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**METHODS OF ACCOUNTING: THEIR ROLE IN THE
FEDERAL INCOME TAX LAW***

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Accounting enters financial transactions in the accounts of the business entity. From these accounts emerge the periodic statements which convey the results of the transactions to management, stockholders, and creditors. Nominally, at least, the income tax law also looks to the accounts of the taxpayer-entity for the basic determination of taxable income. From these same accounts must come the information which forms the essence of the annual income tax assessments. A servant to two masters, accounting has not always performed its Janus-like duties to the satisfaction of all.

The Internal Revenue Code outlines accounting's function with precision. Taxable income shall be computed on the basis of the taxpayer's taxable year,¹ under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.² Items of gross income are to 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 items are to be properly accounted for as of a different period.³ The amount of any deduction or credit shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.⁴ Concisely, this is the role of accounting methods under the federal income tax law.

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1. Int. Rev. Code of 1954, § 441(a).

2. Int. Rev. Code of 1954, § 446(a).

3. Int. Rev. Code of 1954, § 451(a).

4. Int. Rev. Code of 1954, § 461(a).

The simplicity of the statutory terms belies the magnitude of the assigned task. The language of these sections displays "almost perfect circuity of reasoning."⁵ And Congress seems largely to have ignored the fact that concepts of accounting methods have been slow to develop, indefinite in scope, and hazy of application in the field of accounting as well as in the federal income tax law. Broadly defined cash and accrual methods of accounting, as well as several specialized standards, have provided the basic requirements for the administration of the law. Income and deductions have fitted loosely into the slots provided. But where accounting has been short of usable standards—and this has been often; where accounting has failed to pervade judicial logic or permeate judicial loggerheads—and this also has been not infrequent, the Commissioner and the courts have felt entirely free to erect their own *sui generis* structure of debits and credits. The result has been conflict, complaint and confusion.

I. THE ACCOUNTING PERIOD

Accounting long ago assumed the task of reflecting the results of the financial transactions of a business enterprise over a period of less than its life. Indeed, accounting "might almost be defined as the art which attempts to break up the financial history of a business unit into specific units, a year or less in length."⁶ Similarly, the revenue acts since the sixteenth amendment have consistently assessed income taxes on the basis of the annual accounting period.⁷

However, the standards of accounting first developed within the framework of periodic balance sheet evaluations. Only in recent decades has accounting thinking been much devoted to the problems of the periodic matching of costs and revenues. In federal income

5. V. T. H. Bien, 20 T.C. 49, 53 (1953).

6. Paton, *Accounting Theory* 469 (1922). See also Paton, *Recent and Prospective Developments in Accounting Theory*, Dickinson Lectures in Accounting 97 (1943). Determination of the profit from operations *by periods* constitutes "the crux of the accounting problem." 1 Moonitz & Staehling, *Accounting Analysis* 54, 107 (1950).

7. *Helvering v. Morgan's, Inc.*, 293 U.S. 121, 126 (1934). Pre-1913 acts did likewise. See, e.g., Revenue Act of 1909, ch. 6 § 38, 36 Stat. 112; Revenue Act of 1894, ch. 349 §§ 27-36, 28 Stat. 553; Revenue Act of 1864, ch. 173, 13 Stat. 281. A taxable year must be one for which a tax was in effect, however. *Pacific Wholesalers, Inc. v. Mangerich*, 147 F. Supp. 867 (D. Guam 1957).

The experiences of the United States with the income tax prior to the sixteenth amendment are set forth at length by Kennan, *Income Taxation* (1910), and Seligman, *The Income Tax* (2d ed. 1914). Harry Edwin Smith, *The United States Federal Internal Tax History 1861-1871* (1914), and Todd, *Confederate Finance* (1954) describe in detail the tax structures of the two governments during and following the Civil War.

taxation, on the other hand, the sole emphasis has been upon the periodic determination of income and deductions with little, if any, regard for accompanying assets and liabilities. Matching as a part of the taxing process has been largely a matter of association within a time period. While accounting has emphasized firmly the essentially tentative nature of the annual allocation, the courts and the Commissioner have been equally insistent upon a definitive, if artificial, finality, thus glorifying the period of annual reckoning.⁸

The Taxable Year

In both accounting and the federal income tax law the annual accounting period was the product of necessity. Nevertheless, the common maternity yielded few characteristics in common. The demands of investors and creditors for continuing information on the status of the enterprise brought forth the periodic accounting report. The fiscal necessities of the federal government for revenue capable of being ascertained at regular intervals likewise produced the annual income tax return. That the standards of the former have not always proved satisfactory to the latter bespeaks the varying precepts of the progenitors.

The annual accounting period seemingly was not a basic concept of medieval bookkeeping. The first accounts of business enterprise gave small recognition to the periodic determination of income. Such events as the close of the business venture or the filing of the records was deemed ample opportunity to strike a balance of entrepreneurial profit.⁹ But with the growth of the industrial economy, the increased investment of funds, a growing number of venturers, and lengthening ventures came demands for more frequent accounting reports.¹⁰ To meet them accounting adopted its most troublesome convention,¹¹ the accounting period, and the accompanying concept of the "going concern."¹² It began to devote itself to the problems of striking an annual balance and of effecting a periodic

8. Paton & Littleton, *Corporate Accounting Standards* 79 (1940) [hereinafter cited as Paton & Littleton].

9. See Peragallo, *Double Entry Bookkeeping* 34 (1938).

10. As Paciolo, the author of the first printed bookkeeping treatise, prudently pointed out some centuries earlier: "Books should be closed each year, especially in partnership, because frequent accounting makes for long friendship." *De computis et scripturis*, ch. 29, quoted in Geijsbeek, *Ancient Double Entry Bookkeeping* (1914).

11. Gilman, *Accounting Concepts of Profit* 73 (1939) [hereinafter cited as Gilman]; Littleton, *Accounting Evolution* ch. 2 (1933); see Groves, *Trouble Spots in Taxation* 64 (1948).

12. See generally, Gilman ch. 7, *The Accounting Period Convention*.

fictional termination of the business enterprise.¹³ For many years the basis of the annual accounting period was the calendar year, probably because of its significance in an agrarian economy.¹⁴ In the early decades of the twentieth century, however, the accountants became active proponents of the "natural business," or fiscal year.¹⁵

The income tax laws traditionally have viewed income as a quantity of receipts, not presently in possession, but flowing over a period of time.¹⁶ And the chosen interval is not the quarter, the month, the week, the day, or the hour, but the year.¹⁷ The aim of the income tax laws is to compel returns from taxpayers in respect to the income which accrues to them each year.¹⁸ The concept of the taxable year does not encompass particular transactions occurring in a period of less than a year;¹⁹ taxable income is the sum total of all the taxpayer's transactions occurring during the twelve-month period.²⁰ A hybrid system, partly annual and partly transactional, is not authorized by the statute,²¹ nor does the statute sanction the deferral of reporting income until a venture is completed.²² Our system of income taxation operates on the annual basis.²³ It is not suggested that there ever has been any other general scheme for taxing income on any other basis.²⁴

13. *Id.* at 96. Periodic reports of profits require that a continuous stream of activities be viewed, somewhat affectedly perhaps, as a series of time segments. Bray, *The Measurements of Profit, Selected Readings in Accounting* 342 (Murphy ed. 1952).

14. And man still thinks that he must reckon results in terms of the accidental period involved in the circuit of the earth around the sun. Littleton, *Accounting Evolution* 10 (1933).

15. See Sells, *The Natural Business Year* (1924).

16. Opinion of the Justices, 77 N.H. 611, 93 Atl. 311 (1915).

17. *Thorsen v. Commissioner*, 65 F.2d 234, 237 (9th Cir. 1933) (dictum); *Iron Mountain Oil Co. v. Alexander*, 37 F.2d 231, 233 (10th Cir. 1930).

18. The line is drawn sharply to mark off one tax period from another. *Helvering v. National Contracting Co.*, 69 F.2d 252, 254 (8th Cir. 1934). But cf. *Orange Sec. Corp. v. Commissioner*, 131 F.2d 662 (5th Cir. 1942).

19. An absence of transactions in the latter part of the taxable year does not make the income produced by the transactions of the early part any less the income of the taxable year. *Commissioner v. Forest Glen Creamery Co.*, 98 F.2d 968 (7th Cir. 1938), cert. denied, 306 U.S. 639 (1939).

20. *John F. B. Mitchell*, 13 T.C. 368 (1949), rev'd, 187 F.2d 706 (2d Cir. 1951).

21. *Security Flour Mills Co. v. Commissioner*, 321 U.S. 281, 287 (1944).

22. *Heiner v. Mellon*, 304 U.S. 271 (1938); *Commissioner v. Coastwise Transp. Corp.*, 71 F.2d 104 (1st Cir.), cert. denied, 293 U.S. 595 (1934); *American Industrial Corp.*, 20 B.T.A. 188 (1930).

23. *Lewyt Corp. v. Commissioner*, 349 U.S. 237, 243 (1955) (dissenting opinion). An annual accounting contemplates (1) an annual accounting of items to a particular year; (2) an annual classification of items as income, capital, and the like; and (3) an annual computation, return, and payment of tax. *Bartlett v.*

Since 1918 the advantages, both real and otherwise, of the natural business year²⁵ have been available to both the individual and the corporate taxpayer,²⁶ if the taxpayer keeps books²⁷ on that

Delaney, 75 F. Supp. 490, 495 (D. Mass. 1948), *aff'd*, 173 F.2d 535 (1st Cir. 1949). As such it has its problems. The events of a subsequent year are not without effect via the hindsight route. *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952); *Rosenthal v. Commissioner*, 205 F.2d 505, 512 (2d Cir. 1953). Compare the direction to the Tax Court in Int. Rev. Code of 1954, § 6214(b) to consider such facts with relations to the taxes for other years as may be necessary correctly to determine the deficiency of the taxable year. Nor is the federal tax law free of the knotty legalisms of the effect of a decision determining the tax liability of one year upon the liability of a subsequent year involving the same issue. See *Commissioner v. Sunnen*, 333 U.S. 591 (1948); *Tait v. Western Md. Ry.*, 289 U.S. 620 (1933); *United States v. C. C. Clark, Inc.*, 159 F.2d 489 (5th Cir.), *cert. denied*, 331 U.S. 818 (1947); *Lore*, *Res Judicata in the Tax Laws*, 34 *Taxes* 455 (1956).

24. *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 365 (1931). For better or for worse the federal income tax system is married to the principle of computing net income on an annual basis. *Guardian Inv. Corp. v. Phinney*, 253 F.2d 326 (5th Cir. 1958).

The income tax is still sometimes levied over a period of less than twelve months. A taxpayer may usually select a period of less than one year for its initial return; it may cut short its taxable year by ceasing to exist. Int. Rev. Code of 1954, § 443(a)(2); *United States v. Kingman*, 170 F.2d 408 (5th Cir. 1948); *C. Standlee Martin, Inc. v. Riddell*, 51 Am. Fed. Tax R. 1376 (S.D. Cal. 1956). The Commissioner may terminate the taxable year of a taxpayer who designs quickly to depart from the United States or commits certain heinous acts tending to render ineffectual proceedings to collect his income tax. Int. Rev. Code of 1954, § 6851(a); see *Rogan v. Mertens*, 153 F.2d 937 (9th Cir. 1946). The regulations may authorize other than an annual accounting period if necessary to clearly reflect income, e.g., the long-term contract methods. *Daley v. United States*, 243 F.2d 466 (9th Cir.), *cert. denied*, 355 U.S. 832 (1957); *Deer Island Logging Co.*, 14 B.T.A. 1027 (1929); *Treas. Reg. § 1.451-3* (1957). In some instances the annual measurement of income may be impossible. *Virginia Iron Coal & Coke Co. v. Commissioner*, 99 F.2d 919, 921 (4th Cir. 1938), *cert. denied*, 307 U.S. 630 (1939).

25. That is, the taxpayer may report income on the basis of a twelve-month period ending December 31 (the calendar year) or on the basis of a twelve-month period ending on the last day of any month other than December (the fiscal year). Int. Rev. Code of 1954, §§ 441(d), 441(e). A period ending on a date other than the last day of the month is not an annual accounting period and hence requires the computation of income on a calendar year basis. *Rev. Rul. 273*, 1954-2 *Cum. Bull.* 110; *cf. infra* note 29.

In *Wankinco Bog Co.*, 16 B.T.A. 386 (1929), the Board chided the taxpayer for using the "primitive accounting" of the calendar year, and thus "artificially segregating" the financial affairs of its cranberry business. But *cf. Jacob F. Brown*, 18 B.T.A. 859, 868 (1930).

26. Under the Revenue Act of 1916 corporations keeping their books on a fiscal year basis had the option of reporting income accordingly. Ch. 463, § 13(a), 39 Stat. 770. The 1913 Act and the Corporation Excise Tax Act of 1909 provided that income be computed on a calendar-year basis. Ch. 16, § 2, 38 Stat. 167 (1913); Ch. 6, § 38, 36 Stat. 114 (1909). The Revenue Act of 1918 required any

basis within the territorial limits of the United States.²⁸ By keeping his books and electing to compute income accordingly, a taxpayer may now take advantage of a more contemporary accounting phenomenon, the thirteen-month year.²⁹ A new taxpayer entity³⁰

taxpayer keeping his accounts on a fiscal year basis to make his returns on that basis. *Bradstreet Co. v. Commissioner*, 65 F.2d 943 (1st Cir. 1933); *Henry D. Weed*, 2 B.T.A. 84 (1925); G.C.M. 1113, VI-1 Cum. Bull. 178 (1927).

Filing returns on the basis of another taxable year has no significance; it is the taxable year used by the taxpayer in keeping his books which is controlling. *Helvering v. Brooklyn City R.R.*, 72 F.2d 274 (2d Cir. 1934); *Great West Printing Co. v. Commissioner*, 60 F.2d 749 (8th Cir. 1932); *Jonas-Cadillac Co. v. Commissioner*, 41 F.2d 141 (7th Cir. 1930), affirming 16 B.T.A. 932 (1929); *Atlas Oil & Ref. Corp.*, 17 T.C. 733 (1951); Rev. Rul. 256, 1958-1 Cum. Bull. 215.

27. Int. Rev. Code of 1954, § 441(g) (1). The Commissioner has interpreted this requirement rather strictly, although "the reason, necessity, or justification for [it] may not be too obvious." *Louis M. Brooks*, 6 T.C. 504, 508 (1946); see *Malcolm G. Brooks*, 15 P-H Tax Ct. Mem. 168 (1946). But cf. *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930); *Max H. Stryker*, 36 B.T.A. 326 (1937). Perhaps some relaxation may be expected. The 1954 Code committee reports state that the statute is not intended to impose any requirement that the records be bound. S. Rep. No. 1622, 83d Cong., 2d Sess. 299 (1954). Under the regulations the keeping of records which adequately and clearly reflect income for the taxable year constitutes the keeping of books within the meaning of § 441(g). Treas. Reg. § 1.441-1(g) (1957).

The books of a partnership are not the books of the partner so as to enable the partner to report on a fiscal year basis. *Klempner v. Glenn*, 82 F. Supp. 626 (W.D. Ky. 1949); *Fred R. Drake*, 1 B.T.A. 1235 (1925).

28. *Linen Thread Co.*, 14 T.C. 725 (1950); *Max Freudmann*, 10 T.C. 775 (1948).

29. Or, more accurately, the 52-53 week accounting period. Int. Rev. Code of 1954, § 441(f). Thus the taxpayer may adopt a period ending on the last Friday in March each year or whatever Friday falls nearest to March 31 each year. The 52-53 week year is common in certain industries, e.g., retail sales, meat packing, radio and television. S. Rep. No. 1622, supra note 27, at 66.

For some years the courts refused to recognize the 52-53 week period. See *Parks-Chambers, Inc. v. Commissioner*, 131 F.2d 65 (5th Cir. 1942); *Swift & Co. v. United States*, 69 Ct. Cl. 171, 38 F.2d 365 (1930); *J. W. Vaughan*, 19 B.T.A. 478 (1930). In 1952 the Commissioner, in a statement before the Joint Committee on Internal Revenue Taxation, had indicated that the Service accepted returns based upon a 52-week year where the practice of the taxpayer in using such an accounting period was of long standing. See 5 CCH 1952 Stand. Fed. Tax Rep. ¶ 6169.

