute. This need was filled by the development of what we now consider modern accounting theories and concepts.

Accounting Theory in Early Income Tax Statutes

Long before there was such a thing as a federal income tax, accounting theories, and accountants in applying such theories, were concerned with basically the same problems as are the main concerns today. Accounting theories had been developed so that there could be recorded financial data in such a manner as to lead to a proper determination of the income of a given period of time and the proper measurement or evaluation of the financial status of a definable business entity at a given point in its operations. Because accounting theories served these purposes, an income tax based upon the income determined in accordance with such theories was possible.

By its very name, an income tax presupposes a reliance upon concepts which are primarily inherited from or contained in accounting theory. Quite obviously, no income tax would be possible if the measurement of income was not possible; and the measurement of income is an accounting task for which accounting theory was originally developed. The difficulties which naturally develop when the fundamental relationship between accounting theory and a tax on income is disregarded were well illustrated when the first income tax statute was drafted after the enactment of the Sixteenth Amendment to the Constitution. At that time, the initial taxing statute was based upon the fallacious proposition that "income" did not have to be determined in accordance with accounting theory, but could be adequately measured solely through the inflow and outflow of cash. Fortunately, the Treasury Department, even at that early date, had many competent accountants on its staff. Of equal good fortune, the accounting profession outside the Treasury was immediately alerted to the difficulties that would be encountered unless careful and adequate regulations were promulgated which effected a more realistic determination of income in the accounting sense.

Accounting theory made possible an income tax which would obviously not otherwise have worked. At the outset, accounting theory made a contribution to federal income taxation which prevented the early tax from being something other than a tax on income.

Nonaccounting Elements in Income Taxation

If federal income taxation had as its sole motive and objective the raising of revenue, it is probable that a closer relationship with accounting theory might have been maintained. However, from the early beginnings, it became apparent that the partnership between accounting principles and income taxation could not be a complete one. A taxing statute which defined income identically as it was defined under accounting theory would leave much to be desired socially, this lack stemming principally from the fact that underlying motivations and philosophies of the federal taxation of income departed, generally for social reasons, from accounting theory. Progressively, as our income tax statute was operative, there were added numerous situations and transactions which, for social or economic reasons, were required to be handled differently from the way which would have been appropriate under pure accounting theory.

A complete list of the differences brought into income determination for tax purposes seems unnecessary at this time. Extensive articles have been written on the subject. However, a citation of a few as illustrations might help in the consideration of our present subject. A social motivation reflected in the limited encouragement of generosity to charitable, educational, scientific and literary organizations is one of the nonrevenue motivations having an effect upon the determination of income for tax purposes, particularly where the limitation percentage becomes operative. Such an arbitrary limitation has no place in accounting theory. A similar situation exists with regard to the limited deduction for medical expense. Equally apparent in our tax structure is some attention to the matter of public morals through the disallowance of deductions which are held to be contrary to the public good. Without arguing the merits of this concept or its inclusion in a tax structure, it is readily apparent that public morals cannot be measured appropriately under accounting theory.

Certain economic and political influences are also readily apparent in the present income tax structure. The favorable comparative status granted to western hemisphere trade corporations apparently stems from an economic desire to foster trade with countries within the western hemisphere. The allowance of percentage depletion to many producers and suppliers of natural resources is usually justified as being a necessary economic stimulant to the production of those commodities which are essential to the welfare and security of the nation. Similarly, the tax treatment permitted for expenditures for soil conservation is looked upon as a special incentive and a desirable economic objective available through the implementation of special tax treatment.

At the present time, there is pending before Congress a number of bills aimed at the achievement of what are essentially esthetic objectives —for example, the removal of smoke and pollutants from the atmosphere. This list could be expanded greatly, but the aforementioned items may suffice as illustrations of nonaccounting income concepts.

While the accountant as an individual person or as a taxpayer may favor or disfavor such special nonrevenue motivations which enter into the tax law, it is clear that accounting theory, as such, cannot be relied upon to justify these special factors in the determination of income. The motivation is social, political or economic in the broad sense rather than being a motivation arising from a specific, particular, business entity with which accounting theory is primarily concerned.

