



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
KATHERINE M. ROCKHOLD)

Appearances:

For Appellant: David K. Tone, Attorney at Law.

For Respondent: W. M. Walsh, Assistant Franchise Tax Commissioner; Harrison Harkins, Associate Tax Counsel.

OF _IN _ION

This appeal is made pursuant to Section 19 of the Personal Income Tax Act (Chapter 329, Statutes of 1935, as amended) from the action of the Franchise Tax Commissioner in overruling the protest of Katherine M. Rockhold to a proposed assessment of additional tax for the year ended December 31, 1935, in the amount of \$805.10.

During the year 1935 the Appellant paid taxes on certain property located in Cook County, Illinois, and also paid interest on real estate loans secured by that property. In computing her tax for that year she treated the amounts so paid as deductions from gross income. The Commissioner disallowed \$4,385.45 of the deduction for interest and \$17,063.11 of the deduction for taxes on the ground that these amounts represented obligations incurred prior to January 1, 1935, which, under Article 36 of the Regulations Relating to the Personal Income Tax Act of 1935, did not constitute allowable deductions even though Appellant computed her net income upon the basis of cash receipts and disbursements. The taxes disallowed were for the years 1931 to 1934, inclusive. The interest disallowed was for periods prior to 1935; e. g., in the case of an interest payment made in 1935 for the period July 1, 1934, to June 30, 1935, the Commissioner disallowed one-half of the amount paid as applicable to the period from July 1, 1934, to December 31, 1934, even though the entire amount was not due until 1935.

The Appellant maintains that Article 36 is invalid because it is contrary to the provisions of the Personal Income Tax Act of 1935, and that even if it is otherwise valid, it cannot affect the computation of taxes for the year 1935 since the Regulations were not prescribed until February 26, 1936. The

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Appellant also cites an Illinois Statute (Ill. Rev. Statutes, 1937, State Bar Assn. Ed., pp. 2648-2650) under the provisions of which taxes for the years 1933 and 1934 did not become delinquent until January 1, 1935, and subsequent dates? and contends that by reason of this circumstance the deduction of the Illinois taxes for these years is not prohibited by Article 36, even if that Regulation is otherwise applicable to the year 1935.

The relevant provisions of the Personal Income Tax Act are as follows:

sec. 2. For the purposes of this act and unless otherwise required by the context--

(j) the words "**paid or** incurred" and "paid or **accrued**" shall be construed according to the method of accounting upon the basis of which the net income is computed under this act.

Sec. 8. In computing net income there shall be allowed as deductions:

(b) All interest paid or accrued within the taxable year on indebtedness of the taxpayer; ...

(c) Taxes or licenses paid or accrued during the taxable year ...

Sec. 16. (a) The net income shall be computed upon the basis of the taxpayer's annual accounting period . . . in accordance with the method of accounting **regularly employed** in keeping the books for such taxpayer; but if no such method of accounting has been so **employed**, or if the method employed does not **clearly** reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income ...

(d) The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the methods of accounting permitted under subsection (a) of this section, any such amounts are to be properly accounted for as of a different period ...

(e) The deductions and credits provided for in this

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act shall be **taken for** the taxable year in which "paid or accrued" *or* "paid or incurred"? dependent upon the method of accounting upon the **basis** of which the net income is computed, unless in order clearly to reflect the income the deductions or credits should be taken as of a different period ...

Sec. 36. This act ... shall **apply to the** net income of persons taxable **hereunder** received or accrued on and after January 1, 1935.

Article 36-1 of the Commissioner's Regulations provides as follows:

Ordinarily, a taxpayer reporting on the cash receipts and disbursements basis must report all income received during his taxable year even though accrued in a prior year and may deduct all amounts paid during such year, even though incurred in a prior year. However, income accrued prior to January 1, 1935, is not taxable and need not be reported, even though the income is received on or after that date and even though the taxpayer reports on the cash receipts and disbursements basis. Thus, salaries and other compensation for personal **services** earned in 1934 or prior **years**, for example, is not taxable even though received **in** 1935 or subsequently. Furthermore, obligations incurred prior to January 1, 1935, may not be deducted, even though paid on *or* after that date by a taxpayer reporting on the cash receipts and disbursements basis. Thus, delinquent taxes for years prior to 1935, rentals, salaries or other business expenses incurred in **1934** or prior years are not **deductible**, even though paid in 1935 or subsequently.

It is apparent that under the provisions of Section 16 the Commissioner is vested with considerable discretion and may require that, for the purposes of the Act, income be computed according to a method different from that employed in keeping the books of the taxpayer. Comparable provisions of the Federal income tax statutes have been so construed by the United States Supreme Court. See Lucas v. American Code Co., 280 U. S. 445, 449; Brown v. Helvering, 291 U. S. 193, 203. Consequently, any practice or regulation adopted by him in this *con-*nection should not be rejected unless clearly unlawful. Lucas v. American Code Co., *supra*.