30. A status not acquired by marriage, by the revival of a long-dormant corporation, a complete change of corporate stock ownership, nor less than a substantial change in the terms of the partnership agreement. See *Theriot v. Commissioner*, 197 F.2d 13 (5th Cir.), cert. denied, 344 U.S. 874 (1952); *American Coast Line, Inc. v. Commissioner*, 159 F.2d 665 (2d Cir. 1947); *East Coast Motors, Inc.*, 35 B.T.A. 212 (1936); cf. *Gill v. United States*, 258 F.2d 553 (5th Cir. 1958). Compare *Rose Mary Hash*, 4 T.C. 878, aff'd on other grounds, 152 F.2d 722 (4th Cir. 1945), with *Vera Melin Britz*, 14 T.C. 1094 (1950). A revocable trust, the income of which is taxed to the grantor during lifetime but which becomes ir-

generally³¹ is free to choose its own taxable year to its advantage.³² Once adopted, however, the taxable year cannot be changed without the consent of the Commissioner,³³ although the proposed period

revocable at death, becomes a new entity for this purpose at date of death even though fiduciary returns have been filed during the grantor's lifetime. Rev. Rul. 51, 1957-1 Cum. Bull. 171.

31. A partnership may not change to, or adopt a taxable year other than that of all its principal partners unless it establishes to the satisfaction of the Commissioner a business purpose therefor. Int. Rev. Code of 1954, § 706(b) (1).

An individual operating a proprietorship and keeping books must report his nonbusiness income on the same basis as that on which his business accounts are kept. James H. Silcox, 12 B.T.A. 748 (1928); O.D. 941, 4 Cum. Bull. 71 (1921); O.D. 289, 1 Cum. Bull. 62 (1919); cf. J. T. Pittard, 5 B.T.A. 755 (1926); Rev. Rul. 389, 1957-2 Cum. Bull. 298.

32. And sometimes to its mathematical disadvantage, with "straddling" revenue acts. See generally Holzman, *Calendar v. Fiscal Year*, 20 *Taxes* 211 (1942). Filing a Form 7004, Application for Automatic Extension of Time to File U.S. Corporation Income Tax Return, and payment of the installment shown as due thereon, may constitute a selection of accounting period prior to the time the actual return is filed. Rev. Rul. 589, 1957-2 Cum. Bull. 298.

33. Int. Rev. Code of 1954, § 442. If a taxpayer keeps no books of account and adopts an annual accounting period other than the calendar year, he shall be treated as having changed his annual accounting period. *Ibid.* To secure prior approval the taxpayer must file application on Form 1128 on or before the last day of the month following the close of the short period for which a return is required to effect the change of accounting period. In general, a change will be approved where the taxpayer establishes a substantial business purpose for making the change. Treas. Reg. § 1.442-1(b) (1957).

Under Treas. Reg. 118, § 39.46-1(b) (1953), no permission was required for a taxpayer to change his accounting period if the short taxable year resulting from the change ended after June 30, 1953, and none of the following conditions existed: (1) the taxpayer had changed his accounting period within the previous five years; (2) the short taxable year required to effect the change ended more than three months and less than nine months after the close of the existing accounting period; or (3) the taxpayer's net income for the short taxable year required to effect the change, as annualized, was less than 80% of the income of the taxpayer for the immediately preceding taxable year. The new regulations permit a corporation to change its annual accounting period without permission if: (1) it has not adopted or changed its accounting period within the previous ten years (this requirement is not applicable to corporations which have been in existence for sixty months or less); (2) the short period required by the change is not one in which the corporation has a net operating loss; (3) the taxable income for the short period placed on an annual basis is 80% or more of the taxable income of the corporation for the immediately preceding taxable year; and (4) the corporation would not, for the short period, have a different status than the status it had for the immediately preceding taxable year (i.e., as one subject to the accumulated earnings tax, a personal holding company, an exempt corporation, a Western Hemisphere trade corporation, or a China Trade Act corporation). Special provisions are applicable to subsidiary corporations, as under the prior regulations, and to a newly married husband or wife adopting the same taxable year of the other spouse in order to file a joint return. Treas. Reg. §§ 1.442-1(c), (d), (e)

would more clearly reflect income.³⁴ Even in the presence of these statutory frills, the taxable year is normally the calendar year.³⁵

The concept of the annual accounting period for federal income tax purposes has been much criticized. Despite due denunciations,³⁶ constructive criticism,³⁷ and proposed panaceas,³⁸ the taxable year seems destined to remain the primary accounting period. It is the basis upon which business is generally conducted.³⁹ From the viewpoint of the national fisc it meets the primary requirements of producing revenue ascertainable and payable to the Government at regu-

(1957). The new regulations are effective for changes in accounting periods where the short taxable year occasioned thereby ends on and after March 1, 1957. Treas. Reg. § 1.442-1(f) (1957).

If a taxpayer does not request permission to change his accounting period, but files returns on a new basis, the Commissioner may disapprove the change and compute income on the old basis, or accept the returns on a changed basis, and thus evidence his approval. *Jonas-Cadillac Co. v. Commissioner*, 41 F.2d 141 (7th Cir. 1930), affirming 16 B.T.A. 932 (1929); *Andrew John Williamson*, 22 T.C. 684, 686 (1954); *Clark Brown Grain Co.*, 18 B.T.A. 937 (1930); cf. *Greylock Mills v. Blair*, 293 Fed. 846 (D.C. Cir. 1923). Does "only" in § 442 change this rule? Cf. Int. Rev. Code of 1939, ch. 1, § 46, 53 Stat. 26.

34. *Bradstreet Co. v. Commissioner*, 65 F.2d 943 (1st Cir. 1933). The "clearly reflect income" requirement does not refer to the taxpayer's annual accounting period but only to the "method of accounting." *Clara A. McKee*, 11 B.T.A. 1381, 1386 (1928).

35. *Van der Elst v. Commissioner*, 223 F.2d 771, 773 (2d Cir. 1955).

36. Annual income tax accounting makes crucially important for Treasury and taxpayer many hard (or impossible) questions as to the precise allocation of income between years—questions which lead to interminable disputes, hearings, and litigations and which, under a good system, would be of no real importance to either party. Now in a *good* tax law such imputations in time, by legalistic jargon and legerdemain, would be of no consequence to the taxpayer or Treasury. Simon, *Federal Tax Reform 31*, stated in part in *Groves, Production, Jobs and Taxes 84* (1944).

37. While the year is the most logical unit of time for income tax purposes, it is unsatisfactory because: (1) it is not possible to determine with accuracy the specific year in which certain items of income and deduction should be accounted for; (2) the incomes of most people are not stable from year to year. Blough, *The Federal Taxing Process 319* (1952).

38. Recommendations generally include longer accounting periods, actual or constructive, by extending the reporting period, or averaging of income over a period of years. Of these, only the last has found corporeal favor as one of "certain ameliorations of the unduly drastic consequences of such a system in its rigid form." *Lewyt Corp. v. Commissioner*, 349 U.S. 237, 244 (1955) (dissenting opinion); see Int. Rev. Code of 1954, § 172. See also Darrell, *How Long Should the Accounting Period Be for Corporate Income Tax Purposes, in How Should Corporations Be Taxed 135* (1947).

39. *Iron Mountain Oil Co. v. Alexander*, 37 F.2d 231, 233 (10th Cir. 1930).

lar intervals.⁴⁰ Taxes are not, after all, collected, or probably collectible, upon the basis of complete theoretical accuracy; this Procrustean bed is probably no more uncomfortable than the next.⁴¹

Matching Costs and Revenues

Accounting's prior recognition of the problems of the annual accounting period gave it no well-grounded superiority over the federal income tax law in the measurement of annual income. It gave rise instead to a series of postulates for the valuation of assets and liabilities at the end of the accounting period. The demands of the users of the periodic accounting reports, together with the techniques developed by accounting to meet those demands, apparently contributed to the prominence of "balance sheet" accounting.

As accounting was beginning to outgrow its early function as a source of information for management alone,⁴² industrial development in the United States was undergoing a period of wide expansion. Large scale manufacturing was being undertaken by many growing corporations. While some of the capital needs were being supplied by individual investors,⁴³ bankers and creditors remained prominent in corporate financing.⁴⁴ The latter group was wont to look largely to the corporate balance sheets as security. So long as the creditors operated upon this "pounce" theory, the balance sheet was the most important financial statement because it placed emphasis upon the liquidation of the enterprise.⁴⁵

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

41. *Bartlett v. Delaney*, 75 F. Supp. 490, 495 (D. Mass. 1948). And administrative convenience and fiscal necessities are greatly served thereby. Magill, *Taxable Income* 221 (1936 ed.).

42. And to assume "broad social responsibilities." Paton & Littleton. The United States Steel's report to its stockholders in 1902, rendered by Price, Waterhouse & Company, is generally deemed to be the first accounting report to a large group of "public" stockholders. Murphy, *Selected Readings in Accounting* 169 (1952).

43. The Liberty Loan issues floated during World War I developed a great host of small individual investors. That the masses in cities and rural regions might "dwell in the effulgence of the golden glow," in the early 1920's leaders in business enterprise offered stocks and bonds to investors and country banks. Young men, fresh from academic groves, Bachelors of Arts in one thing or another, were recruited by the tens of thousands and drilled into rank and file salesmen for the highways and the byways. Beard, *America In Midpassage* 11-17 (1946).

44. The first active work in the promulgation of accounting and auditing standards was done under the auspices of the Federal Reserve Bank in 1917. See Federal Res. Bd., *Uniform Accounting—A Tentative Proposal* (1917).

45. Blough, *Accounting Principles*, CPA Handbook 17-5 (Kane ed. 1952). Although then widely accepted, the liquidation theory is contra to another of accounting's most time-honored conventions, "the going-concern." See Paton & Littleton 9.

Accounting's efforts during this time thus were devoted chiefly to the proper statement of the balance sheet as of the close of the year, to the almost entire exclusion of the income statement. As a means both of limiting the audit fee and supplying only the requisite information, accountants, beginning about 1910 and chiefly from 1918, developed the "balance-sheet audit," an examination in which the income accounts were given only cursory examination.⁴⁶ Income was viewed, if at all, only incidentally, as the change in net worth on successive balance sheets.⁴⁷ And for a great many years, the federal income tax law notwithstanding, the balance sheet remained the chief financial accounting statement.⁴⁸

Sometime between the two World Wars accounting came to the gradual awakening that its primary task lay not in a periodic valuation of assets, but in the measurement of income.⁴⁹ While this revelation did not stem from any particular date or event, it seems most likely that it gathered impetus in the early 1930's and was widely accepted prior to 1941.⁵⁰ Statements issued by the American Accounting Association in 1936⁵¹ and by the Committee on Accounting Procedure of the American Institute of Accountants in 1938⁵² evinced the

46. The development of the balance sheet audit temporarily counteracted those forces which normally would have shifted accounting emphasis to the profit and loss statement much sooner. Gilman 37.

47. As a matter of accounting theory, net income may be proven by an analysis of surplus alone, if the balance sheets involved in the analysis of surplus are correct. Wernecke-Schmitz Hardware Co., 2 B.T.A. 914 (1925). This concept is not out of harmony with a technique of constructive accounting popular today with the Internal Revenue Service, viz., the net worth method. See *infra* note 174.

48. The continued popularity of the balance sheet seemingly was attributable to the creditor emphasis in accounting, the legal emphasis upon property rights, equities, and values, and the early concern of investors for the "underlying assets" represented by their corporate stocks. 1 Newlove & Garner, *Advanced Accounting* 393-94 (1951); Gilman ch. III, *The New Emphasis on Profits*.

49. The Securities Act of 1933 and the Securities and Exchange Act of 1934, which gave the SEC the power to prescribe the form and contents of registration statements to be filed with the Commission, and the hearings attendant thereto, may have convinced the accounting profession that it was not performing to the fullest extent its "broad social responsibilities." See Frank, *The Sin of Perfectionism*, Papers, 53d Annual Meeting, American Institute of Accountants 97-113 (1940).

50. See Couchman, *The Balance Sheet* 3 (1924); Prickett & Mikesell, *Principles of Accounting* 3 (1937); Study Group, *Changing Concepts of Business Income* 60 (1952); Gilman preface.

51. American Accounting Ass'n, *A Tentative Statement of Accounting Principles*, 11 *Accounting Rev.* 187, 188 (1936).

52. American Institute of Accountants, *Examination of Financial Statements* 4 (1936). See Littleton, *Concepts of Income Underlying Accounting*, 12 *Accounting Rev.* 13 (1937).

changing accounting perspective. In 1940 accounting writers were busy noting the transition.⁵³

The shift in emphasis resulted not so much from a change of accounting observers as from a change in the requirements of existing users. Creditors began to rely more upon the ability of their debtors to pay their obligations out of current income and less upon liquidation values.⁵⁴ A widening group of creditors and stockholders likewise gave support to the income statement doctrine.⁵⁵ With the ascendance of the income statement, the balance sheet in turn became the connecting link between successive income statements.⁵⁶

The change in accounting emphasis from the balance sheet to the income statement, however belated, wrought corresponding changes in accounting thought. The primary problem was no longer one of valuation, but of the allocation of historical costs and revenues to current and succeeding accounting periods. Viewing the income statement as primary meant that the principal concern of accounting was the periodic matching of costs and revenues,⁵⁷ i.e., the bringing into association in the present the revenues identified with the present, and bringing into association in the future the revenues identified with the future and their related costs.⁵⁸ The matching process became fundamental to accounting activity.⁵⁹

Basically, the concept of matching costs and revenues is a simple process. The stream of business activity is divided into two elements,

53. 1 Newlove & Garner, *op. cit. supra* note 48.

54. Blough, *Accounting Principles*, CPA Handbook 17-5 (Kane ed. 1952); Committee on Accounting Procedure, *Accounting Research Bull.* No. 30 (1947).

55. See Moyer & Mautz, *Functional Accounting* 35-36 (2d ed. 1951); Bailey, *The Increasing Significance of the Income Statement*, *Selected Readings in Accounting* 148 (Murphy ed. 1952). The role of the federal income tax law in the evolution, if existent, was ethereal.

56. Committee on Accounting Procedure, *American Institute of Certified Public Accountants*, *Accounting Research Bull.* No. 43 at 7 (1953); Study Group, *Changing Concepts in Business Income* 60 (1952); 1 Newlove & Garner, *op. cit. supra* note 48, at 394. In 1947, George O. May was of the opinion that the time was apropos for a consideration of the usefulness of the balance sheet, and the possibility of substituting another statement. May, *The Future of the Balance Sheet*, 84 *J. Accountancy* 98 (1947). Every movement seemingly must have its reactionaries. See Werntz, *The Resurgence of the Balance Sheet As a Useful Element in Financial Analysis*, 96 *J. Accountancy* 555 (1953).

57. Paton & Littleton 7; Study Group, *op. cit. supra* note 56, at 28.

58. Littleton, *Suggestions for the Revision of the Tentative Statement of Accounting Principles*, 14 *Accounting Rev.* 57, 60 (1939).

59. Ascher, *Survey of Accounting* 467-68 (1952); Karrenbrock & Simons, *Intermediate Accounting* 6 (2d ed. 1953); Mason, Stenberg & Niven, *Elementary Accounting* 358 (1951); Moyer & Mautz, *Functional Accounting* 23 (2d ed. 1951); Werntz, *The Influence of Changing Tax Rates on Accounting and Auditing Procedures*, 28 *Taxes* 658 (1950).

the acquisition of goods and services required for the performance of its objectives, resulting in business costs, and the accomplishment of its objectives to recover costs plus a profit resulting in business revenue. The net income for a specified period is to be determined by matching costs against revenues.⁶⁰ The accountant has merely to ascertain the related money outgoings which promoted the current money incomings; the difference between the two is the profit for the period.⁶¹

The seeming simplicity of the task is nonetheless beguiling. Assignment of costs and revenues to periods can be made in absolute terms only if all costs and revenues are evidenced by the flow of cash.⁶² But it is plain that in most businesses there are likely to be current outgoings which are not immediately consummated by current incomings.⁶³ Objective standards thus are necessary to guide the matching of costs and revenues not so evidenced.⁶⁴ However objective the standards adopted,⁶⁵ costs and revenues matched in accordance with them are indirect,⁶⁶ and to that extent, the correctness of the directly calculated accrual becomes quantitatively impaired.⁶⁷ The matching

60. Karrenbrock & Simons, *Intermediate Accounting* 6 (2d ed. 1953); Paton & Littleton 16.

61. Bray, *The Measurement of Profit, Selected Readings in Accounting* 342 (Murphy ed. 1952).

62. 1 Moonitz & Staehling, *Accounting Analysis* 150 (1950); Sanders, *Progress in the Development of Basic Concepts, in Contemporary Accounting* 1-15 (Leland ed. 1945).

