Notre Dame Law Review

Volume 42 | Issue 4

Article 5

1-1-1967

Accrual Accounting and the Clear Reflection of Inclome: Purity of Accounting Principles Forsaken for the Protection of Tax Revenues

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Accrual Accounting and the Clear Reflection of Income: Purity of Accounting Principles Forsaken for the Protection of Tax Revenues

I. Introduction

The relationship between accrual accounting and the federal income tax constitutes a major battlefield. The accounting profession and the Treasury have seldom agreed on what this relationship should be, and the Supreme Court's pronouncements on tax accounting certainly have not increased interprofessional understanding between lawyers and accountants. Most writing in the area of accrual method tax accounting concentrates on whether there is a right to defer current receipts to future tax years.[1] An equally important question is whether a taxpayer has a right to deduct expenses in one tax year though he will not make the actual expenditure until a later year.

A chief principle of accrual accounting requires that income be reported in the year earned, whether received or not.[2] A corollary to this principle states that expenses are to be reported in the year the corresponding income is earned, whether the expenditure is made in that year or not.[3] Although the exact amount of a future expenditure may not be known until a later year, proper accounting practice requires an attempt to estimate the expense in the year the income is reported.[4] A reserve account, which would be debited in the year payment was made, would be created to reflect the present deduction. If an accurate estimate of the amount of an expenditure is not possible, an expense must be accrued to the year in which the amount can be determined.[5] These accounting techniques are designed to reflect the income earned during the accounting period.

The Internal Revenue Code provides that a taxpayer may use his regular

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1 *E.g.*, Mosher, *Tax Accounting for Prepaid Income and Estimated Expenses*, 13 Tul. 1964 Tax Inst. 339; Comment, 61 Mich. L. Rev. 148 (1962).

2 Paton, Accountants' Handbook, 113-14, 125 (3d ed. 1948); Sellin, Attorney's Practical Guide to Accounting, 6-28 (1965); Shugerman, Accounting for Lawyers, 152-56 (student ed. 1952).

3 *Ibid.*

4 Mosher, *supra* note 1, at 364.

> (1) Revenues are recognized as entering into the determination of income when sales are made or services are rendered. (2) The mere receipt of money or promise of another person to pay money for goods or services does not represent revenue which should be recognized in the determination of income in the period of receipt if it is burdened with an obligation to deliver goods or render services in the future. (3) Costs and expenses directly identifiable with revenues are chargeable against income of the period in which the revenues are recognized. (4) If the precise amount of any costs or expenses is not determinable at the time they are chargeable against income, they should be recognized on the basis of reasonable estimates. (5) Accounting recognition of costs and expenses which cannot be determined with a reasonable degree of accuracy at the time they would otherwise be charged against income of a particular period should be deferred until such determination is possible, whereupon they become chargeable to the income of the period of determination, unless, in the aggregate, they are so material that their inclusion would impair the significance of the income of that period. *Ibid.*

This article cites recommendations to the House Ways and Means Committee by the American Institute of Certified Public Accountants. The complete text of the recommendations appears at 93 *J. Accountancy* 93 (1954).

5 Mosher, *supra* note 1, at 364.

accounting method.[6] If a taxpayer's method of accounting fails to reflect his income clearly, the Commissioner is then entitled to prescribe a different method.[7] Other provisions relied upon to deny deductions by accrual method taxpayers are those providing that taxes shall be levied on the basis of the taxable year,[8] and that expenses shall be deducted in the year incurred.[9]

II. Accrual of Expenses — All Events Test

The "all events test" is the basic criterion adopted by the courts for determining the proper deduction of expenses.[10] This test allows the deduction of an expense in the year in which "all events" determining the liability for it occur. Originally the "all events test" prohibited a deduction before the taxpayer's liability for an expense became certain.[11] Other cases allow a taxpayer to deduct a reasonably accurate estimate although the exact amount of his liability is unascertainable.[12]

A. Early History

The "all events test" stems from the early Supreme Court decision of *United States v. Anderson.*[13] There, the Court held that a taxpayer was required to deduct a munitions tax based on his production during 1916 though he was not liable for the tax until 1917. Reasoning that the amount of the tax could be calculated in 1916 the Court required the accrual basis taxpayer to deduct the tax in the year it became known.

Although the "all events test" was not always applied to defeat the claims of an accrual basis taxpayer,[14] it soon became apparent that many expenses that an accountant would accrue in one year, would be deducted under tax law in another year.[15] In one group of cases, losses resulting from a breach of con-

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6 INT. REV. CODE of 1954, § 446, provides:

(a) General Rule—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) Exceptions—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.

