

DEBUNKING THE MYTH OF THE HISTORIC SUPREMACY OF ANNUAL ACCOUNTING FOR INCOME TAXES: A COALESCENCE OF NON-LITERAL INTERPRETATION WITH ORIGINAL INTENT ANALYSIS

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INTRODUCTION

The statement is often made that our income tax system in the United States is based upon the concept of annual accounting.¹ A more accurate

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This Article is part of a study that I am making of our tax accounting jurisprudence and how it developed. An earlier article that is part of this study is Grauer, *The Supreme Court's Approach to Annual and Transactional Accounting for Income Taxes: A Common Law Malfunction in a Statutory System?*, 21 GA. L. REV. 329 (1986). In that article I examined the growth of the Supreme Court case law in the annual accounting area and the problems which that case law spawned. That article, however, did not consider whether the statutory and regulatory scheme for tax accounting required the Court to rule as it did. That article, though, did acknowledge that that question must be addressed. This Article primarily addresses the question left open in the earlier article and secondarily posits a proposal for reform with respect to one particular problem in the annual accounting area.

1. See *Heiner v. Mellon*, 304 U.S. 271, 275 (1938) ("The federal income tax system is based on annual accounting."). See also *Healy v. Commissioner*, 345 U.S. 278, 281 (1953) ("One of the basic aspects of the federal income tax is that there be an annual accounting of income. Each item of income must be reported in the year in which it is properly reportable and in no other."); *Alice Phelan Sullivan Corp. v. United States*, 381 F.2d 399, 403 (Ct. Cl. 1967) ("Ever since *Burnet v. Sanford & Brooks Co.* . . . , the concept of accounting for items of income and expense on an annual basis has been accepted as the basic principle upon which our tax laws are structured." (citations omitted)); White, *An Essay On The Conceptual Foundations Of The Tax Benefit Rule*, 82 MICH. L. REV. 486, 491 (1983) ("[T]he federal income tax system operates on the principle of annual accounting. . . ."); Note, *An Asset Based Approach To The Tax Benefit Rule*, 72 CAL. L. REV. 1257, 1258 (1984) ("The [tax benefit] rule is necessary because of the interaction between two facets of the

statement would be that the concept of annual accounting plays a major role in our income tax culture. Although at first glance the difference between these two statements might appear to be a minor one of wording or degree, it is not. The latter statement suggests that annual accounting is a useful tool in furthering some of the policies that form the basis of our income tax culture. Such a suggestion invites further inquiry. What are those policies? Does annual accounting further all of those policies? If not, when can annual accounting give way to other types of accounting or analysis in order to further some other important policies without undermining annual accounting's own important policy goals? The first statement, on the other hand, forecloses further inquiry. By stating that our tax system is based on annual accounting, it implies that a deviation from annual accounting could indeed threaten the basis or foundation of our tax culture and cause the system to fall apart.

"But that is ridiculous!" you might say. "Of course," you would continue, "no one really believes that our tax system is so based on annual accounting that we must not countenance any deviation from the concept. Such a belief would preclude consideration of underlying and perhaps competing policies in resolving many tax issues. Therefore, anyone

federal income tax system. First the system is based on annual accounting, so that revenue is ascertainable and payable at regular intervals.") The second facet, which the author called "the system's *income orientation*," *Id.* at 1259 (emphasis in original), appears in reality to reflect some of the equitable issues with which this Article is concerned. Because the author of this Note recognized the multi-faceted nature of our tax system, perhaps his strong statement that "the system is *based on annual accounting*" (emphasis added), can be excused as a slip of the pen. Such slips, however, can lead readers and courts to assume that the concept of annual accounting must play a more prominent role in our tax system than is necessary or indeed wise.

For additional examples of language indicating that our tax system must always adhere to a concept known as annual accounting, see, *United States v. Skelly Oil Co.*, 394 U.S. 678, 681 (1969); *Security Flour Mills Co. v. Commissioner*, 321 U.S. 281, 285-87 (1944); *Burnet v. Thompson Oil & Gas Co.*, 283 U.S. 301, 306 (1931); *United States v. Rexach*, 482 F.2d 10, 22, 23 (1st Cir. 1973).

With respect to the definition of the term "annual accounting," the following statement by one commentator will suffice for the present:

There are two primary accounting approaches to the computation of income tax: the transactional method and the annual method. The transactional accounting approach treats each transaction separately; thus, the income from each transaction is determined only upon completion of the transaction. In contrast, under the annual approach, taxable income is computed on the basis of the income and expenses resulting from all of the taxpayer's transactions during a single year, including transactions not completed in that year. The annual approach thus makes it possible to recognize income in one year on a transaction that ultimately results in an over-all loss.

Note, *Income Tax—Recovered Property Previously Deducted Included in Income in Year of Recovery*—Alice Phelan Sullivan Corp. v. United States, 66 MICH. L. REV. 381, 382-83 (1967). A more detailed exposition of the concept of annual accounting is presented *infra* Part I, especially from text accompanying note 31 to the end of Part I.

who says that our tax system is based on annual accounting cannot really mean what he says. He must mean that annual accounting merely plays a major role in our tax culture. Otherwise, annual accounting would be regarded not as a tool for furthering various policies, but rather as an end in itself that must be attained. Such an approach would turn tax policy on its head and sometimes lead either to questionable results or to proper results that are justified by questionable reasoning."

Well, your analysis is correct, but your conclusion is not. For over half a century, starting with the landmark case of *Burnet v. Sanford & Brooks Co.*², the United States Supreme Court acted as if the annual accounting concept were the basis or foundation of our income tax system.³ In all fairness, I cannot accuse the Court of completely failing to recognize the policies that actually form the basis of our income tax culture.⁴

2. 282 U.S. 359 (1931).

3. See generally Grauer, *The Supreme Court's Approach to Annual and Transactional Accounting For Income Taxes: A Common Law Malfunction in a Statutory System?*, 21 GA. L. REV. 329 (1986).

The following language from the *Sanford & Brooks* opinion exemplifies the Court's belief that our income tax system is based upon annual accounting.

A taxpayer may be in receipt of net income in one year and not in another. The net result of the two years, if combined in a single taxable period, might still be a loss; but it has never been supposed that that fact would relieve him from a tax on the first, or that it affords any reason for postponing the assessment of the tax until the end of a lifetime, or for some other indefinite period, to ascertain more precisely whether the final outcome of the period, or of a given transaction, will be a gain or a loss.

The Sixteenth Amendment was adopted to enable the government to raise revenue by taxation. It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation. It is not suggested that there has ever been any general scheme for taxing income on any other basis . . . 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.

282 U.S. at 364-65.

4. A classic work on the policies underlying our income tax culture is Sneed, *The Criteria of Federal Income Tax Policy*, 17 STAN. L. REV. 567 (1965). Professor (now Judge) Sneed states that the policies shaping our income tax culture are the following: (1) supplying adequate revenue; (2) achieving a practical and workable tax system; (3) imposing equal taxes upon those who enjoy equal incomes (also known as the concept of "horizontal equity"); (4) assisting in achieving economic stability; (5) reducing economic inequality (closely related to a concept known as "vertical equity"); (6) avoiding the impairment of a free-market economy; and (7) accomplishing harmony between the income tax and the desired political order. *Id.* at 568.

I have also stated, and continue to state in this Article, that three paramount goals of our tax system are: (1) providing equitable treatment to both the taxpayer and the government; (2) protecting the federal fisc from depletion by taxpayer manipulation; and (3) raising revenue in an adminis-

Rather, I accuse the Court of placing greater importance on promoting the notion that our tax system is based upon annual accounting than on properly balancing and considering the underlying and competing policies of our tax system in a rational and coherent manner. In other words, the Court was keeping its eye on the wrong ball. Instead of reaching results in a manner that demonstrated a proper balancing of underlying, and perhaps competing, tax policies (making use of the annual accounting concept when appropriate), the Court appeared willing to reach results that properly balanced competing tax policy goals only so long as any threat to the supremacy of annual accounting could be thwarted.⁵ In some cases the tax policy goal of equitable treatment of taxpayers and the government⁶ suffered unduly.⁷ In other cases, the

tratively feasible manner. See Grauer, *supra* note 3, at 338. The first of these goals is analogous to, but also broader than, Sneed's third policy criterion of horizontal equity. See *infra* note 6. The second and third goals combine Sneed's first two policy criteria, adequacy and practicality. As this Article and Sneed both note, these policies, goals, or criteria can often conflict with one another. For example, Sneed states, "Practicality often infringes upon Equity." Sneed, *supra* at 574. For a more recent statement noting the conflict among these goals see Simon, *Tax Simplification and Justice*, 36 TAX NOTES 93, 93 (1987) ("Indeed, it has become generally accepted that the goals of fairness, simplicity, and efficiency frequently may conflict, which results in the need to choose among unpopular alternatives.").

5. See generally Grauer, *supra* note 3.

6. The goal of equitable treatment of taxpayers and the government is difficult to describe or define with much precision. Nevertheless, I have attempted previously to give content to this concept:

The terms "equitable treatment [of] both the taxpayer and the government" and "equity" are admittedly nebulous terms that connote the concept of fairness. While no attempt is made at formulating precise definitions in this article, the reader may wish to consider the following thoughts in evaluating whether a result provides equitable treatment to both the taxpayer and the government.

Tax policy analysts often use the term "equity" to mean "horizontal equity" (i.e., taxpayers with similar incomes should face similar tax bills) or "vertical equity" (i.e., taxpayers with larger incomes should pay proportionately more in taxes than taxpayers with smaller incomes). The term "equity" as used in the article, however, is much broader in scope. It includes the notion that we must be very concerned by a tax system in which the tax liabilities of two taxpayers over an extended period of time may depend as much on the period during which an item of income is recognized as they do on the amount of income received. "Equity" additionally encompasses the concept of Code symmetry, which attempts to limit deductions to dollars that have already been subject to tax, and to require the inclusion in income of the receipt of all dollars that have once been the subject of a deduction by the taxpayer. The concept of Code symmetry is closely related to the proscription against impermissible double tax benefits; for example, a taxpayer should not be permitted to deduct the same dollars twice.

The astute observer may already have noticed that some aspects of the notion of equity can conflict with one another. For example, the Code symmetry requirement that we include in income the receipt of all dollars that have been the subject of a deduction may indeed cause a tax liability to depend as much on the period during which an item is recognized as on the total amount of income received. Thus, a balancing of competing

Court did attain equitable results, but not before it either engaged in mental gymnastics to avoid potential accusations that it was undermining the supremacy of annual accounting,⁸ or defined the parameters of the concept of annual accounting so broadly that it could disingenuously claim it was engaging in annual accounting when in fact it was not.⁹ The result was an overemphasis upon adherence to annual accounting and an unrealistic tax jurisprudence.

What could cause the Supreme Court to do such a thing? Part of the answer may lie in the language of our tax statutes. Section 441(a) of the Internal Revenue Code states that “[t]axable income shall be computed on the basis of the taxpayer’s taxable year.”¹⁰ Furthermore, section 11, in imposing the corporate tax makes reference to the use of a taxable year,¹¹ and section 162 allows deductions for ordinary and necessary

policies or goals is required to achieve true equity, and the concept itself remains somewhat nebulous.

Grauer, *supra* note 3, at 338 n.23.

7. See *United States v. Lewis*, 340 U.S. 590 (1951). In *Lewis*, the taxpayer received monies under a claim of right and reported it as income in 1944. In 1946, he returned the money to his employer. The Court held that because of the annual accounting requirement, the taxpayer could not amend his return for 1944, but had to claim a deduction in 1946. Apparently because the taxpayer’s marginal rate was lower in 1946 than in 1944, the tax saved in 1946 from the deduction did not equal the tax paid in 1944 from the inclusion in income. Thus, strict adherence to annual accounting led to the inequitable result of the taxpayer effectively paying some tax on money he was not ultimately permitted to keep. For a more detailed analysis of the *Lewis* case, and of how the Court in *Lewis* applied annual accounting principles without considering the purposes those principles are intended to serve, see Grauer, *supra* note 3, at 352-57.

8. See *Dobson v. Commissioner*, 320 U.S. 489 (1943). In *Dobson*, the Court affirmed the transactional exclusionary aspect of the tax benefit rule only in dicta by first denying that it was adopting “any rule of tax benefits” and then limiting its holding to that the lower court improperly treated as a rule of law what the Court claimed was only a question of fact. *Id.* at 506-07. For a more detailed exposition of the mental gymnastics of the *Dobson* Court, see Grauer, *supra* note 3, at 373-79.

9. See *United States v. Skelly Oil Co.*, 394 U.S. 678 (1969); *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952). In both cases the Court denied that it was violating annual accounting even though it permitted events in years other than the tax year in question to affect that year’s tax results. For a more detailed analysis see Grauer, *supra* note 3, at 360-71.

10. I.R.C. § 441(a) (West Supp. 1988). Section 441(a) and its requirement of an annual accounting for income taxes is buttressed by § 451(a) which provides: “The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.” I.R.C. § 451(a) (West Supp. 1988). Similarly, on the deduction side, § 461(a) provides: “The amount of any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.” I.R.C. § 461(a) (West Supp. 1988).

11. Section 11(a) provides: “A tax is hereby imposed for each taxable year on the taxable income of every corporation.” I.R.C. § 11(a) (West Supp. 1988).

business expenses paid or incurred during the taxable year.¹² These sections clearly mandate that an annual accounting system be employed by each taxpayer, and the early Revenue Acts contained similar provisions.¹³ These annual accounting sections, however, constitute only a small portion of the complex web of statutory and regulatory provisions which forms the basis of our income tax system. Because of the web's complexity, no one section or regulation or even set of sections or regulations can be analyzed properly in isolation. Rather, each section or regulation or set of sections or regulations must be analyzed and evaluated with regard to the policies that they further and with regard to competing policies and considerations that are evidenced by other sections or regulations. Only by so balancing and considering competing underlying policies can a court interpret and apply Code provisions in a rational and coherent manner.¹⁴

12. Section 162(a) provides in pertinent part: "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, . . ." I.R.C. § 162(a) (West Supp. 1988).

13. See *infra* text accompanying notes 39-46.

14. A recent article supports this approach to interpreting Internal Revenue Code provisions. See Zelenak, *Thinking About Nonliteral Interpretations of the Internal Revenue Code*, 64 N.C.L. REV. 623 (1986). Professor Zelenak states:

[T]he very complexity of the Code may give the Code more in the way of underlying structures and permeating policies than most other statutes. These structures, policies, and principles can be discovered—sometimes easily, sometimes with great difficulty and uncertainty—through a thoughtful reading and study of the Code as a whole.

Id. at 639. Furthermore, Zelenak states:

It is generally accepted that particular words in a statute should not be read in isolation; rather, they must be understood in the context of the statute in which they appear. The relevant context is both internal (the entire statute in which the particular words to be interpreted appear) and external (the legislative history, the conditions to which the statute was a response, and the like.)

Id. at 637.

I go somewhat further in this Article than does Professor Zelenak in advocating nonliteral interpretation. Professor Zelenak adheres to the principle that great deference should be accorded to how Treasury regulations interpret the Code. He states:

[T]he existence of an interpretive regulation should be decisive in a case in which an interpretive regulation is appropriate and in which reasonable arguments can be made both for a literal interpretation and for a nonliteral contextual interpretation. If the regulation reasonably adopts a nonliteral interpretation, a court should defer to the regulation, even if the court otherwise would have preferred a literal interpretation. If, instead, the regulation reasonably adopts a literal interpretation, the court likewise should defer, even if the court otherwise would have favored a nonliteral interpretation. The existence of a regulation enables the government to prevail so long as its regulatory interpretation is reasonable, and a regulatory interpretation may be reasonable even though it is not one the court would have reached in the absence of the regulation.

Id. at 673-74. In this Article I take the position that the regulations, as well as the statutory provisions, should be evaluated in the context of the underlying structures, policies and principles of the

The Supreme Court, however, placed such great importance upon having its decisions comport with the concept of annual accounting for two interrelated reasons. First, the Court failed to consider the annual accounting provisions of the Code in light of the various policies evidenced by the statutory and regulatory scheme which forms the basis of our income tax accounting system. Second, in *Sanford & Brooks*, the Court misinterpreted key statutory provisions as placing greater emphasis on adherence to annual accounting than Congress had ever intended. Indeed, a careful examination of the development of the statutory and regulatory scheme for accounting for income demonstrates that the scheme developed not out of any well-conceived plan to promote a particular system of accounting, but rather through trial and error. The goal of this trial and error system was to raise revenue in an administratively feasible manner without sacrificing two other paramount goals: (1) providing equitable treatment to both the taxpayer and the government, and (2) protecting the federal fisc from depletion by taxpayer manipulation. In developing a statutory scheme to further all these goals, Congress, in some cases, enacted legislation that certainly does comport with the concept of annual accounting.¹⁵ In other cases, however, Congress furthered these goals through legislation that definitely does not comport with the concept of annual accounting.¹⁶ The conclusion to be drawn is that Congress merely regarded annual accounting as a useful tool in its trial and

income tax system as a whole and in light of the conditions to which those regulations were a response. Thus, even if a regulation which adopts a literal interpretation of a Code provision constitutes a reasonable interpretation of the Code language in question, a court should not blindly accept that regulation. A court should consider whether adherence to that regulation conflicts with some policies or principles that underlie the tax system and whether the regulation was a response to, or promulgated under, conditions that are vastly different from those in existence when the issue comes before the court.

In some respects my approach to regulatory evaluation could be deemed a natural outgrowth from Dean Calabresi's view of how courts should evaluate statutory provisions. Calabresi sees "the common law function to be exercised by courts today . . . [as] . . . the judgmental function . . . of deciding when a rule has come to be sufficiently out of phase with the whole legal framework so that, whatever its age, it can stand only if a current majoritarian or representative body reaffirms it." G. CALABRESI, *A COMMON LAW FOR THE AGE OF STATUTES* 164 (1982). The approach to regulatory evaluation suggested here simply extends Dean Calabresi's statutory evaluation approach to the field of regulatory evaluation so that a court should strike down a regulatory provision if, in Calabresi's words, it "has come to be sufficiently out of phase with the whole legal framework."

15. See, e.g., *supra* notes 10-12 and accompanying text.

16. See, e.g., I.R.C. § 172 (West Supp. 1988) (net operating loss carryback and carryforward); I.R.C. §§ 453-453C (West Supp. 1988 as amended by the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, 2365-72) (installment sales); I.R.C. § 1341 (West Supp. 1988) (repayment by taxpayer of substantial amounts previously reported under claim of right).

error approach to revenue raising and never intended for the concept of annual accounting to achieve the status that the Supreme Court granted it.

The purpose of this Article is to prove the foregoing thesis by examining in detail the early history of the statutory and regulatory scheme for income tax accounting. If the examination demonstrates that from the earliest years of income taxation after passage of the sixteenth amendment,¹⁷ Congress either countenanced or promulgated transactional or other non-annual methods of accounting, then it is highly doubtful that Congress intended for the Court to emphasize adherence to annual accounting in the manner that it did. Furthermore, if the examination demonstrates that these inroads upon annual accounting resulted from an effort to achieve goals that conflict somewhat with the policies and goals of annual accounting, then the Court should have considered how annual accounting affected these other goals or policies in its decision-making process.

Admittedly, such an approach requires balancing some competing policy goals. If a historical review indicates that the Court should have, but did not, engage in such balancing, perhaps some aspects of current law should be revised to reflect a better balance among competing policy goals. Such a revision can be justified on two grounds: (1) it would bring current law into greater harmony with the balance among competing policies that Congress historically desired; and (2) it could indicate to courts the importance of balancing the goals of annual accounting

17. Of course, the history of the income tax in the United States did not begin with the sixteenth amendment. The first federal income tax appeared during the Civil War and continued until its repeal in 1872. Act of Aug. 5, 1861, ch. 45, 12 Stat. 292 (income tax), *repealed by* Act of June 6, 1872, ch. 315, 17 Stat. 230. In response to populist pressures from the emerging western states, the tax was revived in 1894 as a means of forcing the wealthy to contribute more to the public fisc. See generally D. POSIN, *FEDERAL INCOME TAXATION* 3-8 (1983) for a brief history of federal income taxation. See also Act of Aug. 27, 1894, ch. 349, 28 Stat. 509 (1894). However, the Supreme Court found the 1894 tax unconstitutional in *Pollack v. Farmers' Loan & Trust Company*, 157 U.S. 429 (1895). As a result of that decision, a federal income tax did not become a permanent fixture until the passage of the sixteenth amendment in 1913. Thus, it is impossible to examine the history of the tax as a continuum prior to the passage of the sixteenth amendment, and it is very difficult to draw conclusions as to Congress' intent as it developed prior to that time. Furthermore, in justifying strict adherence to annual accounting, the Supreme Court in *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 363 (1931) referred only to "the revenue acts which have been enacted since the adoption of the sixteenth amendment." 282 U.S. at 363. For these reasons our examination of the early history will begin with the passage of the sixteenth amendment and will ignore the income tax as it existed prior to that time.

against other policy considerations in reaching decisions, thus leading to a more principled and realistic tax jurisprudence.

Recognition of the need to balance the goals of annual accounting against other policy considerations is not without precedent. Twenty years ago, a proposal was made¹⁸ that could have provided a meaningful first step toward recognition of the importance of policies other than those promoted by annual accounting. Fairly recently, in *Hillsboro National Bank v. Commissioner*,¹⁹ the Court itself took a tentative step toward a more realistic tax jurisprudence.²⁰ However, an observer is forced to wonder whether at this late date in the development of the law the Court feels free to do any more than take tentative steps.²¹ Since the Court first interpreted the statutory and regulatory scheme for tax accounting in a manner that overemphasized adherence to annual accounting, Congress has changed the statutory topography.²² Therefore, the Court will probably never get the opportunity to reevaluate its earlier interpretations. As a result, Congressional adoption of a proposal along the lines of that posited some twenty years ago may indeed be one way to begin the balancing process. In an effort to prove that such proposals fit properly within the original intent of Congress in developing our tax accounting system, this Article examines in some detail the early history of our tax accounting system. In addition, this Article presents a somewhat similar proposal for reform, not as the overall solution to the problem, but rather as a step in the right direction that would alleviate one particular inequity arising from strict adherence to annual accounting. Before

18. Note, *The Tax Benefit Rule, Claim of Right Restorations and Annual Accounting: A Cure for the Inconsistencies*, 21 VAND. L. REV. 995 (1968).

19. 460 U.S. 370 (1983).

20. See Grauer, *supra* note 3, at 391-92 where I discuss the significance of the *Hillsboro* Court's statement that the tax benefit rule is "to approximate the results produced by . . . transactional . . . accounting." 460 U.S. at 381.

21. As to whether *Hillsboro* could be used as an overall entré toward a more realistic tax jurisprudence because it recognizes a role for transactional accounting, we must bear in mind that *Hillsboro* dealt with the tax benefit rule. I have earlier stated:

[B]ecause the tax benefit rule has already been accepted [by commentators] as an aspect of our tax system that involves transactional accounting, *Hillsboro's* recognition of the limits of annual accounting and the benefits of approximating transactional accounting might be limited to tax benefit rule cases and thus not deemed of great precedential value with respect to other tax issues.

Grauer, *supra* note 3, at 393. Therefore, the Court may not believe that language in *Hillsboro* recognizing a role for transactional accounting is sufficient to overcome years of earlier precedent that rejected a role for a transactional approach to accounting in cases that did not involve the tax benefit rule fact pattern.

