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Impact of the Tax Law on GAAP: 1909 to the 1950s

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ABSTRACT: The aim of this article is to bring to light and discuss the many and diverse impacts of the federal income tax law on generally accepted accounting principles (GAAP). Such an analysis can provide accounting academics, practitioners, and standard setters with a broader perspective on these impacts on GAAP, focusing on the period from 1909 to the 1950s.

JEL Classifications: M41.

Keywords: income tax law; GAAP; income realization; depreciation; LIFO; book-tax conformity.

I. INTRODUCTION

In the United States, the accounting profession prides itself on setting accounting standards in the private sector, as opposed to standards set by government. Yet there have been many and diverse impacts of federal income tax legislation, and the regulations thereunder, on generally accepted accounting principles (GAAP), which will henceforth also be called accounting practice. It is important to bring together a discussion of these impacts in a single place so that accounting academics, practitioners, and standard setters can come to appreciate the wide range of sources of GAAP. Until now, such a discussion has been absent, save for sentences and paragraphs dispersed throughout the literature.[1]

This article will focus on the period from 1909 to the 1950s, which was rich with such impacts. The year 1909 was when Congress passed the first federal tax law that allowed a deduction for depreciation. Two reasons justify the choice of when to end this time period. First, it was felt desirable to conclude the time period before the eras of the Accounting Principles Board (1959–1973) and the Financial Accounting Standards Board (since 1973), standard setters that began to prescribe the boundaries of GAAP rather more definitively. Second, there was the desire to conclude the time period shortly after the comprehensive revision of the tax law in 1954, which was preceded by extensive public hearings.

The data for this article consist in the views expressed by contemporary academics and practitioners who testified to the impacts of the tax law on accounting practice occurring on their watch. Whenever possible, it was thought desirable to show two or more supporting quotations or citations for each impact to demonstrate corroboration.

Tax laws and corporate financial reporting have very different objectives (Arnett 1969, 485–489). Tax laws are intended to raise revenue from taxpayers in an equitable manner and, as an instrument of fiscal policy, to promote certain social, economic, and political goals. By contrast, as stated by Arnett (1969, 486), "The objective of financial statements is to inform the reader about the financial condition of a firm and the results of its operations so that he can make

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I am solely responsible for what remains.

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[1] For an extensive catalogue and discussion of differences in net income as between accounting and the federal income tax, see Reimer (1949).

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sound decisions about the company." There is no reason why accounting methods acceptable for the one should necessarily be acceptable for the other.[2]

From 1909 to the 1950s, there were numerous episodes in which the federal income tax influenced accounting practice in important ways. The discussion and analysis of these episodes, drawing on the views expressed by academics and practitioners, will demonstrate that the influence of the tax law on accounting practice has been considerable and widespread.

Before proceeding to the discussion of the episodes, it would be well to establish, via the views expressed by several leading accounting academics and practitioners, the belief that the federal income tax laws have indeed had a marked effect on accounting practice. Cohen (1956, 206) has written, "It cannot be denied that [the income tax laws] have had a profound and far-reaching effect upon accounting theory and practice." Paton (1950, 18) has written, "Tax administration and regulations have already exerted far too much influence on accounting procedures." Werntz (1955, 111) wrote, "Ever since adoption of the income tax in 1913 and more powerfully as rates have risen, the tax treatment of items has become a major consideration in accounting thought." Stempf (1938, 939) wrote, "Too many managements, and likewise accountants, permit tax attitudes to color their reasoning and distort the application of sound principles of accounting." Hendriksen (1965, 40) has written,

> [T]he effect on accounting theory of taxation of business incomes in the United States has been considerable, but it has been primarily indirect in nature. The tax laws themselves have not pioneered in accounting thought. While the Revenue Acts did hasten the adoption of good accounting practices and thus brought about a more critical analysis of accepted accounting procedures and concepts, they have also been a deterrent to experimentation and the acceptance of good theory.

As will be seen, some tax impacts on accounting practice were viewed as salutary, whereas others, if only because the precipitating factor was government action and not advice from the accounting profession, were viewed as objectionable.

II. THE EPISODES

Depreciation Deduction Beginning in 1909

In 1909, Congress passed the Corporation Excise Tax Law (known also as the Corporation Income Tax Act), which for the first time in a tax law called for a deduction for depreciation (Brazell, Dworin, and Walsh 1989, 3). Of interest is the fact that the Treasury Department stipulated that the allowable depreciation deduction for tax purposes "must be charged off on the ledger of the corporation, so as to show a reduction in the capital assets of the corporation to the extent of the depreciation." This provision created a problem for companies because it was not clear that a credit to the depreciation reserve (or allowance) constituted "a reduction in the capital assets" (Richardson 1912, 219).

Four years later, in the wake of passage of the Sixteenth Amendment to the Constitution to allow the federal government to levy an income tax without apportionment among the several States, whose effective date was March 1, 1913, Congress approved the Revenue Act of 1913, which, among other things, also allowed a tax deduction for depreciation. But there was no longer a requirement that the depreciation deduction would be allowed only if also booked in the taxpayer's accounts.[3] This provision, although modified from time to time, has continued to appear in tax legislation ever since.