(c) Permissible methods—Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting— . . . (2) an accrual method . . . .

7 INT. REV. CODE OF 1954, § 446(b).

8 INT. REV. CODE of 1954, § 441.

9 INT. REV. CODE of 1954, § 162(a). Compare INT. REV. CODE of 1954, § 461(a), which provides that a deduction is taken in the "proper taxable year under the method of accounting used in computing taxable income."

10 See Comment, 17 LA. L. REV. 628 (1957).

11 Security Flour Mills Co. v. Commissioner, 321 U.S. 281 (1944); Dixie Pine Prods. Co. v. Commissioner, 320 U.S. 516 (1944); Brown v. Helvering, 291 U.S. 193 (1934); Lucas v. American Code Co., 280 U.S. 445 (1930). See generally 2 MERTENS, LAW OF FEDERAL INCOME TAXATION, §§ 12.60-73 (1961 rev., Supp. 1966).

12 Hilinski v. Commissioner, 237 F.2d 703 (6th Cir. 1956); Pacific Grape Prods. Co. v. Commissioner, 219 F.2d 862 (9th Cir. 1955); Harrold v. Commissioner, 192 F.2d 1002 (4th Cir. 1951). See generally 2 MERTENS, *op. cit. supra* note 11, § 12.61.

13 269 U.S. 422 (1926). The all events test has been expressly adopted by Treas. Reg. § 1.461-1(a)(2)(1964).

14 American Nat'l Co. v. United States, 274 U.S. 99 (1927).

15 *E.g.,* Security Flour Mills Co. v. Commissioner, 321 U.S. 281 (1944); Dixie Pine Prods. Co. v. Commissioner, 320 U.S. 516 (1944); Brown v. Helevering, 291 U.S. 193 (1934).

tract were not permitted to be deducted until the liability for them became fixed and certain.[16] The Court said in one such case, "The prudent business man often sets up reserves to cover contingent liabilities. But they are not allowable as deductions."[17]

The leading case on contingent liabilities is *Brown v. Helvering*.[18] An insurance salesman attempted to estimate and deduct the amount of commissions that he would have to return if his customers cancelled their policies. The Court, denying his deduction because of the uncertainty of any one cancellation, said:

> But no liability accrues during the taxable year on account of cancellations which it is expected may occur in future years, since the events necessary to create the liability do not occur during the taxable year. Except as otherwise specifically provided by statute, a liability does not accrue as long as it remains contingent.[19]

The reserve account in this case was required by good accounting practice. The Court denied the deductions, however, because of their contingent character; there was no assurance that any single insurance policy would be cancelled and the expense incurred.

Another common situation where the Court has consistently denied a deduction concerns the accrual of contested liability for taxes.[20] Early cases held that taxpayers could not deduct the liability for taxes while contesting their validity.[21] In *Dixie Pine Prods. Co. v. Commissioner*,[22] the Court also held that the amount of the tax as well as the liability must be fixed in the year deducted. In *Security Flour Mills Co. v. Commissioner*,[23] the Court held that the concept of an annual accounting period required a taxpayer to deduct the tax in the year the contested liability was settled.

B. Courts of Appeals and the Use of Estimates

While the Supreme Court was rigorously applying the "all events test," some of the courts of appeals developed an approach more compatible with

16 *E.g.*, Lucas v. American Code Co., 280 U.S. 445 (1930); Lewellyn v. Electric Reduction Co., 275 U.S. 243 (1927).

17 Lucas v. American Code Co., *supra* note 16, at 452.

18 291 U.S. 193 (1934).

19 *Id.* at 200.

20 Security Flour Mills Co. v. Commissioner, 321 U.S. 281 (1944); Dixie Pine Prods. Co. v. Commissioner, 320 U.S. 516 (1944). See also United States v. Consolidated Edison Co., 366 U.S. 380 (1961), where the taxpayer was required to deduct taxes in the year the contest was settled and not in the year that he paid them under protest.

21 Security Flour Mills Co. v. Commissioner, *supra* note 20; Dixie Pine Prods. Co. v. Commissioner, *supra* note 20.

22 320 U.S. 516 (1944). The Court further said:

> It has long been held that in order truly to reflect the income of a given year, all the events must occur in that year which fix the amount and the fact of the taxpayer's liability for items of indebtedness deducted though not paid . . . . *Id.*

at 519.

23 321 U.S. 281 (1944).

