

# PRINCIPLES AND RULES OF INCOME DETERMINATION FROM THE ASPECT OF U.S. TAXATION

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There is great diversity in the concept of "income" among accountants, economists and taxation authorities; furthermore, even within each of these groups there is a definite lack of unanimity. In the determination of income for purposes of U.S. taxation, however, certain principles and rules are codified in taxing statutes or embodied in administrative pronouncements or judicial determinations. The more important of these will be summarized and considered herein. (The volume and complexity of the U.S. tax rules obviously prevents any attempt at completeness.) Conceptual departures from current accounting and economic philosophies will be discussed.

Two major limitations in scope should be noted at the outset. First, although income taxes constitute a major source of revenue for the majority of the fifty states and for certain municipalities, consideration will be limited to principles and rules of income determination for federal income tax purposes. Second, although there are, in general, four distinct classes of tax entities, *viz.*, corporations, partnerships, individuals and fiduciaries, each governed by special rules, only those pertaining to corporations and individuals will be specifically discussed. However, certain basic principles are applicable to all classes.

## Basic principles

### *Tax Structure*

Tax is determined by the application of a specified rate schedule to all kinds of income of a taxpayer, *i.e.*, "taxable income". In essence, there is but a single calculation regardless of the type of income of which taxable income is comprised, rather than a series of schedular taxes based upon the source or derivation of the income. An exception concerns the separate tax calculation at favorable rates for net long-term capital gains.

"Gross income" is the starting point in the determination of taxable income. The taxing statute has defined this to mean all income from whatever source derived. But there is no touchstone as to the meaning of "income". One attempted definition of the income concept by the judiciary 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" has proved too narrow. Economic definitions of income, while perhaps conceptually sound, are too broad. Consider, for example, "the increase or accretion in one's power to satisfy his wants in a given period in so far as that power consists of (a) money itself, or (b) anything susceptible of valuation in terms of money,"<sup>1</sup> or "the algebraic sum of (1) market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in

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1) Robert Murray Haig, "The Concept of Income-Economic and Legal Aspects", *The Federal Income Tax*, ed. (New York: Columbia University Press, 1921), p. 7.

question”<sup>2)</sup>). The extensive enumeration of exclusions from these economic definitions which would be required would render tax administration impractical. And accounting pronouncements frankly indicate that the word “income” is used to describe a general concept, not a specific and precise thing.

Although there is no satisfactory comprehensive formula, some degree of conceptual certainty as to whether an item is “income” has been attained as a result of authoritative determinations of an *ad hoc* nature. In view of the tendency to require inclusion of all receipts in gross income, it might be said that few receipts which constitute accessions to wealth, except those excluded by statute or settled custom, will not be includible in gross income.

In general, neither the source, the form nor the sporadic nature of a receipt will constitute a limiting factor. To illustrate: profits or gains derived from illegal transactions are subject to taxation. Thus, corporate income from *ultra vires* transactions is taxable, as are proceeds received as a result of swindling, fraud, extortion or embezzlement. Net profits for gambling, whether legal or otherwise, are taxable (but net losses are not deductible). Also, it makes no difference if the receipts are derived from fortuitous events. Thus, punitive damages and treasure trove and other windfalls are includible in gross income. Compensation need not be received in cash to be taxable. Thus, meals and accommodations, free use of property, and payment in stock are income items if disguised compensation, as generally is gain of a debtor arising from cancellation of indebtedness even though nothing tangible is received.

It was previously indicated that certain receipts are excluded from taxation by statute or settled custom. These include returns of capital, gifts and inheritances, interest on state and municipal bonds and certain welfare payments.

The second and final step in the determination of taxable income is to subtract allowable deductions from gross income. These may broadly be classified for both individuals and corporations as those ordinary and necessary expenses attributable to a trade or business or the production of income, and for individuals only as certain non-business items and personal exemptions.