Before April 1917, when the United States entered into the World War, the top tax rate was 7 percent (1913–1915) and then 15 percent (1916) (Luscombe 2022), and apparently not all that many companies were prompted to acknowledge the propriety of showing depreciation expense in their profit and loss statements. But in 1917, Congress approved a wartime excess profits tax on the excess of profits over prewar earnings, which, together with the Revenue Act of 1917, yielded a top corporate tax rate of 67 percent (Luscombe 2022). This higher rate schedule led many company managers to appreciate the benefit of taking a tax deduction for depreciation. Moreover, Section 212(b) of the 1918 Act (which became Section 41 in subsequent legislation) explicitly related taxable income to accounting income by defining its net income (i.e., taxable income) as follows:

> The net income shall be computed on the basis of the taxpayer's annual accounting period…in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been employed, or if the method employed does not clearly reflect the income, the

[2] See, for example, Lent (1962, 479) and Philips (1963, 20–21).
[3] For a discussion of the 1909 and 1913 Acts, see Carey (1969, 64–71).

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> computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income.

Once company managers began to take full advantage of the depreciation deduction in their tax filings, they apparently came to the view that, when preparing their profit and loss statements, depreciation expense on their fixed assets, a book entry not involving a disbursement of cash, was a genuine expense to be recognized every year and not to be displayed only in times of bountiful profit. Hatfield (1927, 140) wrote,

> [T]he improvement [in recognizing depreciation] since the first edition of this book in 1908 has been very marked. At that time any recognition of depreciation was relatively uncommon in the accounts of American corporations and the relatively few companies which showed depreciation in prosperous years grew faint-hearted when business was poor. But an examination of the balance sheets of corporations during the trying period following the Great War shows that many of them made charges for depreciation though that resulted in a net deficit. This closer adherence to correct accounting principles was doubtless stimulated by the provisions of the income-tax law.

Blough (1957, 290) has written:

> While in the years immediately following March 1, 1913, there were still many instances where provisions for depreciation were made on a haphazard basis, it can safely be said that in the commercial and industrial fields the marked change in thinking and practice with respect to depreciation accounting in this country came about during the years following passage of the 1913 Revenue Act.

Saliers (1939, 17–18) also remarked on how companies had been attuning the depreciation charge on their books to their profitability: "The company bookkeepers, when closing their books, based the amount of the depreciation charge on the amount of profit earned in that year. A lean year caused the property to receive little or no charge for depreciation, while a prosperous year caused a liberal allowance to be made." He added that, in the 1909 Act,

> Depreciation expense was made an allowable deduction and was universally deducted by those corporations affected by the act. The effect of this act on the growth of the use of the depreciation charge cannot be overemphasized. It was the first instance in which the writing off of depreciation as expense was definitely advantageous. That fact alone insured its general application.

The U.S. audit firm of Price, Waterhouse & Co (1913, 26) wrote that "Waiting until the annual earnings are known before deciding upon the provision for depreciation" was one of the "more usual methods of calculating these reserves."

Paton (1922, 14) contributed his own view[4]:

> An immediate factor which has probably contributed more to the present emphasis upon accounting than the efforts of generations of accountants is the advent of income and profits taxes. The levying of high rates of tax upon the net returns of business enterprises has made it imperative from the standpoint of both the taxpayer and the government that net income be rationally determined, that the integrity of the profit figure be protected by adequate accounting principles and devices. As a single example of the influence of the income tax program upon the development of accounting policies, the situation with respect to the treatment of accrued depreciation may be cited. Before the days of income taxation it was very difficult for the accountant to convince the business man, especially the owner of a small enterprise, that it was important that the value expiration of his fixed assets be accrued upon his books. Now he appears to appreciate the significance of accrued depreciation very clearly, and no urging is required to induce him to book a liberal allowance.

Other writers also remarked on this trend in accounting practice. Grant and Norton (1955, 211), in their treatise on depreciation, wrote, "Prior to the passage of the first modern income tax law in 1913, many business enterprises had failed to recognize depreciation on their books as a regular business expense." They added, "Since 1913 the depreciation accounting practices of the business community have improved substantially."

May (1943, 127) recalled the tax developments in the 1910s relating to depreciation as follows:

> The first world war brought wider recognition of the importance of depreciation accounting in the determination of income. In the war taxation the logic of it was fully accepted, since it was recognized that under a system of very high taxation, preservation of the capital employed was essential to the continued effectiveness of the industrial machine. By the end of the war [in November 1918], depreciation accounting in the unregulated industries was fully established.

[4] See also Paton (1933, 578–579).

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By establishing the practice of recording depreciation on companies' books, the tax law, ironically, proved to be a factor in gaining acceptance for the accrual basis of accounting on the part of company accountants.[5]

Interestingly, Montgomery (1919, 1–3) observed that the impact of high taxes transcended just depreciation. He drew attention to the fact that the high taxes that Congress imposed in 1917, coupled with companies' substantial war-time profits, combined to serve a "house-cleaning" function for their balance sheets that, before 1917, had been burdened by overvalued assets and understated liabilities and reserves. The house-cleaning proceeded as follows during the high-tax, high-profit period (Montgomery 1919, 3):

> At the end of the year 1917…great numbers of balance-sheets underwent tremendous changes. The assets side was scrutinized by the boss himself before the books were closed and, if there was the slightest indication of overvaluation, ruthless cuts were made in the book figures. Plant accounts were written down to the lowest possible point by liberal depreciation charges and by reductions in amortization or obsolescence. Inventories of raw materials and finished products were reduced to a cash basis. The most liberal reserves were provided for possible losses in accounts receivable. All possible liabilities were set up in the books.

The conservative balance sheets emerging from this surgery were, he said, "a joy to behold."