22. See *infra* note 285 and accompanying text.

examining the early history of our tax accounting system, however, this Article will first explore the parameters of annual accounting and some policies it furthers as well as some policies furthered by other types of accounting or analyses.

Examination of these policies, however, will be limited to that appropriate to the doctrinal/historical examination that this Article is pursuing. Accounting issues, of course, can be examined through methodologies other than the historical one employed here. Recent articles have examined current accounting issues through the use of economic and financial models.²³ As this Article's purpose is mainly to determine if historically Congress desired annual accounting to be tempered by some policies that conflict with those behind annual accounting, this Article will forego the use of economic and financial models in favor of an examination of the historical context in which the early annual accounting provisions developed in the statutory and regulatory scheme. The decision not to engage in economic and financial modeling in this Article is also justified by the fact that this Article will be evaluating whether courts engaged in a proper balancing of policy goals in an era before the legal literature contained today's economic and financial modeling. It is thus only fair to those courts to evaluate what they were doing in the context of the information available to them at that time.

I. THE CONCEPTS AND GOALS OF ANNUAL AND NON-ANNUAL ACCOUNTING SYSTEMS OR ANALYSES

The concept of annual accounting and the policies that it furthers must be juxtaposed against the concepts of lifetime or transactional accounting and the policies they further. The United States Treasury Department's Tax Policy Staff has acknowledged, "Ideally, two taxpayers should be compared on the basis of a whole *lifetime* of circumstances, and this is taken here to be a general goal of tax system design: lifetime tax burden should depend upon lifetime circumstances."²⁴ Such an approach recognizes that accounting for taxes over shorter periods of time may distort

23. See, e.g., Gunn, *Matching of Costs and Revenues as a Goal of Tax Accounting*, 4 VA. TAX REV. 1 (1984); Halperin & Klein, *Tax Accounting for Future Obligations: Basic Principles Revised*, 38 TAX NOTES 831 (1988); Klein, *Tax Accounting for Future Obligations: Basic Principles*, 36 TAX NOTES 623 (1987).

24. D. BRADFORD, *BLUEPRINTS FOR BASIC TAX REFORM* 24 (2d ed. 1984) (emphasis in original) (While this book, which first appeared in print in 1977, was principally authored by David Bradford, who was Deputy Assistant Secretary of the Treasury for Tax Policy in the Ford administration, it represents a team effort by the Treasury's Tax Policy Staff during the Ford administration.

one's true income picture and produce inequities. For example, suppose a taxpayer incurred all his expenses in generating income during his lifetime in one accounting period, and received all his lifetime income in another accounting period. The inability to offset the income with the expenditures, as a result of having two separate accounting periods, would subject the taxpayer to a higher lifetime tax than if the expenditures and income receipt had occurred in the same accounting period. Thus, the most equitable way to tax two people who have similar incomes over time is to avoid the use of artificial accounting periods and calculate one's lifetime tax after determining one's lifetime income.

Such an approach, however, would be disastrous to the government. Although similar treatment of similarly situated taxpayers is a desirable goal for an income tax system, an income tax system must also raise revenue in a predictable and administratively feasible manner.²⁵ If income taxes were based solely upon one's lifetime income, the government, not knowing who might die at any given time, could not estimate how much revenue it would receive during any particular time period. Furthermore, even if the government could predict its revenue entitlements by combining census and mortality data, the chances of collecting the revenue to which it was entitled would be rather slim. Quite likely, most estates would not contain sufficient assets to satisfy a decedent's lifetime tax bill. Thus, the use of accounting periods, and indeed an annual accounting system, has been deemed "a practical necessity if the federal income tax is to produce revenue ascertainable and payable at regular intervals."²⁶

When viewed in the context of an average lifetime, an annual accounting period is rather short. Additionally, a leading tax theorist recognized some time ago that the shorter accounting periods are, and the more rigidly they are adhered to, the more likely it is that complexities and

Statements contained in the book can therefore be deemed those of the Treasury's Tax Policy Staff at that time).

25. See, for example, *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931) where the Court stated:

The Sixteenth Amendment was adopted to enable the government to raise revenue by taxation. It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation.

282 U.S. at 365.

26. *Hillsboro National Bank v. Commissioner*, 460 U.S. 370, 377 (1983).

inequities will result.²⁷ For example, a construction contract that takes several years to complete may not result in an overall profit, but under annual accounting this contract may give rise to income subject to taxation if the taxpayer receives payments on the contract in a different year than he incurs the offsetting expenditures.²⁸ The question thus arises whether both equity and the need for collecting revenues on a regular and foreseeable basis could be satisfied by imposing taxes on the results of discrete transactions, rather than on the basis of annual accounting periods.

The problem with this transactional approach is that the duration of transactions varies so widely that the government may find it difficult to predict its revenue flow. Additionally, the absence of a definite time period for accounting for taxes could induce taxpayers to extend the duration of various transactions or to convert several shorter transactions into one lengthy transaction in order to obtain the time value of money. Thus, discrete accounting time periods are indeed necessary because they enable the government to predict and obtain revenues at regular intervals and to preclude certain manipulations of the system by taxpayers.

By the same token, limitations on the employment of annual accounting are necessary because they minimize inequities such as those in the example above.²⁹ Furthermore, some limitations may be necessary to

27. See H. SIMONS, FEDERAL TAX REFORM 59-60 (1950). Henry Simons stated:

[Good income tax accounting or] procedure must not require or presuppose sharp allocations of income among short accounting periods. . . . [T]ax legislation calling for definitive annual determinations means awful complexity, difficult administration, expensive compliance, endless litigation, and bad taxpayer and Bureau morale. Like it or not, we must recognize that good income taxation is not merely a succession of events in or respecting discrete, water-tight accounting periods but is essentially process through time. Its objectives must be defined and pursued with respect to long periods, often the taxpayer's whole lifetime Income taxation has simply never faced squarely the axiom that annual-accounting is and should be tentative and provisional.

28. Indeed, this is exactly what occurred in *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931) where the Court held that the taxpayer could not offset income it received in 1920 against losses it incurred in 1913, 1915 and 1916, even though the earlier losses and the later income all arose out of the same transaction. The transaction on the whole, was not a profitable one, and the earlier losses had not generated any tax benefit for the taxpayer. Under the Revenue Act of 1918 the only losses that a taxpayer could carry forward to offset 1920 income were losses incurred in taxable years beginning after October 31, 1918 and ending prior to January 1, 1920. See Revenue Act of 1918, ch. 18, § 204(b), 40 Stat. 1057, 1061 (1919). Therefore, no loss carry over provision was available to the taxpayer in *Sanford & Brooks* to protect it from the inequitable and harsh result that flowed from strict application of annual accounting.

29. An example of such an inequity exists where the tax system imposes a tax on the proceeds from a long term contract that does not result in a gain. See *supra* note 28. See also *infra* Part II. B. 1.

preclude manipulations of the system by taxpayers.³⁰ As a result, Congress and the courts have at times tempered the use of annual accounting with non-annual or transactional accounting.³¹

In order to recognize when the use of annual accounting is tempered or encroached upon, one must understand the requirements of annual accounting. One commentator has described annual accounting as requiring "all taxpayers to calculate their taxable income on an annual basis in light of the facts known to them at the time of filing. Strictly applied, annual accounting treats each year as a discrete unit."³² According to another commentator, a pure theory of annual accounting "requires disregarding the factors of prior or subsequent taxable years, despite their relation to the year in question."³³ In other words, pure annual accounting determines taxable income by netting the actual or accrued receipts of a yearly period against the actual or accrued deductible expenses in that same yearly period, without any regard to the transactions which gave rise to those receipts or expenditures.

Because a taxpayer often receives income as a result of transactions or events that occur in years other than the year of receipt, strict adherence to annual accounting not only might produce inequitable or manipulative results, but also would produce a system of accounting for taxes that bore no relationship to reality. Thus, our tax accounting system, in order to be realistic, does consider events that occur in years other than the year of the receipt or deduction in question. However, it is a misnomer to call that aspect of our accounting system an aspect which comports with the concept of annual accounting.

More accurately, any aspect of our accounting system that considers events occurring in other years, whether for the purpose of bringing real-

30. See Grauer, *supra* note 3, at 364-67 (description of how taxpayers situated similarly to those in *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952) could have used strict adherence to annual accounting to reap an undeserved windfall through abusive premature liquidations of closely held corporations that faced contingent liabilities).

31. See *supra* note 16 for some examples of congressional tempering of strict adherence to annual accounting through the promulgation of transactional or non-annual accounting provisions. The courts have also used non-annual or transactional accounting or analysis. See, e.g., *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952) (if a transaction in one year is so integrally related to a transaction in an earlier year that they are in effect part and parcel of the same transaction, the manner in which the earlier year's transaction was characterized should affect the manner in which the later year's transaction is characterized); *Dobson v. Commissioner*, 320 U.S. 489 (1943) (the transactional exclusionary aspect of the tax benefit rule could apply in situations not specifically enumerated by Congress).

32. White, *supra* note 1, at 492.

33. See Note, *supra* note 18, at 995.

ity to the system, making it more equitable, or precluding manipulation of the system by taxpayers, should be described as a transactional incursion into annual accounting's domain. Also, it is far more accurate to describe an accounting system that tempers the problems presented by pure annual accounting with transactional elements as a hybrid system rather than as an annual accounting system. Acceptance of the system as hybrid could free the courts from the need to justify their decisions as comporting with the concept of annual accounting. If this occurred, courts could concentrate on reaching results by properly balancing underlying policy goals, and thereby draft more lucid opinions. An examination of the history of the governing statutory and regulatory scheme for tax accounting will reveal whether this is what Congress originally intended.

II. THE EARLY HISTORY OF THE STATUTORY AND REGULATORY SCHEME OF ACCOUNTING FOR INCOME: AN UNSTEADY GROWTH

Ever since the Income Tax Law of 1913,³⁴ which was the first income tax act promulgated pursuant to the sixteenth amendment, taxpayers have accounted for income on an annual basis. However, what began simply as a requirement that taxpayers account for income and pay taxes on a regular basis grew quickly into a statutory and regulatory scheme that evidenced somewhat contradictory policies. Prior to the Revenue Act of 1918,³⁵ which was enacted in 1919,³⁶ the income tax statutes were relatively simple documents, and the requirement of accounting for income on an annual basis was woven into the statutes in a manner that did not belabor the point. With the Revenue Act of 1918, the income tax statutes took on a new and much more technically complex form. In this new format, Congress emphasized the existence of annual accounting in an affirmative manner and, for the first time, described in some detail the requirements of annual accounting. However, by the end of 1918, prior to final enactment of the Revenue Act of 1918, detailed requirements of annual accounting had already begun to appear in the Treasury Regulations.³⁷ At about the same time, however, certain statutory and regulatory provisions appeared which did not comport with the concept of

34. Ch. 16, § II, 38 Stat. 114, 166-81 (1913).

35. Ch. 18, 40 Stat. 1057 (1919).

36. *Id.* (giving enactment date as February 24, 1919).

37. See *infra* text accompanying notes 51, 55.

annual accounting.³⁸ A more detailed description of this statutory and regulatory development will demonstrate the contradictory path along which the scheme for tax accounting developed.

A. Strict Adherence to Annual Accounting Prior to the Revenue Act of 1918

In a very simple fashion, the Income Tax Law of 1913 wove annual accounting into provisions that addressed rates, deductions and tax return computation. Section II.A.1. dealing with rates, provided:

That there shall be levied, assessed, collected and paid *annually* upon the entire net income arising or accruing from all sources *in the preceding calendar year* to every citizen of the United States, whether residing at home or abroad, and to every person residing in the United States, though not a citizen thereof, a tax of 1 per centum *per annum* upon such income, except as hereinafter provided; and a like tax shall be assessed, levied, collected, and paid *annually* upon the entire net income from all property owned and of every business, trade, or profession carried on in the United States by persons residing elsewhere.³⁹

Section II.B. dealing with deductions, provided in pertinent part:

That in computing net income for the purpose of the normal tax there shall be allowed as deductions: First, the necessary expenses actually paid in carrying on any business, not including personal, living, or family expenses; second, all interest paid *within the year* by a taxable person on indebtedness; third, all national, State, county, school, and municipal taxes paid *within the year*, not including those assessed against local benefits; fourth, losses actually sustained *during the year*, incurred in trade or arising from fires, storms, or shipwreck, and not compensated for by insurance or otherwise; fifth, debts due to the taxpayer actually ascertained to be worthless and charged off *within the year*; sixth, . . .⁴⁰

Additionally, Section II.D., pertaining to tax return computations provided in pertinent part, "The said tax shall be computed upon the remainder of said net income of each person subject thereto, *accruing during each preceding calendar year* ending December thirty-first. . ."⁴¹

Section II.G.(a) made the foregoing provisions applicable to corporate taxpayers.⁴² As these provisions illustrate, the first income tax act

38. See *infra* Parts II. B. & C. and Part III.

39. 38 Stat. at 166 (emphasis added).

40. *Id.* at 167 (emphasis added).

41. *Id.* at 168 (emphasis added).

42. *Id.* at 172.

promulgated under the sixteenth amendment called for an annual accounting system without being heavy-handed.

Congress continued this approach to an annual accounting system in the Revenue Act of 1916.⁴³ With regard to the emphasis placed on annual accounting, the Act's sections on deductions, both individual and corporate, were not substantially different from Section II.B. of the Income Tax Law of 1913.⁴⁴ The sections of the 1916 Act dealing with tax rates and tax return computation, however, contained a very subtle change from their counterparts in the 1913 Law. The 1916 rate sections, section 1(a) for individuals and section 10 for corporations, both provided in pertinent part: "[T]here shall be levied, assessed, collected, and paid *annually upon the entire net income received in the preceding calendar year* from all sources . . . a tax of two per centum upon such income. . . ."⁴⁵ Additionally, the 1916 return computation sections, section 8(a) for individuals and section 13(a) for corporations, provided in pertinent part: "The tax shall be computed upon the net income, as thus ascertained, . . . *received in each preceding calendar year*. . . ."⁴⁶ The subtle change was the use of the word "received" in these sections. The counterpart to these sections in the 1913 Law had used the term "accruing" to describe the time when items would be accounted.

One could easily read the word "received" in the later Revenue Act of 1918 to indicate the importance of adherence to annual accounting.⁴⁷ Therefore, use of the more specific word, "received," in the 1916 Act

43. Ch. 463, 39 Stat. 756 (1916).

44. See Ch. 463, § 5(a), 39 Stat. 756, 759 (1916) (deductions for individuals); Ch. 463, § 12, 39 Stat. at 767-70 (deductions for corporations).

45. Ch. 463, § 1(a), 39 Stat. 756; Ch. 463, § 10, 39 Stat. 765 (emphasis added with respect to both sections).

46. Ch. 463, § 8(a), 39 Stat. 761; Ch. 463, § 13(a), 39 Stat. 770 (emphasis added with respect to both sections).

47. Ch. 463, § 213(a) of the Revenue Act of 1918 provided in part: "The amount of all such items [which could conceivably encompass gross income] shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period. . . ." Revenue Act of 1918, ch. 18, § 213(a), 40 Stat. 1057, 1065 (1919). Subdivision (b) of § 212 authorized the use of accounting methods other than cash basis. Therefore, the word "received" in § 213(a) could have been used simply to denote cash basis accounting, just as it was in the 1916 Act. See *infra* note 48 and accompanying text. However, the syntax and tone of § 213(a) of the 1918 Act is so different from that of §§ 1(a), 8(a), 10(a), and 13(a) of the 1916 Act, see *supra* text accompanying notes 45, 46, that the word "received" and the language of § 213(a) take on an added connotation: unless a taxpayer is using a special method of accounting authorized by § 212(b) items shall be included in income and accounted for *only in the year of receipt*. Interpreting § 213(a) as emphasizing such a requirement for strict adherence to annual accounting is not unwarranted.

could have indicated a subtle Congressional shift toward emphasizing a system of annual accounting. That was not, however, the reason for this rewording. Rather, as Professor Gunn has noted, this rewording enabled Congress to distinguish between cash and accrual basis accounting and to introduce the concept of accrual basis accounting to the tax laws through sections 8(g) and 13(d) of the 1916 Act.⁴⁸ Nonetheless, because the Revenue Act of 1918 did use the word "received" in a manner that indicated the importance of adherence to annual accounting,⁴⁹ conceivably the Treasury, anticipating the 1918 Act, believed that use of the word "received" in the 1916 Act authorized it to take a more aggressive approach toward requiring strict adherence to annual accounting in regulations under the 1916 Act than it had taken in regulations under the 1913 Law. As discussed below, however, the Treasury's more aggressive approach toward annual accounting resulted from more than simply the appearance of the word "received" in the 1916 Act.

Unlike the language of the 1916 Act itself, the regulations promulgated pursuant to the 1916 Act were in some ways quite heavy-handed in their approach to annual accounting. Article 110 of Regulation 33, promulgated pursuant to the Revenue Act of 1916,⁵⁰ addressed corporate taxpayers and provided:

Bad debts or accounts charged off by a corporation because of the fact that they were determined to be worthless, and subsequently recovered, consti-

Indeed, the Supreme Court in *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931), based its holding on just such an interpretation of § 213(a). See *Sanford & Brooks Co.*, 282 U.S. at 363.

48. See, Gunn, *supra* note 23, at 4-6, n.18-20 (1984) (analyzes the Revenue Act of 1916, ch. 463, §§ 8(g) and 13(d), 39 Stat. 756, 763, 771 (1916)).

Ironically, according to Gunn, the term "accruing" as used in the 1913 Law did not connote the concept of accrual accounting as we know it today, but was rather a nontechnical term. Under the 1913 Law the only acceptable method of accounting was the cash receipts and disbursements method. Therefore, Congress had to replace the term "accruing" with the more specific word, "received," in 1916 to establish a clear general rule of cash accounting to which accrual accounting could be a statutorily authorized alternative pursuant to §§ 8(g) and 13(d) of the Revenue Act of 1916. See Gunn, *supra* note 23, at 4-5, n.18.

49. See *supra* note 47.

50. By the time the Treasury Department promulgated this regulation, the 1916 Act had been amended by the Revenue Act of 1917. The Revenue Act of 1917, ch. 63, 40 Stat. 300 (1917), was not written as a complete entity. Rather, it was an amendment to the Revenue Act of 1916 that consisted of a huge rate increase to help finance World War I. Under the Revenue Act of 1917 the top individual rate rose from 15% under the Revenue Act of 1916 (a 2% base rate, plus a 13% surtax) to 63% under the Revenue Act of 1917. See R. BLAKEY & G. BLAKEY, *THE FEDERAL INCOME TAX* 120, 151 (1940). Because the Revenue Act of 1917 was basically a rate increase, the provisions of the Revenue Act of 1916 that dealt with accounting for taxes on an annual basis were not changed by the Revenue Act of 1917.

tute income for the year in which recovered, regardless of the date when the amounts were charged off. Neither the date at which the debt was charged off nor the fact that it was or was not deducted from gross income in any return made for tax purposes, will in any way affect its character as income of the year in which recovered.⁵¹

The forerunner of this regulation, promulgated pursuant to the 1913 Law merely provided, "Bad debts, if so charged off the company's books, during the year, are proper deductions. But such debts, if subsequently collected, must be treated as income."⁵² One could infer from this regulation under the 1913 Law that the taxpayer should treat subsequently collected bad debts as income in the year of collection. However, the wording of this regulation also permits the interpretation that the taxpayer could treat the collected amount as income by amending the return for the year in which the corporation took the bad debt deduction by offsetting the bad debt deduction with the amount subsequently collected. Such a procedure would accurately correct the tax liability for the earlier year to the extent that it was based upon an erroneous assumption regarding the worthlessness of the debt in question. Furthermore, amendment of the earlier year, rather than inclusion in the later year, would preclude an undeserved windfall to either the government or the taxpayer through a change in applicable tax rates.⁵³ Article 110 of

51. Treas. Reg. 33, art. 110 (1918), *reprinted in* 132 INTERNAL REVENUE ACTS OF THE UNITED STATES 1909-1950: LEGISLATIVE HISTORIES, LAWS, AND ADMINISTRATIVE DOCUMENTS (B. Reams, ed., 1979) [hereinafter REVENUE ACTS 1909-1950].

52. Treas. Reg. 33, art. 125 (1914) *reprinted in* 132 REVENUE ACTS, 1909-1950, *supra* note 51.

53. Inclusion in the later year rather than amendment of the earlier year can give rise to undeserved windfalls in the following ways: If a \$1,000 bad debt were written off when the taxpayer was in the 30% tax bracket, but recovered when the taxpayer was in the 70% tax bracket, the inclusion in the later year would cost the taxpayer \$700 in taxes even though the initial deduction saved the taxpayer only \$300 in taxes. The taxpayer ends up worse off to the extent of \$400 than if he had never taken the deduction in the first place, an undeserved windfall to the government. If the rates were reversed so that the taxpayer was in the 70% bracket when he wrote off the \$1,000 bad debt, but in only the 30% bracket when he recovered that debt, the taxpayer would owe only \$300 in tax in the year of inclusion even though he saved \$700 tax in the earlier year of deduction, thus providing an undeserved windfall of \$400 to the taxpayer. Precluding these windfalls by amending the earlier year's return would not simply mean that the taxpayer should repay to the government only the amount of tax saved in the earlier year of deduction. The taxpayer should also pay interest on the tax saved in the earlier year. The payment of interest would compensate the government for being deprived of money that it would have had if the taxpayer had not erroneously assumed the worthlessness of the debt. The requirement that the taxpayer pay interest should not be regarded as penalizing the taxpayer, but merely as returning to the government the time value of the money that the taxpayer had already obtained by virtue of its having earlier reported on the basis of an erroneous assumption.

It is, of course, possible that if the recovery occurs many years after the deduction was taken, the

Regulation 33, pursuant to the 1916 Act, foreclosed this interpretation and required inclusion in the year of recovery even if the earlier deduction had not given rise to a tax benefit.⁵⁴ Thus, the regulation under the 1916 Act on the collection of bad debts by corporate taxpayers demonstrated an approach that favored ease of administration through strict adherence to annual accounting over an accurate reflection of and taxation of income over time.

This movement toward strict adherence to annual accounting in the regulations pursuant to the 1916 Act was further evidenced by Article 127 of Regulation 33 regarding corporate taxpayers. Article 127 provided in part:

Each year's return complete. []Each year's return, both as to income and deductions therefrom, must be complete within itself. Charges, of whatever character, against income can not be cumulative. They must be deducted from the income of the year in which incurred or not at all. The expenses, liabilities, or deficit of one year can not be used to reduce the income of a subsequent year.⁵⁵

Unlike Article 110 of Regulation 33 under the 1916 Act, dealing with the recovery of bad debts, Article 127 apparently had no antecedent provision in the regulations under the 1913 Law. However, the absence of an antecedent provision does not mean that the regulations as a whole were completely rewritten to emphasize the requirement of annual accounting.