63. Bray, *op. cit. supra* note 61, at 343.

64. Holmes & Meier, *Elementary Accounting* 521 (1949); Paton & Littleton 119; see Fitzgerald, *Current Accounting Trends* 40 (1952). Out of this necessity has arisen a body of conventions, based on a combination of theoretical and practical considerations, which form the basis for the determination of income and the preparation of the balance sheet. American Institute of Accountants, *Examination of Financial Statements* 2 (1936).

65. Generally, accounting has adopted only the tenets that only realized income be recognized and that it be offset by all costs, expenses, and losses, realized or unrealized, insofar as "they can be practically related to the same accounting period" (despite the fact that the recognition of unrealized losses is contrary to the matching concept). Gilman 13.

66. Standards for the determination of income and cost are equally difficult. Once the cash basis for revenue is abandoned, a choice must be exercised by alternative bases of measurement, which are equally verifiable or equally unverifiable. While a number of standards for the assignments of costs to a period exists, e.g., physical expiration, expiration over a period of time, there is no directly traceable relationship between the value amounts assigned to periodic costs and those assigned to periodic revenues. The problem might be more simple if it were a matter of measuring revenues alone or costs alone; measuring them in relation to each other adds to the complications. Sanders, *op. cit. supra* note 62; 1 Moonitz & Staehling, *op. cit. supra* note 62, at 192-96; Paton & Littleton 15.

67. 1 Moonitz & Staehling, *op. cit. supra* note 62, at 150.

of costs and revenues by periods is in itself a measure of expediency, and hence involves possibilities of errors.⁶⁸ While the primary purpose of matching costs and revenues is clear on its face, its effectuation in practice is, as usual, attended by many difficulties.⁶⁹ The utopian standard of matching each unit of expired cost against each unit of revenue does not appear likely of achievement.⁷⁰

Absent statutory recognition and left largely to fend for itself, the matching process, like some other accounting techniques, has fended badly in the law of federal income taxation. While its early recognition may have been hampered by constitutional problems,⁷¹ the bodies administering the federal tax law have shown no great rush to embrace its theories in the years since the 1913 problems have faded.⁷² The Board of Tax Appeals recognized the desirability of balancing against income the expenses of producing that income, but was of the opinion that this concept necessarily must be subordinated to the scheme of annual taxation.⁷³ Income need not necessarily be accrued because expenses are deducted in that year.⁷⁴ Those seeking to delay the return of income on the grounds that expenditures will be required in future years which should be offset against that income generally have been unsuccessful.⁷⁵ Installment basis taxpayers are required to

68. *Id.* at 192.

69. Sanders, *op. cit.* supra note 62.

70. 1 Newlove & Garner, *Advanced Accounting* 416 (1951). The doctrine of matching costs and revenues is not to be confused with, or complicated by, that specialized field of accounting known as "cost accounting." While matching costs and revenues, in financial accounting, refers to the inclusion of items of cost and revenue in the same accounting period, cost accounting is the process of ascertaining the cost of manufacturing a particular product or rendering a service, usually through the use of techniques known as job order costing (for large items of production) and process cost (for small items produced in large quantities). Cost accounting assumes a flow of both identifiable costs and an allocable portion of unidentifiable costs from the acquisition to the sale of finished product. It has been said to give "a fictitious appearance of accuracy." See Gilman 125-27; 1 Newlove & Garner, *Advanced Accounting* 414 (1951); Vance, *Techniques of Cost Accounting* (1952); Blocker, *Essentials of Cost Accounting* (1950).

71. But see *Chicago, R.I. & P. Ry.*, 13 B.T.A. 988, 1029 (1928), *rev'd*, 47 F.2d 990 (7th Cir.), *cert. denied*, 284 U.S. 618 (1931).

72. The view that the accrual method of accounting was to embrace the matching concept seems to have faded. See *United States v. Anderson*, 269 U.S. 422, 437 (1926); cf. Reiling, *Practical Legal Aspects of Tax Accounting*, 30 *Taxes* 1028, 1033-34 (1952).

73. *Buffalo Union Furnace Co.*, 23 B.T.A. 439, 462 (1931), *aff'd in part*, 72 F.2d 399 (2d Cir. 1934).

74. *Breeze Corps. v. United States*, 127 Ct. Cl. 261, 117 F. Supp. 404 (1954). But see *Pacific Grape Prods. Co. v. Commissioner*, 219 F.2d 862, 868 (9th Cir. 1955); *Shelby Salesbook Co. v. United States*, 104 F. Supp. 237 (N.D. Ohio 1952).

75. See *Automobile Club of Mich. v. Commissioner*, 353 U.S. 180 (1957); *Streight Radio & Television, Inc.*, 33 T.C. No. 15 (Oct. 26, 1959); H. J. Irby,

deduct expenses in the year in which paid or incurred, regardless of the year in which the income is collected.⁷⁶ Taxable income is ascertained by assembling all the profit and transactions of the period; any other matching is pure happenstance.⁷⁷

A Tentative Determination

The rising prominence of the income statement and its accompanying emphasis on the matching of costs and revenues have not fostered an accounting concept of income determinable by rules and principles that are "as precise, objective, and impartial as mathematics."⁷⁸ To the contrary, accounting has always tempered its doctrines with the realization that each accounting period is not within itself a definitive measure of income.⁷⁹ The failure of the interpreters of the federal income tax statutes similarly to assuage the finality of the annual ascertainment of taxable income seemingly must be regarded as judicial rejection of accounting as is, and the adoption of that which the courts, in their opiated opinion, would like accounting to be.

Accountants are fully cognizant of the fact that no absolute measurement of profit is possible until the enterprise is at an end.⁸⁰ All measures of income for less than the duration of the enterprise are approximate indexes only.⁸¹ They are mere tentative installments in the record of long-term financial results, at best interim reports.⁸² Business enterprise is a continuous stream of activities, with those of

30 T.C. 1166 (1958); *Your Health Club*, 4 T.C. 385 (1944). But see *Bayshore Gardens, Inc. v. Commissioner*, 267 F.2d 55 (2d Cir. 1959), reversing 30 T.C. 1292; *Bressner Radio, Inc. v. Commissioner*, 267 F.2d 520 (2d Cir. 1959); *Beacon Publishing Co. v. Commissioner*, 218 F.2d 697, 699 (10th Cir. 1955); Int. Rev. Code of 1954, § 455, added by the 1958 Technical Amendments Act, permitting the deferral of "prepaid" subscription income.

76. Treas. Reg. § 1.453-2(c) (1958); *Sally K. Frankenstein*, 31 T.C. No. 43 (Nov. 20, 1958); *A. Finkenberg's Sons, Inc.*, 17 T.C. 973, 982 (1951).

77. It cuts altogether too fine to say that true, and therefore taxable, income can only be ascertained in this manner. *Davis v. United States*, 87 F.2d 323, 325 (2d Cir.), cert. denied, 301 U.S. 704 (1937).

78. Committee on Postwar Tax Policy, *A Tax Program for a Solvent America* 87 (1945).

79. It cannot be considered to measure a twelve-month "venture" that "bought" its assets from the prior period and will "sell" its assets to the next period. *Paton & Littleton* 9.

80. Committee on Auditing Procedure, American Institute of Certified Public Accountants, *Statements on Auditing Procedures No. 1*, at 10 (1939); Fitzgerald, *Current Accounting Trends* 40.

81. Committee on Postwar Tax Policy, *op. cit. supra* note 78; *Canning, Economics of Accountancy* 65 (1929).

82. Committee on Accounting Procedure, American Institute of Certified Public Accountants, *Accounting Research Bull. No. 43*, at 41, 59 (1953).

the moment conditioned by those of the past, and in turn, conditioning those of the future.⁸³

Except in rare instances, however, it is impossible to await the termination of an enterprise to measure its profits.⁸⁴ Allocation to fiscal periods must be made. It is in this process that accounting becomes something less precise than mathematics. Many items of income and deduction will be so clearly associated with the period as to raise no question. But many others will be applicable to past or future periods, or their allocations will be in doubt.⁸⁵ While the principles of accounting furnish a guide for the treatment of the areas of doubt,⁸⁶ the results must always contain many estimates and approximations.⁸⁷ Those who understand accounting well admit that an accounting estimate is at best a reasonable approximation, and sometimes only a very rough approximation.⁸⁸ The assignment of costs and revenues to a period involves an appreciable quantity of opinion and individual judgment.⁸⁹ The judgment of other men, equally honest and competent, surveying the same economic phenomena may differ, perhaps sharply.⁹⁰

The process of breaking the stream of business activity into fiscal segments, for each of which reports are prepared, severs many real connections and tends to give a specious color of immediate reliability to data which in substantial measure depend on the course of future events.⁹¹ It is this specious color upon which the taxing authorities have seized in the annual levy of the income tax. They never have faced squarely the axiom that annual-income accounting is and should be tentative and provisional.⁹² Present and past law, while embracing accounting practice, highlights its infirmities and pardonable shortcomings and leans ponderously upon the empty spaces of its *lacunae*. It seeks a precision and finality in inherently provisional determinations, an insistence "which can only drive accountants into distraction, courts into sophistries, and tax lawyers into pestilential multiplication."⁹³ The taxing authorities seek a determination of "true in-

83. Paton & Littleton 9.

84. Fitzgerald, *op. cit.* supra note 80.

85. Sanders, Hatfield & Moore, *A Statement of Accounting Principles* 25-26 (1938).

86. *Ibid.*; American Institute of Certified Public Accountants, *Audits by Certified Public Accountants* 12 (1950).

87. Committee on Auditing Procedure, *op. cit.* supra note 80.

88. Ascher, *Survey of Accounting* 688 (1952).

89. See Fitzgerald, *op. cit.* supra note 80, at 40-42.

90. Kaplan & Reaugh, *Accounting, Reports to Stockholders and the SEC*, 48 *Yale L.J.* 935, 942 (1939).

91. Paton & Littleton 9.

92. Simons, *Federal Tax Reform* 60 (1950).

93. *Id.* at 59.

come"⁹⁴ from accounting, but never take cognizance of the fact that "true" in accounting terminology means the most accurate profit figure obtainable under the circumstances.⁹⁵ They would do well to recognize that "Taxation, like business, is a going concern; a single separate tax period is not the climax and *end of the taxing process.*"⁹⁶

II. METHODS OF ACCOUNTING

The statutory prescription that taxable income be computed in accordance with the method of accounting regularly employed by the taxpayer in keeping his books generally has been construed as giving the taxpayer a choice between reporting income as received and deductions when paid or income when accrued and deductions when incurred. Once selected, the method must be consistently followed unless permission is given to change. Only if the accounts clearly reflect the income are they determinative of the taxpayer's liability.

"The" Methods of Accounting

Under the Revenue Act of 1913 the taxpayer was required to report income on a cash basis.⁹⁷ The Revenue Act of 1916 gave him the

94. See Treas. Reg. 118, § 39.41-2(b) (1953).

95. 1 Newlove & Garner, *Advanced Accounting* 403 (1951).

96. Blough, *The Role of Accounting in the Taxing Process*, 22 *Accounting Rev.* 248, 251 (1947).

97. Revenue Act of 1913, ch. 16 § 2, 38 Stat. 166. The statutory requirement was at best somewhat illusory in the case of corporate taxpayers, however, inasmuch as the regulations expressly provided that manufacturing companies should compute their income by the use of inventories and should include income, gains or profits from all other sources as shown by the books of account. Deductions except for taxes and losses could be evidenced either by actual disbursements in cash or evidenced in such other way as to be properly acknowledged by the corporate officers and entered on the books of the corporation so as to constitute a liability. Treas. Reg. 33, Art. 104, 158 (1914). Since all books of account in businesses of any magnitude were kept on an accrual basis, the law probably could not have been administered in any other way. *Aluminum Castings Co. v. Routzahn*, 24 F.2d 230, 231 (N.D. Ohio 1927).

This unusual state of affairs was doubtless a direct outgrowth of the skirmish between law and accounting which accompanied the enactment of the Corporation Excise Tax Act of 1909, 36 Stat. 112. The Excise Tax Act sought to levy a tax measured by corporate net income, which was to be ascertained, according to the statute, by deducting from gross income received during the calendar year all expenses actually paid. When the bill was before Congress, the accounting profession waged a vigorous encounter with the Attorney General, alleging that the cash-basis, calendar-year concept violated all accepted principles of accounting and would be absolutely impossible of application. Although the accountants ostensibly lost on both counts, the regulations issued by the Secretary of the Treasury, with the advice of the vanquished, encompassed the accrual concept of income. See Treas. Reg. 31, art. 2, § 5; art. 4, § 8 (1909); Adams, *When Is*

option of reporting income upon the cash basis or upon any basis other than actual receipts or disbursements if it clearly reflected income.⁹⁸ The Revenue Act of 1918 required the taxpayer to compute income in accordance with the method of accounting regularly employed in keeping his books.⁹⁹ Thus, the taxpayer's method of accounting has been the criterion for the computation of taxable income for more than forty years.¹⁰⁰ No particular named method is required by the statute and, prior to the 1954 Code,¹⁰¹ no name was given to the method employed; it only had clearly to reflect income.¹⁰²

Accountants have long been insistent that the purpose of the enactment of section 212(b) of the Revenue Act of 1918, and its substantive re-enactment in subsequent legislation, was to require the determination of taxable income in accordance with generally accepted accounting principles,¹⁰³ rather than merely to set forth alternatives between the cash and accrual bases of accounting. Their position has some merit. The term "basis" of accounting, and particularly, "cash basis" and "accrual basis" had then begun to assume some accounting

Income Realized?, in *The Federal Income Tax* 32 (Haig ed. 1921); May, *Twenty-five Years of Accounting Responsibility* 2:276 (1936). See generally Machen, *The Federal Corporation Tax Law* (1910).

98. Revenue Act of 1916, ch. 463, §§ 8(g), 13(d), 39 Stat. 763-771; *Helvering v. Enright*, 312 U.S. 636, 643 (1941). The difficulty if not the utter impossibility of preparing a return upon a strict basis of cash receipts and disbursements constituted the reason and necessity for the enactment of the statute. *Aluminum Castings Co. v. Routzahn*, 31 F.2d 669, 670 (6th Cir. 1929).

99. Revenue Act of 1919, ch. 18, §§ 212(b), 232, 40 Stat. 1064, 1077; Charles A. Collin, 1 B.T.A. 305, 311 (1925); see *Treas. Reg.* 45, art. 24 (1919).

100. Section 212(b) of the Revenue Act of 1918 proved long-lived, viz.:

<i>Section</i>	<i>Revenue Act</i>	<i>Statutes at Large</i>
212(b)	1918	40 Stat. 1064
212(b)	1921	42 Stat. 237
212(b)	1924	43 Stat. 267
212(b)	1926	44 Stat. 23
41	1928	45 Stat. 805
41	1932	47 Stat. 185
41	1934	48 Stat. 694
41	1936	49 Stat. 1666
41	1938	52 Stat. 473

and § 41 of Int. Rev. Code of 1939. Section 446 of the 1954 Code merely "rearranged and clarified" the tenets of § 41 of the 1939 Code. H.R. Rep. No. 1337, 83d Cong., 2d Sess. 834 (1954).

101. See Int. Rev. Code of 1954, § 446(c).

102. *Planet Line, Inc. v. Commissioner*, 89 F.2d 16 (2d Cir. 1937).