The *laissez faire* attitude in the United States toward the recording of depreciation expense stood in sharp contrast to that in a number of continental European countries. Hatfield (1909, 124) wrote, "Germany, France, Belgium, Switzerland, Austria all prescribe in their statutes that depreciation must be reckoned before showing profits."

The Supreme Court Decision in 1920 on Realization

In 1920, the Supreme Court, by a vote of five to four, declared in *Eisner v. Macomber*, 252 U.S. 189 that a taxpayer's receipt of a common-on-common stock dividend was not a taxable event under the Constitution because this growth or gain in an asset being held was not taxable until it was "*severed from* the capital," that is, realized. It could not be just a "gain *accruing* to capital"[6] (both quotations from *Eisner v. Macomber*, 252 U.S. 189, 207; emphasis in the original).

George O. May (1950, 316, 317) wrote of the impact of this decision[7]:

> A review of accounting, legal and economic writing, suggests that the realisation postulate was not accepted prior to the First World War. In 1913 leading authorities in all these fields in England and America seemed to agree on the "increase in net worth" concept of income, though the way in which it could best be implemented was not settled, and unrealised appreciation was not perhaps deemed to be a part of "income *from operations*." (emphasis in the original)

> The conclusions of the [Supreme] Court lent support to the proposition that, until realised, assets should be carried at cost, and thus contributed to the building up in accounting literature of a so-called "traditional cost principle."

Chatfield (1974, 208; footnotes omitted) wrote on this development:

> The tax code continued to assimilate accounting methods and concepts.…most important was the influence of taxation in popularizing the realization principle. From the transactions approach used in determining taxable income, and from Court decisions [citation to *Eisner v. Macomber*], the idea emerged that realization must occur before income is earned. And since realization is most objectively measured at the time of sale, income should be recognized then. The method replaced the older approach to income determination in which assets were inventoried at the beginning and end of each year.

Storey (1959, 232–233; footnote omitted) wrote:

> This concept of profit [the realization rule] was gradually taking form during the period after the First World War and had become dominant in the field of accounting determination of net income by the late 1930's. That it was influenced by the concept of income laid down by the Supreme Court in early income tax litigation is quite obvious [citation to *Eisner v. Macomber*].

Broad (1954, 583) wrote that "the measurement of income by a process of asset valuation was formally discarded in favor of the realization concept" in the correspondence from a blue-ribbon committee of the American Institute of Accountants (since 1957, the American Institute of Certified Public Accountants (AICPA)) to the New York Stock

[5] I am grateful to Stefan Huber and Terry Warfield for this insight.
[6] For a discussion of *Eisner v. Macomber* in the context of court cases before and after, see Windal (1963).
[7] When referring to the Supreme Court, May did not cite *Eisner v. Macomber* by name, but it is clear from the context of his discussion of the Court's opinion that his reference was to that case. For an almost identical discussion, see the report of the Study Group on Business Income (1952, 23–28). May was the original draftsman of the report (Study Group on Business Income 1952, v).

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Exchange in 1932. In the committee's letter to the Exchange, which was drafted by George O. May, it proposed acceptance of five "broad principles," the first of which was "Unrealized profit should not be credited to income account of the corporation….Profit is deemed to be realized when a sale in the ordinary course of business is effected" (Special Committee on Co-operation with Stock Exchanges 1932, 14).

In the report of the American Accounting Association's (AAA's) 1964 Concepts and Standards Research Study Committee – The Realization Concept (1965, 313, 314), the committee observed that the "increase in net worth" concept of income on which leading authorities seemed to agree in 1913 "was gradually supplanted by one that emphasized the disposition of assets, their 'separation' from the firm," and then proceeded to quote from the *Eisner v. Macomber* opinion, concluding, "This view of income remains the dominant one in accounting today."

Of particular interest is that, in 1941, the Committee on Terminology of the American Institute of Accountants' Committee on Accounting Procedure, then chaired by George O. May, said in Accounting Research Bulletin No. 9 (Special) that the Supreme Court's definition of income in *Eisner v. Macomber* is "appropriate for adoption by accountants for general use as well as for tax purposes" (Committee on Accounting Procedure 1941, 510).

In addition to the *Macomber* decision, another very important explanation of the longevity in GAAP of historical cost accounting (and therefore realization) was its solid backing by the Securities and Exchange Commission (SEC) from the 1930s to the early 1970s (Zeff 2007).

The Emergence of LIFO and the "LIFO Conformity Rule"

The creation of the last-in, first-out (LIFO) treatment for merchandise inventories in the Revenue Act of 1938 was intended mainly to accommodate the adverse impact of the cyclical price behavior of nonferrous metals and petroleum on the measure of taxable income of refining and producing companies, respectively. It was followed by the Revenue Act of 1939, which extended LIFO to all taxpayers and is perhaps the best-known example of the impact of the tax law on accounting practice.[8]

Following passage of the 1938 Act, the Treasury created a committee of three leading accountants to consider the entire question of LIFO (Pincus 1989, 36–39). One of its members was Carman G. Blough, the immediate past SEC chief accountant and then a manager with Arthur Andersen & Co., who opposed LIFO and hoped that it would not be widely adopted. The committee recommended that the law be amended to require that companies could adopt LIFO for tax purposes only if they used LIFO in their financial statements, and this "LIFO conformity rule," as it came to be called, was included in the 1939 Act. In times of rising prices, LIFO would reduce both taxable income and accounting net income, making its adoption somewhat of a challenge to companies: would the benefit of lower taxes be justified by showing lower profits in reports to shareholders? LIFO immediately became controversial in accounting circles (Butters and Niland 1949, 40–41).