Articles 110 and 127 concerned only corporate taxpayers. The articles addressing individuals contained no counterpart to Article 127 which required very strict adherence to annual accounting by corporate taxpayers. Furthermore, Article 4, dealing with an individual taxpayer's collection of previously charged bad debts simply provided, "Bad debts which have been claimed and allowed as a deduction in prior returns are considered income if subsequently collected."⁵⁶ This language is almost identical to that found in the corporate taxpayer regulations promulgated

amount of accrued interest could be quite substantial and, indeed, could exceed the tax owed. Whether this factor, among others, should limit the taxpayer's ability to reopen earlier years in lieu of adhering strictly to annual accounting by simply including the debt recovery in the later year will be addressed later in this Article. See *infra* text accompanying notes 282-85.

54. Treas. Reg. 33, article 110 required inclusion in income in the later year regardless of the absence of a tax benefit in the earlier year, stating, "Neither the date at which the debt was charged off nor the fact that it was or was not deducted from gross income in any return made for tax purposes, will in any way affect its character as income of the year in which recovered." Treas. Reg. 33, art. 110 (1918), reprinted in 132 REVENUE ACTS 1909-1950, *supra* note 51.

55. Treas. Reg. 33, art. 127 (1918), reprinted in 132 REVENUE ACTS 1909-1950, *supra* note 51.

56. Treas. Reg. 33, art. 4 (1918), reprinted in 132 REVENUE ACTS 1909-1950, *supra* note 51.

pursuant to the 1913 Law⁵⁷ which did not take as firm an approach to annual accounting as did the corporate taxpayer regulations promulgated pursuant to the 1916 Act. Thus, the language in the regulations under the 1916 Act was not consistent in its emphasis upon strict adherence to annual accounting. It is unlikely, however, that the Treasury intended for annual accounting to be less strictly applied to individual taxpayers than to corporate taxpayers. Rather, two interrelated factors most likely precluded the Treasury from drafting regulations that were internally consistent in their approach to annual accounting.

The first factor was the Treasury's general lack of experience in administering an income tax. As mentioned earlier, the 1913 Law was the first income tax statute passed pursuant to the sixteenth amendment. However, Congress did not consider the 1913 Law as a separate income tax act. Instead, it considered the income tax provisions merely as part of an overall tariff bill.⁵⁸ Furthermore, the 1913 Law did not raise revenue as effectively as Congress had anticipated,⁵⁹ partly because the administration of the law was complicated and difficult for the Treasury to master.⁶⁰ The Revenue Act of 1916, on the other hand, was written as a separate entity instead of as part of another bill.⁶¹ The Revenue Act of 1916 did not merely clarify the income tax statute; it completely rewrote it.⁶² Thus, the Treasury, faced with a new income tax statute before it had adjusted to administering an income tax at all, probably drafted regulations as ad hoc responses to administrative problems rather than as internally consistent works of art. For example, if a corporate taxpayer raised an issue on accounting for taxes, the Treasury may have resolved that problem by amending the appropriate corporate taxpayer regulations to emphasize the need for strict adherence to annual accounting without ever considering whether the regulations for individual taxpayers should be similarly amended. Although one might question the wisdom or propriety of such an ad hoc approach, the second of the interrelated factors, namely World War I, made it almost impossible for the Treasury to take the time required to develop an internally consistent and carefully planned regulatory scheme.

57. See *supra* text accompanying note 52.

58. See R. BLAKEY & G. BLAKEY, *supra* note 50, at 74-75, 119-20.

59. See R. BLAKEY & G. BLAKEY, *supra* note 50, at 104; J. WITTE, *THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX* 79 (1985).

60. R. BLAKEY & G. BLAKEY, *supra* note 50, at 100-01.

61. *Id.* at 119-20.

62. *Id.* at 120.

At the same time that administrative problems with the new income tax partly caused the failure of the Income Tax Law of 1913 to generate the anticipated revenues,⁶³ the outbreak of World War I in 1914 had a devastating impact on American trade with Europe. Trade with Germany, France and Britain was suddenly cut off in August of 1914, causing a serious decline in both general revenues and customs duties.⁶⁴ An economic recovery in 1915 postponed the need to raise taxes for a short time.⁶⁵ However, by 1916 a tax increase was needed as America prepared for a potential war.⁶⁶ Additionally, as American entry into World War I approached, the government decided that the United States should finance the war effort mainly through increased taxes and not through borrowing.⁶⁷ It also became clear at this time that the income tax would be the most effective of all taxes at raising revenue quickly.⁶⁸ As a result, the Treasury was forced not only to administer a new type of tax that was being amended or rewritten so often that attempts at administration were like shots at a moving target,⁶⁹ but also to administer that tax in a manner that would generate the revenue needed to support a massive war effort.⁷⁰ Thus, in initially administering the income tax, the Treasury

63. See *supra* note 59.

64. See C. GILBERT, *AMERICAN FINANCING OF WORLD WAR I*, 23-26 (1970); J. WITTE, *supra* note 59, at 79.

65. See S. RATNER, *TAXATION AND DEMOCRACY IN AMERICA* 343 (1942); J. WITTE, *supra* note 59, at 79.

66. See S. RATNER, *supra* note 65, at 343-46; J. WITTE, *supra* note 59, at 81-82.

67. See Hamel, *The Joint Congressional Committee On Internal Revenue Taxation*, 5 NAT'L. INCOME TAX MAG. 161, 161 (1927) (Note that *The National Income Tax Magazine* later became the present day *Taxes*.) See also, S. RATNER, *supra* note 65, at 344-52.

68. See J. WITTE, *supra* note 59, at 86.

69. In the space of seven years, 1913 through 1919, five Revenue Acts were passed and took effect; the Income Tax Law of 1913, the Revenue Act of 1916, the Revenue Act of March 3, 1917, the War Revenue Act of October 3, 1917 and the Revenue Act of 1918. All previous and future references in this Article to the Revenue Act of 1917 are to the War Revenue Act of October 3, 1917. The Revenue Act of March 3, 1917, ch. 159, 39 Stat. 1000 (1917) was almost immediately rendered obsolete by the United States' entry into World War I and was replaced by the War Revenue Act of October 3, 1917 before it could even be implemented. See R. BLAKEY & G. BLAKEY, *supra* note 50, at 122, 129.

70. Obviously, more revenue could be raised if a higher rate were applied to equivalent taxable amounts. The major effect of the War Revenue Act of 1917 was to raise tax rates substantially. See *supra* note 50. Thus, after the War Revenue Act of 1917, it was quite likely that a substantially higher rate would apply to a recovered bad debt if annual accounting were strictly applied and the recovered amount were included in income in the later year of recovery than if the earlier year of deduction were amended and only the taxes saved in the earlier year were paid to the government. (For an example of the effect of the rate differential, see *supra* note 53.) Thus, in some instances, strict adherence to annual accounting during World War I enabled the Treasury not only to simplify administration of the tax system, but also to generate greater revenue.

understandably might have drafted regulations as ad hoc responses to problems and might have favored ease of administration through strict adherence to annual accounting over a more equitable system that accurately reflected and taxed income over time.

At the same time, however, the Treasury was not oblivious to the inequities that could result from strict adherence to annual accounting. Nor did it completely ignore the goal of accurately computing and taxing income over time. Even during the early years of its experience with an income tax, the Treasury promulgated regulations that promoted equitable treatment of the taxpayer at the expense of strict adherence to annual accounting.⁷¹ Regulations requiring strict adherence to annual accounting⁷² co-existed with regulations that not only sought an accurate reflection and taxation of income over time, but also furthered that equitable goal by not adhering strictly to the concept of annual accounting. Thus, even in the very early years of our income tax system the Treasury apparently was not zealously wedded to basing our income tax system on annual accounting. Instead, the Treasury was apparently doing its best to administer the income tax fairly and equitably. But the press of revenue needs and its own lack of experience in administering an income tax at times caused the Treasury to opt for administrative convenience at the expense of equity.⁷³ The conflicting goals of developing a new tax system in an equitable manner and of using that tax system to raise revenue quickly for a war effort apparently resulted in a trial and error approach to income tax administration in general⁷⁴ and to accounting for income taxes in particular.⁷⁵ A more detailed examination of this trial and error approach can illuminate the role that the Treasury and Congress really intended for annual accounting to play.

71. See *infra* notes 90, 106-08 and accompanying text.

72. See *supra* text accompanying notes 51 and 55.

73. See J. WITTE, *supra* note 59, at 83. The author states:

The general approach of financing the war through heavy taxation was supported by most of the academic community, which sent a letter to Congress outlining the advantages of this course. Curiously, the question of equity or justice was addressed only in terms of the inappropriateness of laying the burden of war debts on returning servicemen and succeeding generations. Although the proposed changes in the income tax would clearly increase progressivity, changes were not accompanied by calls for income redistribution. The need for revenue ruled the discussion.

74. See Hamel, *supra* note 67, at 161; Kornhauser, *The Origins Of Capital Gains Taxation: What's Law Got To Do With It?*, 39 Sw. L.J. 869, 872-73 (1985).

75. See *Helvering v. Cannon Valley Milling Co.*, 129 F.2d 642, 646 n.3 (8th Cir. 1942).

B. Equitable Deviations from Annual Accounting Whose Origins Antedate the Revenue Act of 1918

In examining strict adherence to annual accounting prior to the Revenue Act of 1918, this Article noted that the Revenue Act of 1916 introduced the concept of accrual basis accounting through sections 8(g) and 13(d) of that Act.⁷⁶ The language of both of those sections, however, authorized more than merely the accrual method of accounting. Section 8(g) provided:

An individual keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect his income, may, subject to regulations made by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, make his return upon the basis upon which his accounts are kept, in which case the tax shall be computed upon his income as so returned.⁷⁷

Similarly, with respect to corporate taxpayers, section 13(d) provided:

A corporation, joint-stock company or association, or insurance company, keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect its income, may, subject to regulations made by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, make its return upon the basis upon which its accounts are kept, in which case the tax shall be computed upon its income as so returned.⁷⁸

Thus, sections 8(g) and 13(d) actually authorized the Commissioner to permit a taxpayer to report his income at annual intervals in accordance with the manner in which he kept his books and records, unless the manner in which the books and records were kept did not clearly reflect the taxpayer's income. If a taxpayer kept his books and records (and calculated his income) in a transactional manner, Congress apparently authorized the Commissioner to let the taxpayer report his income in this manner, so long as this manner clearly reflected his income.⁷⁹

Congress carried sections 8(g) and 13(d) of the 1916 Act into the Revenue Act of 1918 via section 212(b), which provided in pertinent 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 ac-

76. See *supra* note 48 and accompanying text.

77. Revenue Act of 1916, ch. 463, 39 Stat. 756, 763 (1916).

78. *Id.* at 771.

79. Indeed, in regulations promulgated pursuant to the Revenue Act of 1916, the Treasury did authorize the reporting of income on a transactional basis. See *infra* notes 90-92 and accompanying text for a discussion of the completed contract method of accounting.

cordance 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 upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 200 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.⁸⁰

Section 212(b) had to be read in conjunction with section 213(a) which stated in pertinent part: "The amount of all such items [which could conceivably encompass gross income] shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period."⁸¹ Thus, one could interpret section 212(b), like sections 8(g) and 13(d) of the 1916 Act, as authorizing innumerable methods of accounting other than the cash receipts and disbursements method.

However, in 1931 in *Burnet v. Sanford & Brooks Co.*⁸², the Supreme Court indicated that section 212(b) of the 1918 Act authorized only accrual accounting in a manner that adhered strictly to annual accounting.⁸³ Furthermore, the *Sanford & Brooks* Court indicated that section 212(b) was not the statutory underpinning for certain Treasury Regulations that authorized the transactional completed contract method of accounting⁸⁴ when it stated:

Under the statutes and regulations in force in 1920, two methods were provided by which, to a limited extent, the expenses of a transaction incurred in one year might be offset by the amounts actually received from it in

80. Revenue Act of 1918, ch. 18, § 212(b), 40 Stat. 1057, 1064-65 (1919).

81. *Id.* at 1065.

82. 282 U.S. 359 (1931).

83. *Id.* at 363. The Court stated:

All the revenue acts which have been enacted since the adoption of the Sixteenth Amendment have uniformly assessed the tax on the basis of annual returns showing the net result of all the taxpayer's transactions during a fixed accounting period, either the calendar year, or, at the option of the taxpayer, the particular fiscal year which he may adopt.

...

The amount of all such items is required to be included in the gross income for the taxable year in which received by the taxpayer, unless they may be properly accounted for on the accrual basis under § 212(b).

Id.

84. For a description and analysis of the completed contract method of accounting, see *infra* notes 90-92 and accompanying text.

another. One was by returns on the accrual basis under § 212(b). . . The other was under Treasury Regulations (Art. 121 of Reg. 33 of Jan. 2, 1918, under the Revenue Acts of 1916 and 1917; Art. 36 of Reg. 45, Apr. 19, 1919, under the Revenue Act of 1918) providing that in reporting the income derived from certain long term contracts, the taxpayer might either report all of the receipts and all of the expenditures made on account of a particular contract in the year in which the work was completed. . . .⁸⁵

The Court thus described the completed contract method of accounting separately from section 212(b), and thereby indicated that authorization for the completed contract method of accounting must come from some other statutory provision. The Court, however, did not indicate what other provision provided such authorization. Indeed, if section 212(b) could not be read broadly enough to authorize the completed contract method of accounting, the Revenue Act of 1918 did not authorize that transactional method of accounting at all.

The *Sanford & Brooks* opinion, therefore, provided a curious situation in which the Court placed its imprimatur on the transactional completed contract method of accounting but at the same time interpreted the only statute which could authorize such method of accounting as authorizing only accrual accounting in a manner that strictly adhered to annual accounting. The *Sanford & Brooks* Court, by limiting the scope of section 212(b) of the 1918 Act, gave the impression that only methods of accounting that fit within the concept of annual accounting were statutorily authorized. Similarly, methods of accounting that did not comport with annual accounting were unauthorized. The Court's approving reference to the long term contract accounting regulations was thus an anomaly.

After *Sanford & Brooks*, two lower courts soon wrestled with the anomalous position in which the Supreme Court had placed the completed contract method of accounting. These courts upheld the completed contract method most likely because, as discussed below, even prior to the *Sanford & Brooks* case Congress clearly indicated that it intended a broad interpretation of section 212(b), rather than the narrow interpretation with its attendant emphasis upon adherence to annual accounting that the Court accorded it in *Sanford & Brooks*. We now turn to an in-depth examination of the long term contract accounting regulations and how the completed contract method survived the anomalous position in which the Supreme Court had placed those regulations.

85. 282 U.S. at 366.

1. *Accounting for Long Term Contracts*

As already noted, under strict adherence to annual accounting a taxpayer could engage in a transaction that did not generate an overall profit and yet could be subject to taxation if receipts from the transaction exceeded deductible expenditures in any one year. This would result even if deductible expenditures from the transaction produced no tax benefit in previous years. Indeed, this is exactly what transpired in the *Sanford & Brooks* case.⁸⁶ However, despite overbroad language in the Court's opinion indicating the lack of any general scheme for taxing income other than in accordance with annual accounting,⁸⁷ and despite the absence of an applicable loss carryover provision,⁸⁸ the taxpayer in *Sanford & Brooks* suffered from the harsh application of strict adherence to annual accounting for another reason. The taxpayer failed to avail itself of ameliorative provisions in the Treasury Regulations⁸⁹ that applied transactional instead of annual accounting principles to situations just like the one faced by the *Sanford & Brooks* taxpayer.

These ameliorative provisions first appeared in the regulations promulgated pursuant to the Revenue Act of 1916, as amended by the Revenue Act of 1917.⁹⁰ Ironically, this was the same set of regulations that re-

86. See *supra* note 28 and accompanying text.

87. *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 365 (1931). For an analysis of why the Court's language was overbroad, see Grauer, *supra* note 3, at 343-45.

88. See *supra* note 28.

89. See *Sanford & Brooks*, 282 U.S. at 366. The Court stated:

Under the statutes and regulations in force in 1920, two methods were provided by which, to a limited extent, the expenses of a transaction incurred in one year might be offset by the amounts actually received from it in another. . . .

But the court [of appeals] did not hold, nor does respondent assert, that it ever filed returns in compliance . . . with these regulations, . . . or otherwise attempted to avail itself of their provisions,

90. The applicable regulations provided in pertinent part:

Contracting corporations. — Corporations engaged in contracting operations and which have numerous uncompleted contracts, which in some cases run for periods of several years, will be allowed to prepare their returns so that the gross income will be arrived at on the basis of completed work—that is, on jobs which have been finally completed—and any and all moneys received in payment for completed jobs will be returned as income for the year in which the work was completed. If the gross income is arrived at by this method, the deduction from gross income should be limited to the expenditures made on account of such completed contracts.

Income on basis of estimates. — Or the percentage of profit from the contract may be estimated on the basis of percentage of completion and payments made thereon, in which case the income to be returned each year during the performance of the contract will be computed upon the basis of the expenses incurred on such contract during the year; that is to say, if one-half of the estimated expenses necessary to the full performance of the contract are incurred during one year, one-half of the gross contract price should be returned

quired strict adherence to annual accounting in the bad debt recovery area.

The first part of this regulation, "Contracting corporations," was a formalization and elaboration of a position taken by the Treasury in 1915.⁹¹ This part, generally called the "completed contract method of accounting," evidences a purely transactional approach to accounting, and violates every tenet of annual accounting. Under the completed contract method, the taxpayer reports no income or loss until a multi-year transaction is completed. If the taxpayer in *Sanford & Brooks* had availed itself of the completed contract method, it would have attained the result it desired and reported no gain for the year 1920 (aside from interest income that was added to a judgment it recovered). Indeed, the court of appeals in the *Sanford & Brooks* case held for the taxpayer in part because "[t]he case of the petitioner here falls within the spirit, if not within the letter, of this regulation."⁹²

The second part of this regulation, "Income on the basis of estimates," is generally called the "percentage of completion method of accounting." This method evidences neither a purely annual nor purely transactional approach to accounting. Rather, it attempts to ameliorate the inequities that can result from both strict adherence to annual accounting and from transactional accounting under the completed contract method. The percentage of completion method of accounting first looks to see if a transaction is expected to generate a profit. Then it allocates to each year a percentage of the expected profit that is equivalent to the percentage of the anticipated overall expenses that were incurred in that year. In so doing, the percentage of completion method precludes the loss of tax benefits that could result under a strict approach to annual accounting whenever deductible expenses in one accounting period exceed receipts. At the same time, the percentage of completion method alleviates the harshness that could result from the bunching of income in one year under the completed contract method's purely transactional approach.⁹³

as income for that year; all under or over statements of income to be adjusted upon completion of the contract and return made accordingly.

Treas. Reg. 33, art.121 (1918), reprinted in 132 REVENUE ACTS 1909-1950, *supra* note 51.

91. See T.D. 2161, 17 TREAS. DEC. INT. REV. 109, 111 (1915).

92. *Sanford & Brooks Co. v. Commissioner*, 35 F.2d 312, 314 (4th Cir. 1929), *rev'd sub nom. Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931).

93. Bunching is an inequity that usually results from the confluence of the realization requirement with a progressive rate system. Under the realization requirement, income that may accrue over many years is not recognized until a realization event, such as a sale, occurs. For example, if stock is purchased in year one for \$10.00 per share, appreciates to \$20.00 per share at the end of year

The percentage of completion method could thus be described as a hybrid of both annual and transactional accounting. Its existence demonstrates the Treasury's greater concern for equitable results than for adherence to any one system of accounting. However, because this Article is concerned with whether the courts should have emphasized adherence to annual accounting to the extent that they did, and because the completed contract method represents the antithesis of annual accounting, our focus now shifts to the completed contract method and how it survived the Supreme Court's overly emphatic adherence to annual accounting.

In *Bent v. Commissioner*⁹⁴ the dispute revolved around whether the taxpayer was keeping the books and records of his partnership on an accrual or a completed contract basis. The taxpayer contended that his partnership was using the accrual method. The Commissioner maintained that the partnership was using the completed contract method, and that the completed contract method clearly reflected income; therefore the tax liability should be calculated in accordance with the completed contract method of accounting. The validity of the completed contract method was not attacked. However, in lengthy and somewhat murky dicta, the court raised several interesting points.

First, the court noted that on several occasions Congress had reenacted section 212(b) of the Revenue Act of 1918 (the successor provision to sections 8(g) and 13(d) of the 1916 Act which initially authorized the completed contract method) without change after the Treasury had promulgated the completed contract method regulation applicable to the tax year in question. The *Bent* court then stated, "The re-enactment of the statute in exactly the same terms where the statute has been inter-

one, is not sold and appreciates to \$30.00 per share at the end of year two, and is finally sold in year three when it is worth \$40.00 per share, \$30.00 of gain is recognized in year three, even though this gain accrued at a steady pace over three separate accounting periods. If the progressive rate structure taxes each \$10.00 per share of gain at a higher rate than the previous \$10.00 per share of gain, bunching all the gain into the year of realization will result in a higher tax than if the gain had been taxed each year as it accrued. Similarly, under the purely transactional completed contract method, all of the profit from a transaction is bunched into the year that the transaction is completed even though the profit may have been earned or accrued in a steady stream over an extended number of years. Application of a progressive rate system to a completed contract approach could result in a higher tax than if a portion of the profit were reported in each year that it was earned or accrued. The percentage of completion approach tries to preclude the imposition of this higher tax that would result from bunching under the completed contract method by spreading out the profit on the transaction over a number of years.

94. 56 F.2d 99 (9th Cir. 1932).

preted by the regulations of the Treasury Department is 'persuasive evidence of legislative approval of the regulation.'⁹⁵ Although courts often use this line of reasoning to uphold Treasury regulations, this reasoning should not be used absent evidence that in reenacting the relevant statute Congress specifically considered the validity of the regulation in question.⁹⁶ In the instant case, however, this reasoning is even more questionable. Only one year prior to the decision in the *Bent* case, the Supreme Court in *Sanford & Brooks* had intimated that section 212(b) authorized only accrual accounting, thus implying that statutory authorization for the completed contract method must lie elsewhere.⁹⁷ It is therefore perplexing that the *Bent* court should uphold the completed contract method through the reenactment of section 212(b). The most plausible explanation may be that the *Bent* court realized that the *Sanford & Brooks* Court was wrong about the narrow scope of section 212(b), but was not willing to come right out and state that the emperor had no clothes.

Instead, in its second point, the *Bent* court committed heresy. It basically indicated that in some cases, transactional accounting more clearly reflects income than does annual accounting.⁹⁸ How impudent of this appeals court! The Supreme Court in *Sanford & Brooks* had just stated that even though a transaction extending over several years may result in a loss, there was absolutely no precedent for relieving a taxpayer from paying tax on net income received in any one of those years.⁹⁹ But the *Bent* court was quite clever. It included the *Sanford & Brooks* language

95. *Id.* at 102.

96. See *infra* notes 242-49 and accompanying text.

97. See *supra* notes 82-85 and accompanying text.

98. The Court stated:

[T]he contract is a unit, and, until the contract is completed and accepted, it cannot be definitely known what the profit may be or what loss may be suffered by the contractor. The books are full of instances where, by reason of defective work or unsuspected obstacles or changes in prices of labor and materials, contractors have suffered losses, notwithstanding the unit price basis and in the case of the contract based upon cost plus a fixed fee the work may be prolonged over a long period of time by reason of difficulties in the work, or the fee might be diminished or wholly lost because of inability to complete the contract. *These observations, familiar to all, are made merely for the purpose of indicating that under such contracts the income, that is, the profit, derived from a contract is not necessarily reflected by the payments made thereunder for a particular period.*. . .

