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dictions will deal with the right of a subrogee to sue under Tort Claims Acts remains to be seen as proper cases for determination arise, but it would seem that the trend clearly points towards liberal construction of such Acts and the allowance of suit either by the subrogor for the use of the subrogee or by the subrogee in his own name.

Z. CREIGHTON BRINSON

**Taxation—Income—Involuntary Change from Cash to Accrual Basis of Accounting—Accounts Receivable and Inventory**

Many small businessmen, unwary of tax pitfalls and without adequate accounting systems to record the operation of their businesses, are jolted when the tax lightning strikes with a substantial deficiency for a particular year due to the Commissioner's changing their method of reporting income. In one of the typical situations, the partnership's books were kept on the basis of cash receipts and cash disbursements. Accounts receivable reflecting credit sales were not included in the determination of income but inventories were used in determining the cost of goods sold. The Tax Court approved the Commissioner's determination that the partnership should report its net income on the accrual basis and for the year of the change should add the amount of accounts receivable at the beginning of the year to the proper amount of income determined on the accrual basis.[1]

The Internal Revenue Code requires that net income 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.[2] But if the method of keeping books does not clearly reflect the income, the Commissioner is authorized to make a recomputation on such basis as, in his opinion, will clearly reflect the income.[3] Where inventories are required,[4] as in the principal case,[5] the accrual method of accounting must be used.[6] However, the discretion given the Commissioner to

[1] David W. Hughes, P-H 1953 TC MEM. DEC. ¶ 53,285 (1953).

[2] INT. REV. CODE § 41, provides in part: "The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) 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 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."

[3] *Ibid.*

[4] U. S. Treas. Reg. 118, § 39.22 (c)-1 (1953), provides in part: "In order to reflect the net income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor."

[5] Note 1 *supra.*

[6] U. S. Treas. Reg. 118, § 39.41-2 (1953), provides in part: ". . . in any case in which it is necessary to use an inventory, no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method."

decide which method is necessary to reflect clearly the taxpayer's net income is not unlimited and will be reviewed when abuse is clearly shown.[7]

Under the cash system of reporting only receipts and disbursements of cash or its equivalent are considered in determining income.[8] Sales on credit, giving rise to accounts receivable, are not reported as income until payment is received. Therefore, when the Commissioner requires the taxpayer to change to the accrual method,[9] the balance of accounts receivable at the beginning of the year of change represents unreported sales made in prior years. The collection of these accounts would be excluded from income, since under the accrual method, sales are recognized as income in the year in which they are made. To avoid this result the Commissioner has attempted to add the amount of accounts receivable at the beginning of the year of change to the income computed on the accrual basis for the year as was done in the principal case. The effect is to pyramid income into one year.[10]

There is a similar problem with regard to inventory at the beginning of the year of change. This inventory represents purchases which have been deducted as expenses in prior years whenever payment was made for the merchandise. If the opening inventory is included in the cost of goods sold, the taxpayer will receive the advantage of a double deduction of this expense. Since under the accrual method the opening inventory is used in determining the cost of goods sold (opening inventory + purchases − closing inventory = cost of goods sold) the Commissioner has attempted to add the inventory value at the beginning of the year to the income computed on the accrual basis. The effect of this adjustment is to eliminate the use of the opening inventory in determining the cost of goods sold, further bunching income into a single year.[11]

The reception given by the courts to the Commissioner's attempt to bunch income is reflected in decisions lacking in clarity and con-

[7] Brown v. Helvering, 291 U. S. 193, 203 (1934); Lucas v. American Code Co., 280 U. S. 445, 449 (1930); Hardy v. Commissioner, 82 F. 2d 249, 250 (2nd Cir. 1936).

[8] The receipts and disbursements may be actual or constructive. For a discussion of the cash method, see I MONTGOMERY'S FEDERAL TAXES, pp. 1116-1118, (1952).