Between 1938 and 1940, only 32 companies, mostly in the nonferrous metals and petroleum industries, adopted LIFO (Butters and Niland 1949, 62). Pincus (1989, 42; footnote omitted) wrote, "Generally declining prices in the 1938–40 period provided little incentive for most firms to adopt LIFO." But in 1941, the number of LIFO adoptions vaulted by 62, covering a wider array of industries. Steeply rising wholesale prices and a high corporate tax rate in 1941—the top rate ascended to 81 percent (Luscombe 2022)—were among the precipitating factors (Pincus 1989, 43). By 1946–1947, 23 percent of the 525 companies whose corporate reports were surveyed by the American Institute of Accountants (1948, 15)[9] had adopted LIFO, even before the Institute's Committee on Accounting Procedure got around to acknowledging LIFO as an acceptable accounting method. That acknowledgment finally occurred in 1947, when the committee issued Accounting Research Bulletin No. 29, "Inventory Pricing" (Committee on Accounting Procedure 1947). In view of the already widespread adoption of LIFO, the committee could hardly have done otherwise. Yet the long delay in the committee's action on LIFO is curious. The Bulletin advised that, "where sales prices are promptly influenced by changes in reproductive costs, an assumption of the 'last-in first-out' flow of cost factors may be the more appropriate. Where no such cost-price relationship exists, the 'first-in first-out' or an 'average' method may be more properly utilized" (Committee on Accounting Procedure 1947, 198). Perhaps it was hoped that this advice might limit the number of LIFO adoptions, but the fact that this wording was not repeated six years later in the chapter on inventory pricing in Accounting Research Bulletin No. 43, the restatement and revision of previous Bulletins (Committee on Accounting Procedure 1953), suggests that it was not generally accepted.

[8] For extensive treatments of LIFO, see Davis (1982) and Hoffman (1953).

[9] The composition of the sample companies in the Institute's series of annual surveys evidently changed over the years. In the 1946–1947 edition, the industry coverage of the 525 companies was not given, but it was stated that "an attempt was made to select the larger companies in 21 manufacturing groupings, together with companies engaged in the retail and wholesale trades, in non-ferrous mining and in oil producing." In the 1980 edition, the survey was said to cover "the annual reports of 600 industrial and merchandising corporations."

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In the late 1940s, the retail and dollar value LIFO methods became available, making LIFO accessible to many more companies (Firmin 1963).

During the inflationary decade of the 1970s, the number of companies using LIFO for some or all of their inventories skyrocketed from 144 in 1971 to 374 in 1979, the latter representing 62 percent of the 600 surveyed companies (AICPA 1972, 77; AICPA 1980, 139).[10] But Tinkelman and Ling (2022, 108–109) made clear that the AICPA's samples were biased toward LIFO-using companies. Using a much bigger Compustat sample of companies, they showed that, from 1973 to 1981, the percentage of companies adopting LIFO did indeed rise considerably, but from 7.3 percent to 28.8 percent. Even with these Compustat data, it can be seen that the Revenue Acts of 1938 and 1939 and later extensions resulted in a considerable impact on the amounts at which merchandise inventory and cost of goods sold were shown in many companies' balance sheets and income statements.

Two writers argued that the great rise in the number of company adoptions of LIFO was unquestionably due to the tax benefits that it conferred. Backer (1955, 218) has written, "It is doubtful whether the extended use of LIFO would have occurred were it not for the expected tax advantages." Cannon (1952, 420) expressed the same view but more pungently, "Anyone who thinks that the spectacular swing to LIFO comes from an equally sudden awakening of accountants to its intrinsic merits *a la* some of the rationalizations, has got his head in the sand." Further, Butters and Niland (1949, 6) have written, "since 1939 few management decisions on LIFO have been made without reference to their tax effects. Decisions as to whether to use LIFO, how to apply it, and even as to the industries in which the method constitutes acceptable accounting practice, have been dominated by tax considerations."

Internal Revenue Code of 1954 Allows Accelerated Depreciation Methods

In August 1954, Congress overhauled the Internal Revenue Code, which, in Section 167(b), allowed taxpayers to use two methods of accelerated depreciation: double-declining balance (DDB) and sum-of-the-years'-digits (SOYD) for properties acquired after December 31, 1953.[11] Unlike in the case of LIFO, Congress did not require any conformity between tax depreciation and depreciation expense in companies' financial statements.

The report of the Senate Finance Committee in June 1954 gave the reason for these liberalized depreciation deductions (quoted in Grant and Norton 1955, 397–398):

> More liberal depreciation allowances are anticipated to have far-reaching economic effects. The incentives resulting from the changes are well timed to help maintain the present high level of investment in plant and equipment. The acceleration in the speed of the tax-free recovery of costs is of critical importance in the decision of management to incur risk. The faster tax writeoff would increase available working capital and materially aid growing businesses in the financing of their expansion. For all segments of the American economy, liberalized depreciation policies should assist modernization and expansion of industrial capacity, with resulting economic growth, increased production, and a higher standard of living.

Another argument supporting the liberalization of tax allowances was the very high inflation of 1945–1948. Such liberalization "would provide partial compensation for the fact that taxable profits are overstated due to the use of cost as a depreciation base" (Grant and Norton 1955, 389).