56 F.2d at 102-03 (emphasis added).

99. The *Sanford & Brooks* Court stated:

A taxpayer may be in receipt of net income in one year and not in another. The net result of the two years, if combined in a single taxable period, might still be a loss; but it has never been supposed that fact would relieve him from a tax on the first, or that it affords any reason for postponing the assessment of the tax until the end of a lifetime, or for some

in its opinion, albeit buried in a much longer quotation from *Sanford & Brooks* that fills almost two full columns in the Federal Reporter!¹⁰⁰ Interestingly enough, the *Bent* court chose to end its lengthy quotation from *Sanford & Brooks* just at the point where the *Sanford & Brooks* Court simultaneously placed its imprimatur on the completed contract method of accounting and indicated that section 212(b) did not authorize promulgation of the completed contract method of accounting.¹⁰¹ Thus, the *Bent* court's third point was that the Supreme Court had placed its seal of approval (albeit in dicta) on the completed contract method.

The *Bent* court accomplished a neat trick. It cited a Supreme Court case as authority for upholding a regulation, but gave a theoretical justification for the regulation that was contrary to everything for which that same Supreme Court case stood. That the *Bent* court accomplished this with the *Sanford & Brooks* opinion is just one indication of how flawed the *Sanford & Brooks* opinion is.¹⁰²

The more interesting question in all of this is why the *Bent* court engaged in this dicta when the parties had not even challenged the validity of the completed contract method. Perhaps the *Bent* court was concerned that after *Sanford & Brooks* so strongly rejected transactional accounting, the validity of the completed contract method would be challenged as violative of annual accounting, and *Sanford & Brooks*' approving references to the completed contract method could be ignored as dicta. Such concern would not have been unfounded. A direct challenge to the completed contract method as violative of annual accounting was then in the Second Circuit.¹⁰³ Authority for upholding the completed contract method approach might therefore prove helpful to other courts of appeals inclined to uphold this non-annual accounting method.¹⁰⁴

In fact, the *Bent* opinion was helpful. The Second Circuit in *Badgley v. Commissioner*¹⁰⁵ cited *Bent* and disposed of the challenge to the validity

other indefinite period, to ascertain more precisely whether the final outcome of the period, or of a given transaction, will be a gain or a loss.

282 U.S. at 364-65.

100. See 56 F.2d at 103-04.

101. See *supra* text accompanying note 85.

102. For additional evidence of flaws in the Court's reasoning in *Sanford & Brooks*, see Grauer, *supra* note 3, at 343-49.

103. See *Badgley v. Commissioner*, 59 F.2d 203 (2d Cir. 1932).

104. See Comment, *Abolition of The Completed Contract Method Under Fire: A Study in Legislative Compromise*, 32 AM. U.L. REV. 1009, 1012-13 (1983) (completed contract method "is an exception, however, to the annual accounting concept for reporting income. . .").

105. 59 F.2d 203 (2d Cir. 1932).

of the completed contract method in a one paragraph per curiam opinion. The existence of *Bent* precluded the Second Circuit from having to reconcile the completed contract method with the Supreme Court's view of transactional accounting in *Sanford & Brooks*—a reconciliation that could not have withstood close scrutiny.

Finally, one must logically ask, "Why would two circuit courts strive so hard to uphold a transactional method of accounting after the Supreme Court had indicated that our tax statutes required strict adherence to annual accounting?" Certainly, skepticism of the reasoning in *Sanford & Brooks*, standing alone, could not be enough. The following examination of the history of the installment sales provisions offers another explanation. Courts had previously struck down installment sales regulations, which did not strictly comport with annual accounting, as not statutorily authorized and were rebuked by Congress in a manner that may have made future courts wary of provoking similar rebukes.

2. *The Saga of the Installment Sale Provisions*

When property is sold on the installment method, the seller typically takes a small portion of the contract price in the form of cash at the time of sale and accepts an interest bearing promissory note from the buyer for the balance of the purchase price. To secure the buyer's obligation, the seller usually retains a lien on the property sold. If the seller is an accrual method taxpayer, adherence to annual accounting would require that the taxpayer include in income in the year of sale the total profit under the sales contract, not just the cash received. The total profit is includable, because under the contract of sale, the seller's right to receive the full sales price accrued when the seller delivered or transferred the property. If the seller is a cash receipts and disbursements method taxpayer, adherence to annual accounting would also require, in most cases, that the seller include almost the total profit under the sales contract in income in the year of sale. Assuming that the buyer is creditworthy, the note received is property having a value equal almost to its face value (i.e., the difference between the cash received as a down payment and the total contract price). Therefore, having received cash and property of value totaling nearly the entire sales price, the cash basis taxpayer would include almost his entire profit from the sale in income in the year of sale.

Such a result, however, may not be equitable to the seller because he may not receive enough cash in the year of sale to cover his taxes. For example, if property with a basis of \$100 were sold for \$1,100 with the

seller receiving \$100 cash plus a note for \$1,000 payable in installments of \$100 per year for ten years plus appropriate interest, the seller would owe tax of \$280 in the first year, if he were in the 28% tax bracket, even though he had received only \$100 in cash. Generally speaking, the installment sale method of accounting deviates from this annual accounting result by requiring the selling taxpayer to include in income each year only that percentage of the principal cash received that is the same as the percentage of the profit on the transaction to total sales price. In our example, the \$1,000 profit is 90.91% of the total sales price of \$1,100. Therefore, under the installment method of accounting, the seller would include in income only \$90.91 plus interest during the year of sale and in each succeeding year thereafter as the \$100 principal payments on the note flowed in. Equity thus tempers annual accounting by assuring that the seller does not owe more tax each year than cash received in that year. In our example, assuming a 28% tax bracket, the seller would owe only \$25.45 of tax in the year of sale and in each succeeding year on each \$100 principal payment.

The Treasury first introduced the installment sale method of accounting in the regulations promulgated pursuant to the Revenue Act of 1916, as amended by the Revenue Act of 1917.¹⁰⁶ These regulations limited the application of this method of accounting, however, to sales in which the seller retained title to the property until the property was fully paid for.¹⁰⁷ One year later, in regulations promulgated pursuant to the Revenue Act of 1918, the Treasury eliminated the distinction between sales in which the seller retained title until the full contract price was paid and cases in which title passed at the time of sale.¹⁰⁸

Through the Revenue Act of 1918, the only specific authorization for installment reporting was in the Treasury Regulations. Authority for these regulatory provisions could flow from sections 8(g) and 13(d) of the 1916 Act, and from section 212(b) of the 1918 Act, if it were not construed too narrowly. In 1921, however, Congress got into the act.

The Revenue Act of 1921¹⁰⁹ contained a new section, 202(f), which provided simply: "Nothing in this section shall be construed to prevent

106. Treas. Reg. 33, arts. 116, 117 (1918), *reprinted in* 132 REVENUE ACTS 1909-1950, *supra* note 51.

107. *Id.*

108. *See* Treas. Reg. 45, arts. 42, 44, 45 (1919), *reprinted in* 134 REVENUE ACTS 1909-1950, *supra* note 51.

109. Ch. 136, 42 Stat. 227 (1921).

(in the case of property sold under contract providing for payment in installments) the taxation of that portion of any installment payment representing gain or profit in the year in which such payment is received."¹¹⁰ Ironically, however, section 202, even in the absence of subsection (f), could have been read as prohibiting installment accounting only with great difficulty. Section 202 did not address accounting for income at all. Rather, it dealt with the determination and adjustment of basis and contained various nonrecognition provisions. The legislative histories do not explain why section 202(f) was added, or why an installment reporting provision was placed in a section that did not deal with accounting, but with basis determinations and nonrecognition transactions. Perhaps for these reasons, a commentator has described section 202(f) of the Revenue Act of 1921 as vague.¹¹¹ Regardless of whether the section was vague, misplaced, or ambiguous, however, Congress had indicated that installment accounting was acceptable.

The validity of the installment accounting regulations came before the Board of Tax Appeals, the predecessor to the Tax Court, in 1925 in three cases.¹¹² The most extensively reasoned of these was *Appeal of B.B. Todd, Inc.*¹¹³ which involved tax years prior to the enactment of section 202(f) and which evaluated the installment regulations promulgated pursuant to section 212(b) of the Revenue Act of 1918. In a decision that could be deemed a harbinger of the Supreme Court's rigid approach to accounting in *Sanford & Brooks*, the Board held the installment accounting regulations invalid. Apparently, the Board's primary reason for invalidating the installment regulations was a belief that the method did not clearly reflect income.¹¹⁴ This belief arose from a concern that sym-

110. *Id.* at 231.

111. Emory, *The Installment Method of Reporting Income: Its Election, Use and Effect*, 53 CORNELL L. REV. 181, 186-87 (1968).

112. The three cases were *Appeal of Six Hundred And Fifty West End Ave. Co.*, 2 B.T.A. 958 (1925); *Appeal of B.B. Todd, Inc.*, 1 B.T.A. 762 (1925); and *Appeal of Manomet Cranberry Company*, 1 B.T.A. 706 (1925).

113. 1 B.T.A. 762 (1925).

114. *See* 1 B.T.A. at 766. The Board stated:

If this taxpayer were reporting upon a cash receipts and disbursements basis, it would report the total cash received, including the cash received from leases entered into prior to 1918. From this cash received it would deduct the cash expended and would arrive at a net income, correct except to the extent that its business expanded, and, therefore, its accounts receivable and inventory were greater at the close of the year than at the beginning. To report, however, upon a basis which considers only the profit upon the business entered into during a year which is actually reduced to possession in cash, and to exclude all business or prior years reduced to possession in cash, at the same time deducting as expenses all accrued obligations, is to destroy all relationship between the true net income and the

metry would be skewed by allowing a taxpayer to report "only the profits realized in cash during the year, while at the same time deducting upon an accrual basis all the costs of goods upon which such profits were realized, and . . . further deduct[ing] accrued expenses of the taxable period for which the reported income is made."¹¹⁵ However, what made *Todd* a harbinger of *Sanford & Brooks* was the Board's conclusion that only two methods of accounting were authorized by the Revenue Act of 1918: cash and accrual. Although the Board found that there might be minor departures from the cash and accrual methods to fit the exigencies of individual cases, the Board stated that there was "no reason for the injection of a system of computing income foreign alike to the cash receipts and disbursements and to the accrual basis."¹¹⁶ In effect the Board held that the installment method of accounting was unacceptable because it did not comport with the principles of annual accounting.

Congress reacted swiftly. In the Revenue Act of 1926,¹¹⁷ Congress added section 212(d) which provided:

Under regulations prescribed by the Commissioner with the approval of the Secretary, a person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the total profit realized or to be realized when the payment is completed, bears to the total contract price. In the case (1) of a casual sale or other casual disposition of personal property for a price exceeding \$1,000, or (2) of a sale or other disposition of real property, if in either case the initial payments do not exceed one-fourth of the purchase price, the income may, under regulations prescribed by the Commissioner with the approval of the Secretary, be returned on the basis and in the manner above prescribed in this subdivision. As used in this subdivision the term "initial payments" means the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable period in which the sale or other disposition is made.¹¹⁸

The Senate Finance Committee Report which accompanied the Act clearly stated that section 202(f) of the 1921 Act impliedly recognized

income reported for taxation. This is the effect of the installment basis for the earlier years of its adoption, either by reason of the fact that the taxpayer is newly organized and therefore has no prior business experience or by reason of a change of basis from the accrual method.

Id.

115. *Id.* at 764.

116. *Id.* at 767.

117. Ch. 27, 44 Stat. 9 (1926).

118. *Id.* at 23.

the validity of the installment method of accounting and that the purpose of section 212(d) of the 1926 Act was to override the result in the three 1925 Board of Tax Appeals cases.¹¹⁹ Section 1208 of the 1926 Act then retroactively applied section 212(d) to the computation of all taxes for prior years beginning with those governed by the Revenue Act of 1916,¹²⁰ the Act which contained the predecessor sections to section 212(b) of the Revenue Act of 1918.¹²¹ Congress thus repudiated the *Todd* case's narrow interpretation of section 212(b) of the Revenue Act of 1918 that only cash and accrual accounting were statutorily authorized.

Congress' repudiation of the holding in *Todd* may have resulted from more than just the existence of section 202(f) of the 1921 Act, referred to in the Senate Finance Committee Report.¹²² After the *Todd* decision and while the 1926 Act was pending before Congress, a similar case, *Appeal of Blum's Inc.*,¹²³ came before the Board of Tax Appeals. According to an article published at that time, "Dr. T.S. Adams, Professor of Economics at Yale University, and for many years one of the advisers to the Secretary of the Treasury in matters of revenue legislation, appeared and testified [at the hearing in *Blum's* case] in support of the Treasury

119. See SENATE COMM. ON FINANCE, INTERNAL REVENUE BILL OF 1926, S. REP. NO. 52, 69th Cong., 1st Sess. 19 (1926) (to accompany H.R.1), reprinted in 97 REVENUE ACTS 1909-1950, *supra* note 51. The committee stated:

INSTALLMENT SALES

Section 212(d): The revenue act of 1924 and prior acts have specifically provided two bases only for reporting income—first, cash receipts and disbursements, and, second, accrual. Since the enactment of the revenue act of 1921, however, section 202(f) and its successors have impliedly recognized the existence of a third basis, the installment basis, without in any wise defining the situations and businesses to which such basis might be applied. The Commissioner of Internal Revenue has in his regulations provided, in pursuance of his authority to require a method of computation that will clearly reflect income, the installment basis for reporting income in certain cases. . . .

However, recent decisions of the Board of Tax Appeals (see appeal of 650 West End Ave. Co., appeal of Manomet Cranberry Co., and appeal of B.B. Todd (Inc.)—all decided during the past year) have held that similar regulations under earlier acts were invalid and that the commissioner under the law could authorize no basis other than the cash receipts and disbursements basis or the accrual basis, except for certain minor departures. The committee amendment, in order to meet the situation resulting from the decisions, places the principles of the commissioner's regulations in the law and thereby validates the regulations for all periods after January 1, 1925.

120. 44 Stat. at 130.

121. See *supra* text accompanying notes 76-82.

122. See *supra* note 119.

123. 7 B.T.A. 737 (1927).

Department regulations."¹²⁴ The article described Dr. Adams' testimony:

Dr. T.S. Adams, who represented the Secretary of the Treasury before Congress in the discussions of the Revenue Acts of 1917, 1918, and 1921, testified that a question was raised at the time the Senate had under consideration the Revenue Bill of 1918, as to the advisability of incorporating therein a provision specifically taxing the income from sales of real and personal property on the installment plan over the period of years in which the income is realized. The question was considered by Treasury officials and it was decided that the Department had ample authority under the provisions of Sections 212 and 213 to take care of the matter by regulation.

The Senate Finance Committee relied upon the assurance of the Treasury Department that the matter would be taken care of by regulation; otherwise, as Dr. Adams says, the Senate would have inserted a specific provision on the subject in the Bill. *Dr. Adams testified that nothing was further removed from the minds of those who worked on the draft of Sections 212 and 213 of the 1918 Act than the thought that just two systems of accounting would be recognized.*¹²⁵

The publication of this testimony could have had a two-fold effect. First, it could have influenced Congress as the Revenue Act of 1926 was winding its way through the legislative process. Second, combined with the passage and legislative history of section 212(d), Dr. Adams' testimony could have induced the Ninth Circuit in *Bent* to affirm the validity of the completed contract method of accounting as authorized by section 212(b) of the 1918 Revenue Act, despite *Sanford & Brooks*' intimations to the contrary. What it unfortunately did not do was prevent the Supreme Court in *Sanford & Brooks* from making statements about tax accounting that flew in the face of the available evidence at the time. Before considering what actually might have influenced the *Sanford & Brooks* court, however, this Article continues to examine the development of the statutory and regulatory framework.

124. Doyle, *Taxation of Income Derived from Installment Sales*, 4 NAT'L INCOME TAX MAG. (Taxes) 53, 55 (1926).

125. *Id.* at 56 (emphasis added).

Indeed, support for Dr. Adams' position is found in the first set of regulations promulgated pursuant to section 212 of the Revenue Act of 1918. Article 24 of those regulations stated:

It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his true income. He must, therefore, maintain such accounting records as will enable him to do so.

Treas. Reg. 45, art. 24 (1919), *reprinted in* 134 REVENUE ACTS 1909-1950, *supra* note 51.

C. Mixed Signals from a Mixed Act—The Revenue Act of 1918

Initial consideration of a new revenue act in 1918 resulted from growing and unanticipated deficits caused by World War I.¹²⁶ Thus, the initial bill, as passed by the House, contained substantial rate increases.¹²⁷ However, because 1918 was a Congressional election year, Congress was not anxious to raise taxes prior to the election. As a result, the legislative process moved slowly enough for Congress to defer final passage of a tax act until after the November elections.¹²⁸ By the time Congress returned from its election recess, however, World War I had ended and revenue needs had to be recalculated.¹²⁹ Because Congress anticipated that revenue needs would remain high for some time after the War,¹³⁰ a revised bill from the Senate Finance Committee called for a tax increase in 1918, followed by tax decreases in 1919 and 1920.¹³¹

The tax decreases planned for 1919 and 1920 were not the only evidence that the new Act would reflect a transition to a peacetime economy. Even before the War had ended, equitable provisions had worked their way into the Act to protect taxpayers from harsh results caused by the War.¹³² During the House consideration of the Ways and Means Committee Bill on September 10, 1918, Representative Hull of Tennessee stated that although equitable provisions do cause complexity,¹³³ the Committee's "intention and controlling effort" had been "to apportion taxes equitably," because "equity and simplicity should be the prime requisites of any tax law."¹³⁴ On the other hand, the Commissioner of Internal Revenue, primarily interested in administrative feasibility of the tax system as the War ended,¹³⁵ expressed dismay over the insertion of

126. See R. BLAKEY & G. BLAKEY, *supra* note 50, at 156.

127. See *id.* at 167.

128. See generally *id.* at 156-76.

129. *Id.* at 176.

130. *Id.*

131. *Id.* at 178.

132. *Id.* at 186-87.

133. 56 CONG. REC. 10165 (1918).

134. *Id.* at 10164-65.

135. While, prior to World War I, the Treasury had demonstrated concern for equity, see *supra* text accompanying notes 71-75 and Section B of Part II, the Commissioner of Internal Revenue understandably did not want to deal with new equitable provisions, with their attendant administrative complexity, as soon as the War ended. Prior to America's entry into World War I, when the income tax system was new, Congress rewrote the tax laws so often and the revenue demands were so great that administration of the tax system was quite difficult. See *supra* notes 61-73 and accompanying text. When World War I ended, America may have returned to "normalcy," but the Treasury did not. It was not until 1927 that the following statement could be made: "For the first time

equitable provisions into the tax laws.¹³⁶ Thus, tension existed between the desire for equity and the desire for administrative simplicity.

Inasmuch as the Revenue Act of 1918 began its legislative journey before the end of World War I, and was initially envisioned as a revenue raising measure,¹³⁷ it is not surprising that some provisions would be worded to emphasize the need for administrative simplicity. Such provisions include the annual accounting sections.¹³⁸ However, these annual accounting provisions should not be read in a vacuum. Other equitable provisions that undercut any claim to total preeminence by annual accounting existed in the statute. Yet in *Sanford & Brooks* the Supreme Court granted annual accounting a preeminent position by doing just that—reading the annual accounting provisions of the Revenue Act of 1918 in a vacuum. Therefore, those annual accounting provisions must be reexamined in context.

In *Helvering v. Cannon Valley Milling Co.*¹³⁹ the Eighth Circuit noted

since the war it can now be said that the auditing work of the Bureau of Internal Revenue is *practically current*." JOINT COMMITTEE ON INTERNAL REVENUE TAXATION, SURVEY OF THE ADMINISTRATION OF INCOME AND EXCESS-PROFITS TAXES 2 (1927), reprinted in 98 REVENUE ACTS 1909-1950, *supra* note 51 (emphasis in original).

136. The Commissioner stated: "Certainty and simplicity are far more important in a tax measure than the abstract element of equity. . . . [T]he administrative machinery should not be burdened with the responsibility for distinguishing between taxpayers." Roper, *Basis for Reforms of Federal Taxation*, 95 ANNALS OF THE AMERICAN ACADEMY OF POLITICAL AND SOCIAL SCIENCE 161, 164 (May, 1921).

137. See *supra* notes 125, 127 and accompanying text.

138. See § 212(b) which provided 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; . . ." Ch. 18, § 212(b), 40 Stat. 1057, 1064-65 (emphasis added). This section represents the first clear statement in the tax laws that income was to be determined on the basis of annual accounting periods. See also *supra* note 47 (quoting § 213(a) and explaining why that section easily could be read as requiring the administrative simplicity that comes from strict adherence to annual accounting). Additionally, § 213 applied to corporate taxpayers through § 233. Furthermore, §§ 214(a)(1)-(3), with respect to individual taxpayers, and §§ 234(a)(1)-(3), with respect to corporate taxpayers, limited the deductibility of expenses to those paid or accrued during the "taxable year" in question. Section 200, in turn, defined taxable year as follows:

The term "taxable year" means the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the net income is computed under section 212 or section 232. The term "fiscal year" means an accounting period of twelve months ending on the last day of any month other than December. The first taxable year, to be called the taxable year 1918 shall be the calendar year 1918, or any fiscal year ending during the calendar year 1918.

40 Stat. at 1058.

Thus, the circle was completed as § 200 defined taxable year in a way that referred to an annual accounting period, or in the words of § 200, "an accounting period of twelve months." *Id.*

139. 129 F.2d 642 (8th Cir. 1942).

departures from strict adherence to annual accounting in the Revenue Act of 1918.¹⁴⁰ One interesting departure so noted by the *Cannon Valley Milling* court is found in sections 214(a)(12) and 234(a)(14).¹⁴¹ These sections permitted both individual and corporate taxpayers to, *inter alia*, file claims in abatement with respect to their 1918 taxes for rebates paid pursuant to contracts entered into during the 1918 tax year, even if those rebates were paid in a subsequent tax year. If the taxpayer did not file an abatement claim, but ultimately sustained certain types of losses in 1919 as a result of 1918 transactions, the taxpayer could recognize those losses by reopening the 1918 tax year rather than by deducting the losses in the 1919 tax year. The House and Senate committee reports are silent as to the reasons for adopting sections 214(a)(12) and 234(a)(14), which clearly violate the principle of annual accounting. However, these sections can easily be interpreted as providing equitable relief from strict adherence to annual accounting. Income tax rates reached their peak during the World War I era in the 1918 tax year.¹⁴² Thus, the inability to recognize losses from 1918 transactions at the higher 1918 tax rates simply because the losses were not fully realized until after the close of the 1918 tax year would have resulted in a windfall for the government. Sections 214(a)(12) and 234(a)(14) thus exemplify how Congress promoted equitable treatment of the taxpayer at the expense of administrative simplicity.

An even more instructive example of Congress favoring equitable treatment of the taxpayer over simplicity in tax administration is the net operating loss provision.¹⁴³ Indeed, the Senate Finance Committee Report that accompanied the Revenue Act of 1918 recognized that the pro-

140. *Id.* at 646 n.3.

141. 40 Stat. at 1068, 1079-80.