103. May, foreword to Smith & Butters, *Taxable and Business Income* xix (1949); Lasser, *Tax Accounting Methods* 25 (1951); May, *Tax Accounting v. Business Accounting*, 79 J. Accountancy 323 (1945).

significance.¹⁰⁴ "Basis" was the terminology of the 1916 Act.¹⁰⁵ Had Congress intended only that the taxpayer might use either the cash or the accrual basis, it may well be argued that the law-making body would have specifically so provided. It is not apparent that the phrase "method of accounting" then had any particular accounting significance, however.¹⁰⁶ Nor had accounting promulgated, or even proposed, any "systematic methods of accrual and expiry"¹⁰⁷ for the assignment of income and expenses to particular accounting periods. It was then chiefly concerned, as has been previously mentioned, with the problems of balance-sheet valuation. Moreover, accounting was more inclined to the view that the conditions of business required "the most elastic adjustments to their necessities and needs, [and] within the bonds of reason, accounting should be permitted to adjust itself to those needs."¹⁰⁸ Income should, in other words, be that amount of income which accountants, in the exercise of their business judgment, seasoned experience, and expert opinion determined that it should be.¹⁰⁹

Having their own expert opinions, the taxing administrators understandably sought income criteria more nearly within their own do-

104. The "basis" nomenclature appears to have been more popular in accounting than "method." See Bennett, *Advanced Accounting* 22 (1922); Kohler, *Accounting Theory as Affected by Federal Income Taxation*, III Papers and Proceedings, 7th Annual Meeting, American Ass'n of Univ. Instructors in Accounting 73 (1923); *Accountant's Handbook* 114 (Paton ed. 1946); Kester, *Advanced Accounting* 9-11 (1946); cf. Holmes, *Advanced Accounting* 198-99 (1947); 1 Newlove & Garner, *Advanced Accounting* 403 (1951). Although the courts have sometimes used the label "systems" of accounting to refer to the cash and accrual alternatives, *Eckert v. Commissioner*, 42 F.2d 158, 159 (2d Cir. 1930); *National Builders, Inc.*, 12 T.C. 852 (1949), the term has been customarily used in the accounting field to denote that branch of the art devoted to the prescription of accounting procedures and design of accounting forms. This area has in recent years branched out into something somewhat more grandiosely described as "management services." See Bailey, *Specialized Accounting Systems* 1-2 (1951); Willard, *System Building and Constructive Accounting* (1922); Wellington, *The Development of Management Services*, 101 J. Accountancy 57 (1956).

105. See *supra* note 98.

106. The two basic methods of accounting were described by Kester as "analysis" and "synthesis." Rorem used "method" in the title of his text, seemingly in lieu of "principles" and not in any way distinguished therefrom. See 1 Kester, *Accounting Theory and Practice* ch. XXXII (1917); Rorem, *Accounting Method* (1928).

107. Bray, *The Measurement of Profit*, Selected Readings in Accounting 342 (Murphy ed. 1952).

108. Dr. T. S. Adams, quoted in May, *Accounting and the Accountant in the Administration of Income Taxation*, 47 Colum. L. Rev. 377, 390 (1947).

109. See Postulate 3, American Accounting Ass'n, *A Tentative Statement of Accounting Principles Affecting Corporate Reports*, 11 Accounting Rev. 187 (1936).

mains.¹¹⁰ Construing "method" in a manner similar to its use elsewhere in the income tax law as a choice between alternatives,¹¹¹ the judiciary and the Commissioner¹¹² in general promoted the view that "method" in the 1918 Act was meant simply to incorporate the cash and accrual "bases" of the prior legislation.¹¹³ The corporate or the individual taxpayer might compute income on either *the* cash or *the* accrual basis, so long as the method chosen clearly reflected income.¹¹⁴ This concept became so well established that when the installment basis was authorized by the Revenue Act of 1926,¹¹⁵ it became firmly fixed in judicial thinking as *the* third method of accounting.¹¹⁶

110. "Strange legal, economic, or statistical interpretations made by men, no doubt eminent in their own fields, but almost entirely innocent of any technical accounting knowledge . . ." Lasser, *Tax Accounting Methods* 25 (1951), have served to multiply conflicts "by treating as questions of law what really are disputes over proper accounting." *Dobson v. Commissioner*, 320 U.S. 489, 499 (1943).

111. E.g., the depreciation and retirement methods of accounting for fixed assets, *Boston & M.R.R. v. Commissioner*, 206 F.2d 617 (1st Cir. 1953); *Commissioner v. Union Pac. R.R.*, 188 F.2d 950 (2d Cir. 1951); *St. Paul Union Depot v. Commissioner*, 123 F.2d 233 (8th Cir. 1941); the reserve and actual charge-off methods of accounting for bad debts, *Morris Plan Industrial Bank v. Commissioner*, 151 F.2d 976 (2d Cir. 1945); *Rogen v. Commercial Discount Co.*, 149 F.2d 585 (9th Cir. 1945); see *Int. Rev. Code of 1954*, § 166; adding taxes to inventory cost or deducting them as an expense, *Le Bolt v. United States*, 67 Ct. Cl. 422 (1929). Cf. *Treas. Reg. § 1.446-1(c)* (1957).

112. Unable to secure the repeal of § 41, the Bureau "sought to build up the myth that Congress contemplated an alternative between *the cash* and *the accrual* basis." *May, Tax Accounting v. Business Accounting*, 79 *J. Accountancy* 323 (1945). "Nothing was further removed from the minds of those who worked on Sections 212 and 213 of the Revenue Act of 1918. . . ." *Adams op. cit. supra* note 108.

113. Precisely, the Revenue Act of 1916 provided only that a taxpayer "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." *Revenue Act of 1916*, ch. 463, §§ 8(g), 13(d), 39 Stat. 763, 771. The Board of Tax Appeals seems to have been of varying opinion as to whether this contemplated only an alternative between the cash and the accrual bases. See *Great No. Ry.*, 8 B.T.A. 225, 268 (1927), *aff'd*, 40 F.2d 372 (8th Cir.), *cert. denied*, 282 U.S. 855 (1930); *Owen-Ames-Kimball Co.*, 5 B.T.A. 921, 927 (1926).

114. *Commissioner v. South Tex. Lumber Co.*, 333 U.S. 496, 498 (1948); *Beacon Publishing Co. v. Commissioner*, 218 F.2d 697, 699 (10th Cir. 1955); *Elsie SoRelle*, 22 T.C. 459, 468 (1954); cf. *Holland v. United States*, 348 U.S. 121, 131 (1954).

115. *Revenue Act of 1926*, ch. 27, § 212(d), 44 Stat. 23; *Int. Rev. Code of 1939*, ch. 1, § 44, 53 Stat. 24; *Int. Rev. Code of 1954*, § 453. Basically, the installment method permits dealers regularly engaged in selling personal property on the installment basis and other taxpayers selling real property or making casual sales of personalty to report as income each year only that proportion of the cash actually received as the gross profit on the transaction bears to the total contract price.

From time to time various other specialized methods of accounting have been authorized by the income tax regulations.¹¹⁷ Chiefly, they represent administrative modification of the annual accounting requirement.¹¹⁸ Taxpayers engaged in the performance of long-term contracts¹¹⁹ were early authorized¹²⁰ to report the net income arising from such contracts either in the year of completion¹²¹ or during the

Under the installment method expenses are deducted in the year in which paid or incurred, without regard to collections.

The installment basis was first authorized by Treas. Reg. 33, art. 120 (1918). In *B. B. Todd, Inc.*, 1 B.T.A. 762 (1925), this regulation was held invalid because the installment method was not one of "the methods" authorized by the statute. The legislative history of the resulting statutory provision, which applied retroactively from 1916, is discussed at length in *Hoover-Bond Co. v. Denman*, 59 F.2d 909 (6th Cir. 1932); *Willcuts v. Gradwohl*, 58 F.2d 587 (8th Cir. 1932); *Blum's, Inc.*, 7 B.T.A. 737 (1927). The installment basis has been judicially described as a "modified cash receipts basis," since income is in part represented by cash receipts. *Commissioner v. South Tex. Lumber Co.*, 333 U.S. 496, 499 (1948); *Commissioner v. Mackin*, 164 F.2d 527, 529 (1st Cir. 1947); *Palm Beach Mather Co.*, 24 B.T.A. 536 (1931). More accurately, it is "an admixture of both, since revenues are measured principally on a cash basis while expired costs and expenses are measured on the accrual basis." 1 Newlove & Garner, *Advanced Accounting* 465 (1951); *Holmes & Meier, Intermediate Accounting* 423-24 (1949); see note 76 supra.

116. *Healy v. Commissioner*, 345 U.S. 278, 281 n.7 (1952); *Commissioner v. South Tex. Lumber Co.*, 333 U.S. 496, 502 n.13 (1948); *Martin v. Commissioner*, 61 F.2d 942, 943 (2d Cir.), cert. denied, 289 U.S. 737 (1932).

117. Of these it may "hardly appear desirable to write." *Ferst, Basic Accounting for Lawyers* 16 (1950).

118. *Fort Pitt Bridge Works*, 24 B.T.A. 626, 641 (1931).

119. Building, installation, or construction contracts covering a period in excess of one year from the date of the execution of the contract to the date on which the contract is finally completed and accepted. Treas. Reg. § 1.451-3 (1957). A maintenance period is a separate and collateral undertaking; it does not operate to extend the performance time of the contract. *Uvalde Co.*, 1 B.T.A. 932 (1925). Short-term contracts may, under certain circumstances, be reported on this basis if it clearly reflects income. See 1959 Int. Rev. Bull. No. 41, at 12.

A novel use of the "completed contract" method was unsuccessfully urged by the taxpayer in *Whitaker v. Commissioner*, 259 F.2d 379 (5th Cir. 1958), who sought to defer breeding fees until the live colt was born, on the grounds that the contract, guaranteeing delivery of live colt, was not "completed" until that time. Cf. *Wood v. Commissioner*, 245 F.2d 888 (5th Cir. 1957), affirming 24 P-H Tax Ct. Mem. 969 (1955) (contracts for sale of lots are not "building or construction" contracts).

120. See Treas. Reg. 33, art. 121 (1918). The validity of the regulations was sustained in *Badgley v. Commissioner*, 59 F.2d 203 (2d Cir. 1932); *In re Harrington*, 1 F.2d 749 (W.D. Mo. 1924); *Hegeman-Harris Co. v. United States*, 87 Ct. Cl. 296, 23 F. Supp. 450 (1938).

121. This method is generally termed the "completed-contract" method, but it has also been called the "closed-job" method. *D. L. Wheelock*, 10 B.T.A. 540 (1928). The year of completion is, understandably, not always free from doubt. The Tax Court has held that the requirement of "finally completed" in the regu-

construction period on the basis of the percentage of completion.¹²² Maritime venturers may report income upon the accrual system on the completed voyage basis¹²³ and sometimes upon the completed lay-up basis.¹²⁴ Farmers¹²⁵ and other agrarian producers may defer expendi-

lations is redundant, that substantial completion will suffice. *Ehret-Day Co.*, 2 T.C. 25 (1943); cf. *Helvering v. National Contracting Co.*, 69 F.2d 252 (8th Cir. 1934).

122. The percentage-of-completion method is sometimes termed the "job cost" method. *Jud Plumbing & Heating, Inc. v. Commissioner*, 153 F.2d 681 (5th Cir. 1946). The percentage of completion may be based upon architects' fees or the proportion of costs incurred to date to total costs. *Ross B. Hammond, Inc. v. Commissioner*, 97 F.2d 545, 547 (9th Cir. 1938); *Vansant v. Crooks*, 43 F.2d 166 (W.D. Mo. 1930).

The completed contract method is not an accounting method in the sense that it accounts for receipts and disbursements on a day-to-day basis. It is a practice of treating receipts from a contract as income as of a particular time, namely, the completion date of the contract. *Daley v. United States*, 139 F. Supp. 376, 378 (N.D. Cal. 1956), aff'd, 243 F.2d 466 (9th Cir.), cert. denied, 355 U.S. 832 (1957). It is a modification of the strict accrual method and differs from it in that items of income and expense, although recorded in primary accounts when accrued or incurred, are not carried into the profit and loss as earnings of the business until the contracts to which they relate are completed. *Patrick McGovern, Inc.*, 40 B.T.A. 706, 713 (1939).

Income from long-term contracts may also be reported on a cost-plus-fixed-fee basis, a cost-plus-fixed-percentage basis, on the straight accrual basis, or on the cash basis. *Daley v. United States*, supra; *Dingle-Clark Co.*, 26 T.C. 782 (1956); *C. A. Hunt Eng'r Co.*, 25 P-H Tax Ct. Mem. 1029 (1956); 1 *Moonitz & Staehling, Accounting Analysis* 284-94 (1950). *Gilman* 115, observed that practically all accountants argue in favor of allocation of the profits on long-term contracts to the several periods involved, but few attempt to justify it; many have observed that it is illogical and that it represents an important exception to the general convention of realization. See generally *Condon & Horn, Tax Accounting for Long Term Contracts*, 30 *Taxes* 37 (1952); *Wagman, Tax Accounting for Long Term Contracts*, 33 *Taxes* 277 (1955); *Committee on Accounting Procedure, Accounting Research Bull. No. 45, Long-Term Construction Type Contracts* (Oct. 1955).

123. *Planet Line, Inc. v. Commissioner*, 89 F.2d 16 (2d Cir. 1937); *Falketind Ship Co.*, 6 B.T.A. 44 (1927).

124. *Seas Shipping Co.*, 1 T.C. 30 (1942). For the completed-voyage basis, at least, there is more than ample historical accounting background. *Kahuku Plantation Co.*, 12 B.T.A. 977, 984 (1928); see *Peragallo, Double Entry Bookkeeping* 34 (1938).

125. Perhaps the natural objects of legislative bounty, farmers and livestock raisers have a broad choice of accounting methods, including the cash receipts method, the crop method, the ordinary accrual method, and various modifications of the accrual method, including the farm-price method of inventory valuation. *Kenneth S. Battelle*, 9 T.C. 299, 304 (1947). Hatchery operators and breeders of chinchillas, minks, and foxes may be farmers for purposes of this regulation. *United States v. Chemell*, 243 F.2d 219 (5th Cir. 1957); *Rev. Rul. 57-588, 1957-2 Cum. Bull.* 305; cf. *Int. Rev. Code of 1954, § 175*. Certainly, these bucolic businessmen have been the object of bountiful literary endeavors concerning their tax

tures upon each crop until the year in which the crop is sold, and thus report income on the crop basis.¹²⁶ The completed transaction basis¹²⁷ and the earnings basis¹²⁸ may also fulfill the fundamental requirement of clearly reflecting income. The Commissioner, if not the taxpayer, may choose among several constructive methods of accounting in ascertaining taxable income.¹²⁹ The cash method, the accrual method, the installment method, and the long-term contract method remain, however, the principal methods of accounting.¹³⁰

Whatever the proper nomenclature,¹³¹ the function of the basis or method of accounting seems clear in both accounting and the federal income tax law. It is solely one of timing, of determining when income is to be regarded as earned and when expenditures are to be deemed incurred.¹³² A method of accounting is the procedure employed to determine the income of a particular period.¹³³ It does not determine whether there is income¹³⁴ nor the person to whom the income is attributable,¹³⁵ but only when, to which accounting period

quandaries. See, e.g., Beebe, *The Farmer-Control of Income and Expense*, 24 *Miss. L.J.* 208 (1953); Halstead, *Taxation of Farmers: Accounting Methods, Records, and Returns*, 1 *Prac. Law.* 57 (1955); Throckmorton, *Federal Taxation of the Farmer*, 34 *Iowa L. Rev.* 251 (1949); Comment, *Farmers and the Federal Income Tax*, 19 *U. Chi. L. Rev.* 522 (1952).

126. *Treas. Reg.* § 1.61-4(c) (1957). The crop basis has been most popular, judicially at least, among Hawaiian sugar producers. *Kahuku Plantation Co. v. Commissioner*, 132 F.2d 671 (9th Cir. 1943). See *Kekaha Sugar Co. v. Burnet*, 50 F.2d 322 (D.C. Cir. 1931); *Oahu Sugar Co.*, 13 B.T.A. 405 (1928); *Kahuku Plantation Co.*, 12 B.T.A. 977 (1928). But see *Amling-De Vor Nurseries, Inc., v. United States*, 139 F. Supp. 303 (N.D. Cal. 1956) (rose bushes); *A. D. McNeill*, 10 B.T.A. 1285 (1928) (naval stores).