Already in 1954, a total of 101 companies in the American Institute of Accountants' annual survey of 600 industrial and commercial companies' annual financial statements reported using one or both of the two new depreciation methods or an undisclosed "accelerated" method (American Institute of Accountants 1955, 139). Lent (1962, 483–484; footnote omitted) reported, "In 1960,…61 percent of large corporations and 92 percent of smaller businesses reflected substantially the same [depreciation tax] allowances on their financial statements. The minority apparently believed that accelerated depreciation did not properly reflect business income." By 1979, the AICPA's annual survey of companies' annual financial statements reported that the number of companies using an accelerated depreciation method increased to 168 (AICPA 1980, 278).[12]

Yet there was a further side to this story: when companies used different depreciation methods for tax than for financial reporting purposes, tax allocation (deferred tax) accounting came into view. In October 1954, a scant two months after passage of the Internal Revenue Code, the Institute's Committee on Accounting Procedure (1954) hustled to issue Accounting Research Bulletin No. 44, "Declining-Balance Depreciation," in which it gave its blessing to the DDB and SOYD methods as being "systematic and rational" and therefore qualified to be included in GAAP. The

[10] For more on the trend of company adoptions of LIFO over the years, see Barden (1973, 95–96).

[11] The Revenue Act of 1939 had allowed taxpayers to use the declining balance method at one and one-half times the straight-line rate. See Cohen (1954, 547).

[12] In the AICPA's survey, 97 companies said they used DDB or SOYD, and a further 71 said they used an "Accelerated method—not specified." I interpret "accelerated method" to mean DDB or SOYD but without disclosing which one was used.

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committee foresaw that many companies might adopt an accelerated method for tax purposes but continue to use the straight-line method in their financial statements, giving rise to the need for tax allocation.

The committee had previously gone on record as favoring tax allocation (Committee on Accounting Procedure 1945), but it was felt to be important to signal its applicability in the many instances when there was a difference in depreciation methods used. In the committee's initial utterance in Bulletin No. 44 on tax allocation when different depreciation methods were being used, it expressed itself in the softest possible terms:

> There may be situations in which the declining-balance method is adopted for tax purposes but other appropriate methods are followed for financial accounting purposes. In such cases it may be that accounting recognition should be given to deferred income taxes. However, the committee is of the opinion that, in the ordinary situation, deferred income taxes need not be recognized in the accounts unless it is reasonably certain that the reduction in taxes during the earlier years of use of the declining-balance method for tax purposes is merely a deferment of income taxes until a relatively few years later, and then only if the amounts are clearly material.

This version of tax allocation, where one attends to the likely length of time before the deferment is reversed, has come to be known as "partial" tax allocation.

Four years later, after the committee (Committee on Accounting Procedure 1958) had reconsidered the soundness of the partial approach, it issued Bulletin No. 44 (Revised) in which it dropped the partial approach in favor of "comprehensive" tax allocation. Under this approach, no attention is paid to how long the deferment is likely to exist. Many companies were potentially affected by the committee's categorical support for tax allocation when they used different depreciation methods, which led in future years to the issuance of several highly contentious standards on tax allocation. There was considerable debate in the accounting literature over the propriety of tax allocation (Keller 1961; Wheeler and Galliart 1974).

In the AICPA's annual surveys of 600 companies' annual reports, entitled *Accounting Trends & Techniques*, under the heading of Tax Reserves, the number of companies displaying a Deferred Tax Credit arising from the adoption of DDB or SOYD only for tax purposes increased significantly from 1954 to 1965, as shown in the following table:

1954	1955	1956	1957	1958	1959	1960	1961	1962	1963	1964	1965
2	7	16	23	51	57	62	68	180	288	328	348

Clearly, the tax law's support for DDB and SOYD in 1954 had a significant impact on the amounts shown in income tax expense and net income in many companies' financial statements. One can now appreciate why the figures on companies' adoption of DDB or SOYD for depreciation expense were so modest: many companies preferred to continue using the straight-line method and therefore account for the tax allocation.

The Short-Lived Provision for "Estimated Expenses"

The Internal Revenue Code of 1954, in Section 462, provided that taxpayers may deduct "estimated expenses" for such items as accrued vacation pay, sales discounts, advertising allowances, and the costs of performing under warranty agreements in the year in which they could be estimated with a reasonable degree of accuracy, even if they had not yet been incurred in the legal sense of the term. However, the proposed regulations for Section 462 specified that these items could be deducted *only* if the taxpayer were to reflect the same estimated expenses in their financial statements, a LIFO-like conformity rule.[13] Cohen (1956, 210), wrote, "The effect upon accounting practice of this particular provision of the 1954 Code was rapid and significant. Many financial reports for 1954 reflected for the first time expenses on an estimated basis…[which] carried many business firms well beyond the limits that would have been advisable under generally accepted accounting principles." Suddenly, audit firms found themselves pressed by clients to advise them of the maximum amount of estimated expenses that could be deducted under the law. Once the Treasury concluded that the revenue loss from this provision would be many times the original estimate, it got Congress to repeal the provision in June of the following year. Yet again, the lure of an early reduction in taxable income induced companies to alter their financial accounting practice to match the tax deduction (Cohen 1956, 208–210; Lent 1962, 481–482).

[13] The proposed regulations for Section 462 were published in the *Federal Register* on January 22, 1955. The final regulations, published on June 11, 1955 (§ 1.462-1(a)(2)), were identical to those proposed.