> But the petitioner urges that § 43 [§ 461] has altered the rule so that hybrid system, partly annual and partly transactional, may, within administrative discretion, be substituted for that of the annual accounting periods. . . . The very section on which the petitioner relies, however, reiterates the adherence of Congress to the system of annual periods of computation. *Id.* at 287.

proper accrual accounting. In *Ohmer Register Co. v. Commissioner*,[24] the Sixth Circuit held an employer could deduct his sales agents' commissions in the year of sale, though the commissions were subject to adjustment for later defaults by buyers. The Second Circuit applied essentially the same test when it held a seller of sugar could deduct brokerage fees in the year of sale, though the fees might be adjusted upon subsequent default by the purchaser.[25] Both courts reasoned that the taxpayer's liability for these expenses had become fixed at the time of sale because any future adjustments would be based on mere conditions subsequent.

These decisions are in accord with sound accounting practice, but they conflict with the Supreme Court decisions already discussed because the taxpayers' liability, as well as the amount of liability, was contingent upon subsequent events. Although these decisions attempt to reconcile accepted accounting practice with the tax laws, their validity today is doubtful.[26]

C. The Harrold Rule

The Fourth Circuit's decision in *Harrold v. Commissioner*[27] offers the best hope of reconciling tax law and accounting procedure. In *Harrold* the taxpayer was engaged in the strip mining of coal. State law required him to backfill the strip mines when he was finished with them. Expert opinion was used to estimate the cost of backfilling each mine. The Fourth Circuit held that the taxpayer could deduct the estimated cost of backfilling the mines in the year the coal was removed. The court said:

> We conclude that when all the facts have occurred which determine that the taxpayer has incurred a liability in the tax year, and neither the fact nor the amount of liability is contested, and the amount, although not definitely ascertained, is susceptible of estimate with reasonable accuracy in the tax year, deduction thereof from income may be taken by a taxpayer on an accrual basis.[28]

The *Harrold* decision recognized that the basic rule of the "all events test" is that the fact of the taxpayer's liability must have been fixed in the tax year. It also prevented a distortion of the taxpayer's income under the accrual method by allowing him to deduct the expense in the same tax year as the income was earned.[29]

The Third Circuit distinguished *Harrold* in *Patsch v. Commissioner*.[30]

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24 131 F.2d 682 (6th Cir. 1942). The court said: "Correspondingly, the right to deduct an expense item accrues when the fixed obligation is incurred, even though the amount may be diminished by subsequent events." *Id.* at 686.

25 Central Cuba Sugar Co. v. Commissioner, 198 F.2d 214 (2d Cir. 1952), *cert. denied*, 344 U.S. 874 (1952). The court said, "Here the services had been performed, and the possibility that some of the contracts might not finally be executed was, if anything, a condition subsequent to payment by the taxpayer." *Id.* at 217-18.

26 See notes 35-38 *infra* and accompanying text.

27 192 F.2d 1002 (4th Cir. 1951).

28 *Id.* at 1006.

29 This procedure does not violate the principle that income taxes must be calculated on an annual basis, but, on the contrary, allocates to each year the proper income and expenses, and prevents distortion of the taxpayer's financial condition in the tax year. *Ibid.*

30 208 F.2d 532 (3d Cir. 1953).

The Court held that the cost of backfilling a coal mine had to be accurately estimated before it could be deducted as an expense — the cost of backfilling was nondeductible because the taxpayer attempted to estimate the expense by using general averages rather than expertise. Although *Patsch* distinguished *Harrold* it did not contradict it. As subsequent cases have shown, the two circuits have limited *Harrold* to instances where the taxpayer makes a reasonably accurate estimate based on the actual costs involved.[31]

Consistent with *Harrold,* other courts of appeals have allowed a deduction if the amount of liability is subject to a reasonable estimate and the fact of liability is fixed during the tax year. In *Pacific Grape Prods. Co. v. Commissioner,*[32] the court held that the taxpayer was entitled to take a deduction during the present tax year for the cost of moving products out of his warehouse during the following year. The court reasoned that the products had been sold and the income earned during the present tax year, and that the cost of shipping the products the following year was subject to a reasonable estimate.[33] Likewise, the Sixth Circuit held that a taxpayer had a right to deduct the cost of completing a contract to furnish toy pistols in the tax year he received the compensation rather than the later year when he performed the services. Even though the taxpayer's liability was contingent upon the other party supplying parts for the pistols, the court held the liability was substantially fixed during the tax year.[34]