127. *Gilbert W. Lee*, 6 B.T.A. 135 (1927), appeal dismissed, 41 F.2d 1004 (6th Cir. 1930). But cf. *Security Flour Mills v. Commissioner*, 321 U.S. 281, 287 (1944).

128. See Reiling, *Practical Legal Aspects of Tax Accounting*, 30 *Taxes* 1028, 1029-31 (1952).

129. See *infra* note 174.

130. *Lasser, Tax Accounting Methods* 3 (1951); cf. *H. J. Irby, Jr.*, 30 *T.C.* 1166, 1174 (1958).

131. As a matter of accounting precedence "basis" would appear to describe better the process in question. "Method" is the terminology of the federal income tax statute. Generally, this distinction is subsequently preserved herein although the value thereof may sometimes be in doubt.

132. *Commissioner v. Mnookin*, 184 F.2d 89, 92 (8th Cir. 1950); *Holmes, Advanced Accounting* 198 (1947); cf. *Huntington Sec. Corp. v. Busey*, 112 F.2d 368, 370 (6th Cir. 1940).

133. 1 *Newlove & Garner, Advanced Accounting* 403 (1951).

134. *Ahern, Getting the Best Effective Use Out of Accounting Methods and Accounting Periods*, N.Y.U. 6th Inst. on Fed. Tax. 479 (1947).

135. *Standard Paving Co. v. Commissioner*, 190 F.2d 330 (10th Cir.), cert. denied, 342 U.S. 860 (1951).

income and expenses are to be assigned.¹³⁶ For federal income tax purposes a method of accounting does not enlarge the scope of the statutory deductions,¹³⁷ transform ordinary income into capital gain,¹³⁸ or make that income which is not.¹³⁹

Because the sole function is one of timing, any method of accounting will, over the long run, if consistently followed, yield substantially proper results.¹⁴⁰ The Commissioner has evinced, however, a notable reluctance to await the eventual compensating factors of any method. Instead he has chosen to levy upon income as rapidly and to delay deductions as long as the statute and the courts will permit. Methods of accounting, lacking as they are in "glittering perfection,"¹⁴¹ have borne the brunt of this sometimes overly zealous protection of the revenues.

Selection and Choice

The law has given choice of accounting method largely to the taxpayer. The consequences of his selection and the ensuing difficulty of change make it apparent, however, that his espousal should not be undertaken in haste.

The regulations long have recognized that no uniform method of accounting can be prescribed for all taxpayers.¹⁴² Rather, the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are, in his judgment, best suited to his purposes.¹⁴³ He may adopt separate methods for each of his business enterprises, as well as for his personal income.¹⁴⁴ Initial selection¹⁴⁵ is thus lodged

136. Lasser, *Tax Accounting Methods* 2 (1951); see Clarence Shock, 1 B.T.A. 518, 530 (1925). A method of accounting does not refer to the treatment accorded on the books to an isolated transaction. *Stern Bros.*, 13 B.T.A. 1192, 1193 (1928).

137. *Surety-Fin. Co. v. Commissioner*, 77 F.2d 221 (9th Cir. 1935); *J. I. Case Co. v. United States*, 106 Ct. Cl. 257, 65 F. Supp. 464 (1946).

138. *Fisher v. Commissioner*, 209 F.2d 513 (6th Cir.), cert. denied, 347 U.S. 1014 (1954).

139. *Barker v. United States*, 88 Ct. Cl. 468, 26 F. Supp. 1004, 1006 (1939).

140. Committee on Postwar Tax Policy, *A Tax Program for a Solvent America* 90; see *Bent v. Commissioner*, 56 F.2d 99, 102 (9th Cir. 1932); *Great No. Ry.*, 8 B.T.A. 225, 268 (1927).

141. Judge Opper, dissenting in *Pacific Grape Prods. Co.*, 17 T.C. 1097, 1110 (1952).

142. Treas. Reg. § 1.446-1(a)(2) (1957); Treas. Reg. 118, § 39.41-3 (1953); Treas. Reg. 45, art. 24 (1919).

143. *Ibid.* This phraseology contemplates that a liberal latitude be allowed to the taxpayer in keeping his books, but it does not waive the requirement that any system adopted must truly reflect income. *G. E. Cotton*, 25 B.T.A. 866, 869 (1932).

144. Int. Rev. Code of 1954, § 446(d); S. Rep. No. 1622, 83rd Cong., 2d Sess. 200 (1954). See *Commissioner v. Standing*, 259 F.2d 450 (4th Cir. 1958); *Harvey v. Commissioner*, 172 F.2d 952, 955 (9th Cir. 1949); *Bird Ranch & Oil Co. v. Commissioner*, 152 F.2d 874 (9th Cir.), cert. denied, 328 U.S. 863 (1946); *Cecil v.*

exclusively in the taxpayer,¹⁴⁶ and the law contemplates considerable discretion on his part in that respect.¹⁴⁷

His hand is not altogether untrammelled. The method selected may not leave control over the items of income and deductions within the taxpayer's own judgment.¹⁴⁸ If he keeps no books of account, income must be reported on the cash basis.¹⁴⁹ The primary limitation is that set forth in the statute: any method of accounting employed must clearly reflect income.¹⁵⁰ This requirement has been construed to mean that the method must reflect income with as much accuracy as standard methods of accounting practice permit.¹⁵¹ If inventories are an income-determining factor, the accrual method may be the only one

Commissioner, 100 F.2d 896 (4th Cir. 1939); David Hanover, 12 T.C. 342 (1949); Berryman D. Fincannon, 2 T.C. 216 (1943); Joseph Stern, 14 B.T.A. 838 (1928); cf. M. G. Corlett, 15 P-H Tax Ct. Mem. 95 (1946); I. Townsend Burden, 12 P-H Tax Ct. Mem. 246 (1943). The system used as to each separate business must be consistent within itself, however. Bennett Properties Co., 45 B.T.A. 696 (1941).

Quaere: what constitutes a separate business? See *Wetherbee Elec. Co. v. Jones*, 73 F. Supp. 765 (W.D. Okla. 1947); Int. Rev. Code of 1954, § 355.

145. The Commissioner has been sometimes chary of the status of a "new" taxpayer. See *Berryman D. Fincannon*, 2 T.C. 216 (1943); 3 CCH 1960 Stand. Fed. Tax Rep. ¶ 2822.492; Int. Rev. Code of 1954, § 381(c)(4). But see *Morris Poston Coal Co. v. Commissioner*, 46 F.2d 620 (6th Cir. 1930); *Akron, C. & Y. R.R.*, 22 T.C. 648 (1954); *Elsie SoRelle*, 22 T.C. 459 (1954).

146. *Huntington Sec. Corp. v. Busey*, 112 F.2d 368 (6th Cir. 1940). But cf. *Harvey v. Commissioner*, 171 F.2d 952, 955 (9th Cir. 1949).

147. *Hiram W. Evans*, 15 P-H Tax Ct. Mem. 312 (1946).

148. Such a method is without the pale of the sound basis of accounting required by the Internal Revenue Code. *V. T. H. Bien*, 20 T.C. 49 (1953).

149. *In re Newman*, 94 F.2d 108 (6th Cir. 1938); *Greengard v. Commissioner*, 29 F.2d 502 (7th Cir. 1928); *Bellevue Mfg. Co.*, 26 P-H Tax Ct. Mem. 331 (1957); *Dan Birkemeier*, 39 B.T.A. 1072 (1939); *Oscar G. Joseph*, 32 B.T.A. 1192, 1204 (1935); *Wilson Marks*, 6 B.T.A. 729 (1927); U.S. Treas. Dep't, *Your 1959 Federal Income Tax Forms 7* (1959).

150. Int. Rev. Code of 1954, § 446(b); *Aluminum Castings Co. v. Routzahn*, 282 U.S. 92 (1930); *Jud Plumbing & Heating Co. v. Commissioner*, 153 F.2d 681 (5th Cir. 1946). The income clearly reflected may be in part illegal. *Barker v. United States*, 88 Ct. Cl. 468, 26 F. Supp. 1004 (1939).

151. *Caldwell v. Commissioner*, 202 F.2d 112 (2d Cir. 1953). The view expressed in *Osterloh v. Lucas*, 37 F.2d 277 (9th Cir. 1930), and subsequently cited with approval in *Welch v. DeBlois*, 94 F.2d 842, 844 (1938), *Huntington Sec. Corp. v. Busey*, 112 F.2d 368 (6th Cir. 1940), and *Kentucky Color & Chem. Co. v. Glenn*, 186 F.2d 975 (6th Cir. 1951), that "clearly" means only "plainly, honestly, straightforwardly and frankly," but not necessarily "accurately" has been rejected by its progenitor. *Boynton v. Pedrick*, 136 F. Supp. 888 (S.D.N.Y. 1954), aff'd per curiam, 228 F.2d 745 (2d Cir. 1955).

The clear reflection of "net earnings" is seemingly something entirely different. *South Dade Farms v. Commissioner*, 138 F.2d 818 (5th Cir. 1943).

which will meet this requirement.¹⁵² Even approved standard methods of accounting may not clearly reflect income in every instance.¹⁵³

Prior to the 1954 Code, at least,¹⁵⁴ it was clear that the taxpayer was required to follow consistently the method adopted. Hybrid methods of accounting were not ordinarily regarded as clearly reflecting income.¹⁵⁵ Thus income could not be reported upon an accrual basis and deductions upon a cash basis;¹⁵⁶ nor could various items of

152. *Herberger v. Commissioner*, 195 F.2d 293 (9th Cir.), cert. denied, 344 U.S. 820 (1952); *A. & A. Tool & Supply Co. v. Commissioner*, 182 F.2d 300 (10th Cir. 1950); *E. S. Iley*, 19 T.C. 631 (1952); *Treas. Reg. § 1.471-1* (1958); *A.R.R. 217*, 3 Cum. Bull. 76 (1920); cf. *Simon v. Commissioner*, 176 F.2d 230 (2d Cir. 1949); see *Kohler & Morrison, Principles of Accounting 166-67* (1926). But see *Goodrich v. Commissioner*, 243 F.2d 686 (8th Cir. 1957); *Glenn v. Kentucky Color & Chem. Co.*, 186 F.2d 975 (6th Cir. 1951); *Russell v. Commissioner*, 45 F.2d 100 (1st Cir. 1930); *Stanford R. Brookshire*, 31 T.C. No. 119 (Mar. 18, 1959).

153. *Keasbey & Mattison Co. v. United States*, 141 F.2d 163 (3d Cir. 1944). Methods of accounting which clearly reflect the income of a going concern may not clearly reflect the income of the entity when it is in the process of liquidation, particularly if the liquidation would, under the method of accounting employed, prevent the taxpayer's realizing income at any time. *Idaho First Nat'l Bank v. United States*, 265 F.2d 6 (9th Cir. 1959); *Floyd v. Scofield*, 193 F.2d 594 (5th Cir. 1952); *United States v. Lynch*, 192 F.2d 718 (9th Cir. 1951), cert. denied, 343 U.S. 934 (1952); *Standard Paving Co. v. Commissioner*, 190 F.2d 330 (10th Cir.), cert. denied, 342 U.S. 860 (1951); *Jud Plumbing & Heating v. Commissioner*, 153 F.2d 681 (5th Cir. 1946); *Susan J. Carter*, 9 T.C. 364 (1947); cf. *Int. Rev. Code of 1954, §§ 337, 482; Rev. Rul. 59-120, 1959 Int. Rev. Bull. No. 15, at 13*. The problem in some instances may not be so much one of method of accounting as method of allocation of income to the proper taxpayer. *Alden Charles Palmer*, 29 T.C. 154 (1957), aff'd, 267 F.2d 434 (9th Cir.), cert. denied, 361 U.S. 821 (1959); cf. *Int. Rev. Code of 1954, § 482*.

154. *Int. Rev. Code of 1954, § 446(c) (4)*. And even under the 1954 Code, a hybrid method apparently may not be used unless it clearly reflects income. See *Alta Co-op. Elevator, P-H 1959 Tax Ct. Rep. & Mem. Dec. ¶ 59,033*. See *Treas. Reg. § 1.446-1(c) (iv)* (1957); *Jones, Hybrid Accounting Is Bad Taxwise*, 92 *J. Accountancy* 206 (1951).

155. *Hygienic Prods. Co. v. Commissioner*, 111 F.2d 330 (6th Cir.), cert. denied, 311 U.S. 665 (1940); *Harry Hartley*, 23 T.C. 353 (1954); *Frank Imburgia*, 22 T.C. 1002 (1954); *Stern Bros. & Co.*, 16 T.C. 295 (1951); *Comstock-Castle Stove Co.*, 4 B.T.A. 114 (1926); *Treas. Reg. 118, § 39.41-2* (1953). But cf. *Bernard B. Carter*, 26 P-H Tax Ct. Mem. 237 (1957), modified on other grounds, 257 F.2d 595 (5th Cir. 1958). Not even the Commissioner, in the exercise of his discretion, can compel a taxpayer to remain on a hybrid basis. *Elsie SoRelle*, 22 T.C. 459 (1954). The Commissioner may make adjustments necessary to conform to the predominant method. *Julius I. Byrne*, 16 T.C. 1234, 1246 (1951); *Maine Dairy Co.*, 4 B.T.A. 375 (1926).

156. *Commissioner v. South Tex. Lumber Co.*, 333 U.S. 496, 501 (1948); *Hygienic Prods. Co. v. Commissioner*, 111 F.2d 330, 331 (6th Cir. 1940); *Eckert v. Commissioner*, 42 F.2d 158, 159 (2d Cir.), aff'd, 283 U.S. 140 (1930); *Julius I. Byrne*, 16 T.C. 1234, 1246 (1951); *Henry Reubel*, 1 B.T.A. 676 (1925).

income and deductions be accounted for under different methods.¹⁵⁷ When the law speaks of "the method of accounting," it brooks no merely haphazard division between the cash and the accrual bases.¹⁵⁸ The taxpayer cannot be permitted any variations from the basis selected.¹⁵⁹ Consistency is the key; it is required regardless of the method used.¹⁶⁰

Having selected a proper method of accounting for keeping his books,¹⁶¹ the taxpayer is required to report his taxable income in ac-

157. *Income: Merchants Nat'l Bank*, 6 B.T.A. 1167 (1927); *Continental Life Ins. Co.*, 5 B.T.A. 407 (1926); cf. *Automobile Club of N.Y.*, 32 T.C. No. 79 (July 20, 1959) (dissenting opinion). Deductions: *Waldheim Realty & Inv. Co. v. Commissioner*, 245 F.2d 823 (8th Cir. 1957); *Herndon v. Commissioner*, 175 F.2d 55 (5th Cir. 1949); *J. H. Martinus & Sons v. Commissioner*, 116 F.2d 732 (9th Cir. 1940); *National Straw Works*, 16 B.T.A. 463 (1929), aff'd, 47 F.2d 844 (7th Cir. 1931); *Bruno O. A. dePaoli*, 8 B.T.A. 294, 296 (1927) (dicta). But see *New Capital Hotel, Inc.*, 28 T.C. 706 (1957), aff'd per curiam, 261 F.2d 437 (6th Cir. 1958). The consistency required is with respect to the treatment by each taxpayer of all his transactions. *Jenkins v. Bitgood*, 22 F. Supp. 16, 17 (D. Conn. 1938), aff'd, 101 F.2d 17 (2d Cir.), cert. denied, 307 U.S. 636 (1939).

158. *Mt. Vernon Trust Co. v. Commissioner*, 75 F.2d 938, 940 (2d Cir.), cert. denied, 296 U.S. 587 (1935).

159. *W. L. Moody Cotton Co. v. Commissioner*, 143 F.2d 712 (5th Cir. 1944). Not even "in the interest of that elasticity necessary if the income tax under the revenue acts is to be adjusted to the idiosyncrasies of individual business?" *B. B. Todd*, 1 B.T.A. 762, 767 (1925). May the Commissioner? *Geometric Stamping Co.*, 26 T.C. 301, 304 (1956).