142. See *supra* note 131 and accompanying text.

143. See Revenue Act of 1918, § 204(b) which provided:

If for any taxable year beginning after October 31, 1918, and ending prior to January 1, 1920, it appears upon the production of evidence satisfactory to the Commissioner that any taxpayer has sustained a net loss, the amount of such net loss shall under regulations prescribed by the Commissioner with the approval of the Secretary be deducted from the net income of the taxpayer for the preceding taxable year; and the taxes imposed by this title and by Title III for such preceding taxable year shall be redetermined accordingly. Any amount found to be due to the taxpayer upon the basis of such redetermination shall be credited or refunded to the taxpayer in accordance with the provisions of section 252. If such net loss is in excess of the net income for such preceding taxable year, the amount of such excess shall under regulations prescribed by the Commissioner with the approval of the Secretary be allowed as a deduction in computing the net income for the succeeding taxable year.

40 Stat. at 1061.

vision violated annual accounting¹⁴⁴ but indicated that the desire for the administrative simplicity of annual accounting must be tempered by equitable concerns caused by the realities of the business world. The Finance Committee Report stated: "The chief merit of the present plan [of strict adherence to annual accounting] is its simplicity of administration. But it does not adequately recognize the exigencies of business, and, under our present high rates of taxation, may often result in grave injustice."¹⁴⁵

Furthermore, Congress passed the net operating loss provision over Senator Lenroot's protestations that it violated the principle of annual accounting.¹⁴⁶ Despite his protestations, Senator Lenroot apparently did not believe that adherence to annual accounting must never be violated. Rather, he was seemingly more concerned that the broad scope of the net operating loss provision would have a deleterious effect on revenue raising efforts.¹⁴⁷ In fact, he indicated that he might support a more nar-

144. Perhaps the statement that the net operating loss provision violated annual accounting should be clarified. One certainly cannot contend that the net operating loss provision exemplified pure transactional accounting. Taxpayers could recognize in one year losses that provided no tax benefit in another year without regard to whether the transactions generating those losses had terminated. Furthermore, the net operating loss provision carried over losses that resulted from netting the receipts and expenditures arising from many transactions. Thus, the provision was far more an income averaging provision than it was a transactional accounting provision. Still, by permitting the taxpayer to recognize losses in a year other than that in which they were realized, the net operating loss provision violated the principle of annual accounting.

145. SENATE COMM. ON FINANCE, REVENUE BILL OF 1918, S. REP. NO. 617, 65th Cong., 3d Sess. 7 (1918) (to accompany H.R. 12863) *reprinted in* 94 REVENUE ACTS 1909-1950, *supra* note 51. The Report continued:

The committee has accordingly incorporated an amendment (sec. 204) which provides that under certain limitations . . . a net loss . . . may be deducted from the net income of the preceding taxable year, and if it is in excess of the net income for such preceding taxable year, that such excess may be allowed as a deduction in computing the net income for the succeeding taxable year. Provision is made for the necessary adjustment of the taxes for the years involved, and for crediting or refunding to the taxpayer any amounts found due under such adjustment.

Id.

146. Senator Lenroot, addressing the net operating loss provision, stated:

[T]his is a very far-reaching amendment, more important than I think many Members outside of the Finance Committee perhaps realize. It is something entirely new with reference to a taxation policy in the United States. It proposes instead of treating a taxable year as a unit to group this into two or three taxable years as the case may be.

57 CONG. REC. 513 (1918).

147. Senator Lenroot stated:

The importance of this provision becomes very apparent when we look into the future and realize that possibly in the very near future we may have an industrial depression. We may have, instead of profits upon the part of a very considerable percentage of the industries of the country, actual losses. Although they may make large profits during the year 1918, we propose to this extent at least to insure them in future against losses and provide that if

rowly drafted provision that alleviated the hardships caused by annual accounting when a particular loss transaction did not close before the end of a particular taxable year.¹⁴⁸ However, the unmistakable tenor of Senator Lenroot's comments indicated that he did believe that annual accounting was the foundation of our tax system, and the net operating loss provision caused unjustifiable damage to that foundation.¹⁴⁹ That Congress passed the net operating loss provision after Senator Lenroot's clear admonition that it violated the foundation upon which our tax system was based substantially undercuts contentions that Congress intended our tax system to be based upon annual accounting.

Senator Lenroot's concern, however, that the net operating loss provision would have a deleterious effect on revenue raising efforts, did not fall on deaf ears. As discussed below, the availability of a net operating loss provision waxed and waned for the first twenty years after its initial pas-

they sustain losses in the future we will pay them back when the taxes have been a revenue to the Government for the year 1918.

Mr. President, it seems to me that this is clearly wrong and can not be defended, because the Government must have money to carry on its operations. Taxes must be paid for that purpose whether business is conducted at a profit or whether it is conducted at a loss. The excise taxes that are found in this bill are imposed whether the seller is carrying on his business at a profit or whether it is carried on at a loss

[I]t seems to me that if the Senate realized the scope of these sections, realized their possible effect upon the Treasury of the United States in the future, it would not adopt them.

57 CONG. REC. 513-14 (1918). Senator Lenroot then asked: "I do not know whether or not the Finance Committee have any estimates of how much is involved or how much the loss of revenue will be to this Government, but I should like to ask whether any member of the committee has any estimate upon that subject?" 57 CONG. REC. 514 (1918).

148. Senator Lenroot noted:

I am wholly in sympathy with the amendment that we have been discussing for the past hour or two with reference to losses upon inventories and the refund that is there provided; I can see some justification for making an adjustment in the case of sale of plants acquired since April 6, 1917, for war purposes, and where a loss has been entailed; but I can see no justification for applying that principle to ordinary business which is carried on in the ordinary way. There might be reason for some legislation of this kind if the transaction out of which a loss occurred began in a taxable year and was not ended or the loss not incurred until a subsequent taxable year; but what justification can there be when here is a business during the year 1918 which is making a profit during that entire year, and its business is closed, and then we come along to the year 1919, and that same business suffers a loss, not through any transactions which were begun in 1918, but through transactions which were begun and ended in 1919?

57 CONG. REC. 513-14 (1918).

149. See, for example, Senator Lenroot's statement:

The whole theory of the income-tax law is that a man shall pay taxes each year according to the income that he makes that year. That is the theory of the income-tax law; and this provision would wholly and totally upset that theory and make the basis a three-year average instead of providing for a tax on the annual income.

57 CONG. REC. 515 (1918).

sage. However, whenever Congress limited or withdrew the availability of the net operating loss provision, it did so to protect the federal fisc at times when economic conditions made revenue raising quite difficult. It did not do so simply to preserve the concept of annual accounting.

Under the net operating loss provision contained in the Revenue Act of 1918, the only losses which a taxpayer could carry back or carry forward were losses sustained in a taxable year which began after October 31, 1918, and ended prior to January 1, 1920.¹⁵⁰ Thus, that net operating loss provision was limited in that it did not apply to net losses incurred after the end of the 1919 calendar year. With the Revenue Act of 1921,¹⁵¹ Congress decided to revive the net operating loss provision. However, the 1921 provision applied only to losses incurred in taxable years beginning after December 31, 1920.¹⁵² When read together, the Revenue Acts of 1918 and 1921 permitted net losses incurred in 1919 to be carried back and carried forward, and net losses incurred in 1921 and thereafter to be carried forward, but did not permit use of net losses for the year 1920 to offset income in any other year.

This gap was not accidental. In the Senate hearings on the 1921 revival of the net operating loss provision, Senator McCumber stated that despite taxpayer requests Congress had previously refused to allow taxpayers to deduct 1920 losses from the previous year's gain because "the Government absolutely needed the money."¹⁵³ Dr. T.S. Adams, the noted economist, who acted as an advisor to the Treasury, had only one reservation about enacting the provision: whether the budget could "stand the strain."¹⁵⁴ Thus, the lack of a net operating loss provision for

150. See Revenue Act of 1918, ch. 18, § 204(b), 40 Stat. 1057, 1061 (1919).

151. Ch. 136, 42 Stat. 227 (1921).

152. See Revenue Act of 1921, ch. 136, § 204(b), 42 Stat. 227, 231 (1921).

153. *Internal Revenue: Hearings Before the Committee on Finance, on H.R. 8245* [Confidential Print for Use of Members of the Senate] 67th Cong., 1st Sess. at 34 (Sept. 1921), reprinted in 95A REVENUE ACTS 1909-1950, *supra* note 51.

154. *Id.* Adams stated:

While I doubt very much if the Treasury Department could stand for a provision recognizing losses of 1920, if you can put it off for several years, I think it highly desirable that it should be done

The Treasury Department has considered this very carefully. It would have liked to authorize deductions for net losses of 1920. That, however, seems impracticable. The department thinks the House provision is safe. They think this will relieve the taxpayers eventually, and that by 1923 we shall be able to stand it. The department thinks that prosperity will have returned by that time and that we can stand the strain; that, in any event, if these corporations have these losses, it is not fair to tax them heavily in their prosperous years and then take no account of those years in which they are in red ink.

losses incurred in 1920 resulted solely from revenue concerns caused by a temporary economic downturn and not from any concern that a net operating loss provision did not comport with the principle of annual accounting. Moreover, the lack of a sunset provision in the net operating loss section in the 1921 Act¹⁵⁵ indicates that Congress intended to make the net operating loss provision a permanent fixture in our tax laws. Thus, Congress was very willing to forsake the annual accounting concept to achieve equitable treatment of the taxpayer.

Of course, the net operating loss provision of the 1921 Act did not always lead to results that were entirely satisfactory to Congress or the Treasury. As with any new provision, taxpayers learned how to manipulate it to achieve results that Congress and the Treasury did not desire. Thus, the net operating loss provision was renumbered and fine-tuned in the Revenue Act of 1924.¹⁵⁶ In the Revenue Act of 1928, the tax laws were completely reorganized and the net operating loss provision was given a new section number.¹⁵⁷ However, with the exception of the fine-tuning and renumbering, through the Revenue Act of 1928 there was no indication that the net operating loss provision was anything other than a well-established fixture in our tax laws.

Then came the Great Depression. Previously, starting with the Revenue Act of 1921, taxpayers who reported net operating losses could carry those losses forward to the following year. If in that following year the carried-forward losses still exceeded the income for that year, the taxpayer could carry forward those losses for one additional year.¹⁵⁸ In

155. Unlike the net operating loss provision in the Revenue Act of 1918 which applied only to losses sustained in a taxable year which began after October 31, 1918, and which ended prior to January 1, 1920, see Revenue Act of 1918, ch. 18, § 204(b), 40 Stat. 1057, 1061 (1919), the net operating loss provision contained in the Revenue Act of 1921 applied to losses sustained in any taxable year beginning after December 31, 1920. See Revenue Act of 1921, ch. 136, § 204(b), 42 Stat. 227, 231 (1921).

156. In the Revenue Act of 1924, the net operating loss provision was renumbered as § 206. Revenue Act of 1924, ch. 234, § 206 43 Stat. 253, 260 (1924). Section 206(b) clarified that the amount of net loss carried forward was "not allowable . . . as a deduction in computing the net loss of the succeeding taxable year, since to do this would allow the benefits of the net loss to be taken not only in the two succeeding taxable years but for an indefinite time until it was absolutely wiped out." SENATE COMM. ON FINANCE, INTERNAL REVENUE BILL OF 1924, S. REP. NO. 398, 68TH CONG., 1ST SESS. 20 (1924) (to accompany H.R. 6715) reprinted in 96 REVENUE ACTS 1909-1950, *supra* note 51. For other examples of fine-tuning, see STAFF OF SENATE COMM. ON FINANCE, 68TH CONG., 1ST SESS., STATEMENT OF THE CHANGES MADE IN THE REVENUE ACT OF 1921 BY H.R. 6715 AND THE REASONS THEREFORE, 15-17 (Comm. print 1924), reprinted in 67 REVENUE ACTS 1909-1950, *supra* note 51.

157. See Revenue Act of 1928, ch. 852, § 117, 45 Stat. 791, 825-26 (1928).

158. See Revenue Act of 1921, ch. 136, § 204(b), 42 Stat. 227, 231 (1921).

other words, starting with the Revenue Act of 1921, the tax laws permitted a two year carryforward of net operating losses. The Revenue Act of 1932, the first major tax act passed after the start of the Great Depression, however, limited loss carryovers to only the following year.¹⁵⁹ According to the House Report accompanying the Revenue Act of 1932, this cutback in the loss carryover provision was necessitated by "the urgent need of revenue."¹⁶⁰

With the inauguration of President Roosevelt and the start of the New Deal, the government needed revenue even more urgently. Thus, in 1933 Congress repealed the net operating loss provision via section 218(a) of the National Industrial Recovery Act.¹⁶¹ Although the Supreme Court declared portions of the National Industrial Recovery Act unconstitutional in *Schechter Poultry Corp. v. United States*,¹⁶² the holding in that case was framed so that it did not affect the repeal of the net operating loss provision.¹⁶³ The net operating loss provision thus remained absent from the tax laws until it was reinstated in the Revenue Act of 1939.¹⁶⁴

A primary purpose of the Revenue Act of 1939 was to stimulate business by removing business deterrents from the tax laws.¹⁶⁵ Such legislation was needed to aid an economy that not only had not yet recovered from the Great Depression, but which, moreover, had lapsed deeper into the Depression through a major recession that began in late 1937.¹⁶⁶ One would think that at such a time Congress would be unwilling to reinstate a net operating loss provision with its attendant costs to the

159. See Revenue Act of 1932, ch. 209, § 117(b), 47 Stat. 169, 207 (1932).

160. HOUSE COMM. ON WAYS AND MEANS, THE REVENUE BILL OF 1932, H.R. REP. NO. 708, 72d Cong., 1st Sess. 23 (1932) (to accompany H.R. 10236), reprinted in 99 REVENUE ACTS 1909-1950, *supra* note 51.

161. National Industrial Recovery Act, ch. 90, § 218(a), 48 Stat. 195, 209 (1933). Section 218(a) was part of the revenue raising provisions of the National Industrial Recovery Act. SENATE COMM. ON FINANCE, NATIONAL INDUSTRIAL RECOVERY BILL, S. REP. NO. 114, 73d Cong., 1st Sess. 5 (1933) (to accompany H.R. 5755), reprinted in 99 REVENUE ACTS 1909-1950, *supra* note 51. ("Sections 210 to 218, inclusive, cover the taxes necessary to raise \$220,000,000.")

162. 295 U.S. 495 (1935).

163. The Court stated, "[W]e hold the code [of fair competition (pursuant to which the Live Poultry Code was promulgated)] provisions here in question to be invalid." *Id.* at 551.

164. See Revenue Act of 1939, ch. 247, § 211, 53 Stat. 862, 867-69 (1939).

165. See HOUSE COMM. ON WAYS AND MEANS, THE REVENUE BILL OF 1939, H.R. REP. NO. 855, 76th Cong., 1st Sess. 1, 3 (1939) (to accompany H.R. 6851) reprinted in 105 REVENUE ACTS 1909-1950, *supra* note 51. ("The bill has two major objectives. The first is to remove from the existing corporate income-tax structure such business deterrents and tax irritants as may be possible to consider at this time." *Id.* at 1. "[O]ne purpose of the bill as reported is to stimulate business activity." *Id.* at 3.)

166. See J. WITTE, *supra* note 59, at 104.

federal fisc. However, an official of the Chamber of Commerce of the United States testified before the House Ways and Means Committee and urged the enactment of a net operating loss provision to alleviate hardships and inequities caused by strict adherence to annual accounting.¹⁶⁷ The House agreed that reenactment of such an equitable provision was appropriate,¹⁶⁸ and the net operating loss provision was restored to the tax laws.¹⁶⁹

In thus reinstating the net operating loss provision Congress again undermined the legitimacy of the exalted status which the Supreme Court had granted to annual accounting. One must remember that the reason for annual accounting is to help raise revenue in an administratively convenient manner. While this desire for administrative convenience had always been tempered by a desire for equitable treatment of the taxpayer, the balance had generally been tipped in favor of administrative convenience when the economy was faltering and revenue raising was impaired. In 1939, however, when a faltering economy would indicate that the bal-

167. Ellsworth C. Alvord, Esq., Vice Chairman of the Committee on Federal Finance, of the Chamber of Commerce of the United States, testified as follows on June 2, 1939:

We urge that the privilege of carrying forward net operating losses be restored to the revenue act immediately.

The selection of a single year as the taxable period is admittedly arbitrary, and results in great hardship to industries and particular companies in which years of profit and loss alternate. If such companies are taxed in years of profit, without allowance for prior years' losses, their tax burden is wholly out of proportion to the income actually earned over the period as a whole. As compared with businesses having a stable income from year to year, moreover, they are at a severe competitive disadvantage. . . .

The revenue acts from 1921 to 1933 recognized this hardship and permitted a net loss carry-over. The privilege was abolished in the National Industrial Recovery Act in 1933, solely by reason of the urgent necessity of protecting the revenues at that time. It has never been disputed that such a provision is an essential feature of an equitable tax system.

The determination of the carry-over period is necessarily arbitrary. The British income tax permits losses to be carried forward for 6 years. A shorter period may be desirable for revenue purposes. In view of the abnormal conditions of the last 10 years and the wide fluctuation of business activity, incomes, and values we have experienced, a carry-over of at least 3 years should be allowed.

Revenue Revision, Hearings Before the Comm. on Ways and Means of the House of Representatives, 76th Cong., 1st Sess. 99, 104 (1939) (statement of Ellsworth C. Alvord), reprinted in 23 REVENUE ACTS 1909-1950, supra note 51.

168. The House Report stated:

In the interest of equity, the committee, in the bill as reported, has recommended an amendment under which individuals and partners are allowed a 2-year carry-over of losses. This carry-over is substantially the same as that which was granted to them under the Revenue Act of 1928.

HOUSE COMM. ON WAYS AND MEANS, THE REVENUE BILL OF 1939, H.R. REP. NO. 855, 76th Cong., 1st Sess. 6 (1939) (to accompany H.R. 6851), *reprinted in 105 REVENUE ACTS 1909-1950, supra note 51.*

169. *See Revenue Act of 1939, ch. 247, § 211, 53 Stat. 862, 867-69 (1939).*

ance should have tipped toward administrative convenience, Congress forsook adherence to a major tool for achieving administrative convenience and opted for an equitable result. Arguably, Congress not only balanced the need for administrative convenience against the need for equity, but also desired equity wherever possible and believed that administrative convenience, and its tool of annual accounting, were necessary evils that could be forsaken if the cost was not too great. From that analysis flows the conclusion that the mixed signals from the Revenue Act of 1918, which spawned the net operating loss provision, were the natural reactions of an infant income tax system in 1918 and 1919, as it freed itself from its childlike desire for simplicity and facing a complex world. The Revenue Act of 1924¹⁷⁰ further evidences this maturation process. The next part of this Article examines that evidence of maturation and the Supreme Court's failure to accept it for what it was—the further rejection of strict adherence to annual accounting.

III. THE IRONY OF SECTION 200(d): OR HOW WHAT WAS INTENDED AS AN INCURSION UPON ANNUAL ACCOUNTING'S DOMAIN ACTUALLY SOLIDIFIED ITS EXALTED POSITION

So far, this Article has considered deviations from annual accounting as a means of providing equitable relief to the taxpayer from the harsh consequences of strict adherence to annual accounting. However, early on, this Article noted that the goals of the overall statutory and regulatory scheme also included protection of the fisc from depletion by taxpayer manipulation, and equitable treatment of the government. Implicit in this premise is that strict adherence to annual accounting might at times unfairly benefit taxpayers, and that deviations from annual accounting are also needed to protect the Treasury from taxpayer manipulation. Indeed, just such a concern led to the enactment of section 200(d) of the Revenue Act of 1924.¹⁷¹ However, Congress purposely worded that section broadly enough to benefit taxpayers as well as the Treasury.

In pertinent part section 200(d) of the 1924 Act provided:

The deductions and credits provided for in this title 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 under section 212 or 232, *unless in order to clearly reflect the*

170. Ch. 234, 43 Stat. 253 (1924).

171. Ch. 234, 43 Stat. 253, 254 (1924).

*income the deductions or credits should be taken as of a different period.*¹⁷²

The House Ways and Means Committee and the Senate Finance Committee both explained the reason for this provision in identical language:

The Revenue Act of 1921 in sections 214(a)(6) and 234(a)(4) authorizes the Commissioner to allow the deduction of losses in a year other than that in which sustained when, in his opinion, it is necessary to clearly reflect the income. The proposed bill extends that theory to all deductions and credits. The necessity for such a provision arises in cases in which a taxpayer pays in one year interest or rental payments or other items for a period of years. If he is forced to deduct the amount in the year in which paid, it may result in a distortion of his income which will cause him to pay either more or less taxes than he properly should.¹⁷³

The last sentence of each Committee's report clearly indicates that Congress intended section 200(d) to provide equitable treatment to both the Treasury *and* to taxpayers. However, the reason given by the Committees' reports for the necessity of section 200(d)—the need to prevent income distortion by the prepayment of expenses—usually related to the taxpayer's ability to manipulate annual accounting to his benefit and the Treasury's detriment.

By accelerating deductions the taxpayer could mismatch expenses and the accounting period over which they generated income, taking the benefit of the time value of money for himself to the detriment of the government. This was especially true for accrual basis taxpayers because they could recognize a deduction before actually incurring the expense that generated the deduction, if all events fixing ultimate liability for the expenditure had occurred.¹⁷⁴ In fact, the early accrual of a deduction could work to the detriment of the taxpayer only if the taxpayer's marginal rate was lower in the earlier year of accrual than in the later year of payment.¹⁷⁵ Thus, section 200(d) of the 1924 Act can be viewed as an incursion upon annual accounting's domain to protect the fisc from tax-

172. *Id.* (emphasis added).

173. HOUSE COMM. ON WAYS AND MEANS, THE REVENUE BILL OF 1924, H.R. REP. NO. 179, 68th Cong., 1st Sess. 10-11 (1924) (to accompany H.R. 6715) and SENATE COMM. ON FINANCE, INTERNAL REVENUE BILL OF 1924, S. REP. NO. 398, 68th Cong., 1st Sess. 10-11 (1924) (to accompany H.R. 6715), reprinted in 96 REVENUE ACTS 1909-1950, *supra* note 51.

174. See *United States v. Anderson*, 269 U.S. 422, 441 (1926) (established the "all events test" and upheld the Treasury's position that a tax liability that became fixed in 1916 must be deducted in 1916 even though the tax was neither due nor paid until 1917). See also *Dixie Pine Products Co. v. Commissioner*, 320 U.S. 516 (1944) (the deduction for a state tax liability could not be accrued while the taxpayer was challenging the validity of the state tax because all events which would fix the liability had not occurred so long as the challenge to the validity of the state tax was pending).

175. Indeed, the taxpayer's (unsuccessful) argument in *Anderson*, 269 U.S. 422, for recognition

payer manipulation and to provide equitable treatment to the government.

Section 200(d), however, was not framed so narrowly that it should be read as remedying only the problem enumerated in the Committees' reports. Rather, the broad scope of its language suggests that it could be used to remedy other inequities that result from strict adherence to annual accounting, and that the problem of accounting for prepaid expenses was merely one example of when section 200(d) could play an equitable role. Indeed, Congress' failure to define the phrase, "unless in order to clearly reflect the income," indicates that Congress was inviting the courts to formulate a concept of what constitutes a clear reflection of income, taking into account equitable considerations along the way. Furthermore, Congress' handling of the installment sales provisions¹⁷⁶ and initial enactment of a net operating loss provision¹⁷⁷ indicates that its view of a proper and equitable system of accounting for income need not adhere strictly to a system of annual accounting. Therefore, read in the context of the statutory development of a system of accounting for taxes through a trial and error approach, section 200(d), with its "in order to clearly reflect the income" exception to annual accounting, appears as an invitation to courts to violate annual accounting if equity so demands and if the violation does not impair the administrative feasibility of predicting and collecting revenues on a regular basis. The Supreme Court's failure to even acknowledge this interpretation of section 200(d) is part and parcel of its mishandling of annual accounting.