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Reporting of Credit Losses by Banks[14]

Banks' accounting for credit loss allowances—that is, the accrual of estimated credit losses, comparable to company accounting for doubtful accounts receivable—began in 1948 but only after the tax law was changed to make such allowances deductible. Yet there was no LIFO-like conformity requirement. Walter (1991, 24; footnote omitted) wrote:

> On December 8, 1947, the Commissioner of Internal Revenue liberalized its policy for banks by ruling that banks' reserves [i.e., allowances] for loan losses could be calculated in a manner that differed from that of other businesses. Banks were allowed to hold a reserve for loan losses equal to three times their average yearly loan loss experience of the past 20 years. Soon after the 1947 ruling most large banks and many small banks began holding reserves for loan losses.

Before 1948, "most banks relied instead on the 'specific charge-off method'…[which] involved the subtraction of loan losses from current income or net worth when the loan was charged off" (Walter 1991, 24). Schroeder (2023, 237–238; footnote omitted) has written, "Prior to 1947, banks generally did not recognize allowances for credit losses. The modern era of recording allowances started in December 1947 when Internal Revenue Service (IRS) rules began to permit their deductibility. Banks were incentivized by this tax change to maximize loan loss provision expenses that led to building allowances for credit losses." This was yet another instance of accrual accounting being reinforced by a provision in the tax law.

Inventories: Lower of Cost or Market and the Base-Stock Method

On the subject of "lower of cost or market" for inventories, Gilman (1939, 17; footnote omitted) wrote:

> The illogical rule of cost or market [for inventories], while not originating in this country, became popular here upon the advent of the Federal income tax program. Paton (1938) says that: "The early American enthusiasm for the device—among trade associations, business managements, and corporate accountants—was not a tribute to the merits of the scheme as a worthwhile accounting mechanism—but as an immediate method of reducing taxable income."

McLaren (1947, 179) added the following view:

> Long before the advent of income taxation the accounting profession advocated the principle that inventories should be stated for balance-sheet purposes and in the determination of income at the lower amount of cost or market. Upon the sanction of the rule by the Treasury Department in 1917, most corporations engaged in mercantile activities availed themselves of the tax economies thus permitted.

Yet not all agreed. Sanders, Hatfield, and Moore (1938, 74) wrote, "Rules like the lower of cost or market were devised as an aid to prudent business management and for the protection of investors, and not for tax purposes." May (1925, 253) wrote that the lower of cost or market method was "one of the best trade practices" at the time. It is not entirely clear whether, over the years, tax rules influenced accounting practice or accounting practice influenced tax rules regarding the acceptance of the lower of cost or market method (Simon 1956).

McLaren (1947, 183) said the following about the base-stock method of inventory valuation, which was superseded in the 1930s by LIFO: "This method has never been accepted for income tax accounting; hence, its use has been limited."

The Installment Basis of Reporting Income

Backer (1955, 218) argued that the differences between tax accounting rules and accounting principles "have created a number of serious problems. Perhaps of greatest significance is the disturbing tendency to adjust accounting standards so as to conform to tax concepts. This has occurred in a number of areas as for example, amortization of defense facilities, installment basis of reporting income, deferred compensation plans, depletion and the use of the last-in, first-out method for pricing inventories." The installment method of reporting income was introduced in the Revenue Act of 1926 (Lent 1962, 482).

The propriety of the installment method of reporting income was criticized by the AAA's Committee on Concepts and Standards Underlying Corporate Financial Statements (1952, 429; footnote omitted) in its Supplemental Statement No. 4, "Accounting Principles and Taxable Income":

[14] I am grateful to Hal Schroeder for suggesting the inclusion of this subsection.

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> The tax laws have unduly and unintentionally tended to influence the development of corporate accounting in that to some extent legislative concessions in measuring taxable income have been adopted into accounting practice without justification in principle. An illustration of this is the installment basis of reporting income, when the consideration is received over a period of time. There is no sound accounting reason for the use of the installment method for financial statement purposes in the case of closed transactions in which collection is dependent upon lapse of time and the probabilities of realization are properly evaluated.

Paton (1933, 1080; bold face deleted) corroborated this tax influence: "The fact that income taxes can be deferred…through the use of the installment method of reporting income—a method of reporting income in proportion to receipts—has been a major influence in securing the wide adoption of this method" [for reporting purposes].

Amortization of "Emergency Facilities" during World War II

The AAA's Committee on Concepts and Standards Underlying Corporate Financial Statements (1952, 429–430) also criticized the propriety of the 60-month amortization of "emergency facilities" (or defense facilities) during World War II: "Another example [of the undue influence of the tax laws] is the practice common during World War II of reflecting amortization of 'emergency facilities' in financial statements in amounts corresponding to allowable tax deductions even though in some cases the expected useful life of the facilities was longer than the statutory sixty months." Bailey (1946, 45), Paton (1948, 284), the Committee on Accounting Procedure (1947, paragraph 2), and the U.S. SEC (1947, 114) all corroborated this tax influence on GAAP, namely, on the use in accounting records of the 60-month accelerated amortization of "emergency facilities" during the war.

Research and Development Expenditures

Drebin (1966, 414) has written, "At present, most firms follow the practice of charging all research costs to current expense regardless of the accounting periods which are expected to benefit from these expenditures. This procedure is undoubtedly influenced by income-tax considerations." Although this view was expressed about practice in the mid-1960s, it would very likely have prevailed also in the 1950s, following Section 174 in the Internal Revenue Code of 1954, which, for the first time in statute law, allowed the immediate deductibility of research and development (R&D) expenditures. In this regard, Gellein and Newman (1973, 20) wrote,

> The influence of tax practice on accounting practice cannot be determined but the change in the Revenue Act [of 1954] seems in retrospect to have been the final blow to the accounting practice of deferring research and development costs. Although tax procedures should not influence the development of accounting procedures, they seem to have done so.