Because of its importance, one non-allowable deduction should be noted now. This concerns dividends paid, which a corporation is not permitted to deduct in the computation of taxable income. This tax policy is in accord with commercial accounting practice which does not account for implicit costs. The accounting calculation of corporate profits omits the alternative cost of using shareholders’ capital in the enterprise rather than elsewhere, and profits are calculated before any payment to the shareholders. But, unlike accountants, economists include a corporation’s costs a reasonable rate of return on the shareholders’ investment. Therefore, economic profit is the excess of income over all costs including this implicit cost. Because interest on debt is deductible in the computation of taxable income, a corporation’s implicit interest in the economic sense, *i.e.*, dividends paid or undistributed profits plowed back into the company, is more heavily taxed than the explicit interest on debt paid to bondholders.

It might also be noted that because a dividend distribution is taxable to the shareholders, corporate earnings distributed are in effect taxed twice, once at the corporate level when earned and again at the shareholder level when distributed.

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<sup>2)</sup> Simons, *Personal Income Taxation* 5.

Furthermore, if there are sufficient earnings and distributions are not made, a penalty tax may be imposed on the corporation.

### *Separateness of Entity*

A husband and wife, although deemed separate taxpayers (generally with income from their separate services and separately-owned property) are permitted to file a joint return. (It is usually advantageous to do so because of the progressive tax rate. In a joint return, the tax is computed at the rate applicable to one-half the combined income and is then multiplied by two.)

Generally, under both tax and accounting principles, shareholders of the corporation and the corporation itself are legally separate entities as regards income determination. Shareholders generally have no income solely as a result of the corporation having income. Any increase in a shareholder's equity attributable to undistributed earnings is no more than potential income for tax and accounting purposes. Any resulting enhancement in market value is unrealized appreciation, not income.

In general, legally separate corporations are considered separate taxpaying entities. Branches within a corporation, even if separately operated, are combined, and the income is considered to be that of one entity. But an affiliated corporation, even if a wholly-owned subsidiary, is with certain exceptions a separate entity. The affiliate's taxable income is separately determined and it is separately liable for its tax.

The principal exceptions to separateness of entity in the case of affiliated corporations have one of two purposes. The first concerns elimination of adverse tax consequences which would otherwise result from the use of separate corporations rather than unincorporated branches. Thus, affiliated corporations may elect to file a consolidated return in which, generally, gross income and deductions of the separate corporations are aggregated.

The second exception is designed to prevent tax avoidance through separate incorporation. Thus, there may be a reallocation or reapportionment of income and deductions between or among organizations owned or controlled by the same interest if such is necessary to prevent tax evasion or to more clearly reflect income. Also, under certain circumstances, losses, expenses and interest with respect to transactions between related taxpayers may be disallowed.

It might be noted at this point that the above rules disregarding separateness of entity of related corporate taxpayers are also applicable to individuals. Thus, no deduction would be allowed with respect to a loss incurred on the sale of property in a transaction between certain members of a family or between a corporation and its controlling shareholder.

Disregard of what legally are separate taxpayers is in accord with the economic view which looks to the substance of the entire economic unit and disregards legalistic formalism.

Accountants, also where appropriate, look through the form of corporate organization and in consolidated or combined financial statements present the financial position and results of operations of a group of companies as if they were those of a single enterprise. However, they draw an important distinction between business combinations arising from the purchase of a subsidiary's stock and those effected through a "pooling of interest."

Basically, the distinguishing characteristic which differentiates a pooling of interests from a purchase is that in the former case there is a continuity of ownership in the constituent corporations whereas in the latter there is new ownership. The distinction is important because of the differing accounting treatments accorded. Very succinctly, if there is a pooling of interests, the balance sheets of the constituent corporations are carried forward as they were prior to the combination, and the respective income statements are combined. When the combination is deemed to be a purchase, the capital stock or assets acquired are recorded at cost which then becomes the new basis of accountability and financial statements are consolidated. Thus, under the pooling of interest concept, the legal forms are observed as to the entity, but the accounting treatment of transactions with outsiders is as though the formerly separate entities were still in existence.