D. Recent Developments

Recent decisions involving the accrual of income and expenses have impeded the use of proper accounting procedures as a basis for tax accounting. In *American Auto. Ass'n v. Commissioner,*[35] the Supreme Court stated that the repeal of sections 452[36] and 462[37] of the 1954 Code indicated a congressional intention to disallow the deferral of income and the deduction of expenses provided for by good accrual-accounting procedure.[38] In *United States v. Consolidated Edison Co.,*[39] the Supreme Court, reiterating the "all events test," held again that the liability for a contested tax could not be deducted until the contest was settled. It had been argued that the tax should be deducted in the

31 See Denise Coal Co. v. Commissioner, 271 F.2d 930 (3d Cir. 1959). In this case the court allowed a deduction for backfilling because the taxpayer showed that his deduction was reasonably accurate. Commissioner v. Gregory Run Coal Co., 212 F.2d 52 (4th Cir. 1954), *cert. denied,* 348 U.S. 828 (1954). Here, the Fourth Circuit denied the taxpayer's deduction because he failed to show that it was based on a reasonable estimate.

32 219 F.2d 862 (9th Cir. 1955).

33 The court said:

> Consistently, and to make reflection of income complete, it properly accrued its shipping expenses relating this merchandise as part of its cost of goods sold in the respective years billed. The records show that the items making up these expenses were either precisely known or determinable with extreme accuracy. *Id.* at 868.

34 Hilinski v. Commissioner, 237 F.2d 703 (6th Cir. 1956).

35 367 U.S. 687 (1961). See text accompanying note 54 *infra.*

36 INT. REV. CODE of 1954, ch. 736, § 452, 68A Stat. 152, provided for the deferral of prepaid income in accordance with good accounting procedures. See generally MERTENS, *op. cit. supra* note 11, §§ 12.22a-c.

37 INT. REV. CODE of 1954, ch. 736, § 462, 68 Stat. 158, provided for the accrual of expenses by use of reserves for estimated expenses.

38 American Auto. Ass'n v. United States, 367 U.S. 687, 695-96 (1961).

39 366 U.S. 380 (1961).

year paid. The Court, rejecting this argument, held that "all events" fixing liability did not occur until the contest was settled by the parties or the court. The Court, in the same year, relied solely on the two cases just discussed to reverse a Seventh Circuit decision that had allowed a deduction based on a reasonable estimate of a contested liability.[40]

Subsequent decisions of the lower federal courts reveal an inclination to enforce the "all events test" strictly. In 1965 the Seventh Circuit held a corporation could not deduct additions to reserves to improve a cemetery in which it was selling gravesites. The taxpayer was unable to show that the funds were impressed with a trust or that an accurate estimate of liability was possible.[41] In 1966 the Sixth Circuit, which had been most liberal in allowing deductions for estimated expenditures,[42] refused a deduction for the estimated cost of supplying dancing lessons because the taxpayer could not show his exact liability on each transaction.[43] In this case the taxpayer clearly was subject to liability; however, only the extent of the liability was subject to conjecture. The court, constrained by the decision in *American Auto. Ass'n,* implied that the amount of liability must be fixed or readily ascertainable before the deduction could be allowed.

It is fairly certain that no deduction can be taken unless the fact of liability has been determined during the tax year. Where this fact is determined, good authority exists for allowing the deduction of a reasonably accurate estimate of the amount of liability.[44] Other decisions, however, including those in the *Harrold* line, have not recognized deductions based on average cost or the average liability resulting from a multitude of claims.[45] Deductions of expenses that are similarly contingent in fact or speculative in amount have been disallowed. It is apparent, therefore, that the law governing the deduction of such expenses is presently unsettled.

III. Deferral of Income

A. History

Cases dealing with the deferral of income have developed along lines similar to those dealing with the accrual of expenses. The accrual method of accounting requires income to be reported in the year earned. If a taxpayer

40 Commissioner v. Milwaukee & Suburban Transp. Corp., 367 U.S. 906 (1961) (per curiam), reversing 283 F.2d 279 (7th Cir. 1960). The Seventh Circuit had held that what were essentially reserves for self insurance were deductible. See also Spring Canyon Coal Co. v. Commissioner, 43 F.2d 78 (10th Cir., 1930), *cert. denied,* 284 U.S. 654 (1931). See generally MERTENS, *op. cit. supra* note 11, § 12.69.

41 Sherwood Memorial Gardens, Inc. v. Commissioner, 350 F.2d 225 (7th Cir. 1965). Where the funds set aside for the improvement or care of a cemetery are subject to a trust under state law, the cemetery corporation does not have to report them as income. Portland Cremation Ass'n v. Commissioner, 31 F.2d 843 (9th Cir. 1929). See generally MERTENS, *op. cit. supra* note 11, § 12.71.

