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Accounting in Relation To the Income Tax

It Underlies and Supports the Whole Income Tax Structure—Income Taxation Is Almost Entirely a Matter of Accounting.

By HOMER ST. CLAIR PACE, C. P. A., Formerly Acting Deputy Commissioner, Income Tax Unit, Bureau of Internal Revenue.

IN this month of September, 1919, 2,000,000 individuals and business concerns, more or less, will make tax payments to the Federal Government. These payments will constitute the third installment of a gigantic tax which was voluntarily reported last spring by citizens and corporations on an historical or accounting basis—the history of the business of the preceding year. The individual reported his income, less certain exemptions, and computed his tax on the basis of the taxable income. The business concern reported its income, actually received or accrued to be received, and deducted its costs and expenses, actually paid or accrued to be paid, and thus determined a base for the calculation of income and excess profits taxes. And the history was not altogether a matter of recording specific facts, for judgment had to be expressed in respect to such probational matters as depreciation and depletion. Upon the completeness of the record of financial transactions of the year 1918 must depend the accuracy of the most stupendous tax levy in the history of the world.

The historical or accounting basis for taxes, which requires a complete and permanent record of business history is comparatively new. Heretofore taxes quite generally have been levied upon an inventory basis—a listing of values in hand such as real estate, personal property, stocks and bonds, and the like. These assets have then been given a value appraisal for the purpose of a tax. This method is comparatively simple because of the fact that the tax is based on specific articles in hand which can usually be inspected and appraised.

Income and excess profits taxes, on the contrary, are not based on specific values in hand—the tax is calculated upon the basis of a taxable income or profit earned during a certain elapsed period of time. The actual property values may have been consumed even before the tax is reported. I have in mind a citizen, whose income is \$6,000 a year, who is making his September installment payment on last year's tax from his September salary. However, this action may be on his part, it is strictly his right, because his tax return, which was filed in March to cover his income for last year, is merely his statement of the account between himself and the Government. The only obligation on the part of the citizen is to meet the fall due. Similarly, a business may stretch for the cash payments upon the cash earned and realized in a period succeeding its tax period, although business concerns preferably should reserve, from month to month, funds for the purpose of meeting their tax obligations when due.

The value transactions that enter into the determination of the tax extend over the taxable year and, under the present arrangement, the reporting and the payment of the tax extend over another year. The final review and the determination of the facts by the Government require at least another year. Three years, therefore, and in practice probably a longer period, are required in the determination and the settlement of the tax, during which time the only dependable source of information is the accounting record of income transactions which is made during the taxable year.

Accounting underlies and supports the whole income tax structure. It provides a method for recording financial transactions in such a way that income and expenditures—the progress of the business by years in the matter of earnings—may be stated. It supplies a dependable basis for any action, whether a tax or of a business nature, which basis is available as long as the records are preserved.

The exactitude of the records in the preparation of their returns and the difficulties of administration on the part of Government officials are due almost entirely to defective financial records. Even the larger and more successful concerns have often been lamentably weak in their accounting procedures and many such concerns are having their accounts for the last six or eight years reviewed and auditorially stated by certified public accountants. Partnerships, probably because of the fact that they have not been as strictly regulated as corporations, have often been singularly lax in respect to financial records. Small retail traders, professional men and others whose accounting has not required the services of a trained bookkeeper have, more often than not, kept no accounts whatever, or, possibly, only such accounts as affected customers or clients. The difficulties of income taxation have seldom arisen from antagonism or dishonesty on the part of the taxpayer, but almost entirely from the lack of the proper historical basis upon which to compute the tax.

Income taxation, therefore, is almost entirely a matter of accounting. The larger business concerns, with its controller and staff of bookkeepers, is rapidly mastering the situation. A concern of this class, no matter how small, will readily adapt itself to the new accounting basis of taxation. The greatest difficulty, and one that must be overcome in order to make this basis of taxation effective, is with the business concerns, the professional men and the farmers whose affairs do not require the organization of a bookkeeping department with a technically trained bookkeeper or accountant in charge. It is not altogether, either, a matter of protecting the Government, for no taxpayer can assure himself of

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expense of running the truck and of keeping in repair, however, is an operating expense which is a charge against gross returns or profits. The wasting, or depreciation, of the truck over the term of its life, say five years, would also be an expense to be charged off against income during the five year period. If this ratio were adopted one-fifth of the value of the truck would be charged off as an expense during the first year of its use and four-fifths of the value would remain. These matters are vital to the determination of the proper amount of tax.

Another fundamental distinction made in accounting is between the determination of income on an accrual basis and on a receipt and payment basis. In determining profits and losses on an accrual basis all items which are earned are included, whether or not they are actually collected in cash; likewise, all expenses incurred are charged whether or not they are actually paid in cash. The correct determination of profit and loss requires an understanding and use of the accrual basis. The business man should have this distinction clearly in mind for business as well as for taxation purposes.

These are some of the accounting principles which the business man should learn. They are all essential to the correct determination of the profit of a business and to the localization of losses. Many of them are essential to the determination of a personal income, even though such income does not arise in the conduct of a regular business. No business man should work without a first hand knowledge of these principles.

The business man, who presumably learned in school the fundamentals of English, has developed his use of that subject for the purpose of writing business letters and of selling merchandise. Why should he limit his use of arithmetical processes, also learned in school, to the calculation of pounds of butter or yards of cloth? Accounting is merely the systematic, arithmetical recording of completed business transactions according to certain understandable principles. Accounting should be as much a part of the business man's equipment as his knowledge of the markets in which he trades and of the qualities of the wares in which he deals. It should as certainly be a part of the equipment of the engineer and of the lawyer; and there are substantial reasons why the physician, the surgeon and the dentist, who are presumably less concerned

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