160. *Advertisers Exch.*, 25 T.C. 1086, 1092, aff'd per curiam, 240 F.2d 958 (2d Cir. 1957); see *Jones v. Smith*, 193 F.2d 381 (10th Cir. 1951), cert. denied, 343 U.S. 952 (1952). Does the law impose a greater duty of good faith? Require that the taxpayer's actions shall be consistent with his books of account? See *Helvering v. Superior Wines & Liquors, Inc.*, 134 F.2d 373, 378 (8th Cir. 1943); *Alamo Nat'l Bank v. Commissioner*, 95 F.2d 622, 623 (5th Cir.), cert. denied, 304 U.S. 577 (1938); *Acacia Park Cemetery Ass'n v. Commissioner*, 67 F.2d 700, 703 (7th Cir. 1934). Mere consistency may sometimes lose its virtue if it fails clearly to reflect income. *Wood v. Commissioner*, 197 F.2d 859, 861 (5th Cir. 1952); *V. T. H. Bien*, 20 T.C. 49 (1953). But cf. *International Cigar Mach. Co.*, 36 B.T.A. 124 (1937).

The income tax law itself may sometimes offer alternatives. The World War II excess profits tax law, 56 Stat. 917 (1942), 26 U.S.C. §§ 736(a), (b) (1952), gave taxpayers reporting under the installment or completed contract method of accounting for income tax purposes, an option to report income on an accrual basis for excess profits tax purposes. See *Carroll Furniture Co. v. Commissioner*, 197 F.2d 718 (5th Cir. 1952); *Leo Kahn Furniture Co. v. Commissioner*, 195 F.2d 404 (6th Cir. 1952); *Basalt Rock Co. v. Commissioner*, 180 F.2d 281 (9th Cir.), cert. denied, 339 U.S. 966 (1950); *Kimbrell's Home Furnishings, Inc. v. Commissioner*, 159 F.2d 608 (4th Cir. 1947); *Aetna-Standard Eng'r Co.*, 15 T.C. 284 (1950).

161. Or perhaps, as in the case of a partnership, having had it selected for him. See *Int. Rev. Code of 1954*, § 703 (b); *Percival H. Truman*, 3 B.T.A. 386 (1926); cf. *National Builders, Inc.*, 12 T.C. 852 (1949).

cordance with such method.¹⁶² If he desires to change his method of accounting, he must comply with the statutory requirements.¹⁶³ If he files returns upon a basis other than that used in keeping his accounts, or changes his method of reporting income without permission, the Commissioner's acceptance of prior returns does not give rise to an estoppel.¹⁶⁴ The taxpayer may not, after the time for filing the original return has expired, change the method selected by filing an amended return.¹⁶⁵

162. *Huntington Sec. Corp. v. Busey*, 112 F.2d 368, 370 (6th Cir. 1940); *Kabatznick v. Eaton*, 45 F.2d 244 (D. Conn. 1930); *Shaw v. United States*, 49 F.2d 628 (N.D. Ill. 1930); *American Conservation Serv. Corp.*, 24 B.T.A. 183 (1931); *Ribbon Cliff Fruit Co.*, 12 B.T.A. 13 (1928); *J. L. Allhands*, 10 B.T.A. 1089 (1928). If the taxpayer keeps his formal accounts on the accrual basis and converts them to a cash basis by means of entries on the accountant's work papers prior to preparation of the tax return, are his "books" kept on the cash or accrual basis? *Patchen v. Commissioner*, 258 F.2d 544 (5th Cir. 1958), reversing 27 T.C. 592 (1956); cf. *Geometric Stamping Co.*, 26 T.C. 301 (1956).

When the installment method or long-term contract method is used for reporting income, it is only necessary that the books be kept in such fashion that "adequate information" is available from which income on an installment or a long-term contract method can be computed. *Daley v. United States*, 243 F.2d 466 (9th Cir.), cert. denied, 355 U.S. 832 (1957); *Davenport Mach. & Foundry Co.*, 18 T.C. 39 (1952); *R. G. Bent Co.*, 26 B.T.A. 1369 (1932); *Herman Tillman*, 10 B.T.A. 4 (1928); *Redlick-Newman Co.*, 8 B.T.A. 719 (1927). *Contra*, *Bent v. Commissioner*, 56 F.2d 99 (9th Cir. 1932).

163. See *Change of Accounting Method*, *infra* p. 30.

164. *Niles Bement Pond Co. v. United States*, 281 U.S. 356, 362 (1930); *Wood v. Commissioner*, 245 F.2d 888 (5th Cir. 1957); *Carver v. Commissioner*, 173 F.2d 29 (6th Cir. 1949), affirming per curiam 10 T.C. 171 (1948); *Ross B. Hammond, Inc. v. Commissioner*, 97 F.2d 545 (9th Cir. 1938); *Mt. Vernon Trust Co. v. Commissioner*, 75 F.2d 938, 940 (2d Cir.), cert. denied, 296 U.S. 587 (1935); *Charles D. Mifflin*, 24 T.C. 973 (1955); *Harry Hartley*, 23 T.C. 353 (1954). But see *Maloney v. Hammond*, 176 F.2d 780, 782 (9th Cir. 1949); *Alexander H. Kerr & Co. v. United States*, 97 F. Supp. 796 (S.D. Cal. 1951).

165. *Pacific Nat'l Co. v. Welch*, 304 U.S. 191, 194 (1938); *Daley v. United States*, 243 F.2d 466 (9th Cir.), cert. denied, 355 U.S. 832 (1957); *Franklin County Distilling Co. v. Commissioner*, 125 F.2d 800 (6th Cir. 1942); *Elmwood Corp. v. United States*, 107 F.2d 111 (5th Cir. 1939), cert. denied, 309 U.S. 675 (1940); *Kay-Jones Furniture Co.*, 24 P-H. Tax Ct. Mem. 790 (1955); *Hegeman-Harris Co. v. United States*, 87 Ct. Cl. 296, 23 F. Supp. 450 (1938); I.T. 1190, I-1 Cum. Bull. 49 (1922). But see *Key Largo Shore Properties, Inc.*, 21 B.T.A. 1008 (1930). Acceptance of a method applied by the Commissioner in determining a deficiency is equally binding. *Louis Werner Saw Mill Co. v. Commissioner*, 96 F.2d 539 (D.C. Cir. 1938). The taxpayer must originally have had some choice, however, *James D. Boone*, 27 B.T.A. 1064 (1933).

The rule is not based upon estoppel, but upon the fact that the contrary view would allow the taxpayer to escape taxation on income attributed to closed years, thus rendering impossible the taxation of income on an annual basis. *Southern Abstract & Loan Co. v. Commissioner*, 25 B.T.A. 1095 (1932), aff'd, 72 F.2d 130 (6th Cir. 1936). It applies to treatment of a particular item as well as a general

If the method of accounting employed by the taxpayer does not clearly reflect the income,¹⁶⁶ or if no method of accounting has been employed,¹⁶⁷ taxable income is to be computed in accordance with such method as, in the opinion of the Commissioner, does clearly reflect income.¹⁶⁸ Much discretionary latitude is here given to the Commissioner,¹⁶⁹ and the burden is upon the taxpayer to prove that computation in accordance with a method of accounting different from the one employed by the Commissioner will more clearly reflect income.¹⁷⁰ Thus, the Commissioner may determine income¹⁷¹ upon the cash or the accrual basis;¹⁷² adjust particular items;¹⁷³ or reconstruct

method of accounting. See, e.g., *Wichita Coca-Cola Bottling Co. v. United States*, 152 F.2d 6 (5th Cir. 1945), cert. denied, 327 U.S. 806 (1946); *Grand Central Pub. Mkt., Inc. v. United States*, 22 F. Supp. 119 (S.D. Cal.), appeal dismissed, 98 F.2d 1023 (9th Cir. 1938) (deposits); *Bobrow Bros., Inc. v. Commissioner*, 135 F.2d 209 (3d Cir. 1943); *Le Bolt & Co. v. United States*, 67 Ct. Cl. 422 (1929) (import duties); *S. Nicholas Jacobs*, 21 T.C. 165 (1953) (installment basis); *Walter L. Ross*, 30 B.T.A. 496 (1934), aff'd, 83 F.2d 18 (6th Cir. 1936) (election to report income from employment contract as received); *J. E. Mergott Co. v. Commissioner*, 176 F.2d 860 (3d Cir. 1949) (container inventories).

166. Whether or not the method of accounting employed by the taxpayer clearly reflects income is a question of fact. *Boynton v. Pedrick*, 136 F. Supp. 888, 889 (S.D.N.Y. 1954), aff'd per curiam, 228 F.2d 745 (2d Cir. 1955).

167. The Tax Court has, upon occasion, questioned whether a taxpayer keeping records could be considered to have any accounting method. See *Arthur B. Bellwood*, 20 P-H Tax Ct. Mem. 40 (1951); *John A. Brander*, 3 B.T.A. 231 (1925). The congressional reports on Int. Rev. Code of 1954, § 446, make it clear, however, that it is not necessary to keep books in order to have an accounting method. In the case of a taxpayer whose sole source of income is wages, duplicate tax returns or other records may be sufficient to constitute the use of the method of accounting used in the preparation of income tax returns. H.R. Rep. No. 1337, 83d Cong., 2d Sess. a158 (1954).

168. Int. Rev. Code of 1954, § 446 (b); *In re Newman*, 94 F.2d 108 (6th Cir. 1938).

169. *Lucas v. American Code Co.*, 280 U.S. 445, 449 (1930); *Wood v. Commissioner*, 197 F.2d 859 (5th Cir. 1952); *Harvey v. Commissioner*, 171 F.2d 952, 955 (9th Cir. 1949).

170. *Welp v. United States*, 103 F. Supp. 551 (N.D. Iowa 1952), and cases there cited; *Arthur B. Bellwood*, 20 P-H Tax Ct. Mem. 40 (1951).

171. The Commissioner has no statutory authority to order a change in the method of accounting; he merely computes income as if a change to the proper method had been made. *Welp v. United States*, 103 F. Supp. 551, 560 (N.D. Iowa 1952).

172. Even though the taxpayer kept no books. *A. & A. Tool & Supply Co. v. Commissioner*, 182 F.2d 300 (10th Cir. 1950); *Schram v. United States*, 118 F.2d 541 (6th Cir.), cert. denied, 314 U.S. 695 (1941); *United States v. McKenna*, 126 F. Supp. 831 (D.C. Minn. 1954); *Bond-Gleason, Inc.*, P-H 1959 Tax Ct. Rep. & Mem. Dec. ¶ 59,002; *Ella Pipes Cline*, 15 B.T.A. 934 (1929). May the Commissioner determine income under a long-term contract method or the installment method if such method would more clearly reflect the income? Cf. Int. Rev. Code

income in accordance with any one or more of several "constructive methods" of accounting,¹⁷⁴ in order clearly to reflect income.¹⁷⁵ His

of 1954, § 453 (a); Treas. Reg. § 1.451-3 (1957); *Dawley v. United States*, 186 F.2d 978 (4th Cir. 1951); *Dan Birkemeier*, 39 B.T.A. 1072 (1938); *J. R. Vansant*, 4 B.T.A. 58 (1926) (semble).

173. *Gatliff v. Helburn*, 31 F. Supp. 495 (E.D. Ky. 1940); *First Nat'l Benefit Soc'y*, 18 P-H Tax Ct. Mem. 730 (1949), aff'd per curiam, 183 F.2d 191 (9th Cir. 1950); *Susan J. Carter*, 9 T.C. 364 (1947); *Theodore Stanfield*, 8 B.T.A. 787, 823 (1927); cf. *Automobile Club of Mich. v. Commissioner*, 353 U.S. 180 (1957); *United States v. American Can Co.*, 280 U.S. 412 (1930).

174. A taxpayer who keeps no records, or inadequate records, or records which do not accurately reflect "true income," may be subjected to a determination of his income by the Commissioner via any, or any combination of the following methods:

(1) The net worth method, in which the taxpayer's net worth at the beginning and at the end of the taxable period are determined, and the increase, adjusted for living expenses, is deemed to be taxable income. See *Holland v. United States*, 348 U.S. 121 (1954); *Friedberg v. United States*, 348 U.S. 142 (1954); *Daniel Smith v. United States*, 348 U.S. 147 (1954); *United States v. Calderon*, 348 U.S. 160 (1954). The net worth method was once deemed to be a necessary concomitant of the single entry system of bookkeeping. See *Index Notion Co.*, 3 B.T.A. 90 (1925).

(2) The bank deposit method, which assumes that the taxpayer's bank deposits, unless otherwise identified, constitute taxable income. See *Doll v. Glenn*, 231 F.2d 186 (6th Cir. 1956); *Boyett v. Commissioner*, 204 F.2d 205 (5th Cir. 1953); *Halle v. Commissioner*, 175 F.2d 500 (2d Cir. 1949), cert. denied, 338 U.S. 949 (1950); *Harris v. Commissioner*, 174 F.2d 70 (4th Cir. 1949); *Frank J. Moore*, 37 B.T.A. 378, 387 n.1 (1938).

(3) The percentage method, which assumes that the taxpayer's net profit should be the same as that of other taxpayers in similar lines of endeavor. See *Casper v. Commissioner*, 225 F.2d 284 (6th Cir. 1955); *Gamm v. Commissioner*, 39 F.2d 73 (5th Cir. 1930); *Glenn Stewart*, 24 P-H Tax Ct. Mem. 297 (1955); cf. *United States v. Mayer*, 26 Fed. Cas. 1225 (No. 15,753) (D. Ore. 1865).

(4) The excess cash expenditures method, which compares the taxpayer's expenditures during the taxable year with his reported income, and increases the latter by any excess of the former. See *Marcella v. Commissioner*, 222 F.2d 878 (8th Cir. 1955); *Dupree v. United States*, 218 F.2d 781 (5th Cir. 1955); *Max Cohen*, 9 T.C. 1156, 1163 (1947).

Pollock v. United States, 202 F.2d 281, 285 n.4 (5th Cir.), cert. denied, 345 U.S. 993 (1953); *Hyman B. Stone*, 22 T.C. 893 (1954). In recent years the Commissioner appears to have added a fifth, the "raw materials consumption method." See *D & H Bagel Bakery, Inc.*, 24 P-H Tax Ct. Mem. 279 (1955); *Neptune Bagel Bakers, Inc.*, id. at 283.

The ingenuity of the Commissioner in this field is equaled only by that of the taxpayer. Compare *Commissioner v. Gasper*, 225 F.2d 284 (6th Cir. 1955) (liquor receipts should be computed by multiplying the number of bottles in each selling price group by 22 drinks per bottle) and *Albert E. MacCrowe*, 24 P-H Tax Ct. Mem. 799 (1955), remanded (most recently), 264 F.2d 621 (4th Cir. 1959) (the number of morphine tablets purchased times the fee per operation equals the taxpayer's income from abortion patients) with *Boyett v. Commissioner*, 204 F.2d

"clear-reflection-of-income" powers are subject to some limitation. The Commissioner's rejection of a return made in accordance with the method of accounting regularly employed by the taxpayer is subject to judicial review.¹⁷⁶ Departure is justified only where there would otherwise be a material distortion of income.¹⁷⁷ The power does not enable the Commissioner to add to income an item which properly belongs to an earlier year and thus nullify the statute of limitations.¹⁷⁸

Change of Accounting Method

Change of accounting method the law has largely placed within the province of the Commissioner. He has sometimes been circumvented in his protection of the fisc, however, by some lamentable niceties of legal nuances.

205 (5th Cir. 1953) (the taxpayer's bank deposits consisted of currency which he had formerly secreted in an old thermos jug) and *Doris Loissell Mullen*, 19 P-H Tax Ct. Mem. 377 (1950) (her increases in assets were due to gifts from her paramour; her small profits from her restaurant business to the facts that she was away such an unusual amount of time and the OPA price on her blue plate was so low she could not make any money).

The use of constructive methods of accounting is not limited to situations where the taxpayer keeps no books or where his books are inadequate. Congress never intended "to make § 41 a set of blinders which prevents the Government from looking beyond the self-serving declaration in a taxpayer's books." *Holland v. United States*, 348 U.S. 121, 131 (1954); see *Thomas v. Commissioner*, 223 F.2d 83 (6th Cir. 1955); *Abraham Galant*, 26 T.C. 354 (1956); cf. *Jacobs v. United States*, 126 F. Supp. 154 (Ct. Cl. 1954); *Bechelli v. Hofferbert*, 111 F. Supp. 631 (D. Md. 1953). Contra, *United States v. Riganto*, 121 F. Supp. 158 (E.D. Va. 1954); *Ragsdale v. Paschal*, 118 F. Supp. 280 (E.D. Ark. 1954).