42 See notes 24 and 34 *supra* and accompanying text.

43 Villafranca v. Commissioner, 359 F.2d 849 (6th Cir. 1966) (per curiam), *cert. denied,* 385 U.S. 840 (1966).

44 Cases cited notes 27-34 *supra.*

45 See Patsch v. Commissioner, 208 F.2d 532 (3d Cir. 1953); Capital Warehouse Co. v. Commissioner, 171 F.2d 395 (8th Cir. 1948).

receives payment on a contract in 1967 for work to be done in 1968, accrual accounting will allocate the income to 1968. In determining tax liability, however, the courts have adopted the "claim of right test," which requires that a taxpayer must report as income an amount received under a claim of right and without restriction as to its disposition, even though he may have to return all or a part of it in a future year.[46] Moreover, the Supreme Court implied that the "all events test" may apply to income as well as expenses, when it held that profits were not taxable to a company until they were actually received, because there was a contest as to who was entitled to them.[47] On the other hand, the Court required an accrual basis taxpayer to report income in the first year he could calculate the amount he was to receive.[48] Although these two tests insure that income will be taxed at the earliest date, they have not contributed to the reconciliation of the tax laws and proper accounting methods.

B. The Liberal Approach

In *Beacon Publishing Co. v. Commissioner*,[49] the Tenth Circuit held that a publisher of periodicals had the right to defer subscription income, received in one year, to the years in which he was liable to supply the magazine. In this case the court gave an excellent description of the "claim of right" doctrine.

> In other words, the tax court holds that advance payments received by a taxpayer, which are subject to income tax, must be returned in the year of receipt if owned or claimed by the taxpayer, regardless of the method of accounting, which has been adopted, or when the funds are actually earned. Such application of the rule limits the accrual method to that class of cases where money has been earned and the right to it has been fixed, but the receipt is delayed to a subsequent taxable period. The application of the doctrine would in most cases result in a distortion of an accrual taxpayer's true income.[50]

Subsequent courts of appeals decisions allowed accrual basis taxpayers to defer income to the period in which experience showed it would be earned. In one case a vendor was allowed to defer a proportionate part of the purchase price of furnaces to the years in which he performed the maintenance services required by the sales contract.[51] In *Bressner Radio, Inc. v. Commissioner*,[52] the taxpayer was allowed to apportion income from a television service contract to the years in which the services would be performed. These cases, however, are now of doubtful authority.[53]

46 North Am. Oil v. Burnet, 286 U.S. 417, 424 (1932). See also INT. REV. CODE of 1954 §§ 1341-42.

47 North Am. Oil v. Burnet, *supra* note 46. "The net profits were not taxable to the company as income in 1916. For the company was not required to report an amount which might never be received." *Id.* at 423.

48 Continental Tie & Lumber Co. v. United States, 286 U.S. 290 (1932).

49 218 F.2d 697 (10th Cir. 1955).

50 *Id.* at 700. Deferral of prepaid subscription income is now provided for by statute. INT. REV. CODE of 1954, § 455. See generally MERTENS, *op. cit. supra* note 11, § 12.27.

51 Shuessler v. Commissioner, 230 F.2d 722 (5th Cir. 1956).

52 267 F.2d 520 (2d Cir. 1959).

53 See notes 54-62 *infra* and accompanying text.

C. Supreme Court Repudiates Deferral of Income

With the decision in *Automobile Club v. Commissioner*[54] the Supreme Court began to reverse the trend towards the acceptance of true accrual basis accounting by the lower federal courts. In this case the association received membership dues three years in advance. It deferred this income by prorating it over this membership period. The Court held the association could not defer income to subsequent years because it failed to show that it had done so on the basis of the services to be performed. This decision would not have prevented the accrual of income allowed in *Bressner* and other lower court decisions because the Supreme Court emphasized the automobile club's lack of reasonable apportionment and the Commissioner's discretion in establishing accounting methods.[55]

In a case involving essentially the same facts, *American Auto. Ass'n v. United States*,[56] the Court held that although the apportionment of income was reasonable and consistent with past experience, it would not be allowed. The majority opinion stated that the authority for such an apportionment was outweighed by the contrary implications of the congressional repeal of sections 452 and 462 of the Code.[57] The purpose of these sections had been to allow the deferral of income and the deduction of expenses dictated by sound accrual accounting. The Court also emphasized that apportionment of income based on averages, a normal accounting procedure, would not be allowed because the association did not know when it would incur an expense in the form of services to its individual members.[58]