[9] The accrual basis ordinarily ignores the receipts and disbursements of cash or its equivalent as the basis for determining income. Under the accrual system, income is recognized whenever the right arises to receive cash or other property, regardless of when collection or other receipt actually occurs. A deduction from income is generally recognized during the accounting period in which the liability is incurred, regardless of when payment is made. For a discussion of the accrual method, see I MONTGOMERY'S FEDERAL TAXES, pp. 1118-1120 (1952).

[10] For a brief discussion of the pyramiding aspects and other effects of a change from an incorrect cash basis to a proper accrual basis see, Note, 37 A. B. A. J. 694 (1951).

[11] *Ibid.*

sistency.[12] The decisions upholding the Commissioner have been based on the principle that it is within the Commissioner's discretion in changing the method of accounting to add income that would otherwise escape taxation.[13]

Beginning with *Commissioner v. Mnookin's Estate*[14] in 1950, the courts began to distinguish between a change of accounting method and a change of reporting method.[15] If the taxpayer properly kept his books on the accrual basis but erroneously reported on the cash basis the Commissioner could not pyramid income in the year of change.[16]

[12] For a collection of cases and discussion, see Rabkin and Johnson, FEDERAL INCOME, GIFT AND ESTATE TAXATION, § 12.03 (3) (1953).

[13] Carver v. Commissioner, 173 F. 2d 29 (6th Cir. 1949); Hardy v. Commissioner, 82 F. 2d 249 (2nd Cir. 1936); Michael Lovallo, P-H 1950 TC MEM. DEC. ¶ 50,184 (1950); Schuman Carriage Company v. Commissioner, 43 B. T. A. 880 (1941); Alameda Steam Laundry Association v. Commissioner, 4 B. T. A. 1080 (1926); Appeal of John G. Barbas, 1 B. T. A. 589 (1925).

[14] 184 F. 2d 89 (8th Cir. 1950). In this case the taxpayer kept his books on the accrual basis. However, in the tax returns the amount of uncollected credit sales (accounts receivable) at the end of each taxable year were excluded from income. The Commissioner changed the method of reporting and in the year of change added the beginning balance of accounts receivable to the proper income computed on the accrual basis. The court, relying on Greene Motor Company v. Commissioner, 5 T. C. 314 (1945), held that the Commissioner had no power to pyramid income in this situation and distinguished this case from Carver v. Commissioner 173 F. 2d 29 (6th Cir. 1949), Hardy v. Commissioner, 82 F. 2d 249 (2nd Cir. 1936) and Schuman Carriage Company v. Commissioner, 43 B. T. A. 880 (1941) on the basis that here the books were kept on the proper basis and no change in the method of accounting was required, there being merely a change in the method of reporting.

The facts in Carver v. Commissioner, *supra,* were almost identical with the facts in Commissioner v. Mnookin's Estate, *supra,* but an opposite result was reached. In Carver the taxpayer changed his method of keeping books to the accrual basis sixteen years prior to the year in which the Commissioner required the change in reporting while in Mnookin the taxpayer apparently had always kept his books on the accrual basis. This difference does not appear to be significant.

In Greene Motor Company v. Commissioner, *supra,* the taxpayer kept its books and reported its income on the accrual basis. The taxpayer set up unwarranted reserve accounts and took some admittedly improper deductions as additions to these reserves in 1938. The Commissioner sought to include the amount of these reserves in the taxpayer's income for 1939. The Tax Court held that there was no change in method of accounting involved and that the Commissioner had no power to increase the income of one year by an amount erroneously deducted in a prior year.

In Mnookin the error was in reporting sales on a cash basis while in Greene Motor Company the error was merely in taking an improper deduction in the prior year. Hence Mnookin appears distinguishable because there was a change in accounting method as to sales while in Greene Motor Company there was only an attempt to include in income an improper deduction of the prior year.

[15] For a full discussion of this development see Dixon, *Pyramiding Income In Changing From a Cash To an Accrual Method Of Accounting,* 8 TAX L. REV. 355 (1953).