Before the Supreme Court interpreted the relevant portion of Section 200(d), Congress reorganized the tax statutes and renumbered the sections. As a result, when the language referred to above as section 200(d) came before the Court, it appeared in section 43 of the Revenue Act of 1934.¹⁷⁸

The Supreme Court interpreted section 43 in *Security Flour Mills Co.*

of its deduction in the later year 1917 rather than in the earlier year 1916, is readily explained by the fact that tax rates were much higher in 1917 than in 1916. See *supra* note 50.

176. See *supra* notes 106-20 and accompanying text.

177. See *supra* notes 143-49 and accompanying text.

178. Ch. 277, 48 Stat. 680, 694 (1934). Section 43 of the Revenue Act of 1934 provided in pertinent part:

The deductions and credits provided for in this title 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 to clearly reflect the income the deductions or credits should be taken as of a different period.

Id.

v. *Commissioner*.¹⁷⁹ The facts in *Security Flour Mills* were virtually indistinguishable from those in *Helvering v. Cannon Valley Milling Co.*,¹⁸⁰ and the Court granted certiorari in *Security Flour Mills* to resolve the split of authority caused by the differing results in those two cases at the circuit court level.¹⁸¹ Because the facts in the two cases were virtually the same,¹⁸² and because the Supreme Court's opinion in *Security Flour Mills* is murky, at best, analysis of the cases can be simplified by describing them in a single hybrid fact pattern drawn from all the opinions in both cases.¹⁸³

In 1935 the taxpayer, a flour milling company, was subject to a processing tax, the accrual of which the taxpayer could deduct in determining taxable income for income tax purposes, subject to satisfaction of the all events test.¹⁸⁴ In 1935 the taxpayer included in the contract price it charged to customers the processing tax that it, the taxpayer, would owe as a result of each transaction. The invoice did not list the processing tax as a separate item. Rather, the tax was added to and included in the contract price so that the tax burden was effectively passed on to the customer. However, all sales contracts clearly noted that the sales prices included the amount of the processing tax and further indicated that if the amount of the processing tax changed, the sales prices would similarly change. Thus, were it not for the processing tax, the taxpayer would have charged less on its contracts in 1935 and would have reported less gross income. Furthermore, if the taxpayer had been able to accrue an offsetting deduction in 1935 for the processing tax, its taxable income for that year would have been the same as if it had never charged its customers for the processing tax in the first place.

However, in 1935 the taxpayer was also challenging the constitutionality of the processing tax. Because of this challenge, the all events test

179. 321 U.S. 281 (1944).

180. 129 F.2d 642 (8th Cir. 1942).

181. Compare *Commissioner v. Security Flour Mills Co.*, 135 F.2d 165 (10th Cir. 1943), *aff'd* 321 U.S. 281 (1944) with *Cannon Valley Milling*, 129 F.2d 642 (8th Cir. 1942).

182. Note that the circuit court in *Security Flour Mills* stated, "[T]he two cases are distinguishable." 135 F.2d at 168. However, the attempt by the circuit court in *Security Flour Mills* to distinguish *Cannon Valley Milling* is totally unconvincing. The analysis in this Article therefore treats the two cases as factually identical.

183. See generally *Security Flour Mills Co. v. Commissioner*, 45 B.T.A. 671 (1941), *rev'd* 135 F.2d 165 (10th Cir. 1943), *aff'd* 321 U.S. 281 (1944); *Cannon Valley Milling Co. v. Commissioner*, 44 B.T.A. 763 (1941), *aff'd sub nom Helvering v. Cannon Valley Milling Co.*, 129 F.2d 642 (8th Cir. 1942).

184. See *supra* note 174.

required for the accrual of a deduction was not satisfied, so the taxpayer could not take the deduction in that year.¹⁸⁵ Therefore, the taxpayer's taxable income, as well as gross income, for 1935 was increased by the amount of the processing tax that was passed on to customers. In 1936, the processing tax was declared unconstitutional. Although under no legal obligation to do so, but to maintain goodwill and settle claims by irate customers, the taxpayer repaid to some of its customers in the years 1936, 1937, and 1938 a portion of the taxes that the taxpayer collected from them in 1935.

Strict adherence to annual accounting would require the taxpayer to deduct the repayments in the years they were made, namely 1936, 1937, and 1938. However, the taxpayer contended that because its 1935 taxable income would have been substantially lower had it not included the processing taxes in the 1935 sales prices, and because the sales prices for 1935 were increased only because of the existence of the processing taxes,¹⁸⁶ it should be able to amend its 1935 tax return so as to offset its taxable income for that year with the repayments made in 1936, 1937, and 1938.¹⁸⁷ The taxpayer argued that this violation of annual accounting was necessary to clearly reflect the income of 1935 and was authorized by section 43 of the Revenue Act of 1934.

Given the choice between interpreting section 43 quite narrowly or somewhat expansively, the Supreme Court in *Security Flour Mills* opted

185. See *supra* note 174.

186. Obviously, the contention that the sales prices for 1935 were increased only because of the existence of the processing taxes is undercut by the fact that the taxpayer did not repay to its customers all of the processing taxes that it collected. That the taxpayer did not repay *all* of the taxes collected is closely related to the fact that it was not under a legal obligation to repay *any* of the taxes collected. Thus, the question arises as to why the taxpayer made the repayments in the first place. The answer to that question, however, in the view of the *Cannon Valley Milling* dissent, addressed whether the repayments were deductible in the first place, not when those repayments, once deemed deductible, were in fact deductible. *Cannon Valley Milling*, 129 F.2d at 650 (Thomas, J., dissenting). However, the IRS conceded that the repayments were deductible. *Id.* at 644. Furthermore, the failure to repay some of the collected taxes does not appear to have been relevant to the courts in deciding the timing issue. Therefore, the failure to repay all of the taxes collected shall be deemed immaterial for purposes of this analysis.

187. From a practical standpoint, the taxpayer did not want to deduct the payments in the years they were made because the taxpayer had a net loss for the year 1937, but had taxable income for the year 1935. See *Cannon Valley Milling*, 129 F.2d at 647; *Security Flour Mills*, 135 F.2d at 168 (noting a net loss for the year 1937). Because the tax laws did not contain a net operating loss carryover provision for the years in question, see *supra* text accompanying notes 161-64, recognition of the repayments as deductible items in 1937, a loss year, would generate no tax benefit and would thus generate tax on a greater amount than the taxpayer's overall net income during the multi-year period in question.

for a very narrow interpretation. It held that section 43 merely applied to the mismatching of receipts and expenses that would occur if a taxpayer could deduct in one year all expenses that gave rise to a benefit over the course of several years. For example, section 43 could preclude a taxpayer from prepaying and deducting all rent due under a multi-year lease in the first year of the lease.¹⁸⁸ The Court rested its conclusion, in part, on the theory that our tax system was based on annual accounting and that section 43, therefore, "was not intended to upset [this] well-understood and consistently applied doctrine."¹⁸⁹ In support of its contention that our tax system was based upon annual accounting the Court cited and quoted from its opinion in *Sanford & Brooks*.¹⁹⁰

Two problems exist with such an approach. First, as discussed above, the *Sanford & Brooks* opinion over emphasized adherence to annual accounting through an improperly constrained reading of section 212(b) of the Revenue Act of 1918.¹⁹¹ Second, and of even greater importance, *Sanford & Brooks* involved accounting for income in the tax year 1920, while the predecessor to section 43 was not enacted until 1924. Thus, when the Supreme Court spoke of the importance of adherence to annual accounting in *Sanford & Brooks*, it did so in the context of a tax statute that did not contain the broad language of section 43 that indicated that annual accounting could be violated "in order to clearly reflect the income." Therefore, the Court should have considered the subsequent enactment of the predecessor to section 43 as at least undercutting the precedential value of *Sanford & Brooks*. The failure of the Court to recognize this possibility makes its analysis quite weak.¹⁹²

Indeed, the Court's opinion in *Security Flour Mills* was so inartfully

188. *Security Flour Mills*, 321 U.S. at 285.

189. *Id.* at 285-86.

190. *Id.* at 286.

191. See *supra* text accompanying notes 76-86 and 122-26.

192. Note that the Court in *Security Flour Mills* did acknowledge the taxpayer's contention that the enactment of the predecessor to § 43 should be deemed to have altered the *Sanford & Brooks* rule of strict adherence to annual accounting. 321 U.S. at 287. However, the Court's response to the taxpayer's contention does not withstand careful scrutiny and is in fact very misleading. The Court stated: "As we said in *Dixie Pine Products Co. v. Commissioner*, *supra*, referring to a section identical with § 43 now under consideration, 'The provisions of the Revenue Act of 1936 worked no significant change over earlier Acts respecting the permissible basis of calculating annual taxable income.'" 321 U.S. at 287.

Dixie Pine Products Co. v. Commissioner, 320 U.S. 516 (1944), addressed the general rule of when an obligation has sufficiently accrued under the all events test to be deductible by an accrual basis taxpayer. The specific issue in that case was whether an accrual basis taxpayer could take a deduction for state taxes when the taxpayer was contesting the validity of the state tax. The Court

drafted that it seems as much an opinion on whether a deduction has accrued as it is on whether annual accounting may be violated. In its confusion, the Court improperly applied precedent dealing with when a deduction accrues pursuant to the all events test to the question of whether annual accounting could be violated.¹⁹³ Only an examination of the circuit court opinions in *Security Flour Mills* and *Cannon Valley Milling* brings into proper focus the legal issue at stake.

The Tenth Circuit, in *Security Flour Mills*, quoted the committee reports that accompanied section 200(d) of the Revenue Act of 1924,¹⁹⁴ the predecessor of section 43, and construed section 43 quite narrowly. It read the committee report examples of problems resulting from prepaid interest and rents as the only types of situations to which section 43 could legitimately apply.¹⁹⁵

Such a reading of section 43, however, ignored the possibility that the committee report examples were merely intended to illustrate only two of a wide variety of situations to which the predecessor to section 43 could

held that no deduction was allowed while the challenge to the state tax was proceeding, because all events fixing the ultimate liability for the tax had not occurred.

Section 43, on the other hand, was relevant only after a determination was made that an obligation had in fact already sufficiently accrued. Only then did section 43 address whether a taxpayer could recognize the accrued obligation in the year that it had accrued or, instead, in some other year in order to clearly reflect income.

Nowhere in *Dixie Pine Products* did the Court interpret a statute "identical with § 43." The Court did note the existence of § 43, but the statement in *Dixie Pine Products* quoted by the *Security Flour Mills* Court merely stood for the proposition that nothing in the Revenue Act of 1936 changed the general rule of when a deduction had sufficiently accrued *under the all events test*. The language in the quote, "the permissible basis of calculating annual taxable income," simply referred to how one calculates taxable income under the permissible annual method known as accrual. Interpreting the quoted language in any other way takes it out of context and gives it a totally unintended meaning. To imply, as did the *Security Flour Mills* Court, that *Dixie Pine Products* is even remotely helpful in interpreting § 43 both grossly misrepresents the holding and issue in *Dixie Pine Products* and improperly applies precedent regarding when an obligation has sufficiently accrued to the separate issue of when, if ever, annual accounting may be violated.

193. See *supra* note 192.

194. 135 F.2d at 168. See also *supra* text accompanying note 173 (quoting and discussing the committee reports).

195. 135 F.2d at 168. The court stated:

It is manifest that Congress had in mind for application of the provision only instances in which a taxpayer receives income or makes expenditures in one year which are attributable to or related to business operations extending over a number of years. . . . The provision comes into operative play in instances of that kind. It was never intended to go beyond that scope. These transactions were not of that kind. All of the income was fully earned in 1935. No part of it extended over a period of years. The expenditures were not for interest, or rental, or other items of that kind covering a period of years.

Id.

apply. A broader interpretation of section 43, and its predecessor, is supported by the broad language of the section itself which lacks any indication that Congress intended section 43 to have limited application.¹⁹⁶

The Eighth Circuit in *Cannon Valley Milling* noted that section 43 was worded broadly enough to cover many more situations than those mentioned in the committee reports.¹⁹⁷ The Eighth Circuit also noted the trial and error nature of the tax laws' development and viewed section 43 as fitting within an overall congressional attempt to balance the need for administrative convenience with the desire for equity. The *Cannon Valley Milling* court stated:

Federal income tax legislation is a progressive growth based upon developing experience. Several distinct levels of growth are evident. One of these concerns us here. While an annual period has always been maintained as the normal basis for taxation, experience soon developed that injustice would result in some instances from a strict adherence thereto. This experience led the Congress to provide departures from this annual basis in specified situations for the purpose of avoiding injustice.¹⁹⁸

The court recognized, however, that because section 43 represented a departure from a general rule of adherence to annual accounting, the judiciary must impose limits on the section's scope. Furthermore, because deviation from annual accounting could impair the administrative feasibility of predicting and collecting revenues, the court realized that its test had to balance the need for administrative convenience against the desire for equity. The Eighth Circuit therefore stated its test (to be imposed on a case-by-case basis) to require not only "some relation between a deductible item and a business transaction in some year other than the one in which it was paid" but also a situation in which strict adherence to annual accounting would cause a "*distortion* of the income of the taxpayer for one or both years, which would amount to an injustice either to the taxpayer or to the Government."¹⁹⁹ The dissenting opinion from the

196. See *supra* text accompanying notes 175-76.

197. *Cannon Valley Milling*, 129 F.2d at 645.

198. *Id.* at 646 n.3.

199. *Id.* at 645-46 (emphasis in original) (footnote omitted). The opinion states:

To construe this clause broadly to cover all instances where there is merely some relation between a deductible item and a business transaction in some year other than the one in which it was paid or finally accrued would introduce an uncertainty seriously interfering with the practical administration of tax statutes. Clearly, no such general disturbance of the system was contemplated by section 43. Therefore, such relationship alone is not enough. There must be, in addition to such relationship, a situation which clearly convinces that unless such deduction item is transferred there would be a *distortion* of the income of the taxpayer for one or both years, which would amount to an injustice either to

Tenth Circuit's decision in *Security Flour Mills*, however, did the best job in applying the *Cannon Valley Milling* test to the facts in the two cases. The *Security Flour Mills* dissent stated:

Obviously, these payments had absolutely no relation to the cost of earning income in the years of payment. Equally apparent is the fact that they had direct relation to the taxpayer's 1935 gross income. They represented refunds to vendees of amounts paid to the taxpayer in 1935 as a part of the sale price of flour because of the processing tax. They, in fact, resulted in a reduction of taxpayer's gross income from 1935 sales. Only by relating them to the year 1935 can the income for that year be truly reflected. It seems to me that it was to relieve against just such a situation that Sec. 43 was enacted.²⁰⁰

Indeed, by noting that income for the year 1935 would be clearly reflected only if the payments in the later years were used to offset 1935 income, the dissenting judge, in countenancing a violation of annual accounting, both furthered the goals of annual accounting itself and promoted equitable treatment of the taxpayer. Annual accounting can achieve its goal of enhancing the predictability of the revenue flow only if the income reported for each year clearly and accurately reflects the ultimate income resulting from activities during that year. By proposing to

the taxpayer or to the Government. We think the guide for construction of this "unless" clause is that it comprehends those exceptional situations where it is necessary to transfer a deduction item in order to avoid such a distortion of income as would produce an injustice. It is this guide we apply to the fact situation here.

Id. (emphasis in original) (footnote omitted).

200. *Security Flour Mills*, 135 F.2d at 170 (Phillips, J., dissenting). A similar approach is found in the Board of Tax Appeals opinion in *Cannon Valley Milling*:

"Taxation is an intensely practical matter, and laws in respect of it should be construed and applied with a view of avoiding, so far as possible, unjust and oppressive consequences." *Farmers Loan & Trust Co. v. State of Minnesota*, 280 U.S. 204, 212. The objective of all accounting methods is to "clearly reflect income." The ideal method would be to charge against income earned during a taxable period the expenses attributable to the earning of it. The computation of net income upon the basis of a taxpayer's annual accounting period in accordance with the method of accounting regularly employed does not always accomplish the desired objective. Section 43 was intended to aid in accomplishing it. While no limitation was placed upon its application, we are of the opinion that it was intended to apply to unusual and exceptional situations such as we have here. It is quite unlikely that this petitioner will ever again make, or be called upon to make, any reimbursements of the kind here involved. They were of a nonrecurring nature and resulted primarily from a judicial decision that the act imposing the processing tax was invalid. They could not have been foreseen on June 30, 1935, the end of petitioner's fiscal year. They, however, represented payments under claims relating to 1935 sales. If such sales had not been made there would have been no basis for the claims and no reimbursements. They were not in any sense of the word related to sales made in 1937 and were not proper charges against the income of that year.

Cannon Valley Milling, 44 B.T.A. at 771.

permit the 1935 income to be offset by the later years' repayments, the dissenting judge was proposing an interpretation of section 43 that would more clearly reflect the ultimate income of both 1935 and the years of repayment, thus giving the Treasury a more accurate historical picture to use in predicting future revenue flows.

When read together, the Eighth Circuit opinion in *Cannon Valley Milling* and the dissent from the Tenth Circuit's decision in *Security Flour Mills* represent a highly sophisticated approach to interpreting section 43. Not only did they recognize the historical trial and error development of the tax statutes during the early years of the income tax, but they also attempted to place section 43 within this history. Furthermore, they interpreted section 43 in a manner that balanced the policy goal of providing equitable treatment to the taxpayer and the government against the policy goal of predicting and collecting revenue in an administratively feasible manner. In the light of these truly sophisticated opinions, it is quite lamentable that the Supreme Court in *Security Flour Mills* delivered a murky and weak opinion that rigidly adhered to the principle of annual accounting.

This is not to say that the result reached by the Supreme Court in *Security Flour Mills* was totally unjustified. A narrow and quick reading of the committee reports supporting section 200(d), the predecessor to section 43, could easily lead to the result reached by the Supreme Court. In fact, the Tenth Circuit opinion in *Security Flour Mills* is a creditable opinion based upon such a narrow and quick reading of section 43 and the committee reports supporting its predecessor. The position taken in this Article is simply that the opinion of the Eighth Circuit in *Cannon Valley Milling* and the dissent from the Tenth Circuit decision in *Security Flour Mills* more accurately interpret section 43 in the historical context of the overall statutory and regulatory scheme and the policies which that scheme was seeking to both further and balance.

In light of the fact that the Supreme Court had available to it both of these sophisticated opinions, how can we explain the Court's weak opinion that not only rigidly adhered to annual accounting, but also failed to even acknowledge the cogent arguments raised by each of these other opinions? Perhaps the answer lies in the era in which the Court decided *Security Flour Mills*. *Security Flour Mills* was decided in 1944, in the midst of World War II. By 1942, revenue needs for the war effort were

quite pressing.²⁰¹ As a result, Congress raised taxes in 1942.²⁰² However, the act which raised taxes was quite complicated,²⁰³ and by 1944 Congress was concerned with simplifying a tax code that had become difficult to administer.²⁰⁴ One can readily imagine that in such a climate the Court would not be amenable to arguments for a sophisticated balancing approach in order to further equity, but would instead do whatever it could to embrace bright-line tests that would facilitate administration of the tax system.

Analyzed in this way, *Security Flour Mills* bears a striking similarity to *Sanford & Brooks*, which was decided in the depths of the Depression. Because revenue needs were also pressing when the Court decided *Sanford & Brooks*,²⁰⁵ both cases may represent the favoring of administrative convenience over equitable concerns out of a desire to aid in the collection of revenue. One might well posit that the supremacy of annual accounting resulted not from the provisions of the underlying statutory and regulatory scheme, but instead from the accident of the eras in which the Court interpreted that scheme. If that is the case, *Security Flour Mills* presents a great irony. The Court in that case analyzed a statute that countenanced the violation of annual accounting in very broad terms. By construing that statute quite narrowly, the Court indicated an unwillingness to accept congressional attempts at limiting annual accounting's status. The net result was to so solidify annual accounting's exalted status that courts would continue to seek adherence to annual accounting, even during periods of less pressing revenue needs.

IV. RECOVERIES OF PREVIOUSLY DEDUCTED ITEMS AND REPAYMENTS OF PREVIOUSLY INCLUDED ITEMS: A CASE STUDY AND SUGGESTION FOR REFORM

Our inquiry now comes full circle back to the first regulations requiring strict adherence to annual accounting. These regulations involved the recovery of previously deducted bad debts²⁰⁶ and the inability to use expenses incurred in one year to offset income received in another

201. See J. WITTE, *supra* note 59, at 114.

202. *Id.* at 115-18.

203. *Id.* at 118.

204. *Id.* at 122-23.

205. The Court decided *Sanford & Brooks* in 1931. For a discussion of the pressing revenue needs at that time see *supra* text accompanying notes 157-69.

206. See *supra* note 51 and accompanying text.

year.²⁰⁷ We return to these regulations for several reasons. First, strict adherence to the principles flowing from these regulations exemplifies how inequitable results can be reached when courts blindly follow annual accounting. Second, the courts validated at least one of the underlying regulations, the recovery regulation, without any consideration of whether it comported with the mix of policies evidenced by the overall statutory and regulatory scheme. Instead, the courts applied an unsophisticated analysis that relied in part on the supremacy of annual accounting as indicated by the *Sanford & Brooks* case. Although the unsophisticated analysis may well have resulted from the taxpayer's lack of clean hands in the validating case, from that time forward the principles flowing from those regulations developed a life of their own, divorced from their regulatory underpinnings and the history and context surrounding those regulations. Third, a re-examination of the recovery regulation in the context of the history surrounding the overall statutory and regulatory scheme of accounting for income indicates that a sweeping validation of the regulation may not have been appropriate and the law need not have developed as it did. Finally, a proposal for modifying the approach of these strict annual accounting regulations, which better balances the need for administrative convenience against the desire for equity, could bring one aspect of current law into harmony with the policies that emanate from the history of the overall statutory and regulatory scheme. Such a proposal could also indicate to the courts that our tax accounting system is a hybrid one that need not always comport with annual accounting. If the courts would accept this indication, tax jurisprudence might become more realistic by focusing on the truly important issues.

The inquiry will proceed in the following manner. First, it will note how the timing of the final affirmation of the principles flowing from these early regulations, and the manner in which these principles were affirmed, indicate that these principles developed a life of their own, separate and apart from their history and regulatory underpinnings. Next, this Article will critique the validation of one of the underlying regulations and the principles flowing from it. Finally, it shall examine a proposal that properly balances the desire for equity and the need for administrative convenience and which might assist in attaining a more realistic tax jurisprudence.

207. See *supra* note 55 and accompanying text.

A. How Final Affirmation of the Principle Flowing From the Early Regulations Indicates That They Developed a Life of Their Own

The first regulations requiring strict adherence to annual accounting were promulgated by the Treasury during World War I. As demonstrated earlier, during this era the government faced pressing revenue needs and the Treasury lacked experience in administering an income tax. These factors may have caused the Treasury to put its concern for equity to one side in order to ease the burden of administering the income tax.²⁰⁸ However, final judicial affirmation of the principle behind these strict annual accounting regulations occurred in periods without such pressing revenue needs.