Justice Stewart's vigorous dissent in this five to four decision presents a compelling rebuttal of the majority's reasoning. Justice Stewart insisted that the use of averages is permissible under the Code.[59] He particularly disagreed with the majority regarding the repeal of sections 452 and 462 of the Code. Although the majority had completely ignored the legislative history concerning the repeal of these sections, Justice Stewart used it to show that Congress had done everything possible to dissuade courts from arriving at the type of decision that the majority reached.[60] He said:

> Congressional intent with respect to this possibility was entirely clear—the trend of judicial decisions should be allowed to run its course *without any inference of disapproval being drawn from the repeal of § 452 and § 462.*

54 353 U.S. 180 (1957).

55 *Id.* at 189-90.

56 367 U.S. 687 (1961). Petitioner attempted to distinguish the facts in the *Automobile Club* case by showing that the income was allocated to the period in which experience showed the services would be performed. Deferral of prepaid dues income is now provided, under certain circumstances, by INT. REV. CODE of 1954, § 456.

57 American Auto. Ass'n v. United States, *supra* note 56, at 695-96.

58 *Id.* at 692. "The Code exacts its revenue from individual member's dues which, no one disputes, constitute income. When their receipt as earned income is recognized ratably over two calendar years, without regard to correspondingly fixed individual expense or performance justification, but consistently with overall experience, their accounting doubtless presents a rather accurate image of the total financial structure, but fails to respect the criteria of annual tax accounting and may be rejected by the Commissioner." *Ibid.*

It seems somewhat inaccurate to imply that the Federal Income Tax is exacted from a particular source of income rather than from the taxpayer's total revenues.

59 *Id.* at 703.

60 *Id.* at 708.

> This intent was evidenced in the assurances which the House Ways and Means Committee demanded and received from the Secretary of the Treasury, who had sought the repeal of the two sections.[61]

Justice Stewart's dissent was of no avail. Five years later the Court again held taxpayers were not entitled to defer income to the period earned. In *Schulde v. Commissioner*,[62] the taxpayer operated a dance studio. He sold lessons on a package basis and added the income to a deferred income account. When the income was earned by giving the lessons, he would transfer it from the deferred income account to the current income account and report it. In denying the taxpayer's claim, the majority, in a five to four decision, held that its decisions in *American Auto. Ass'n* and *Automobile Club* precluded such a deferral of income. As a result of the Court's pronouncements in these three major cases, it is quite difficult to sustain a deferral of income in a lower federal court today.[63]

IV. Relationship Between Reserves and Expenses

Dealers' reserves offer an interesting example of the relationship between the accrual of income and expenses. A dealers' reserve is a sum retained by a finance company when it discounts the installment paper of a retailer to insure the dealers' surety on the notes.[64] At first the retail dealers, usually of automobiles, did not report this sum as income until it was paid to them. Although some lower courts approved of this practice,[65] the Supreme Court required dealers on the accrual basis to report all sums credited to the reserves.[66] The Court said accrual accounting required income to be reported when earned and did not allow the taxpayer to defer it until received.[67]

After this decision, dealers reported these sums as income in the year earned and then deducted them as additions to a bad debt reserve. The Commissioner contended these sums could not be deducted as part of a bad debt reserve because a debt was not owed to the dealers until the installment debtor defaulted on his obligation to the finance company. The Tax Court has supported the Commissioner's contentions.[68] The courts of appeals, however, have rejected

61 *Id.* at 706.

62 372 U.S. 128 (1963).

63 Parkchester Beach Club Corp. v. Commissioner, 335 F.2d 478 (2d Cir. 1964). Here the court denied the taxpayer the right to defer dues to the year in which membership privileges would be extended. Automobile Ass'n v. Commissioner, 304 F.2d 781 (2d Cir. 1962). The automobile association attempted to defer income over the period of membership. The association stipulated that it could not predict a member's requirements for service. The court held such deferral was not allowed. The court said, however, that its decision in Bressner Radio Co. v. Commissioner, 267 F.2d 520 (2d Cir. 1959) was still valid. *Id.* at 784.

64 See Mertens, Law of Federal Income Taxation, § 12.67 (1961 rev., Supp. 1966).

65 Texas Trailercoach, Inc. v. Commissioner, 251 F.2d 395 (5th Cir. 1958); Johnson v. Commissioner, 233 F.2d 952 (4th Cir. 1956); Keasbey & Mattison Co. v. United States, 141 F.2d 163 (3d Cir. 1944).