[16] Commissioner v. Cohn, 196 F. 2d 1019 (2d Cir. 1952); Commissioner v. Schuyler, 196 F. 2d 85 (2nd Cir. 1952); Commissioner v. Frame, 195 F. 2d 166 (3rd Cir. 1952); Commissioner v. Mnookin's Estate, 184 F. 2d 89 (8th Cir. 1950); George V. Gilbert, P-H 1952 TC MEM. DEC. ¶ 52,183 (1952). In these cases the books were kept on the accrual basis but in reporting income the unpaid accounts receivable were omitted or the inventory was excluded so that as to these items the cash basis was improperly used.

However, if the taxpayer incorrectly kept his books on the cash basis and reported income on the cash basis then the Commissioner's adjustments were proper.[17] This distinction was based on the fact that Section 41 of the Internal Revenue Code refers to "the method of accounting regularly employed in keeping the books." Therefore, when a change was required only in the method of reporting income, the Commissioner did not have the discretionary power conferred by this section to recompute the income and add the amounts of accounts receivable and inventory at the beginning of the year of change.

A further refinement of this distinction was made in later cases so that taxpayers who kept books *or records* from which a computation could be made of proper income on the accrual basis were not penalized when the change to the accrual method was required.[18] The theory of these cases is that a change in keeping books is not required since the proper income could be computed from the books and auxiliary records. A change in reporting method was all that was required.

Even though income escapes taxation the principle invoked by the cases prohibiting the bunching of income is that neither income nor deductions may be taken out of the proper accounting period for the benefit of the government or the taxpayer.[19] Moreover, the discretion which the Commissioner has under Section 41 of the Internal Revenue Code to recompute income when it is not clearly reflected by the taxpayer's method of accounting does not give him authority to include items of income attributable to earlier years or to disallow proper deductions which were also (erroneously) taken in prior years.[20] This would follow since the net income is to be computed on an annual basis to reflect the net result of operations during a fixed accounting period.[21]

In *Commissioner v. Dwyer*,[22] the taxpayer incorrectly kept his books on the cash basis and reported income on the cash basis. The Tax Court held that, since inventories were recorded and available, sufficient information was available to compute the income on the proper

[17] David W. Hughes, P-H 1953 TC Mem. Dec. ¶ 53,285 (1953); Iley v. Commissioner, 19 T.C. 631 (1952); Koby v. Commissioner, 14 T.C. 1103 (1950), *appeal dismissed.*

[18] Caldwell v. Commissioner, 202 F. 2d 112 (2d Cir. 1953) (card file of accounts receivable); Welp v. United States, 201 F. 2d 128 (8th Cir. 1953) (constructed inventory figures).

[19] Security Flour Mills v. Commissioner, 321 U. S. 281, 285, 287 (1944); Commissioner v. Mnookin's Estate, 184 F. 2d 89, 92 (8th Cir. 1950); Ross v. Commissioner, 169 F. 2d 483, 492 (1st Cir. 1948).

[20] Welp v. United States, 201 F. 2d 128, 133 (8th Cir. 1953); Commissioner v. Mnookin's Estate, 184 F. 2d 89, 93 (8th Cir. 1950); Clifton Manufacturing Co. v. Commissioner, 137 F. 2d 290, 293 (4th Cir. 1943).

[21] Burnet v. Sanford and Brooks Company, 282 U. S. 359 (1931).

[22] 203 F. 2d 522 (2nd Cir. 1953), *affirming* Cornelius J. Dwyer, P-H 1951 TC Mem. Dec. ¶ 51,206 (1951).

basis and consequently the Commissioner was not justified in attempting to bunch income. This was clearly in accord with the distinction developed in prior cases. However, the Eighth Circuit in affirming went further and overruled the case of *Hardy v. Commissioner,*[23] on which the Commissioner had relied in all of the cases involving involuntary changes of methods of accounting, and based the decision on the following principle:

> Although there have been exceptions, it is established by the great weight of authority that, if a taxpayer has not misrepresented or suppressed the facts, the statute of limitations not only prevents any reassessment of the tax after the prescribed period has passed; but that the Treasury may not assess a tax for a later year to make up for a credit erroneously allowed, or a charge erroneously omitted, in an earlier year.[24]

The court recognized that distinctions had grown up concerning the method of keeping books and the method of reporting but rejected them as being without merit.