The distinction is also important for tax purposes. For example, a combination qualifying as a reorganization is generally tax-free. In addition, there is a carry-over of the tax basis of property from the acquired corporation. If the combination does not so qualify, it is in essence treated as a purchase. Therefore gain would be taxable to the seller and there would be a stepped-up cost basis for the buyer. The tax principles of what constitutes a reorganization differ from the accounting principles concerning a pooling of interests, although in both cases there must be a continuity of ownership from a prior enterprise where only the form and not the essence of the investment differs. Tax treatment is determined by rather rigid rules which require strict compliance with statutory standards, whereas characterization for accounting purposes is based upon all attendant circumstances and not upon formalisms. But both the tax and accounting principles are approaches to the determination of the same basic question: Does the merger of two formerly independent entities constitute an ingestion of one by the other or a continuation of both?

### *Accounting Methods*

The "method of accounting" for tax purposes includes not only the over-all method employed by the taxpayer but also the accounting treatment of each item. The general approach to tax accounting is, with some important exceptions, *infra*, to follow generally accepted commercial accounting principles. For both tax and commercial accounting purposes, the accounting method chosen must clearly reflect income and must be applied consistently each year so as not to distort annual income. In most frequent use are the cash receipts and disbursements, and the accrual methods.

Generally accepted accounting principles require the use of the accrual method for most business enterprises because costs and revenues are more closely matched and annual income is more clearly reflected.

The accrual method in essence reflects the effect of transactions when they occur, rather than at the time of a receipt or disbursement of cash. But it should be noted that as regards all enterprises, since accounting methods relate primarily to timing, total income over the entire economic life of the enterprise, will tend to be the same, regardless of which method is employed.

Under the cash method, income is not includible in taxable income until actually or constructively received; expenses are not deductible until paid. Property or services having a cash value are treated as the equivalent of cash. And even though

cash or property is not received directly, the taxpayer may have income as, for example, where payment of compensation is made to a third party for the taxpayer's benefit.

Income is constructively received by a taxpayer although not actually reduced to his possession in the year during which it is credited to his account, set apart for him or otherwise made available so that he may draw upon it without limitation or restriction. Thus, interest credited to a bank account is constructively received when credited although not withdrawn.

But despite the doctrine of constructive receipt with regard to income items, there is no clearly defined corresponding doctrine of "constructive payment." Therefore, deductions may usually be taken by cash method taxpayers only in the taxable year in which items are actually paid.

An income item received under "a claim of right" and without restriction as to its use or disposition must be reported by the recipient in the year received, even though it may still be claimed that the taxpayer is not entitled to retain the property and even though the taxpayer may later be required to restore its equivalent. Thus, salaries or bonuses are income in the year of receipt even if it is subsequently determined that they were erroneously paid and must be refunded. The foregoing is applicable whether the taxpayer is on the cash or accrual method.

The claim of right doctrine is in direct conflict with the generally accepted accounting principle of not recording income until earned. This doctrine is, however, firmly embedded in our tax law. One reason advanced is that inclusion of income items actually received is necessary for efficient administration. Another is "the bird in hand" theory, *i.e.*, to tax a receipt when the taxpayer gets it and while he still has it.

Prepaid income items received in advance by a cash basis taxpayer, as for services to be performed, are includible in the year of receipt. This too is in direct conflict with accounting theory which would defer recording of income until earned.

Where the production or purchase and sale of merchandise is an income producing activity, it is required that the accrual method of accounting be used with respect to purchases and sales (but farmers are excepted). Under the accrual method, in general, income is includible in the year earned and expenses are deductible in the year incurred; the year of receipt or payment is immaterial.