In referring to methods of accounting the statutory provisions quoted above clearly contemplate the two systems of reporting that have been developed and received recognition in the administration of the Federal income tax laws, namely, the so-called "cash receipts and **disbursements**" and the "**accru-**al" methods. See Aluminum Castings Co. v. Routzahn, 282 U. S.

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92. It has been recognized that the accrual basis of reporting is the more scientific and that it more accurately reflects the actual gains and profits of each period than does the cash receipts and disbursements basis. *See* 1 Paul and Mertens, Law of Federal Income Taxation, 548; *Magill*, Taxable Income, 165; *United States v. Anderson*, 269 U. S. 422.

In the case of many types of taxpayers such distortion of annual income as may be caused by the use of the cash basis is relatively slight, ordinarily resulting only in the income affected being taxed in one year rather than another and not justifying the requirement that the accrual method be followed by all taxpayers, *See Magill*, *supra*, 166. In cases, however, in which large items of income or expense earned or incurred prior to January 1, 1935, were not received or paid, respectively, until on or after that date, it is obvious that the unrestricted use of the cash basis would have an important bearing on the aggregate amount of income subject to the tax, and would often cause particular individuals to be unduly favored or discriminated against. *Thus*, in the instant matter, if the Appellant should be allowed to deduct the delinquent taxes she will be favored over the great mass of taxpayers who paid their taxes and other expenses during the years in which they fell due. Conversely, taxpayers, who as a result of unusual circumstances did not receive until 1935 large amounts earned by them and falling due prior thereto, would bear a disproportionately heavy tax burden if they were compelled to include such items in their 1935 incomes.

We are of the opinion that as a means of eliminating or alleviating this condition the Commissioner was justified in providing in Article 36 of the Regulations, that income accrued and expenses incurred prior to January 1, 1935, should not be considered in the computation of net income under the Act.

On the basis of statutory provisions similar to Section 16, the Court of Appeals of Kentucky in *Reeves v. Turner*, 289 Ky. 426, 158 S. W. (2d) 973, upheld the action of the Department of Revenue of that State in disallowing the deduction in a return of income for 1936 of a taxpayer on a cash basis of the amount of a Federal income tax payment made in 1936. The Federal tax was based on income earned prior to 1935 and should have been paid prior to the effective date of the state tax act. Although the factual situations involved in that action and in the instant case are not identical, the tax there in question having been due in a year prior to that in which it was paid whereas the amounts for which deductions were here disallowed were in part at least due in the year in which paid, it is to be observed nevertheless that the Court denied to a taxpayer reporting on a cash basis a deduction for a tax paid during the year and stated that "The true income of appellees for the year in question was not reflected where such a deduction was made."

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While it is contended that Article 36-1 is contrary to the express provisions of Section 36 of the Act, we do not find in the provisions of that Section any language compelling the conclusion that taxpayers keeping their accounts on the cash basis may or must report all their income and deductions on that basis. The Section states merely that the Act "shall apply to . . . net income . . . received or accrued on and after January 1, 1935", cash or the accrual method be used in computing the net income subject to the tax. We are, accordingly, unwilling to conclude that Section 36 was intended as a limitation upon the discretion vested in the Commissioner by Section 16 of the Act. Since the provisions of the Act did not give the Appellant any unequivocal right to take the deductions in question, the fact that Article 36-1 was not prescribed until February 26, 1936, does not present any obstacle to its application in computing taxes for the year 1935.

There remains for consideration only the question whether the taxes and interest represent obligations incurred prior to January 1, 1935, within the meaning of Article 36. Inasmuch as the taxes were imposed for 1934 and prior years, and became liens upon the property on the first day of April of the respective years for which they were imposed (Ill. Rev. Statutes, 1937, State Bar Assn. Ed. p. 2648), no possible basis appears upon which they may be regarded as having accrued or been incurred in a subsequent year. The fact that the taxes for 1933 and 1934 did not become delinquent until on or after January 1, 1935, is immaterial. An obligation "accrues" or is "incurred" at the time the liability is created (United States v. Anderson, 269 U. S. 422) and not at the time when payment is required. A like conclusion must be reached with regard to the interest, which for both income tax and accounting purposes is regarded as accruing ratably over the period of the loan, regardless of the date when it is due. Higginbotham-Bailey-Logan Co. v. Commissioner, 8B. T. A. 566, 577; Jamison v. Commissioner 18 B. T. A. 399, 404; Montgomery, Auditing Theory and Practice (5th Ed., 1934) 347.

O R D E R

Pursuant to the views expressed in the opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED that the action of Chas. J. McColgan, Franchise Tax Commissioner, in overruling the protest of Katherine M. Rockhold to a proposed assessment of additional tax in the amount of \$805.10 for the year ended December 31, 1935, be and the same is hereby sustained.

Done at Sacramento, California, this 2nd day of December, 1942, by the State Board of Equalization.

R. E. Collins, Chairman
George R. Reilly, Member
Wm. G. Bonelli, Member

ATTEST: Dixwell L. Pierce, Secretary