Importance of Nonaccounting Elements

Despite the number of social, economic and political elements which have been included in our taxing statutes, there is no reason to believe that, in the aggregate, they vitiate the importance of basic accounting theory any more than do the special concepts applied for other accounting purposes. Because of its initial position as a means of communication in business, accounting theory does not provide for firm and fixed concepts applicable to all business. This is particularly true where governmental agencies use accounting data for control purposes. Accounting theory or concepts as applied to public utility companies differs from the application to other business enterprises. These differences arise sometimes through the accounting theory itself and sometimes through special provisions of regulatory commissions which differ only in degree from those applied under our taxing statutes. Accounting for insurance companies, used as a control over reserve requirements by regulatory commissions, differs materially from accounting for any other business enterprise. Here, as in utilities, as under the tax law, and as in many other fields, basic accounting theory is first applied in the determination of income and then certain adjustments or variances for the particular purpose are appropriately applied.

It can be seen from the foregoing comments that while the special motivations have had their effect upon the determination of income for tax purposes, they have not made the application of accounting theory any less important than is true in any other field of income determination.

Effect of Taxation upon Accounting Theory

While the presence of a body of accounting theory bearing upon the problem of income determination can be credited with creating the environment within which a tax upon income was possible, it cannot be maintained that accounting theory has remained static during the intervening years and has not itself undergone considerable change. To a considerable extent, much of this change in accounting theory might be traced directly to the presence of a tax upon income.

Business operations and business practice are dynamic types of things and necessarily make adjustments to accommodate to changes in the environment within which business operates. The presence of a tax upon income must necessarily have some rather profound effect upon the way in which business enterprise and persons pursue the quest for income. Probably largely as a result of the tax levied by the federal government upon income, entirely new problems confronting business enterprises have been created—problems and resultant solutions which conceivably might not have arisen had it not been for an income tax. The form and mechanism by which business transactions are accomplished have been designed to a large extent with an eye to the tax consequences of those transactions.

To an almost dismaying extent, it is true that today significant business decisions and material business transactions cannot possibly be undertaken without careful preliminary thinking as to the impact of federal taxation. Frequently, the treatment which a transaction will be accorded under the federal tax law will be the determining factor in deciding whether a transaction is consummated or not, or whether a legitimate business objective is accomplished by one available route or another.

Under these circumstances, it is not at all surprising that the presence of the federal income tax has created entirely new problems which the accountant has had to solve within the framework of accounting theory. If the existing framework of accounting theory was inadequate, that framework was required to be expanded to take care of the new situations which were continually confronting business enterprises.

Frequently, this process by which the federal income tax affects accounting theory can be fairly indirect. One illustration may serve to bring the point into focus. By reason of the income tax and the fairly high rates of recent years, it has become increasingly difficult for individuals to achieve a degree of comfort and security for their later years. It is much more difficult under today's tax rates to accumulate a fund of wealth which will provide comfort during the years of retirement of an individual and will provide the security which every person seeks for his family and for his survivors. As a result, there have been developments in the personal affairs of individuals which have been directed at the objective of overcoming the obstacle of taxation in achieving these objectives. One of the outgrowths of the search for a means of accumulating a fund for retirement and security has been the growing use of stock options and pension and profit sharing plans as a means of remuneration. It is probably completely true that these developments can be traced largely to an attempt on the part of individuals to accommodate themselves to an unfavorable tax climate. At the same time, the pressure stemming from individuals upon their employers to grant these benefits, and the willingness on the part of employers to do so in order to secure and adequately compensate the necessary personnel, have presented the field of accounting theory with entirely new problems. It is perhaps no exaggeration to say that were it not for income tax, accounting theory probably would not have to deal with the problem of retirement plans and with the treatment of stock options granted to employees.

The accelerated amortization for tax purposes of the cost of certain facilities acquired during war times has had its unquestioned effect upon accounting theory. This is particularly true because the actual concept itself was based upon proper accounting but was subjected to an arbitrary measurement for tax purposes which was not appropriate under accounting theory. Accounting theories had to be developed, therefore, which would reconcile proper accounting for asset cost with an imbalance of tax effect arising from special social or economic provisions.