Somewhat more specifically, income is required to be accrued when all the events have occurred which fix the right to receive it and the amount can be determined with reasonable accuracy. It is not necessary that the precise amount be known. If either the right to income or the amount is contingent or contested, the general rule is that accrual will be postponed. With respect to deductions, they are accrued when the obligation is established and the amount of the expense can be determined with reasonable accuracy. If a deduction item is disputed, the general rule for disputed income items is applicable here also, *viz.*, that accrual will be postponed.

As previously discussed, one significant area of divergence between tax accounting and generally accepted accounting principles concerns the tax treatment of income under the claim of right doctrine. The second major area of divergence relates to the deductibility of reserves for estimated future expenses or contingencies.

The tax accounting rule is that, with the exception of reserves for bad debts, no accruals to reserves will be permitted to be deducted unless all the events have occurred to establish liability at the end of the taxable period. Under generally accepted accounting principles, reserves are required for probable expenses and liabilities which relate to current income even though not unconditionally fixed by the end of the taxable year, in order to properly reflect income.

Special tax accounting methods are permitted for income from deferred payment sales and from long-term contracts.

An installment method for reporting income from deferred payment sales may be elected under certain circumstances. If the election is made, only that portion of the profit on the entire transaction which is reflected in the payments received within each taxable year is included in taxable income for that year. Thus, income is spread over the years in which payments are received, rather than being included in full in the year of sale. The accounting view is that installment sales should generally be accounted for on the same basis as other sales, *i.e.*, generally on the accrual basis, despite the greater collection risk.

Income from long-term building, installation or construction contracts may, by election, be reported under one of two special methods. Under the percentage-of-completion method, that portion of the contract price which corresponds to the estimated percentage of the work completed during the taxable year is included in gross income. All expenditures during the taxable year, after taking into account inventories of material and supplies at the beginning and at the end of the year, are deducted. Under this method, the estimated income or loss will be spread over the period during which work is being performed. Thus, current performance is reflected in current income. But the disadvantage is that the percentage of completion is dependent upon estimates of ultimate costs and may not reflect inherent hazards.

Under the completed contract method, the net income or loss (*i.e.*, gross income less deductions) on the entire contract is reported only in the year of completion. This method may be preferable if the total net profit or loss is uncertain or unknown until completion of the contracts as, for example, where there are significant inherent hazards or unreliable estimates. But the disadvantage is that current performance is not reflected and net income may fluctuate widely between periods simply as a result of the number or size of the contracts completed in each period. Therefore, except where cost forecasts are very unreliable, accountants believe the percentage-of-completion method preferable.

### *Valuation of Inventories*

Generally the use of inventories is required in all cases in which the manufacture, production, or purchase and sale of personal property is an income-producing factor.

Accounting for inventories for both tax and commercial accounting purposes concerns two aspects of the same problem. This is the matching of appropriate costs against related revenues in order that there may be a proper determination of realized income. One aspect concerns inventory valuation, the other inventory identification.

The two basic methods of inventory valuation for both tax and accounting purposes are "cost" and "cost or market, whichever is lower." The latter is more

commonly used. It has two advantages: first, loss of utility is recognized during the period in which the loss takes place. Second, the write-down reflects conservatism in that inventories are not measured in excess of future recoverable amounts.

Inventories may not properly be stated above cost, except in certain very limited circumstances. This is because under generally accepted accounting principles, income accrues only at the time of sale. Reflection of assets at current sales prices which are in excess of cost would constitute anticipation of gain prior to realization. Furthermore, it is asserted that statement above cost is not conservative, in that estimated amounts may not prove recoverable.

Some have contended that inventories should be stated at market, even if above cost. Their principal argument is the inherent inconsistency in valuing goods below but not above cost. They state that an increase in utility should be recognized in the period in which the increase takes place. They note that the recognition of losses but not the anticipation of gains, on the grounds of conservatism, reverses itself in a subsequent period (as beginning inventory represents a cost). And they point out that as the absence of realization does not constitute a bar to the use of market value where that is below cost, it should not where market is above cost. So far, this point of view has not prevailed.