66 Commissioner v. Hansen, 360 U.S. 446 (1959). It may be argued that Congress acquiesced in this decision by passing the "Dealer Reserve Income Adjustment Act of 1960," 74 Stat. 124 (1960) to alleviate hardships resulting from the *Hansen* decision. For discussion of this act see Mertens, *op. cit. supra* note 64, §§ 12.67a-f.

67 Commissioner v. Hansen, *supra* note 66.

68 Glen L. Bolling, 33 P-H Tax Ct. Mem. 953 (1964), *affirmed on other grounds*, 357 F.2d 3 (8th Cir. 1966); Mike Persia Chevrolet, Inc., 41 T.C. 198 (1963); Foster Frosty Foods, Inc., 39 T.C. 772 (1963), *rev'd*, 332 F.2d 230 (10th Cir. 1964).

these arguments. In *Wilkins Pontiac v. Commissioner,*[69] the Ninth Circuit held that additions to reserves are deductible as reserves for bad debts because, traditionally, payments as a guarantor are deductible as bad debts[70] and the provision for bad debt reserves was intended as a substitute for such deductions.[71] Other circuits have subsequently followed this same reasoning.[72]

The Commissioner's contentions urged in these cases indicate his reluctance to allow good accrual accounting procedures. When taxpayers are prevented from deferring income they resort to the less favorable device of establishing reserves. Deferral of income is more attractive because it does not have to be reported in the year deferred, whereas the use of reserves requires the taxpayer to report the income at an earlier date and prove that the deduction is reasonable.

V. Accounting Principles v. Protection of Revenue

It is easy to understand the Commissioner's reluctance to allow the full use of accrual basis accounting. His insistence on the "claim of right" test and "all events test" is founded on the need to protect the tax revenues and a desire for administrative convenience.

The "claim of right" test guarantees that the tax will be exacted as soon as the taxpayer has unrestricted use of the funds received. To impose the tax later would risk the dissipation of these funds or the death or dissolution of the taxpayer. The "all events test" insures that the taxpayer will not take deductions for expenditures that might never occur or might be much less than the amount estimated. In this way the Government is assured of receiving the full amount to which it is entitled. If either rule were completely abolished, the taxpayer, in all good faith, might defer taxation to a period when he would be unable to pay.

The Commissioner is also interested in maintaining an efficient system of exacting revenue. The use of the annual accounting period provides the Government with a regular flow of revenue.[73] Were the Commissioner required to open old tax returns repeatedly to make corrections for erroneous estimates, a severe administrative handicap would result. For these reasons the Commissioner has consistently opposed the deferral of income and the deduction of contingent expenses.

Taxpayers and the accounting profession have supported the use of the accrual method for equally compelling reasons. Besides the possibility that a

69 298 F.2d 893 (9th Cir. 1961).

70 INT. REV. CODE of 1954, § 166.

71 Wilkins Pontiac v. Commissioner, 298 F.2d 893 (9th Cir. 1961).

72 Bolling v. Commissioner, 357 F.2d 3 (8th Cir. 1966). In this case, the court sustained the tax court's finding in favor of the Commissioner because the taxpayer had not shown that the additions to the reserves were reasonable. It specifically approved the *Wilkins Pontiac* holding. Foster Frosty Foods, Inc. v. Commissioner, 332 F.2d 230 (10th Cir. 1964). Congress recently codified the *Wilkins* result in INT. REV. CODE of 1954, § 166(g).

73 The Supreme Court has said:

> While, conceivably, a different system might be devised by which the tax could be assessed, wholly or in part, on the basis of the finally ascertained results of particular transactions, Congress is not required by the amendment to adopt such a system in preference to the more familiar method, even if it were practicable.

Burnet v. Sanford & Brooks Co., 282 U.S. 359, 365 (1931).

taxpayer may die or become insolvent and thus escape a tax altogether, several other good reasons arise why a taxpayer would wish to defer income and deduct contingent expenses. Individual and partnership taxpayers are particularly interested in escaping the rigors of the graduated tax. In cases such as *Harrold,* a taxpayer may have all his income in one tax year and substantial, related expenditures in subsequent years. The taxpayer will pay considerably less tax if he can deduct the expenses in the same year that he reports the related income. Even corporations that do not pay a graduated tax have good reason to defer income and deduct contingent expenses. Accrual prevents the distortion of business income, particularly at the beginning and end of a business enterprise.[74]

Some of the hardships resulting from a denial of the right to defer income and deduct contingent expenses are mitigated by the net operating loss provision[75] — carry-overs and carry-backs — and the income averaging sections of the Code.[76] Some difficulties still arise which only the adoption of a true accrual method could overcome. A taxpayer forced to pay a high rate of tax on income received from an executory contract in one year might conceivably be unable to fulfill the contract if his operating revenue were depleted by taxes. Clearly some compromise between the position of the Commissioner and that of the taxpayers is necessary.