Ideal Role of Accounting Theory in Taxation

It can be observed readily from the foregoing comments that the relationship between accounting theory and federal income taxation is at least twofold. On the one hand, accounting theory is the basic pool of logical determination upon which a tax on income is based and without which a tax on income would be impossible. On the other hand, the presence of and the development of a tax upon income, along with the injection of nonaccounting motives, such as the social, political and economic, have, in turn, reacted upon accounting theory and have presented and created new problems and new challenges which have had to be solved by or absorbed into accounting theory.

In the light of these observations, what then can be an ideal relationship between accounting theory and taxation? What is the most beneficial role that accounting theory can and should play in the future development of taxation of income?

As has been noted, accounting theory developed initially without regard to income taxation but in response to commercial development and commercial need. Accounting theory is essentially commercial logic applied in the measurement of commercial fact. It is an attempt to communicate in the way that businessmen think and to give them business information in a form upon which they can base judgment and act intelligently. After business decisions have been made and transactions carried out, accounting is an attempt to measure the results of the transactions in business terms.

If it is an ideal of federal income taxation to leave business, in whatever form transacted, as free to act as is possible in the presence of a tax on income and to effect as little distortion of business conduct as is possible in such an atmosphere, then it is imperative that income tax statutes utilize definitions of income and income measurement concepts, in other words, accounting theory, which are the same as are utilized by the business community in its own thinking. Most politicians pay at least lip service to the ideal just set forth. If it is to be any more than lip service, then the determination of income for federal tax purposes should not be basically different from the determination of income in accordance with the application of the basic principles of accounting theory.

Obviously, the foregoing generality requires some modification if it is to be practical. If social motives or political motives are to enter into our tax structure, income under the application of accepted accounting theory and income for tax purposes cannot be identical. The general rule which will produce the most equitable and beneficial results over the long run would be this: Income for tax purposes should be determined primarily within the framework of accepted accounting theory and the variances should only be where there is a clear, conscientious effort to create a variance.

Can you imagine the simplicity of a business income tax return which would start with income as certified by independent accountants and as reported to management, and to stockholders and creditors, and which would then adjust this figure solely by those items which specifically and deliberately were to vary from normal accounting concepts?

This might seem like an utopian idea in tax determination and administration. It is not impossible.

Is Suggested Ideal Role Desirable?

While the preceding is a suggestion as to an ideal role which dependence upon accounting theory might serve in the overall simplification of tax determination and administration, there must be further favorable factors if it is to be seriously considered.

Upon careful study, it will be found that the close relationship between our revenue system and accounting theory is not only desirable but also vital. Reference has been made, upon occasions too numerous to mention, to the overwhelming size and detail of the Internal Revenue Code. It is unnecessary to elaborate at length, to a sophisticated audience, upon the fact that most of the Internal Revenue Code, in its income tax provisions, is made up of exceptions, exemptions and differences from a normal income determination. This is not a proper forum for an argument as to the justification of such exceptions and variances. However, it is these items which could, if carried to an improper extreme, destroy our revenue system.

In discussing our present provisions for the taxation of income, we must never lose sight of the fact that this system, as applied to business income, is almost entirely self-assessing in the first instance. Any system of self-assessment of tax is dependent upon many factors, some of which are psychological. The entity being taxed must be convinced of the overall honesty of the tax officials. There must be at least a general confidence in the fairness of the manner of imposition. There must also be a belief that the amount of tax applicable to any period can be determined promptly and will not be the subject of prolonged uncertainty, even litigation. This desire for certainty in the amount of tax is as important in a self-assessing system as would be any other consideration. Once the businessman was convinced that the provisions of the Internal Revenue Code were so involved and so at variance from normal business concepts that he could not determine with any degree of accuracy the income upon which the tax was to be levied, there would be an immediate disintegration of our revenue collection system. Similarly, should the variance from general accounting concepts be so great as to invite improprieties in the self-assessing process, there would again be disintegration. The difficulties which can arise, once confidence in a self-assessing system is lost, are being clearly demonstrated in other countries at the present time. The infinitesimal percentage of tax returns now being filed which become the basis for litigation is the greatest available evidence of the propriety of basic dependence upon sound accounting theory in income taxation.