Clearly these refinements which have been made and to which the court refers in *Dwyer* are without merit.[25] For example, the innocent who keep books and report on the cash basis would be penalized while a taxpayer who keeps his books on the proper basis but who reports on the cash basis would be rewarded with a windfall in the form of tax-free income whenever the proper change is required. It appears that both parties are equally at fault and that both should be treated equally before the courts.[26]

The confusion in this field may soon be eliminated by the decision in the *Dwyer* case. The clear-cut rule would seem to be that the Commissioner may not pyramid income when an involuntary change of

[23] 82 F. 2d 249 (2nd Cir. 1936). In this case the taxpayer, a corporation, which kept its books and reported income on the cash basis, requested the Commissioner to allow it to change to the proper accrual method in 1926. The Commissioner granted the request but required the taxpayer to make the change in 1925. The Commissioner added the accounts receivable and inventory at the beginning of 1925 to the income for that year. The court approved the Commissioner's action in this language: "In putting the petitioner on the accrual basis in 1925, the commissioner, bound to do it in a way that would clearly reflect its income, was not required to adhere strictly to a stereotyped accrual form of accounting. It is obvious that there must be some leeway in making the change from the cash basis in order that the income for the first taxable period under the changed method of reporting will be reflected accurately." 82 F. 2d at 251.

[24] Commissioner v. Dwyer, 203 F. 2d 522, 524 (1953).

[25] For a collection of cases and discussion, see Rabkin and Johnson, FEDERAL INCOME, GIFT AND ESTATE TAXATION, § 12.03 (3) (1953).

[26] In regard to a taxpayer who incorrectly reported interest on a cash basis, one court said: "The failure of the petitioner to make its returns consistently upon the accrual basis may place it in an unfortunate position. But for this situation the petitioner is alone to blame." Schuman Carriage Company v. Commissioner, 43 B. T. A. 880, 889 (1941).

accounting method is imposed. However, the decision in the *Hughes*[27] case may be an indication that the Commissioner and the Tax Court will continue to embrace the distinction in regard to methods of accounting and methods of reporting. Such a course would only prolong the adjustment of an unsatisfactory situation.

On the premise that all taxpayers who are required to change from the cash to the accrual basis should be treated alike, the next consideration is whether or not the result of the *Dwyer* decision is desirable in our self-assessing tax system. It must be noted that when the taxpayer requests permission to change from the cash to the accrual basis, the taxpayer and Commissioner must agree to conditions under which the change is to be made.[28] The implication is clear that the Commissioner may not consent unless the omitted income is included and the duplicate deductions are excluded. Therefore, it seems that after following *Dwyer* to its logical conclusion there would still be a different result in changing accounting methods depending on whether the Commissioner or the taxpayer initiates the change. Again, there is no logical reason for this difference. Why should the taxpayer who recognizes that he is on the wrong reporting basis and who attempts to make the proper change be penalized while the taxpayer who waits until he is forced to make the change is rewarded?

It must be recognized that in changing from the cash to the accrual basis of reporting there may be amounts which will be duplicated or entirely omitted as a result of the change. A coherent tax policy would require the taxing of this income in all cases regardless of who initiated the change in accounting method. Perhaps the most equitable method of adjustment would be to recompute income for the prior years in which the sales arose and the inventory was paid for, even where the statute of limitations would otherwise prevent any reassessment of tax. An alternative would be to spread the additional income over a reasonable number of tax years. Legislation has been proposed which would accomplish this uniform result.[29] It seems clear that this in-

[27] Note 1 *supra*.

[28] U. S. Treas. Reg. 118, § 39.41-2 (c) (1953), provides in part: "A taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. . . . The application shall be accompanied by a statement specifying the classes of items differently treated under the two methods and specifying all amounts which would be duplicated or entirely omitted as a result of the proposed change. Permission to change the method of accounting will not be granted unless the taxpayer and the Commissioner agree to the terms and conditions under which the change will be effected."