In 1967 the Court of Claims decided *Alice Phelan Sullivan Corp. v. United States*.²⁰⁹ In 1967 a federal deficit existed, but it was a much lower percentage of the Gross National Product (GNP) than it was when the Treasury first promulgated the recovery regulation.²¹⁰ Yet the court in *Alice Phelan Sullivan Corp.* held that the tax consequence of recovering a previously deducted item was to include in income in the year of recovery the amount that gave rise to a tax benefit in the year of deduction, even if changes in tax rates caused more tax to be due in the year of recovery than was saved in the year of deduction. Similarly, in 1951, when the Supreme Court decided *United States v. Lewis*,²¹¹ the federal deficit was again a much lower percentage of the GNP than it was during World War I.²¹² Yet, in *Lewis* the Court strictly applied the concept of annual accounting and held that a taxpayer who repaid an amount in 1946 that he had included in income under a claim of right in 1944 could merely deduct the repayment in 1946. This rule applied even though, due to a change in tax rates, the taxpayer still paid more tax than if he had never received the repaid item in the first place.

In both cases, the inequitable nature of the result was duly noted: in *Alice Phelan Sullivan Corp.* by the court,²¹³ and in *Lewis* by Justice Douglas in dissent.²¹⁴ However, this recognition of inequity did not pre-

208. See *supra* notes 58-70 and accompanying text.

209. 381 F.2d 399 (Ct. Cl. 1967).

210. See J. WITTE, *supra* note 59, at 151 for a graphic depiction of federal expenditures and receipts as a percentage of GNP from 1913 to 1980.

211. 340 U.S. 590 (1951).

212. See *supra* note 210.

213. 381 F.2d at 403 n.5.

214. 340 U.S. at 592 (Douglas, J., dissenting).

clude strict adherence to annual accounting. One must ask, therefore, why these courts, at a time of no administrative or deficit crisis, strictly applied annual accounting principles that flowed from regulations adopted to achieve administrative convenience at a time of pressing revenue needs.

The easy and expected answer would be that the regulations did not constitute an unreasonable interpretation of the underlying statutory requirement of accounting for income on an annual basis. Because the courts almost always uphold Treasury regulations that constitute reasonable interpretations of a statutory provision,²¹⁵ courts should also uphold principles flowing logically and consistently from such reasonable regulations. Curiously, however, neither *Lewis* nor *Alice Phelan Sullivan Corp.* made any reference to the regulations that espoused the principles with which they were dealing.²¹⁶ Rather, both the *Lewis* court and the *Alice Phelan Sullivan Corp.* court relied simply on case law flowing from *Sanford & Brooks* as authorizing and requiring strict adherence to annual accounting.²¹⁷ Thus, the real answer to our inquiry appears to be that the *Sanford & Brooks* opinion created such a strong foundation for strict adherence to annual accounting²¹⁸ that courts failed to balance equitable

215. See *Commissioner v. South Texas Lumber Co.*, 333 U.S. 496 (1948). The Court stated: "[T]his Court has many times declared that Treasury regulations must be sustained unless unreasonable and plainly inconsistent with the revenue statutes and that they constitute contemporaneous constructions by those charged with administration of these statutes which should not be overruled except for weighty reasons." *Id.* at 501.

216. Note that the court in *Alice Phelan Sullivan Corp.* did make reference to the regulations under § 111 of the Code. 381 F.2d at 402. These regulations, and indeed § 111 pursuant to which they were promulgated, by implication do support the principles flowing from the recovery regulation. However, the *Alice Phelan Sullivan Corp.* court did not cite either § 111 or the regulations pursuant to it for the proposition that Congress had placed its imprimatur on the principles flowing from the recovery regulation. Rather, the court merely noted that § 111 and the regulations pursuant to it placed certain limits upon unbridled application of the recovery principles with which the court was dealing. 381 F.2d at 401-02. From a careful reading of the case, one could infer that the basic recovery principle itself found its genesis in case law and not in any regulatory provision. See 381 F.2d at 401 where the court cites case law for the statement, "[T]he principle is well ingrained in our tax law that the return or recovery of property that was once the subject of an income tax deduction must be treated as income in the year of its recovery." The opinion nowhere cites to the true parent of that principle, namely the recovery regulation, even though to this day the recovery regulation's provisions remain in the Treasury regulations without any material change. See *Treas. Reg. § 1.451-1(a)* (1988) ("To the extent that income is attributable to the recovery of bad debts for accounts charged off in prior years, it is includable in the year of recovery . . . regardless of the date when the amounts were charged off.").

217. *Lewis*, 340 U.S. at 592; *Alice Phelan Sullivan Corp.*, 381 F.2d at 403.

218. For evidence of the strength of the foundation created by *Sanford & Brooks*, see *supra* Part III where this Article describes how the Court improperly used *Sanford & Brooks* in *Security Flour*

concerns against the administrative convenience of adherence to annual accounting by the time of the *Lewis and Alice Phelan Sullivan Corp.* decisions.²¹⁹

Furthermore, the strength of the *Sanford & Brooks* opinion obviated the need for reference to the regulations that gave rise to the principles in question. Because neither *Lewis* nor *Alice Phelan Sullivan Corp.* evaluated the underlying regulations when upholding the principles that flowed from them, it is appropriate that at least one of the regulations, the recovery regulation, be evaluated here.

Because regulations should be evaluated in the context of the underlying structures, policies, and principles of the income tax system as a whole and in the light of the conditions to which those regulations were a response,²²⁰ the recovery regulation must not be deemed valid merely because it constitutes a reasonable interpretation of the requirement that income be accounted for on an annual basis. Rather, the recovery regulation must be evaluated in the light of the era in which it was adopted and with an eye toward whether, in a different era, it properly accommodates the sometimes conflicting goals of the overall statutory and regulatory scheme. Under this approach, if the recovery regulation unnecessarily promotes administrative convenience at the expense of equity, it should not be upheld and should be replaced by a more balanced approach.²²¹ An examination of how courts early on validated the recovery regulation demonstrates that their approach was flawed, and so is not sufficient to foreclose our inquiry.

Mills to limit the applicability of a statute that authorized incursions upon annual accounting's domain.

219. During the era of *Lewis and Alice Phelan Sullivan Corp.* one case did forsake annual accounting in order to achieve an equitable result. *Perry v. United States*, 160 F. Supp. 270 (Ct. Cl. 1958). However, the *Perry* opinion was so bizarre that the Court of Claims was able to overrule *Perry* in *Alice Phelan Sullivan Corp.* 381 F.2d at 401-03. See, Grauer, *supra* note 3, at 379-81.

220. See *supra* note 14.

221. If my position here places me in conflict with contrary Supreme Court authority (see *supra* note 215), so be it. By now it should be obvious to the reader that one purpose of the study encompassed by this Article and by my previous Article, Grauer, *supra* note 3, is to demonstrate and try to repair certain jurisprudential errors that the Supreme Court has made in the tax field. The reader should not be surprised, therefore, if the repair process includes adopting a new methodology for evaluating the validity of Treasury regulations. In any event, as noted *supra* note 14, this methodology is merely an extension to the field of regulatory interpretation and evaluation of the positions taken by Dean Calabresi and Professor Zelenak in the area of statutory interpretation and validation.

B. *The History of the Validation of the Recovery Regulation*

First of all, it is not entirely clear when the recovery regulation was first validated. Professor White finds the first validation in 1927²²² in *Lee v. Commissioner*.²²³ Although the Board of Tax Appeals in *Lee* did include in income in the year of recovery accounts receivable that the taxpayer had written off as worthless in earlier years, the taxpayer did not appear to challenge the validity of the underlying principle of the recovery regulation. Rather, the taxpayer contended that the amount included in income in the year of recovery should be offset by additional accounts receivable that had proved worthless in that later year. Thus *Lee* did not address the validity of the recovery regulation (which the taxpayer had apparently conceded) but rather the worthlessness of the accounts receivable that the taxpayer attempted to write off in the later year of recovery.²²⁴ As a result, one cannot really say that the *Lee* decision validated the recovery regulation.

The confusion as to the initial validation of the recovery regulation is further noted by Professor Bittker who stated:

[A]s late as 1929, the Board of Tax Appeals seemed uncertain about the validity of a Treasury regulation providing that the collection of a debt previously charged off as worthless must be included in income. Within a few months, however, the Board of Tax Appeals accepted the principle enunciated by this regulation; by 1931, it was described as a principle that "seems to be taken for granted, as indeed it must be"; and it has been a basic part of the federal income tax structure ever since.²²⁵

Professor Bittker found that the Board of Tax Appeals accepted the principle enunciated by the recovery regulation in *Excelsior Printing Co. v. Commissioner*.²²⁶ In *Excelsior Printing Co.*, however, the issue was not the validity of the principle enunciated by the recovery regulation but rather whether the payment received in the later year, pursuant to a provision in the debtor's will, should be regarded as a taxable receipt of a previously deducted bad debt or as a nontaxable receipt of a gift or bequest. Furthermore, even *Putnam National Bank v. Commissioner*,²²⁷ the case cited by Professor Bittker as describing the principle of the re-

222. White, *supra* note 1, at 489 n.16.

223. 6 B.T.A. 541 (1927), *aff'd sub nom.* Carr v. Commissioner, 28 F.2d 551 (5th Cir. 1928).

224. 6 B.T.A. at 544.

225. Bittker & Kanner, *The Tax Benefit Rule*, 26 UCLA L. REV. 265, 266 (1978) (citations omitted).

226. 16 B.T.A. 886 (1929).

227. 50 F.2d 158 (5th Cir. 1931).

covery regulation "as a principle that 'seems to be taken for granted, as indeed it must be,'"²²⁸ did not address the validity of the recovery regulation or its principle, but rather considered whether the taxpayer had properly taken the deduction in the earlier year.²²⁹ In fact, none of the cases cited by either Professor Bittker or Professor White as validating the recovery regulation actually held that the recovery regulation was a valid exercise of the Treasury's rulemaking authority.²³⁰ Indeed, it was not until after the Supreme Court's *Sanford & Brooks* decision that the Board of Tax Appeals clearly stated that the principles of annual accounting and the administrative finality sought by the statute of limitations required that the recovery of previously deducted bad debts (and other amounts) must be reflected in income only in the year of recovery.²³¹ Even then, the Board made no reference to the underlying Treasury regulation, and it is not clear that the Board's statement was necessary to the decision in the case.

Ironically, the only case in which any court appears to have clearly stated that the recovery regulation was a valid exercise of the Treasury's rulemaking authority is the circuit court decision which reversed the Board of Tax Appeals case cited by Bittker²³² as indicating uncertainty about the recovery regulation's validity. In that case, *Commissioner v. Liberty Bank & Trust Co.*,²³³ the taxpayer claimed certain amounts as bad debt deductions for the years 1916, 1917, 1918 and 1919. The returns for those years were audited, and the deductions were allowed.²³⁴ When the taxpayer recovered those bad debts in 1920 and 1921, the taxpayer did not include the recoveries in income. The taxpayer claimed that the debts were not in fact worthless when they were charged off and

228. Bittker & Kanner, *supra* note 225, at 266 (quoting *Putnam Nat'l Bank v. Commissioner*, 50 F.2d 158, 158 (5th Cir. 1931)).

229. If the deduction in the earlier year had been improper, as the taxpayer contended, the remedy would have been to reopen the earlier year rather than to include the payment in income in the later year.

230. The only case cited by Professor Bittker or Professor White as upholding the principle of the recovery regulation not discussed in the text of this Article is *Chicago, Rock Island & Pac. Ry. Co. v. Commissioner*, 13 B.T.A. 988 (1928), *aff'd in part, rev'd in part*, 47 F.2d 990 (7th Cir. 1931), *cert. denied*, 284 U.S. 618 (1931). See White, *supra* note 1, at 489 n.16. In that case, too, the issue revolved not around the validity of the recovery regulation, but instead around the definition of income. See *Chicago Rock Island & Pac. Ry. Co. v. Commissioner*, 13 B.T.A. at 1022-23.

231. *South Dakota Concrete Products Co. v. Commissioner*, 26 B.T.A. 1429, 1431-32 (1932).

232. Bittker & Kanner, *supra* note 225, at 266 n.5.

233. 59 F.2d 320 (6th Cir. 1932), *rev'g Liberty Insurance Bank v. Commissioner*, 14 B.T.A. 1428 (1929).

234. *Liberty Ins. Bank*, 14 B.T.A. at 1431.

therefore the deductions were improper. The taxpayer argued that proper remedy was to amend the returns for the earlier years. The Board of Tax Appeals agreed with the taxpayer.²³⁵ However, because the statute of limitations had expired for reopening those earlier years, the Board held that those returns need not be amended. Furthermore, on a theory akin to "two wrongs do not make a right," the Board held that the Commissioner could not correct the improper deductions of the earlier closed years by re-computing the tax liability for the recovery years.²³⁶ As a result, the Board held that the taxpayer did not have to account for the recovered debts in any year.²³⁷

The Commissioner appealed, asserting that the taxpayer should be estopped from claiming that the debts were not in fact worthless when they were charged off, inasmuch as the taxpayer had earlier sworn that the debts were worthless and obtained a tax benefit as a result.²³⁸ The Sixth Circuit agreed with the Commissioner, noting, "It is the duty of the taxpayer to deal fairly and truthfully with the government."²³⁹ This statement by the Sixth Circuit best explains the appeals court result in *Liberty Bank*.

Once the taxpayer was estopped from claiming that the debts were never worthless, the debts were assumed to have indeed been worthless.

235. *Id.* at 1433-34.

236. The Board's approach as to when the proper remedy is the reopening of the earlier year and when the proper remedy is an inclusion in the year of recovery was correct under strict annual accounting principles. If a taxpayer properly charges off an item in an earlier year but recovers it in a later year, the earlier year should not be reopened because the taxpayer properly accounted for that year based upon all the facts known at that time. Instead, annual accounting requires that the taxpayer make an adjustment in the year of recovery. An earlier year should be reopened only if it was reported incorrectly based on the facts known at that time. Thus, if the charge-off in the earlier year was improper, given the facts known at that time, the taxpayer should amend the return for the earlier year to correct the mistake, regardless of whether the improperly charged off item is recovered at a later date. Such an approach comports with strict annual accounting principles in that each year's return accurately reflects the events of that year as determined by the facts known during that year. Annual accounting would be violated and income for each year would not be accurately reflected if mistakes on returns for earlier years could be "corrected" by counterbalancing entries in the returns for later years. Thus, so long as the Board was willing to accept the taxpayer's contention that it never should have taken the deductions in the first place, the Board was correct in not requiring (or even permitting) the correction of that earlier error in a later year. However, it is questionable whether the Board even should have entertained the taxpayer's argument that the deductions were improperly taken in the earlier years, especially after the taxpayer had sworn that they were properly taken, the statute of limitations on those years had expired, and those years could not be reopened. See *infra* text accompanying note 238.

237. *Liberty Ins. Bank*, 14 B.T.A. at 1434.

238. *Liberty Bank*, 59 F.2d at 325.

239. *Id.*

Thus, their subsequent recovery had to be accounted for in the year of recovery under the strict annual accounting approach of the recovery regulation. The court then validated the recovery regulation, stating first that *Sanford & Brooks* indicated the validity of the regulation²⁴⁰ and stating further:

Like regulations were promulgated under corresponding provisions of the Revenue Acts of 1916 and 1918 (39 Stat. 756; 40 Stat. 1057), and with these earlier regulations in effect Congress enacted sections 213(a) and 233(a) of the Revenue Act of 1921 in substantially the same language as the earlier acts. The same language was incorporated into the succeeding Revenue Acts of 1924, 1926, and 1928. It must be taken as settled that Congress was cognizant of the interpretation which the Treasury Department had put on the Revenue Acts of 1916 and 1918, and yet, with that interpretation extant, the provisions to which it applied were re-enacted in 1921. If such interpretation had not been consonant with the intent of Congress, it is reasonable to suppose that it would have modified this construction in the act of 1921, or in the later acts.²⁴¹

The court thus affirmed the validity of the recovery regulation on the following theory: If the recovery regulation had not accurately reflected Congressional intent, Congress would have amended the statutory basis for the regulation to correct the Treasury's mistake. Here, however, Congress affirmatively reenacted the statutory basis for the regulation, without any change, after the regulation had been promulgated. Thus, the regulation must reflect how Congress intended recoveries of bad debts to be accounted for.

This particular rationale, however, when viewed in connection with the facts in *Liberty Bank*, makes *Liberty Bank* a weak precedent in other fact patterns for the validity of the recovery regulation and the principles flowing from it. Although some Supreme Court authority supports the view that administrative construction of a statutory provision is deemed to have Congressional approval when Congress reenacts the underlying statute without material change,²⁴² important and quite relevant qualifications limit this approach to validating regulations.

In *Commissioner v. Glenshaw Glass Co.*,²⁴³ the Court refused to hold punitive damages nontaxable even though the Board of Tax Appeals had

240. *Id.*

241. *Id.*

242. See *Commissioner v. Estate of Noel*, 380 U.S. 678, 681-82 (1965); *United States v. Dakota-Montana Oil Co.*, 288 U.S. 459, 466 (1933).

243. 348 U.S. 426 (1955).

earlier held them to be nontaxable, and Congress had reenacted the underlying statute without change after the Board's decision. In refusing to apply the "reenactment theory" the Court stated, "Re-enactment—particularly without the slightest affirmative indication that Congress ever had the [Board's] decision before it—is an unreliable indicium at best."²⁴⁴ Then, in *S.E.C. v. Sloan*,²⁴⁵ the Court applied this limitation on the reenactment theory in a challenge to an administrative agency's order. The Court refused to uphold the SEC's construction of section 12(k) of the Securities Exchange Act of 1934,²⁴⁶ even though Congress had substantially reenacted that section after the SEC had interpreted it.²⁴⁷ Moreover, in *United States v. Correll*,²⁴⁸ the Court upheld a Treasury ruling on the reenactment theory, but only after noting that Congress had focused upon and evaluated the existing ruling before reenacting the underlying statute without change.²⁴⁹

On the other hand, the legislative history of each of the acts cited in *Liberty Bank* as reenacting the statutory authority for the recovery regulation contains absolutely no evidence that Congress ever considered or evaluated the recovery regulation or its ramifications when it reenacted the underlying statutory provision. As a result, the reenactment theory was "an unreliable indicium at best"²⁵⁰ in determining the validity of the recovery regulation. A better indicium would have been an evaluation of whether the recovery regulation properly balanced the need for administrative convenience against the desire for equity that was evidenced by

244. *Id.* at 431.

245. 436 U.S. 103 (1978).

246. 15 U.S.C. § 781(k) (1982).

247. 436 U.S. at 120-21. The Court stated:

[A] contemporaneous administrative construction of an agency's own enabling legislation "is only one input in the interpretational equation. Its impact carries most weight when the administrators participated in drafting and directly made known their views to Congress in committee hearings." Here the administrators, so far as we are advised, made no reference at all to their present construction of § 12(k) to the Congress which drafted the "enabling legislation" here in question—the Securities Exchange Act of 1934. They made known to at least one Committee their subsequent construction of that section 29 years later, at a time when the attention of the Committee and of the Congress was focused on issues not directly related to the one presently before the Court. Although the section in question was re-enacted in 1964, and while it appears that the Committee Report did recognize and approve of the Commission's practice, this is scarcely the sort of congressional approval referred to in *Zuber, supra*.

Id.

248. 389 U.S. 299 (1967).

249. *Id.* at 305-06 n.20.

250. See *supra* note 244 and accompanying text.

the overall trial and error approach to tax accounting taken by Congress and the Treasury during the early years of the income tax.

Unfortunately, the facts in *Liberty Bank* did not lend themselves to such an approach. The taxpayer in *Liberty Bank*, as the appeals court had noted, did not deal fairly with the government.²⁵¹ *Liberty Bank* had tried unfairly to manipulate to its advantage the interplay between strict adherence to annual accounting and the statute of limitations by taking inconsistent positions at opportune times.²⁵² Thus, unlike the taxpayer in *Alice Phelan Sullivan Corp.*, *Liberty Bank* lacked clean hands and could not convincingly argue that strict application of the recovery regulation was inequitable in that it would work an injustice upon the taxpayer.²⁵³ The appeals court in *Liberty Bank* was therefore able to uphold the recovery regulation as a reasonable interpretation of a statutory provision without being concerned about the potential for inequitable results in other factual situations. There is evidence, however, that had the taxpayer not lacked clean hands, the result could have been different, and better balanced the desire for equity against the need for the administrative convenience of annual accounting.

As late as 1941 the Board of Tax Appeals stated that with respect to the recovery of previously deducted taxes, the general rule was that the taxpayer should amend the year of deduction to eliminate the deduction, rather than include the recovered tax in income in the year of recovery.²⁵⁴ The taxpayer was to include the recovered tax in income in the year of recovery only if the statute of limitations precluded amendment of the year of deduction.²⁵⁵ Furthermore, the Board of Tax Appeals apparently approved of amendment of the earlier year even when the deduction was properly taken in the earlier year.²⁵⁶ Thus, with respect to the recovery of previously deducted taxes, the Board, by requiring the

251. See *supra* text accompanying note 239.

252. See *supra* notes 234-37 and accompanying text.

253. In *Alice Phelan Sullivan Corp. v. United States*, 381 F.2d 399 (Ct. Cl. 1967) strict application of the principles flowing from the recovery regulation did work an injustice upon the taxpayer. In that case, the taxpayer made a charitable contribution and saved almost \$1900 in taxes as a result. Some years later, when the taxpayer's marginal tax rate was substantially higher, the charity reconveyed the donated property to the taxpayer. Because of the change in the applicable marginal rate, the recovery resulted in a tax of almost \$4500 being assessed against the taxpayer. Thus, the taxpayer would have been better off by some \$2600 (\$4500 minus \$1900) had it never made the charitable contribution in the first place.

254. *E.B. Elliott Co. v. Commissioner*, 45 B.T.A. 82, 91 (1941).

255. *Id.*

256. See *Id.* at 93.

amendment of an earlier return that had been properly filed, forsook strict adherence to annual accounting²⁵⁷ in favor of equitable treatment of the taxpayer and the government. Whenever the statute of limitations for amending returns had not expired, the approach of the Board of Tax Appeals to recovered taxes put both the taxpayer and the government in the same position that they would have been in (except for the effects of the time value of money) had the recovered taxes never been paid and deducted in the first place. Neither party inequitably gained a windfall at the expense of the other simply because of a change in the taxpayer's marginal tax rate.

The Board's approach to recovered taxes had another appealing aspect. Although it countenanced a violation of annual accounting, the violation should not have undermined the government's ability to predict and collect revenues in an administratively feasible manner. Because revenue flows should be most predictable when the historical picture accurately reflects the ultimate income resulting from the activities transpiring in each earlier year, the requirement that the year of deduction be amended should further predictability by providing a more accurate historical picture. Furthermore, by permitting amendment of an earlier year's return only so long as the statute of limitations had not expired, the Board apparently recognized that for past returns to have any predictive value they must be finalized and not subject to amendment after a reasonable period of time. Additionally, permitting amendment only so long as the statute of limitations had not expired recognized that the vast majority of adjustments would be required because of the short duration of an annual accounting period and the need for adjustment would likely become known relatively soon after the annual accounting period had ended. Those that became known later (after the statute of limitations had expired) would be fewer and more far between. Thus, although they were treated differently than adjustments that became known within the statute of limitations, their differing treatment should not, to any substantial degree, have impaired a clear reflection of income or the ability to predict and collect future revenues by reference to the historical picture.