VI. Conclusion — Need for Reform

A. Congressional Action

Only Congress can resolve the conflict between accrual accounting and the federal income tax. Such action might take the form of allowing only the deduction of contingent expenses. If this suggestion were adopted, a taxpayer would not be able to defer income but would be allowed to deduct reasonably accurate estimates of the expenses to be incurred in earning such income. The "all events test" should be abandoned, and the emphasis should be placed completely on the reasonableness of the estimate. To insure reasonable estimates, the Commissioner would be given wide latitude to regulate deductions and a statutory penalty for estimates that varied excessively from the actual cost.[77] This type of statutory reform would be broader than the recent congressional codification of the *Wilkins Pontiac* result.

In protecting the interests of both the taxpayer and the Government, the deduction of contingent expenses would have several advantages over the deferral of income. It would result in taxing income in the year received but would respect the principles of accrual accounting to the extent that deductions

74 Petite, *Deferred Income and Reserves for Estimated Expenses,* N.Y.U. 19th Inst. on Federal Tax 1241, 1242-43 (1961).

> In the absence of deferring prepaid income or reserving for estimated expenses, income is exaggerated in a period of increasing business and losses are exaggerated when business declines, since the income is received or accrued in the period of business increase and the expenses or providing services or fulfilling other obligations are reflected in the period of declining business.

75 Int. Rev. Code of 1954, § 172, provides a net operating loss deduction which may be carried back for three years and forward for five years.

76 Int. Rev. Code of 1954, §§ 1301-05, provides a method by which the disadvantages of income bunching in one year may be mitigated.

77 Comment, 61 Mich. L. Rev. 148 (1962).

related to that income would be taken in the same tax year, irrespective of whether such income was "earned" for accrual accounting purposes. This approach would minimize the possibility of loss of income through the death or insolvency of the taxpayer. It would not, however, solve the problem of administrative convenience, although the Internal Revenue Service has shown that it can tolerate a system that allows the recomputation of past tax years by its adaptation to the carry-back provisions of the Code.[78]

B. Judicial Action

Pending adoption of a congressional solution, the courts should adopt a partial remedy. While continuing to deny the deferral of income, the courts could adopt a modified version of the *Harrold* rule. Under this approach the taxpayer would be allowed to deduct expenses that were no longer contingent in fact if the amount were subject to a reasonable estimate. In addition the courts could recognize the use of average costs as a legitimate means of estimating expenses. In cases such as *Harrold* and *Patsch,* where expenses varied from coal mine to coal mine, the courts could still insist on an expert estimate. In some situations, however, the courts could allow the use of "average cost" to estimate future expenditures. Although the amount of liability on any one contract might not be subject to a reasonable estimate, it would be possible to estimate the average cost of fulfilling a large number of contracts. Such an estimate should be allowed because the present computation of taxes is based on the taxpayer's total income and not individual liability; inflexibility resulting from a rigid adherence to the concept of attachment of liability should not subvert this principle.

Pending any new court decisions or congressional action, the taxpayer should proceed cautiously. To avoid conflict with the Commissioner, the taxpayer would be wise to obtain a ruling before attempting any deferral of income or deduction of additions to reserves for contingent expenses. If the Internal Revenue Service will not give a favorable ruling on either, the taxpayer should deduct his contingent liability rather than defer his income. To prepare for a possible contest, a careful estimate of the cost involved should be made. If possible, the estimate should be based on particular liability and should not use averages which may not be accurate. The evidence used in making the estimate should be preserved for possible litigation. If all these precautions are taken, the taxpayer's deduction of contingent expenses is likely to be upheld.

In conclusion, tax law and accounting principles are far from reconciled. The differences seem to increase with each decision of the courts. Apparently, to the Commissioner, the "clear reflection of income" envisioned by the Code[79] is something other than that sought by the accrual method purist. The taxpayer is faced with the problem of keeping two sets of books — one to accurately reflect his income and the other to calculate his income tax. The only reasonable solution is congressional action. In the meantime, the courts have available theories under which it is hoped they will provide the taxpayer some relief.

James T. Harrington

78 Freeman, *Tax Accrual Accounting for Contested Items,* 56 MICH. L. REV. 727 (1958).
79 INT. REV. CODE of 1954, § 446(b).