Strictly speaking, these constructive methods are not "methods of accounting" at all. They are not substitutes for the cash or accrual method or any other recognized method of keeping books, but merely evidences of income. *Holland v. United States*, 348 U.S. 121, 131 (1954); *United States v. Ridley*, 120 F. Supp. 530, 535 (N.D. Ga. 1954); *Eugene Vassallo*, 23 T.C. 656, 661-62 (1955); *Morris Lipsitz*, 21 T.C. 917, 931 (1954). See also *Kohler & Morrison, Principles of Accounting* 277-79 (1926); Note, 98 U. Pa. L. Rev. 563 (1950), both of which make some critical statements of the so-called constructive methods. The former deems every assumption in the process "an absurdity"; the latter suggests that "judicial guess" should be added to the list of methods.

175. If the taxpayer's method of accounting does not clearly reflect income, and the method proposed by the Commissioner likewise fails, the courts will not select one which does. The statute contemplates action by the Commissioner, not by the courts. *Hardin v. Commissioner*, 223 F.2d 418 (10th Cir. 1955).

176. *Russell v. Commissioner*, 45 F.2d 100 (1st Cir. 1930); *Oesterlein Mach. Co.*, 1 B.T.A. 159 (1924).

177. *National Builders, Inc.*, 12 T.C. 852 (1949).

178. *Commissioner v. Schuyler*, 196 F.2d 85 (2d Cir. 1952); *Commissioner v. Mnookin*, 184 F.2d 89 (8th Cir. 1950); *Clifton Mfg. Co. v. Commissioner*, 137 F.2d 290 (4th Cir. 1943); *Kenosha Auto Transp. Corp.*, 28 T.C. 412 (1957).

Section 446(e) of the 1954 Internal Revenue Code¹⁷⁹ requires a taxpayer who is changing his method of accounting¹⁸⁰ to secure the permission of the Commissioner before computing his taxable income under the new method.¹⁸¹ The purpose of the requirement is to promote consistent adherence by the taxpayer to the same accounting practice from year to year, thereby securing uniformity of collection.¹⁸² If the taxpayer were permitted to change at random, confusion would result.¹⁸³

Some confusion prevails, nonetheless, regarding what constitutes a change in the method of accounting. The 1954 Code Regulations define such a change to include a change in the over-all method of accounting for gross income or deductions, or a change in the treatment of a material item; examples cited are a change from the cash method to an accrual method, or vice versa, a change in the method of inventory valuation, or a change from the cash or accrual method to the long-term contract method.¹⁸⁴ The courts from time to time have set forth their views. A change from the retirement method of accounting to the depreciation method falls within the ambit of the requirement.¹⁸⁵ A change in billing from a shipment basis to a monthly contract basis has been held to constitute a change of method requiring permission,¹⁸⁶ as has the establishment of a reserve de-

179. And, prior thereto, the regulations. See, e.g., Treas. Reg. 118, § 39.41-2(c) (1953).

180. "On the basis of which he regularly computes his income in keeping his books . . ." Int. Rev. Code of 1954, § 446(e). Whatever other improvements were wrought by the 1954 Code, it did nothing for the grammatical construction of § 41.

181. Int. Rev. Code of 1954, § 442.

182. *Shoong Inv. Co. v. Anglim*, 45 F. Supp. 711 (S.D. Cal. 1942).

183. *Maurice W. Simon*, 16 P-H Tax Ct. Mem. 40 (1947), *aff'd*, 176 F.2d 230 (2d Cir. 1949).

184. Treas. Reg. § 1.446-1(e) (1957). The 1939 Code regulations [Reg. 118, § 39.41-2(c)] did not differ materially. The new regulations embody in part the language of the Committee reports, which added to the existing definition "a change in the treatment of a material item, such as a change in the method of depreciating any property." The Commissioner did not include, however, the Committee language distinguishing "a substantial change (in the method of accounting) from each change in the treatment of each item." H.R. Rep. No. 1337, 83d Cong., 2d Sess. a158 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 300 (1954). Property taxes and vacation pay are "material items" for this purpose. Rev. Rul. 59-285, 1959 Int. Rev. Bull. No. 36, at 32.

185. *St. Paul Union Depot Co. v. Commissioner*, 123 F.2d 235 (8th Cir. 1941); *Chicago & N.W.R.R. v. Commissioner*, 114 F.2d 882 (7th Cir. 1940), *cert. denied*, 312 U.S. 692 (1941); *Cincinnati Union Terminal Co.*, 44 B.T.A. 905 (1951). See *Jones v. Smith*, 193 F.2d 381 (10th Cir. 1951), *cert. denied*, 343 U.S. 952 (1952).

186. *Advertisers Exch., Inc.*, 25 T.C. 1086 (1956), *aff'd per curiam*, 240 F.2d 958 (2d Cir. 1957).

ferring a part of the sales price.¹⁸⁷ Correction of individual items is not a change in the method of accounting,¹⁸⁸ nor is a method adopted to reflect a new mode of operation.¹⁸⁹

In some instances the necessity for the consent of the Commissioner has been dispensed with by the statute, the regulations or the courts. Permission is not required, for example, to change from the accrual basis to the installment basis.¹⁹⁰ Under the 1939 Code Regulations, farmers were not required to obtain formal permission to change from the cash method to the farm-price inventory method, if there was no change in the method of inventory valuation.¹⁹¹ The bride may adopt the method of the groom.¹⁹² If the method previously employed does not clearly reflect income, it may be possible to change to the correct method without permission.¹⁹³ Acceptance of returns on the new basis in some instances may estop the Commissioner from contending that the necessary consent has not been obtained.¹⁹⁴ In general, however, the regulations are mandatory and must be followed.¹⁹⁵ The Commissioner is vested with a wide discretion in granting or refusing permission to change.¹⁹⁶

187. *Pacific Vegetable Oil Corp.*, 26 T.C. 1 (1956); cf. *Erica Giepen*, 26 P-H Tax Ct. Mem. 17 (1957).

188. *Cedar Rapids Eng'r Co. v. United States*, 86 F. Supp. 577 (N.D. Iowa 1949); *Wetherbee Elec. Co. v. Jones*, 73 F. Supp. 765 (W.D. Okla.), appeal dismissed, 164 F.2d 278 (10th Cir. 1947); cf. *Beacon Publishing Co. v. Commissioner*, 218 F.2d 697, 702 (10th Cir. 1955).

189. *Alexander H. Kerr & Co. v. United States*, 97 F. Supp. 796 (S.D. Cal. 1951). Resumption of a method of depreciation following a period during which no depreciation was claimed is not a change in accounting method. *Guantanamo & W.R.R.*, 31 T.C. 842 (1959).

190. Int. Rev. Code of 1954, § 453 (c).

191. *Kenneth S. Battelle*, 9 T.C. 299 (1947); *Angel Milani*, 16 P-H Tax Ct. Mem. 945 (1947); *Treas. Reg. 118*, § 39.22(c)-6 (1953); O.D. 841, 4 Cum. Bull. 53 (1921). *Contra*, I.T. 2614. XI-1 Cum. Bull. 48 (1932); *Treas. Reg. § 1.471-6* (1958). The farmer must comply with the requirements of the regulations relating to adjustment sheets and the payment of additional tax due for prior years, if any. *A. J. McDaniel*, 19 T.C. 474 (1952), *aff'd per curiam*, 210 F.2d 540 (6th Cir. 1954).

192. Cf. *Elsie SoRelle*, 22 T.C. 459 (1954).

193. *William Hardy, Inc. v. Commissioner*, 82 F.2d 249 (2d Cir. 1936); *Reynolds Cattle Co.*, 31 B.T.A. 906 (1934); *Chatham & Phenix Nat'l Bank*, 1 B.T.A. 460 (1925); cf. *Gus Blass Co.*, 9 T.C. 15 (1947); *Beacon Publishing Co. v. Commissioner*, 218 F.2d 697, 702 (10th Cir. 1955) (*dictum*). The question is posed but not answered in *Simon v. Commissioner*, 176 F.2d 230 (2d Cir. 1949).

194. *Fowler Bros. & Cox, Inc. v. Commissioner*, 138 F.2d 774 (6th Cir. 1943); *Tampa Tribune Publishing Co. v. Tomlinson*, 52 Am. Fed. Tax R. 1799 (S.D. Fla. 1957). See *supra* note 164.

195. *Ross B. Hammond, Inc. v. Commissioner*, 97 F.2d 545 (9th Cir. 1938); *Jerome R. George*, 27 B.T.A. 765 (1933).

196. *Shoong Inv. Co. v. Anglim*, 45 F. Supp. 711 (N.D. Cal. 1942); cf. *Brown v. Helvering*, 291 U.S. 193 (1934). For several years the Commissioner has been

The gradual recognition of the inherent superiority of the accrual method over the cash method,¹⁹⁷ coupled with the Commissioner's growing insistence that only the accrual method would, in certain instances, clearly reflect income,¹⁹⁸ produced a flood of changes from the cash to the accrual method.¹⁹⁹ Unlike the change from the accrual to the installment method, which early was defined in relatively orderly fashion,²⁰⁰ the cash-accrual change problem took a queasy little quirk which has produced far more case law than it probably merited.

The difficulty arises because of the "gap or hiatus" between the two methods in the year of change.²⁰¹ If the taxpayer is allowed to use opening inventories and accounts receivable²⁰² in computing the first year's income on an accrual basis, the net amount of these assets

exercising this discretion by simply failing to pass upon applications for change of accounting method. His nonaction may be due in part to the problems attendant to the statutory relief of § 481 of the 1954 Code. See *infra* note 218.

197. See *infra*, p. 49, Accrual Bases of Accounting.

198. See *supra* note 152.

199. Changes from an accrual basis to a cash basis involve similar difficulties. Accounts receivable previously included in income on the accrual basis would again be taxed as income in the year of receipt. Inventories which had increased the income of the prior year would be sold without any offsetting cost deduction. The Commissioner, understandably, has been less concerned with the inequities arising under this variation, however. See *Chemung Canal Trust Co.*, 30 B.T.A. 230 (1934), *aff'd per curiam*, 74 F.2d 1009 (2d Cir.), cert. denied, 295 U.S. 751 (1935); *Chatham & Phenix Nat'l Bank*, 1 B.T.A. 460 (1925).

200. The regulations, under the regulations version of the installment method, *supra* note 115, provided that if the taxpayer changed from an accrual basis to the installment basis, all profit reduced to cash during the year of change was required to be included in income even though it had previously been reported as income on the accrual basis. See *Mayer & Co.*, 9 B.T.A. 815 (1927); *Warren Reilly*, 7 B.T.A. 1327 (1927). Revenue Act of 1928, ch. 852, § 44(c), 45 Stat. 805, contained a similar provision. Sec. 705 of the Act (45 Stat. 881) provided, however, that as to original returns made prior to Feb. 26, 1926, for the taxable year 1924 or prior, if the taxpayer changed to the installment basis: (1) no refund would be granted unless the taxpayer had overpaid his tax, computed by including in income amounts received during the year of change on account of the sales of previous years; and (2) no deficiency would be determined unless the taxpayer had underpaid his tax, computed by excluding from income the amounts received during the year of change on account of sales of the previous year. See *Wanamaker v. Commissioner*, 62 F.2d 461 (3d Cir. 1932), cert. denied, 289 U.S. 738 (1933); *Grand Rapids Show Case Co.*, 12 B.T.A. 1024, 1043 (1928), *aff'd sub nom. Grand Rapids Store Equip. Corp. v. Commissioner*, 59 F.2d 915 (6th Cir. 1932).

201. *Bank of Hartsville*, 1 B.T.A. 920, 921 (1925).

202. As a matter of sheer consistency, the taxpayer customarily also takes into account the opening accounts payable. It would be to his advantage to be able to ignore them since amounts charged to opening accounts payable would otherwise appear as expense of the taxable year.

in effect escapes taxation.²⁰³ The early decisions clearly sustained the right and indeed the duty²⁰⁴ of the Commissioner to exact as the price of permission to change the requirement that the opening inventories

203. On a "pure" cash basis the opening inventories would have been deducted as an expense of the preceding years when acquired. Permitting the taxpayer to use the opening inventories to compute the first year's income on an accrual basis permits him to deduct the cost of these inventories a second time, opening inventories serving to increase the cost of goods sold. Similarly, the taxpayer would not have taken into the income of the preceding year the ending accounts receivable since they were not collected in that year. If he is entitled to use the opening balances in the first year's income on an accrual basis, the amounts will escape taxation entirely, the collections being credited to the asset account rather than to income in that year. The problem perhaps may be illustrated by the following example in which Column (a) sets forth the customary contention of the taxpayer and Column (b) that of the Commissioner as to the proper method of computing the income of the first taxable year on the accrual basis:

<i>Sales:</i>	(a)	(b)
Receivables at end of year	\$20,000	\$20,000
Cash collections during year		
(1) on this year's sales	18,000	18,000
(2) on last year's sales	—	7,000*
	<hr/>	<hr/>
Net Sales	\$38,000	\$45,000
 <i>Cost of Goods Sold:</i>		
Inventory beginning of year	\$ 5,000	\$ —
Goods purchased during year	19,000	19,000
	<hr/>	<hr/>
	\$24,000	\$19,000
Inventory end of year	3,000	3,000
	<hr/>	<hr/>
Cost of goods sold	\$21,000	\$16,000
	<hr/>	<hr/>
Gross Profit on Sales	\$17,000	\$29,000
 <i>Expenses:</i>		
Accounts payable year-end	\$ 5,000	\$ 5,000
Paid during the year in cash		
(1) this year's expenses	2,000	2,000
(2) last year's expenses	—	4,000**
	<hr/>	<hr/>
Net expenses	\$ 7,000	\$11,000
	<hr/>	<hr/>
Net income	\$10,000	\$18,000
	<hr/>	<hr/>

* Assumed, for purposes of simplicity, to be the opening balance of accounts receivable.

** Similarly, the opening balance of accounts payable.

204. *Kahuku Plantation Co. v. Commissioner*, 132 F.2d 671, 674 (9th Cir. 1942); *Maurice W. Simon*, 16 P-H Tax Ct. Mem. 40 (1947), *aff'd*, 176 F.2d 230 (2d Cir. 1949).

and receivables be "pyramided" into the year of change.²⁰⁵ He was not required to adhere strictly to a "stereotyped accrual form of accounting,"²⁰⁶ but could take whatever action was necessary to protect the Government in the collection of its revenues.²⁰⁷

The complication arose in those cases in which the taxpayer was not applying for permission to change to the accrual method, and in fact was resisting it, but the Commissioner was imposing the change pursuant to his clear-reflection policing power. The decision in *Commissioner v. Mnookin*²⁰⁸ severely limited the pyramiding ability of the Commissioner, at least in cases in which the taxpayer's change of method was not self-imposed.²⁰⁹ Mr. Mnookin, a partner in a retail jewelry business, kept his books on an accrual basis, reflecting both inventories and receivables. In reporting his income for federal income tax purposes, however, he used inventories, but reported only the cash collections on sales. In determining his 1942 income on an accrual basis, the Commissioner sought to add the opening receivables to income on the grounds that they would otherwise escape taxation. The Eighth Circuit refused to permit him to do so, distinguishing *William Hardy, Inc.*²¹⁰ on the grounds that Mnookin's books clearly reflected his income. The change was only in the method of reporting income, not in the method of keeping his accounts. In fact the Commissioner was seeking to add to the taxpayer's income for the current year an amount properly belonging to an earlier year. The Commissioner's discretion under section 446 did not enable him to nullify the statute of limitations.²¹¹

205. The alleged result of column (b), note 203 supra. See Dixon, *Pyramiding Income in Changing from a Cash to an Accrual Method of Accounting*, 8 Tax L. Rev. 355 (1953).

206. *William Hardy, Inc. v. Commissioner*, 82 F.2d 249, 251 (2d Cir. 1936).

207. *Ibid.* See Z. W. Koby, 14 T.C. 1103 (1950); *Escanaba & L.S.R.R.*, 24 B.T.A. 412 (1931); *Alemeda Steam Laundry Ass'n*, 4 B.T.A. 1080 (1926); *Arthur Kaiser*, 2 B.T.A. 609 (1925); cf. *Schuman Carriage Co.*, 43 B.T.A. 880 (1941); *Daily Record Co.*, 13 B.T.A. 458 (1928). But if the Commissioner does not impose the conditions, the Tax Court may not impose them for him. *Ross v. Commissioner*, 169 F.2d 483 (1st Cir. 1948).