Even before 1954, the Bureau of Internal Revenue[15] allowed a deduction for R&D expenditures so long as the taxpayer followed this practice in its financial accounting, which led to many companies expensing their R&D expenditures as well (Raby 1964).

Employee Stock Options

Income tax considerations also affected the accounting for employee (or executive) stock options. Under Section 130-A of the Revenue Act of 1950, to secure favorable tax treatment when issuing employee stock options, a company had to set the exercise price on the grant date at an amount not much lower than the stock price (Sweeney 1960, 81–85). If the two were equal, no compensation expense would be shown in the company's income statement, and this was the prescription set by the Committee on Accounting Procedure in Chapter 13B in Accounting Research Bulletin No. 43, issued in 1953. Thus, the tax law influenced the setting of the terms of the option grant, which in turn shaped the company's accounting practice (Raby 1962; Bomeli 1962). Bohan (1979, 261) wrote, "The use of stock options in executive compensation packages increased significantly with the amendments to the Revenue Act of 1950, which granted specialized tax treatment to certain types of stock option plans….The accounting rules generated at that time were quite attuned to the tax rules." Cannon (1952, 420) has written that, for deferred compensation and pension plans, "The reporting of cost has been in part or wholly dictated by deductibility for tax purposes, though perhaps in lieu of agreement on an alternative."

[15] The Bureau of Internal Revenue was renamed the Internal Revenue Service in 1953.

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Tax Law as an Obstacle to the Reform of GAAP

Advocates of reform in GAAP have acknowledged that they face an obstacle in the tax law. Grady (1959, 60), who had been arguing for price-level depreciation, wrote, "It may be of interest to note that Treasury Department officials have made it clear that they will not endorse any price-level depreciation allowance for tax purposes unless it is coupled with appropriate recognition in the accounts. This suggests that the possibility of obtaining tax reform would be greatly improved if the accounting profession would remove the roadblock created by [Chapter 9 of Accounting Research Bulletin No. 43]." Grady (1965, 56) later opined, quite oppositely, that "The emphasis in business thinking in the United States in regard to [accounting for] inflation has been to seek income tax allowance of price-level deprecation before price-level adjustments are made in the accounts. Accordingly, for this and other reasons, we remain for the most part on an historical dollar basis for accounting."[16]

Paton (1940, 134), a leading advocate of showing depreciation at current cost, advised that, because the income tax law is predicated on historical cost, any use of current cost in financial statements must not be allowed to "obscure" the recorded historical cost.[17] He added (Paton 1940, 136, footnote):

> [I]t must be remembered that there is at present no authoritative recognition of the right to compute income otherwise than by matching revenues with dollar costs actually incurred, and in the face of this situation the accountant cannot escape the obligation of presenting somewhere in the income statement, in a clear and unmistakable manner, the legally recognizable income available for income taxes.

These concerns expressed by reformers Grady and Paton were instances of what Hendriksen (1965, 40), quoted above, said was how the Revenue Acts were "a deterrent to experimentation."

Impact of Treasury's Bulletin "F" on Depreciation Rates in Accounting

An interesting question is whether the Treasury Department's 1942 edition of Bulletin "F," which "provided 'average useful life' estimates for over 5,000 types of assets used in 57 different industry activity categories" for use as guidance when determining depreciation rates for tax purposes, also influenced accounting practice (Brazell et al. 1989, 11). Grant and Norton (1955, 142) advised that Bulletin "F" "should be purchased by everyone who is responsible for setting straight-line depreciation rates for accounting purposes." Devine (1955, 349) wrote, "The value of assets that are fully depreciated on the books of business enterprises is certainly staggering. Businessmen often use [in their books] the maximum rates suggested in the Treasury Department's *Bulletin F*." The 1942 edition of Bulletin "F" stipulated the following "link" to the taxpayer's operating policy and accounting practice (U.S. Treasury Department and Bureau of Internal Revenue 1942, 11):

> A reasonable rate for depreciation is dependent not only on the prospective useful life of the property when acquired but also on the particular conditions under which the property is used as reflected in the taxpayer's operating policy and accounting policy followed with respect to repairs, maintenance, replacements, and charges to the capital asset account and to the depreciation reserve.

Impact of the Nondeductibility of Goodwill on Accounting for Business Combinations[18]

In 1950, the Committee on Accounting Procedure (1950), in Accounting Research Bulletin No. 40, formally accepted "pooling of interests" accounting, by which the assets in qualifying mergers and acquisitions would be recorded at their combined historical-cost balances, with no recognition of goodwill. Arnett (1969, 391) wrote, "The fact that goodwill cannot be amortized for tax purposes has unduly influenced accountants to follow the pooling concept, rather than the purchase concept, when handling business combinations."

Sundry Other Impacts of the Tax Law on Accounting

Before passage of the Internal Revenue Code of 1954, Bailey (1948, 688) complained that "the preference of the tax authorities for straight-line depreciation has almost driven out other useful methods…because many corporations have desired to have their books agree with the tax bases of depreciation."

[16] Paton (1950, 18) expressed a similar view as that set forth by Grady.
[17] Paton (1980, 629) has written that "I added as a supplement, with my co-author's consent," the section of the Paton and Littleton monograph entitled "Interpretation." Hence, Paton was the author of that section.
[18] I am grateful to one of the journal's reviewers for suggesting the inclusion of this subsection.