[29] *Cf.*, 66 HARV. L. REV. 187, 188 (1952), where the author refers to a proposed statute (A. L. I. FED. INCOME TAX STAT. §§ X330, X332, Tent. Draft No 6, 1952) which would give the taxpayer the option of reconstructing previous years' income or spreading the additional income over a three year period.

come should not be pyramided into the year of change inasmuch as it is income attributable to other accounting periods.

PAUL M. CARRUTHERS

**Workmen's Compensation—"Accidental" Injury—an Anachronism**

A 1953 Mississippi decision[1] has added one more drop to the ocean of confusion concerning the legal meaning of the word "accident." There a baker contracted a skin allergy from the use of a baker's pad in handling hot pans of bread. After testimony by a dermatologist to the effect that the employee was allergic to some material or chemical in the pad, the attorney-referee awarded compensation on the basis of "accidental" injury and the entire Commission affirmed.[2] On appeal the Mississippi Supreme Court refused to overturn the finding, agreeing that this was an "accidental" injury within the purview of the Mississippi statute.[3]

To understand the decision, it is first necessary to briefly examine the theory underlying Workmen's Compensation. In an economic society containing as one of its basic essentials a large group of laborers, it is desirable for the well being of all integrated society to protect this group from industrial accidents which seem inevitable in the industrial machine.[4] To accomplish this end the economic burden is placed upon industry rather than upon workers and their dependents, who might otherwise well become wards of the State.[5] And since this benefit is *directly* for the laborer and only *indirectly* for the society, Workmen's Compensation Acts should be construed liberally in favor of the employee.[6]

[1] Hardin's Bakeries, Inc. v. Ranager, 64 So. 2d 705 (Miss. 1953).

[2] Under Mississippi procedure, hearings may be conducted by a Commissioner or a representative of the Commission, who grants or denies compensation and then files his decision with the Commission. This decision is final unless within twenty days a request or petition for review by the full Commission is made. Appeal may be made from the Commission's finding within thirty days to the Circuit Court of the county in which the injury occurred, this appeal being based only upon the record as made before the Commission. Finally, appeal may be taken to the Supreme Court of Mississippi. MISS. LAWS 1948, c. 354, §§ 18,20.

[3] MISS. LAWS 1948, c. 354, *as amended by* MISS. LAWS 1950, c. 412.

[4] Bowen v. Hockley, 71 F. 2d 781 (4th Cir. 1934).

[5] Tedars v. Savannah River Veneer Co., 202 S. C. 363, 25 S.E. 2d 235 (1943)

[6] Employers Mutual Liability Ins. Co. of Wis. v. Konvicka, 197 F. 2d 691 (5th Cir. 1952); Beck v. National Sur. Corp., 171 F. 2d 862 (5th Cir. 1949); Peterson v. Moran, 111 Cal. App. 2d 766, 245 P. 2d 540 (1952); Danziger v. Industrial Accident Comm., 109 Cal. App. 71, 292 Pac. 525 (1930); Shockley v. King, 31 Del. 606, 171 Atl. 280 (1922); Di Giorgio Fruit Corp. v. Pittman, 49 So. 2d 600 (Fla. 1950); Guevara v. Inland Steel Co., 120 Ind. App. 47, 88 N.E. 2d 398 (1949); Forcade v. List and Clark Const. Co., 172 Kan. 119, 238 P. 2d 549 (1951); Alexander v. Chrysler Motor Parts Corp., 167 Kan. 711, 207 P. 2d 1179 (1949); Jurich v. Cleveland-Cliffs Iron Co., 233 Minn. 108, 46 N.W. 2d 237 (1951); Brookhaven Steam Laundry v. Watts, 214 Miss. 569, 55 So. 2d 381 (1951); McWilliams v. Southern Bleaching and Printing Works, 216 S. C. 121, 57 S.E. 2d 26 (1949); Thornton v. R. C. A. Service Co., 188 Tenn. 644,