Whether the method used is "cost" or "lower of cost or market," the principles involved in the determination of cost are the same. "Cost" means the sum of the applicable expenditures and charges directly or indirectly incurred in bringing an article to its existing condition and location. Thus, if goods are purchased, cost is the invoice price plus freight, handling, excise taxes and customs duties and other acquisition expenses. In the case of manufactured or processed goods, cost includes materials and supplies entering into or consumed in the operation, direct labor costs and applied manufacturing overhead.

"Market" in the case of purchased goods means replacement cost; in the case of manufactured goods it means reproduction cost, except that in either case "market" should not exceed current selling prices less direct cost of disposition. When market value is lower than actual cost and is therefore used as the inventory basis at the end of the taxable year, this value will be deemed the cost of the inventory at the beginning of the succeeding taxable year.

Five principal inventory identification methods are permitted for tax purposes. The first, "specific identification" of the cost of each item or lot, ordinarily is impossible or impractical with a large inventory. The second is the "first-in, first-out" method. "FIFO", as it is called, assumes that the goods first purchased or produced are the goods first sold or used. Consequently, the goods included in closing inventory are those last acquired.

FIFO should be contrasted with the third inventory identification method of "last-in, first-out", called "LIFO". This assumes that the goods last purchased or produced are the goods first sold or used. Consequently, the goods included in closing inventory are those first acquired. Under the LIFO method, however, the goods must be valued only at cost for tax purposes, so that a write-down to market is not allowed as a tax deduction. This is at variance with the generally accepted commercial accounting principle, noted above, which requires that inventories be reduced to market where that is below cost.

Since LIFO matches current purchases against current sales, the impact of price

level changes upon inventory valuation is minimized. In a rising market, the LIFO method results in lower profits, and in a declining market, higher profits than FIFO.

The two remaining principal methods of inventory identification are the "retail" method and the "average cost" method.

### *Depreciation and Amortization*

Tax depreciation principles are a synthesis of current accounting and economic thought regarding investments in assets. Accountants are primarily concerned with the allocation of the cost of depreciable assets to the periods of their use in the manner which will most clearly reflect periodic income. Thus, proper measurement of income is the accountants' objective. As modern economists are agreed that investment is one of the most significant factors affecting income and employment, they view the amount of allowable tax depreciation from the aspect of stimulating or retarding the level of investment in depreciable assets. Accordingly, accountants and economists have a fundamentally different way of judging the adequacy of depreciation allowances. To the accountant, the test is the accuracy of the income measurement. To the economist, the test is the influence of tax depreciation on the purchase of the proper types of depreciable assets in the proper amount.

The tax law allows a depreciation deduction of a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property with a definite useful life, used in a trade or business or held for the production of income. The tax considerations concern the determination of whether a particular asset is depreciable, what amount is depreciable, and the rate of depreciation.

The first consideration, whether a particular asset is depreciable, is perhaps the easiest with which to deal. As noted above, the depreciation deduction is allowed only for property used in a trade or business or held for the production of income. But generally, land is not depreciable although improvements which may be added to it are. An exception is where the utilization of land involves the extraction of natural resources, in which case a deduction for depletion may be allowed. Nor is depreciation allowed for inventories or stock in trade. Intangible assets are amortizable, but only if the life of the asset is of definite duration. If duration is indefinite, cost is taken into account for tax purposes only when the asset is sold or abandoned. Accordingly, patents and copyrights are depreciable, but goodwill, secret processes and perpetual franchises are not. Certain corporation organization expenses and trademark and trade name expenditures are amortizable at the taxpayer's election over a period of not less than 60 months.

With regard to amortization of intangibles having no limited term of existence, it might be noted that there is great variance among accountants as to proper treatment, tax principles notwithstanding. Although immediate write-offs to surplus are not considered acceptable, there is no consensus as to whether these intangibles which have no determinable date of expiration of life should be periodically amortized against income when no loss of utility is evident.