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Gilman (1939, 31) wrote, "The effect of income taxation in influencing a shift from the balance sheet to the profit and loss viewpoint [in the 1920s and 1930s] is obvious." Yet there were other factors contributing to this shift: the vast increase in the population of retail investors in company shares in the 1920s and the establishment of the SEC in 1934, which was charged with "investor protection." In turn, the Committee on Accounting Procedure, which became the first accounting standard setter in 1939, was much influenced by the views of the SEC's chief accountants (Zeff 2021, 18–23).

The Committee on Accounting Procedure's (1941, 510) Committee on Terminology wrote, "No doubt the income tax is largely responsible for the extension of the use of the term 'income' into the industrial field and of the use of the expression 'income account' (or 'statement'), one result of which has been to reduce the term 'profit-and-loss account' to a state of ill-defined subserviency to the term 'income account'."

Sanders et al. (1938, 66) wrote that the classification of intangible assets on the balance sheet, whether as a deferred charge or otherwise, "is sometimes influenced by the regulations and rulings of the Bureau of Internal Revenue, under which most intangible items may not be written off as allowable deductions."

Pros and Cons of Tax Effects

Although most of the views quoted above from published writings by academics and practitioners about the effects of the tax law on GAAP were critical, Hendriksen (1965, 39–40) has catalogued several favorable and unfavorable impacts of the tax law on accounting practice (and thought):

> [T]he tax laws have been responsible for the development of accounting thought. *First*, the laws were important in bringing the average accounting practice up to the standards of the better practices of the times. This created an improvement in general accounting practices and in the maintenance of consistency. *Second*, the provision for depreciation included in the 1909 Act and subsequent acts gave rise to the use of systematic depreciation methods, a search for better depreciation concepts, and more appropriate methods of calculating depreciation cost. *Third*, the requirement in the 1918 Act making inventories mandatory where necessary in the determination of income brought about widespread discussion relating to the appropriate methods of inventory valuation. *Fourth*, the acceptance of cost or market, whichever is lower, in the valuation of inventories in the early regulations led to a general adoption of this procedure and to discussions regarding the propriety of the concept. (emphasis in the original)

> In more recent years, the income tax rules have had a considerable adverse effect on accounting theory and principles. The tendency to accept income tax provisions as accepted accounting principles and practices is unfortunate. The following are examples: (1) Any depreciation method acceptable for tax purposes is acceptable for accounting purposes also regardless of whether or not it follows good accounting theory in the situation. (2) LIFO must be used for financial reporting purposes if it is used in the tax return. (3) Many items (e.g., research and development expenditures) that should be capitalized are charged to expense to obtain the earliest possible tax deduction. (4) Since the tax law does not permit it, no provision is generally made for "accruing" repair and maintenance expenses except indirectly and haphazardly through accelerated depreciation.

III. CONCLUSIONS

The foregoing discussion of the numerous impacts of the tax law on accounting practice from 1909 to the 1950s was drawn from the views of academics and practitioners who witnessed them firsthand. Some of the impacts contributed to an improvement in practice, whereas others were seen as deleterious.

Many of the contemporary writers who were cited or actually quoted in the paper, when attesting to the impact of the tax law on GAAP, were critical of what they observed. Even when the impacts were salutary, as with the very first episode addressing the influence of the tax law on the systematic booking of depreciation, the writers very much regretted that the stimulus for the improvement in GAAP was action by government and not a recommendation from leaders of the accounting profession.

The main contribution of this paper is to reveal and discuss in one place the many and varied impacts of the income tax law on GAAP during an era, from 1909 to the 1950s, when there was no authoritative GAAP for the first 30 years, followed by 20 years when authoritative GAAP frequently allowed optional treatments. An appreciation of historical antecedents is essential to a full understanding of present-day GAAP, and the mission of this paper has been to enrich our knowledge of those antecedents by bringing to light many of the impacts of the tax law on GAAP. As an example, if a standard setter or a teacher in a theory seminar were in search of an explanation for the long-standing entrenched position of historical cost/realization when accounting for property, plant, and equipment, two sources could be cited: the

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SEC's well-known antipathy toward upward valuations since its founding in 1934 and, even earlier, the impact on accounting practice of a momentous decision by the Supreme Court in 1920.

The main limitation of this study is that the source of all the episodes discussed in the paper was their revelation in the published writings by contemporary academics and practitioners. There may have been other tax impact episodes that were omitted from the paper because of being unable to find any contemporary published writings attesting to their existence.

As stated at the outset, the objective of this study has been to bring these many impacts to light, so that academics, practitioners, and standard setters can come to appreciate the widespread influence of the tax law on accounting practice. A companion objective is specifically to inform the authors of accounting textbooks, many of whom may believe the assertion in one recent textbook, namely, that LIFO "is one of the very few instances in which tax policy has influenced GAAP" (Revsine, Collins, Johnson, Mittelstaedt, and Soffer 2021, 1–32).

It is this author's experience that relatively few accounting textbooks draw attention to the tax influence on accounting practice, even about LIFO. In the author's view, accounting instructors, even in the first course in financial accounting, should point to instances, such as LIFO and the methods of accelerated depreciation, where accounting practice has been influenced by changes in the income tax law. In the intermediate accounting courses, the textbooks and teachers should point to an even broader array of such influences and stimulate a discussion about whether these influences have enhanced or worsened the quality of financial reporting.

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