If the Board's approach to recovered taxes is so appealing, why was that approach not taken to recovered bad debts? Certainly no evidence exists that the courts were concerned that I.R.S. personnel would become

257. See *supra* note 236.

inundated with amended returns or that taxpayers would rebel against having to file amended returns when the recovery was de minimus in nature. Rather, the courts most likely took a different approach to the recovery of bad debts because there was a specific regulation dealing with them. However, there is no principled justification for treating recovered bad debts differently from recovered taxes. Thus, one approach had to yield to the other, and it was the approach to recovered taxes that finally gave way.²⁵⁸ The approach to recovered taxes yielded to the approach to bad debt recoveries not because of any principled balancing of the desire for equity against the need for administrative convenience but instead because of the decision of the Supreme Court in *Security Flour Mills*.²⁵⁹

Unfortunately, as we have already seen, the opinion of the Supreme Court in *Security Flour Mills* was itself somewhat flawed.²⁶⁰ It, too, failed to balance the desire for equity against the need for administrative convenience and failed to consider the trial and error nature of Congress' and the Treasury's approach to accounting period issues. If one does, however, take into account the trial and error nature of the early approach to accounting period issues (and the context in which the recovery regulation was promulgated), one can make a plausible argument that the courts should not have upheld the recovery regulation's validity when its inequitable features became evident.

The recovery regulation (along with the complementary regulation which precluded a taxpayer from using expenses incurred in one year to offset income received in another) was promulgated by the Treasury during World War I. At that time not only were revenue needs quite pressing, but moreover, the Treasury lacked experience administering an income tax.²⁶¹ Thus, at that time, regulations that aided administrative convenience, even at the expense of equity, were appropriate. Nonetheless, both at that time and thereafter, Congress and the Treasury indicated that, whenever possible, the tax laws would be administered so as to provide both equitable treatment to the taxpayer and the government.

258. See, e.g., *Bartlett v. Delaney*, 173 F.2d 535, 540 (1st Cir. 1949), cert. denied, 338 U.S. 817 (1949) ("We think the rule of tax accounting applied in the Elliott [*supra* note 254 and accompanying text] and Leach cases is no longer tenable in view of the decision in *Security Flour Mills v. Commissioner*"). See also *Taylor Instrument Companies v. Commissioner*, 14 T.C. 388 (1950) (the Tax Court refused to continue its approach to recovered taxes laid down in *Elliott* after the Supreme Court decision in *Security Flour Mills*).

259. See *supra* note 258.

260. See *supra* text accompanying notes 187-201.

261. See generally *supra* Part II(A).

Evidence of this desire for equity is found in the methods of accounting for long term contracts (the completed contract method and the percentage of completion method),²⁶² the installment sales provisions,²⁶³ and, of course, the net operating loss provisions.²⁶⁴ Indeed, a review of the early history of the net operating loss provisions indicates that whenever they were not available to taxpayers, it was not because of a desire to adhere to annual accounting but rather because of pressing revenue needs.²⁶⁵ Finally, in 1924, Congress authorized the violation of annual accounting if doing so was needed to clearly reflect income.²⁶⁶

The Eighth Circuit's opinion in *Cannon Valley Milling*, a sophisticated interpretation of a successor to this 1924 provision, stated that the provision authorized the violation of annual accounting to preclude the distortion of the income of the taxpayer for one or both of the years in question.²⁶⁷ Even though this statutory provision did not address when items must be *included* in income,²⁶⁸ its principle that annual accounting could be violated in order to preclude distortion of the taxpayer's income for one or both of the years in question should be equally applicable to how and when the recovery of previously deducted items must be accounted for. Amendment of the earlier year of deduction provides a more accurate historical picture of the ultimate income from activities transpiring in that earlier year than does inclusion of the recovery as income in the later recovery year. Similarly, because the recovery in the

262. See *supra* Part II(B)(1).

263. See *supra* Part II(B)(2).

264. See *supra* notes 143-70 and accompanying text.

265. See *supra* text accompanying notes 149-70.

Even to this day it appears that when Congress limits the availability of an equitable provision that violates annual accounting, it does so not to preserve annual accounting as a concept or to even promote administrative convenience at the expense of equity, but rather to preserve revenues. For example, the Tax Reform Act of 1986 more or less repealed the use of the completed contract method of accounting and limited taxpayers to the percentage of completion method or the "percentage of completion—capitalized cost method". Congress did this not because the completed contract method involved transactional accounting or violated annual accounting, but rather because the deferral of taxes caused by the completed contract method was costing the Treasury too much in revenues. See STAFF OF THE JOINT COMM. ON TAXATION, 100TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 (H.R. 3838, Pub. L. No. 99-514) 527, 530 (Joint Comm. Print 1987). (U.S. Gov't. Printing Office Publication reproduced in CCH Standard Federal Tax Reports, Extra Edition No. 19, May 8, 1987 (CCH Special 24)). In fact, even the alternatives which the 1986 Act provided to replace the completed contract method could not be described as adhering to annual accounting principles.

266. See *supra* note 172 and accompanying text.

267. *Cannon Valley Milling*, 129 F.2d at 646. See also *supra* note 199 and accompanying text.

268. The statute in question dealt only with the timing of deductions.

later year resulted only from the payment or accrual in the earlier year, the income picture for activities transpiring in that later year is more accurately reflected if it does not include the recovery. Therefore, amendment of the earlier year's return precludes distortion of the historical picture of the income for both the year of deduction and the year of recovery and comports with the Eighth Circuit's interpretation of the 1924 statutory provision.

Thus, viewed in the context of both Congress' and the Treasury's contemporaneous and subsequent emphasis on equity and a subsequent statutory provision that could be interpreted as authorizing violations of annual accounting to preclude income distortions, the recovery regulation appears as an outdated relic from a time when administrative convenience was sorely needed. Although the recovery regulation remained a reasonable interpretation of one statutory provision, by the time it was validated in the *Liberty Bank* case, its rigid application of annual accounting principles failed to comport with the overall tenor of the statutory and regulatory scheme.²⁶⁹

Unfortunately, however, the taxpayer in *Liberty Bank* had acted so unfairly toward the government that the case did not confront the court with the inequities that the recovery regulation could cause. In fact, the taxpayer's questionable behavior could have induced the *Liberty Bank* court to blindly apply the reenactment theory without regard to whether Congress had considered the recovery regulation or its ramifications during the reenactment process. Furthermore, the tax years in *Liberty Bank* preceded enactment of the statutory provision that indicated annual accounting could be violated to preclude a distortion of income. But these explanations for the *Liberty Bank* decision only make it more unfortunate that after *Liberty Bank* the validity of the recovery regulation was

269. Perhaps the propriety of basing a portion of this argument on the Eighth Circuit's approach which was ultimately rejected by the Supreme Court in *Security Flour Mills* deserves some explanation. At the time that *Liberty Bank* was decided neither the Eighth Circuit opinion in *Cannon Valley Milling* nor the Supreme Court decision in *Security Flour Mills* had been handed down. However, by the time of the *Liberty Bank* case, the statutory and regulatory scheme that the Eighth Circuit analyzed in *Cannon Valley Milling* was already in place. Furthermore, Congress did not pass the predecessor to current section 111, which accepts the basic principle of the recovery regulation but injects some equity into the result, *see infra* text accompanying note 278, until well after the *Liberty Bank* decision. Therefore, because *Cannon Valley Milling* better accounted for the overall tenor of the statutory and regulatory scheme than did *Security Flour Mills*, *see supra* Part III, an approach similar to that found in *Cannon Valley Milling* would certainly have been appropriate at the time of *Liberty Bank*.

never really challenged.²⁷⁰ Moreover, its validation may have reinforced the myth of the supremacy of annual accounting, thus making it virtually impossible for the Eighth Circuit's sophisticated interpretation of the 1924 congressional enactment to survive in the Supreme Court.²⁷¹

One further irony surrounding the validation of the recovery regulation should be noted. The *Liberty Bank* case and the *Putnam National Bank* case, which stated that the principle of the recovery regulation "seems to be taken for granted, as indeed it must be,"²⁷² were both decided during the depths of the Depression. This Article has explained that the Supreme Court decided *Sanford & Brooks* at that time and that revenue needs were then quite pressing.²⁷³ It has further noted that the Court decided *Security Flour Mills* during World War II when not only were revenue needs pressing, but also the tax code was becoming difficult to administer.²⁷⁴ Thus, one could argue that the supremacy of annual accounting resulted not from the provisions of the statutory and regulatory scheme, but rather from the accident of the eras in which the Court interpreted that scheme.²⁷⁵ Perhaps now, given the timing and the fact pattern in the *Liberty Bank* case, the conclusion can be reached that the supremacy of annual accounting resulted both from the eras in which courts faced accounting period issues and from the factual patterns in the cases that came to the courts.

The supremacy of annual accounting did not result from any intention on the part of Congress or the Treasury to require strict adherence to annual accounting. Indeed, Congress and the Treasury desired just the opposite. They appeared to view annual accounting more as a necessary evil for predicting and collecting revenues in an administratively feasible manner. When the cost was not too great, annual accounting was forsaken for further equity.

C. A Modest Proposal for Reform

Section 1341 of the current Code²⁷⁶ further evidences Congress' desire

270. Indeed, even prior to *Liberty Bank* the validity of the recovery regulation was treated as beyond challenge by the Fifth Circuit, even though it had never been formally evaluated by a court. See *supra* notes 227-28 and accompanying text.

271. See *supra* text accompanying notes 179-201.

272. *Putnam National Bank v. Commissioner*, 50 F.2d 158, 158 (5th Cir. 1931).

273. See *supra* notes 157-70, 205 and accompanying text.

274. See *supra* text accompanying notes 201-04.

275. See *supra* text accompanying note 205.

276. I.R.C. § 1341 (West Supp. 1988).

for equitable treatment of the taxpayer. Congress enacted this provision in 1954 as a response to the Supreme Court decision in *Lewis*.²⁷⁷ *Lewis* had held that a taxpayer who repaid some \$11,000 in 1946 that he had included in income in 1944 under a claim of right could do no more than take a deduction of \$11,000 in 1946, even though the tax paid on the inclusion in 1944 exceeded the tax saved by the deduction in 1946. Section 1341 gives the taxpayer another option when the amount repaid exceeds \$3,000. For the year of repayment the taxpayer can either deduct the repayment, as under *Lewis*, or can forgo the deduction and credit his taxes with the amount by which the earlier inclusion had previously increased his taxes. Thus, aside from lost interest on the taxes earlier paid, the taxpayer is never worse off, if the amount repaid exceeds \$3,000, than he would have been had he not initially received the repaid amount and included it in income.

Section 1341, however, provides more than just equity to the taxpayer. It can also provide him with a windfall. If the taxpayer's marginal rate is higher in the year of repayment than in the year of inclusion, he will choose the deduction and reap a greater tax savings in the year of repayment than the tax liability incurred in the year of inclusion. Thus, section 1341 fails to provide equity to the government.

Another problem with section 1341 arises because it treats the repayment of previously included items differently from the recovery of previously deducted items. Section 111²⁷⁸ still applies the principle of the recovery regulation but reduces the amount includable in the year of recovery by any portion of the earlier deduction that did not provide a tax reduction. Thus, a change in the taxpayer's marginal rate will often preclude the taxpayer from being placed in the same position that he would have been in had he never taken the deduction. The differing statutory treatment of the recovery of previously deducted items from the statutory treatment of the repayment of previously included items has been

277. *United States v. Lewis*, 340 U.S. 590 (1951).

Both the House Ways and Means and Senate Finance Committee Reports that accompanied the passage of the Internal Revenue Code of 1954 specifically noted that § 1341 produced a result different from that in the *Lewis* case. See HOUSE COMM. ON WAYS AND MEANS, INTERNAL REVENUE CODE OF 1954, H.R. REP. NO. 1337, 83d Cong., 2d Sess. (to accompany H.R. 8300), reprinted in 1954 U.S. CODE CONG. & ADMIN. NEWS 4017, 4436; SENATE COMM. ON FINANCE, INTERNAL REVENUE CODE OF 1954, 83d Cong., 2d Sess. (to accompany H.R. 8300), reprinted in 1954 U.S. CODE CONG. & ADMIN. NEWS 4621, 5095.

278. I.R.C. § 111 (West Supp. 1988).

subjected to criticism.²⁷⁹

The proposal noted in the Introduction to this Article²⁸⁰ suggests a uniform transactional solution to the disparate treatment of recoveries of previously deducted items and the repayment of previously included items. That proposal would require the taxpayer to amend the earlier year to account for the later recovery or repayment whenever the amount recovered or repaid exceeded \$3,000. Furthermore, to account for time value of money problems, it would require that interest be paid by the paying party in both cases on the amount of taxes that were either paid or refunded.²⁸¹ In this manner equity would be served by placing both parties in the same position that they would have been in had the transactions, which in effect were reversed, never occurred. Indeed, the requirement that an adequate rate of interest be paid would preclude either party from even gaining a windfall from the time value of money. In reaching this conclusion the proposal recognized that exceptions to annual accounting have become so prevalent in the tax code that this transactional approach should not really be deemed that shocking.²⁸²

A current step toward balancing the policy goals of annual accounting against other goals found in the statutory and regulatory scheme could involve a somewhat similar approach. The approach would be reminiscent of the old treatment of the Board of Tax Appeals to the recovery of previously deducted taxes. It would require the taxpayer to amend the earlier year if: (1) the earlier year and the later year were within five years of one another; and (2) the tax liability differential between reopening the earlier year and adhering to annual accounting (as limited by section 111) exceeded \$1,000 in the case of an individual taxpayer and \$2,500 in the case of a corporate taxpayer. If either of these two requirements were not satisfied, current law, i.e., the recovery regulation, as limited by section 111, and the *Lewis* treatment of claim of right restorations, would apply. However, section 1341 (with its provision of benefits only to taxpayers) would be repealed. If the earlier year were to be reopened because the tax liability differential exceeded the threshold and the two years were within five years of one another, interest would of course be due from the paying party in order to compensate the repaid party for the loss of the time value of the money.

279. See Note, *supra* note 18.

280. See *supra* text accompanying note 18.

281. Note, *supra* note 18, at 1019-20.

282. *Id.* at 1018.

This approach takes the equity inherent in the pure transactional approach suggested by the earlier proposal and tempers it with some practical considerations. It should first be noted that this approach imposes a statute of limitations, but not to relieve the IRS from having to assign too many personnel to process amended returns. As the processing of amended returns becomes more and more computerized, the administrative inconvenience of processing more amended returns should not be that great. This approach, however, imposes a statute of limitations to recognize the need to finalize returns after a reasonable period of time. Finalized returns have better predictive value than do returns that are always subject to amendment. Furthermore, taxpayers should only be required to retain old returns for a reasonable period of time. Additionally, the amendment of an earlier year's return might require the amendment of the returns for all the intervening years, for example, because of a change in a loss carryover. Thus, a limit on how far back a taxpayer must go to amend a return protects a taxpayer from the inconvenience of also having to amend the returns for an inordinate number of intervening years.

The imposition of a statute of limitations, in fact, furthers the goal of equity as well as the goal of administrative convenience. While amendment of the earlier year's return, with an interest component added in, is an attempt at returning the taxpayer and the government to their initial positions, the longer time passes, the more difficult it becomes to return the parties to initial positions. Furthermore, the accruing of interest over an extended period of years could run up such a high interest liability that the paying party would be begging for the "equity" of the vicissitudinal effects of marginal rate fluctuations that inhere in strict adherence to annual accounting. Thus, the earlier year should be reopened only if it is not too far distant from the later year.

A five-year limitations period has been chosen because it falls between the usual statute of limitations of three years²⁸³ and the statute of limitations of six years whenever there is a substantial understatement of income by the taxpayer.²⁸⁴ Because of the latter statute, a taxpayer is well advised to retain tax records and returns for at least six years. A requirement that a taxpayer amend returns that are more than five years old may create a substantial burden on the taxpayer. The prospect of having to amend the returns for all intervening years could be quite onerous, and

283. See I.R.C. §§ 6501(a), 6511(a) (West Supp. 1988).

284. See I.R.C. § 6501(e) (West Supp. 1988).

the interest that could accrue over a six-year period could be quite substantial. By the same token, a three-year limitation period may be too short to provide enough benefit. With any period of limitation, quite a few recoveries or repayments may occur shortly after the period expires, thus denying equity in those situations. The shorter the period, the greater the numbers of such inequitable applications. On the other hand, the longer the time period between the earlier year and the later year, the more likely it is that a dramatic enough change in a taxpayer's marginal rate would occur to justify reopening the earlier year for the sake of equity. Thus, this new proposal adopts a limitations period that falls in between the usual three-year period and the substantial underpayment six-year period.

The imposition of a threshold figure for triggering amendment of the earlier year's return is based solely on practical considerations. If every recovery or repayment within a five-year period required the reopening of the earlier year, the transaction costs of amending returns could well outweigh the equitable benefits of placing the parties as near as is possible to their initial positions. A threshold is therefore proposed so that the transaction costs of amending returns would not be incurred when the tax consequences were de minimis.

This threshold is substantively different from those found in section 1341 and in the earlier proposal. Those thresholds are based upon the amount repaid or recovered. However, it would be almost a fruitless exercise for a taxpayer to reopen an earlier year even if the amount repaid or recovered were very large, if in both years the taxpayer was in the same or almost the same tax bracket. This could especially occur at the present time with tax brackets compressed since the Tax Reform Act of 1986. The tax liability differential between reopening the earlier year and adhering to annual accounting (as limited by section 111) could be too small to justify the transaction costs of amending the earlier returns. Thus, the threshold posited here revolves around the differential between the tax that would change hands if the earlier year were reopened and the tax that would change hands if annual accounting (as limited by section 111) were applied.

The threshold figures of \$1,000 for individual taxpayers and \$2,500 for corporate taxpayers are a best estimate as to the average costs that would be incurred by both individual and corporate taxpayers if they were forced to amend returns of earlier years. The threshold figures therefore reflect not only my belief that placing the parties in their original posi-

tions is justified only when the benefits of doing so exceed the costs of doing so, but also my belief that the cost of amending an individual's tax returns is generally not as great as the cost of amending a corporation's tax returns. These thresholds, of course, could be periodically adjusted for inflation.

The foregoing proposal would, of course, require congressional action. Mere judicial recognition that *Security Flour Mills* did not sufficiently account for either the trial and error approach of Congress and the Treasury toward accounting periods or Congress' and the Treasury's apparent desire to promote equity, even at the expense of annual accounting, will not suffice. The proposal is too specific in its detail to be appropriate as a judicial pronouncement. Also, since *Security Flour Mills*, Congress has enacted section 1341. Additionally, section 111, which was enacted well after *Liberty Bank*, but just prior to the Supreme Court decision in *Security Flour Mills*, runs counter to the result proposed here. Furthermore, the current version of the statute scrutinized in *Security Flour Mills* is sufficiently different in wording from its earlier counterpart that it might not be open to the interpretation suggested here for the earlier version.²⁸⁵ Finally, of course, as tax practitioners do appreciate bright line tests, a carefully drafted congressional enactment appears to be the only acceptable approach.

Such a reform in the tax law might not be an item of high priority for

285. The current counterpart to the statute interpreted in *Security Flour Mills* is now found in §§ 461(a) and 446(a)-(c) of the Code. Section 461(a) provides, "The amount of any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income." I.R.C. § 461(a) (West Supp. 1988). Sections 446(a)-(c) provide:

- (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, 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 —
 - (1) the cash receipts and disbursements method;
 - (2) an accrual method;
 - (3) any other method permitted by this chapter; or
 - (4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary.

I.R.C. §§ 446(a)-(c) (West Supp. 1988).

Thus, the emphasis of the statutory language now is simply on reporting deductions and credits in accordance with a consistently applied method of accounting, and the statute does not provide for reporting a particular item during the period in which reporting that particular item would most clearly reflect income.

Congress at the present time. Problems with the deficit make revenue raising a greater concern than the providing of equity. However, sooner or later Congress must admit that the most sensible way to reduce the deficit is to raise tax rates above the artificially low levels at which they were set by the 1986 Act.²⁸⁶ When rates are increased and the deficit is reduced, the equitable problems discussed in this Article will be both accentuated and ready for cure.

The enactment of a proposal like the one suggested here could also have a beneficial effect upon tax jurisprudence. The 1986 Act contains even further evidence that Congress does not consider the concept of annual accounting to be sacrosanct. The attack on tax shelters through the passive loss limitation rules²⁸⁷ is but another example of the abandonment of strict adherence to annual accounting. Adoption of a proposal such as the one posited here could send another signal to the courts—evaluate tax issues according to whether they: (1) promote equitable treatment of the taxpayer and the government, (2) do not unduly impair the ability of the Treasury to predict and collect revenues in an administratively feasible manner, and (3) do not permit depletion of the fisc by taxpayer manipulation. Do not evaluate tax issues according to whether the result reached promotes a shibboleth such as “annual accounting.”

CONCLUSION

Over the course of the twentieth century the myth has developed that our income tax system is based upon annual accounting. This myth gains support if one cursorily examines some key statutory and regulatory provisions.²⁸⁸ However, a more thorough examination of the overall statutory and regulatory scheme for accounting for income, together with an examination of the circumstances surrounding the development of that scheme, leads to the following conclusion. The supremacy of annual accounting developed in spite of efforts by Congress and the Treas-

286. In advocating an increase in tax rates, I am not necessarily advocating a return to the pre-1986 Act rate schedule. Rather, I am advocating that rates be sufficiently high that we do not need to distort the proper tax base with revenue enhancers such as I.R.C. § 67 (two percent floor on miscellaneous itemized deductions). This section, added by the Tax Reform Act of 1986, § 132, Pub. L. No. 99-514, 100 Stat. 2085, 2113-15, can cause more than just income to be taxed by disallowing a deduction to employees for the first two percent of unreimbursed expenses incurred in the furtherance of some income producing activities.

287. See I.R.C. § 469 (West Supp. 1988) as added to the Code by § 501(a) of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, 2033-41 (1986).

288. See *supra* text accompanying notes 10-13.

ury to temper the role that it had to play. It was the courts that overemphasized adherence to annual accounting, and they did so by failing to consider the ramifications and history of the overall statutory and regulatory scheme with which they were dealing. We should not, however, judge the courts too harshly. The eras in which the key cases arose, and the fact patterns of some of those cases, precluded the courts from recognizing the folly of their ways until it was too late.²⁸⁹ A modest congressional response, such as the one proposed here, would comport with the original intent of Congress in developing our tax accounting system and could resolve a few of the equitable problems that have resulted from strict adherence to annual accounting. Additionally, it could indicate to courts that they should take a more realistic approach to tax jurisprudence and not be concerned with having results comport with a concept called annual accounting.

289. For some evidence of recognition of the inequitable folly, combined with resignation that it was too late for a court to resolve the problem, see *Alice Phelan Sullivan Corp. v. United States*, 381 F.2d 399, 403 n.5 (Ct. Cl. 1967).