Economists characterize intangibles as reflecting conditions of imperfect competition, the utility of which is derived from such conditions. They consider intangibles economically significant when combined with tangible assets. In this context, the economic view would seem to be no amortization without diminution in value.

As stated above, amortization of these intangibles of indefinite duration is not permitted for tax purposes, though, whether or not accompanied by diminution in value. Advertising expenses are normally deductible as ordinary business expenses, even if they have a substantial future benefit.

There is currently a great deal of controversy about the proper amount of total depreciation deductions of a depreciable asset. Under the tax law, total depreciation deductions may not exceed the original cost of the asset less its estimated salvage value. The basis of original or historical cost reflects the traditional accounting concept which regards depreciation as the allocation of the cost of the asset over its useful life in the business, during which it produces income.

This approach, based on historical cost, has been criticized on the grounds that the purpose of depreciation should be to provide an adequate fund for the replacement of fixed assets. Where replacement prices have risen, it is contended that depreciation charges against current income will be inadequate if based on historical cost. Thus, an economist would say that if an enterprise is at a break-even point after depreciation charges based on historical cost, but the replacement cost of the fixed assets is rising, the enterprise is actually operating on a economic loss because when the machinery and equipment have worn out there will not be sufficient funds to replace them as a result of the higher price level. Therefore, recognition of the probability that plant, machinery and equipment will have to be replaced at costs much greater than those incurred for the facilities currently in use has been vigorously advocated even by some accountants. These advocates suggest that depreciation charges against current income be based on the replacement cost.

In rebuttal, defenders of the maintenance of the historical cost basis state that depreciation based upon replacement cost would tend to increase rather than reduce economic cycles, because depreciation charges would be directly proportionate to price level changes and taxes would be inversely proportionate. Therefore, during a period of recession where increased investment would be needed, taxes would claim a greater amount of available funds. And during inflationary periods, tax revenues would be reduced rather than increased. They also contend that a departure from historical cost is impracticable because of price level instability and the difficulty of measuring price level changes. At this time, there is little likelihood of a change in either the tax rule or the accounting principle which require the use of historical cost.

The permissible methods of depreciation under present tax law reflect the economic approach to the adequacy of depreciation allowances. For the most part they tend to encourage the purchase of capital assets. At a prior time, it was generally required that depreciation be based on the historical cost of the asset, allocated over its full useful life in the business on a straight line basis, *i.e.*, ratably. Although the requirements of historical cost and allocation over the full useful life have been retained, the permissible methods of depreciation have been liberalized. As a result, larger deductions for depreciation are concentrated in the earlier years of an asset's useful life. The effect of this acceleration is a speedier recovery of investment, an increase in after-tax profits, and an addition to working capital.

The foregoing was accomplished by the authorization in 1954 of two new methods of depreciation. These are the declining balance method and the sum-of-

the-years-digits method. Both of these may be used in the computation of depreciation allowance for new tangible property with a useful life of at least three years. Moreover, primarily as an aid to small business, if new or used property has a useful life of at least six years, a flat deduction of 20 % of cost not in excess of \$ 10,000 is permitted in the first year.

## Conclusion

In a broad sense, the determination of income can more properly be regarded as an art rather than as a science, in that there are no ordered classifications from which predictable results necessarily follow. But as indicated in this article, there are applicable principles within the dictionary definition of "principle" as "a general law or rule adopted or professed as a guide to action; a settled ground or basis of conduct or practice . . ." Although these principles are mutable and admit of deviations in their application, they provide a practical framework into which related facts can be fitted. And the more complete the framework, the more scientific in the technical sense income determination becomes.

This article has examined the more important structural components of this framework, with primary emphasis on tax principles but with consideration given to accounting or economic principles. In connection with this, certain underlying concepts were analyzed and some rules resulting from the application of these principles were noted. It is hoped that the reader has been guided to a basic understanding of how income for purposes of United States taxation is determined.