208. 184 F.2d 89 (8th Cir. 1950).

209. Under the Tax Court view, a taxpayer simply changing his method of reporting income without permission is still subject to the adjustment requirements of the Commissioner. *Stanford R. Brookshire*, 31 T.C. No. 119 (Mar. 18, 1959), on appeal, 4th Cir.; *Advance Truck Co.*, 29 T.C. 666, aff'd, 262 F.2d 388 (9th Cir. 1958); *Josef Patchen*, 27 T.C. 592 (1956), rev'd on this issue, 258 F.2d 544 (5th Cir. 1958); *William H. Goodrich*, 25 T.C. 1235 (1956), rev'd 243 F.2d 686 (8th Cir. 1957); *Elbridge L. Walker*, 25 P-H Tax Ct. Mem. 443 (1956).

210. 82 F.2d 249 (2d Cir. 1936).

211. See supra note 178. *Accord, Welp v. United States*, 201 F.2d 128 (8th Cir. 1953), reversing 103 F. Supp. 551 (N.D. Iowa 1952). The lower court's opinion in *Welp* discusses many of the decisions on this problem.

The gentle art of legal distinction was triumphant. If the method of reporting income did not clearly reflect the income of the taxpayer, but his books did, no change in the method of accounting was required. It was merely a change in the method of reporting income.²¹² The Commissioner had no clear-reflection power to pyramid income in such a situation. This subordination of the paramount task of reporting income to the purely ancillary and mechanical operation of keeping records²¹³ came by the enthusiastic approval of the Second Circuit²¹⁴ and the Tax Court.²¹⁵ Following rumblings of an inclination of the former to overrule *William Hardy, Inc.*,²¹⁶ the Tax Court abandoned this legal fantasy spun on the rock of accounting reality,²¹⁷ just as the gentlemen on Capitol Hill ostensibly were providing a legislative solution to the problem.²¹⁸

212. *Gus Blass Co.*, 18 T.C. 261, 266 (1952), aff'd, 204 F.2d 327 (8th Cir. 1953).

213. Judge Opper, dissenting in *Robert G. Frame*, 16 T.C. 600, 605 (1951).

214. *Commissioner v. Dwyer*, 203 F.2d 522 (2d Cir. 1953); *Caldwell v. Commissioner*, 202 F.2d 112 (2d Cir. 1953); *Commissioner v. Schuyler*, 196 F.2d 85 (2d Cir. 1952); *Commissioner v. Cohn*, 196 F.2d 1019 (2d Cir. 1952), affirming per curiam 20 P-H Tax Ct. Mem. 399 (1951).

215. *E. S. Iley*, 19 T.C. 631 (1952); *Robert G. Frame*, 16 T.C. 600 (1951); *George V. Gilbert*, 21 P-H Tax Ct. Mem. 535 (1952); *Daniel Montgomery*, 20 P-H Tax Ct. Mem. 510 (1951).

216. Even if the Second Circuit were "to turn a deaf ear to the compulsions of logic." *Caldwell v. Commissioner*, 202 F.2d 112, 116 (1953); *Commissioner v. Dwyer*, 203 F.2d 522, 523 (1953).

217. See *W. Cleve Stokes*, 22 T.C. 415 (1954); *D. E. Alexander*, 22 T.C. 234 (1954); *Clement A. Bauman*, 22 T.C. 7 (1954); *David W. Hughes*, 22 T.C. 1 (1954); *Jesse Werner*, 23 P-H Tax Ct. Mem. 816 (1954).

218. Int. Rev. Code of 1954, § 481(a), as originally enacted, provided that if a taxpayer's income be computed under a method of accounting different from that used in the preceding year, then there should be taken into account those adjustments which were determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted, "except that there shall not be taken into account any adjustment in respect of any taxable year to which this section does not apply." In the event that the increase in taxable income resulting from the year of change adjustments exceeded \$3,000, then the increase was to be taken into account pro rata, one-third in the year of change and one-third in each of the two preceding years, unless the taxpayer established his actual taxable income for the preceding years computed under the new method.

The quoted language evoked considerable discussion as to whether a taxpayer could accomplish a "windfall" by changing from the cash to the accrual method on January 1, 1954. If the taxpayer was correctly reporting his pre-1954 income on a cash basis, change to the accrual basis appeared to constitute a change of method requiring the consent of the Commissioner. The consensus was that the Commissioner, in such event, could require as the price of consent the adding of beginning inventories and net receivables to income in the year of change. If the taxpayer was reporting incorrectly on the cash basis in 1953, and changed to the correct accrual basis in 1954, he might have been able to take into account opening receivables and inventories in 1954 without penalty. See *Montgomery*,

Accounts As a Basis of Income

The income tax law requires all taxpayers except those whose gross income is derived solely from compensation for personal services or farming²¹⁹ to keep such permanent books of accounts and records as are sufficient to establish gross income and deductions.²²⁰ They fail to do so at their peril.²²¹ Ostensibly, such accounts serve the primary purpose of permitting the taxpayer to ascertain and the Commis-

Federal Taxes 20-12 (36th ed. 1955); Green, *Adopting and Changing Accounting Methods and Periods*, N.Y.U. 14th Inst. on Fed. Tax. 1489, 1502 (1956); Burns, *Accounting Periods and Methods of Accounting*, U. So. Cal. 1955 Tax Inst. 123, 148-149; cf. *Alta Co-op. Elevator*, P-H 1959 Tax Ct. Rep. & Mem. Dec. ¶ 59,033.

The Commissioner was not unmindful of this potential benefit, intended by statute though it may have been. He sought presumably to protect the revenues by announcing first that he would not act upon applications for permission to change the method of accounting which involved adjustments under § 481 until regulations had been issued under §§ 446 and 481. News Release, 1956 Int. Rev. Bull. No. 3, at 32. A year later the Service announced that "in view of the announced consideration of technical problems in connection with section 481 . . . and the consequent possibility of legislation which would amend this section," proposed regulations would not then be issued. Notice, 1957 Int. Rev. Bull. No. 9, at 38. The delay was further lengthened by the requirement that requests for action on applications for change of accounting method, although already on file, be renewed "subsequent to the issuance of final regulations."

The final regulations were adopted under § 446 on December 24, 1957, and under § 481 on February 19, 1959. The waiting game was successful. By this time Congress had been made to see the error of its ways. Section 481 was amended by § 29 of the Technical Amendments Act of 1958, to provide that a taxpayer who initiated a change in accounting method for pre-1954 Code years was required to make adjustments for "omissions and duplications." 72 Stat. 1066.

219. Precisely, in the 1939 regulations, a person "whose gross income . . . arises solely from the business of growing and selling products of the soil." Treas. Reg. 118, § 39.54-1 (1953). The new regulations under the 1954 Code specify only "the business of farming." Treas. Reg. § 1.6001-1(b) (1959).

220. Int. Rev. Code of 1954, § 6001; Int. Rev. Code of 1939, ch. 1, § 54, 53 Stat. 28. The mechanical process of keeping accounts is not prescribed by statute. Such accounts may be recorded in an elaborate set of books, in mere memoranda, or only in the brain of the taxpayer. Charles A. Collin, 1 B.T.A. 305, 308 (1925); cf. *Klempner v. Glenn*, 82 F. Supp. 626 (W.D. Ky. 1949). "He has got to look in the books. He cannot make it from his head, counsel; he cannot make an income tax return from his head. He has got to make it from the books." *Yorkville Live Poultry Co.*, 18 B.T.A. 47, 48 (1929).

221. *Schwarz v. United States*, 138 F. Supp. 841, 843 (E.D. Wis. 1956). A taxpayer who is unable to establish proof of his deductions may be entitled to some approximation thereof, although such approximation may bear heavily upon the taxpayer, "whose inexactitude is of his own making." *Cohan v. Commissioner*, 39 F.2d 540, 543-44 (2d Cir. 1930); cf. *Nellis v. Commissioner*, 232 F.2d 890 (6th Cir. 1956); *G. Herberger*, 19 P-H Tax Ct. Mem. 516 (1950), aff'd on other grounds, 195 F.2d 293 (9th Cir. 1952); *H. L. Scales*, 10 B.T.A. 1024 (1928).

sioner, upon examination, to verify taxable income.²²² Neither the Commissioner nor the courts, however, have shown evidence of any disposition to accept the "self-serving declarations in the taxpayer's accounts"²²³ as conclusive evidence of his income.²²⁴ The reinforcing requirements of regulatory agencies and of certified public accountants seemingly add little to the stature of "mere" accounting.²²⁵

The courts have zealously guarded their own power and that of the Commissioner to determine taxable income without regard to accounting rules prescribed by other and sometimes more venerable federal and state regulatory bodies.²²⁶ If there is no conflict between the requirements of the second agency and those of the Commissioner, they graciously admit that the taxpayer's adherence to those of the former lends an element of consistency and soundness to its accounting practices.²²⁷ But in the event of varying criteria, the Supreme Court's decision in *Old Colony R.R. v. Commissioner*²²⁸ left no doubt that taxable income was not to be determined by alien artists:

The rules of accounting enforced upon a carrier by the Interstate Commerce Commission are not binding upon the Commissioner, nor may he resort to the rules of that body, made for other purposes, for the determination of tax liability under the revenue acts.²²⁹

222. The revenue acts having accepted the fundamental proposition that the basis for income returns should, so far as possible, be that upon which the books are kept. Magill, *Taxable Income* 176 (1936 ed.).

223. *Holland v. United States*, 348 U.S. 121 (1954).

224. But see *Osterloh v. Lucas*, 37 F.2d 277 (9th Cir. 1930). Always to accept for tax purposes the accounts as shown by the books would violate not only the tax objective of uniformity, but also the objective of preventing tax avoidance. Blough, *Federal Income Tax Reporting*, in *Corporate Financial Statements* 117, 120 (Kester ed. 1940).

225. See *Proximity Mfg. Co.*, 22 B.T.A. 1153, 1158 (1931); *Bruce & Human Drug Co.*, 1 B.T.A. 342 (1925); *American Inst. Accountants*, 1943-1944 Yearbook 132, 134 (1944); cf. *Robert Gage Coal Co.*, 2 T.C. 488 (1943); *Treas. Reg. 130*, § 448-2(e) (2) (1953) (excess profits tax).

226. In 1906 the Interstate Commerce Commission was given the power not only to prescribe uniform financial statements, but also to specify the exact accounts to be kept by the regulated carriers. 34 Stat. 584. See Stewart, *Accounting and Regulatory Bodies in the United States*, 50th Anniversary Celebration 133, 139 (1937); Brundage, *Influence of Government Regulation on Today's Accounting Practices*, Selected Readings in Accounting 132 (Murphy ed. 1952). Accounting system prescribed by mere private entities would seem doomed to a similar fate. But see *Melvin E. Tunningley*, 22 T.C. 1108 (1954).

227. *Boston & M.R.R. v. Commissioner*, 206 F.2d 617, 623 (1st Cir. 1953); *Kauai Terminal, Ltd.*, 36 B.T.A. 893, 898 (1937); *Central R.R.N.J.*, 35 B.T.A. 501, 505 (1937).

228. 284 U.S. 552 (1932).

229. 284 U.S. at 562. *Accord*, *Gulf, M. & N.R.R. v. Commissioner*, 83 F.2d 788, 792 (5th Cir.), cert. denied, 299 U.S. 574 (1936); *New York Cent. R.R. v.*

The effect of this language generally has been to insulate the revenues against encroachment by the accounting regulations of any other administrative agency. The fact that the retirement method of accounting is required by the Interstate Commerce Commission, for example, does not mean that the railroad is required to use that method for federal income tax purposes.²³⁰ Interest charged on the taxpayer's own funds used in construction does not constitute taxable income.²³¹ If the taxpayer maintains its books on a cash basis, it must report interest income on that basis, although the regulations of the Comptroller of the Currency require its accrual.²³² The requirement of a state insurance commission that annual reports be filed showing income on a cash basis and deductions on an accrual basis does not make such a hybrid system permissible for reporting income for tax purposes.²³³ The mandatory write-offs of the costs of a title abstract plant pursuant to the requirements of the state insurance commission²³⁴ or the write-off of the excess of cost over "original use" cost pursuant to the orders of the Federal Power Commission are not binding upon the revenue authorities, although perhaps fully warranted by conservative accounting practice.²³⁵ Public utilities required by their regulatory bodies to defer unearned revenues may be never-

Commissioner, 79 F.2d 247, 252 (2d Cir. 1935); *Chesapeake & O. Ry. v. United States*, 5 F. Supp. 7, 10 (E.D. Va. 1933); *Grand Rapids & I. Ry. v. Doyle*, 245 Fed. 792, 796 (W.D. Mich. 1915); *Pennsylvania Elec. Co. v. United States*, 135 F. Supp. 416 (Ct. Cl. 1955); *Barretville Bank & Trust Co.*, 27 P-H Tax Ct. Mem. 640 (1958); see *Tank Truck Rentals, Inc.*, 26 T.C. 427 (1956); *Rev. Rul. 56-630*, 1956 Cum. Bull. 964. But see *Atlas Oil & Ref. Corp.*, 17 T.C. 733 (1951); *Chicago, R.I. & P. Ry.*, 13 B.T.A. 988, 1023 (1928), *aff'd*, 47 F.2d 990 (7th Cir.), *cert. denied*, 284 U.S. 618 (1931); *Great No. Ry.*, 8 B.T.A. 225, 265 (1927); *cf. Northwestern Improvement Co.*, 14 B.T.A. 79 (1928).

230. *St. Paul Union Depot Co. v. Commissioner*, 123 F.2d 235 (8th Cir. 1941). If it has consistently used the retirement method, however, it cannot use the retirement method for property acquired before 1913 and the depreciation method for property acquired subsequent to such date. *Central R.R.N.J.*, 35 B.T.A. 501 (1927); *cf. Chicago & N.W.R.R. v. Commissioner*, 114 F.2d 882 (7th Cir. 1940).

231. O.D. 1061, 5 Cum. Bull. 206 (1921); O.D. 246, 1 Cum. Bull. 212 (1919); see O.D. 811, 4 Cum. Bull. 276 (1921); *1 Moonitz & Staehling, Accounting Analysis* 334 (1950).

232. *First Nat'l Bank*, 4 B.T.A. 317 (1926). Bad debts charged off pursuant to the specific orders of the banking examiners are conclusively presumed, for income tax purposes, to have become worthless to the extent charged off. *Treas. Reg. § 1.166-2(d)* (1959); *Treas. Reg. 118, § 39.23(k)-1* (1953); *Pacific Nat'l Bank v. Commissioner*, 91 F.2d 103 (9th Cir. 1937); *cf. Citizens Nat'l Bank*, 33 B.T.A. 758, 761 (1935).

233. *Continental Life Ins. Co.*, 5 B.T.A. 407 (1926).

234. *Suffolk Title & Guar. Co.*, 2 P-H Tax Ct. Mem. 491 (1933).

235. *Gulf Power Co.*, 10 T.C. 852, 857 (1948).

theless required to include such fares in taxable income in the year of receipt.²³⁶

The rationale underlying the *Old Colony* rule is not always apparent. Euphemistically, it may be emphasized, as the Supreme Court did in that case, that the rules of other regulatory agencies are made for entirely different purposes under other acts of Congress.²³⁷ On the other hand, fear that the taxing authority's recognition of the regulations of another agency would not be reciprocated, that such agency would in effect control the assessment of taxes for entities under its jurisdiction, perhaps promulgating unduly favorable procedures,²³⁸ probably must account in part for the conclusion, however purposeful, that each in its own domain must discharge its duties as prescribed by the statutes.²³⁹ The only loser is, of course, the taxpayer, who must keep his accounts in one way for one governmental agency and in a different way for another; and apparently he may expect amelioration of the situation only by way of statute.²⁴⁰

If accounting's role in the federal tax structure has been somewhat uncertain, the function of that mechanical process of keeping accounts known as bookkeeping has been even more narrowly circumscribed. In spite of this catholic condemnation of the elementary art of "mere bookkeeping,"²⁴¹ unassuming journal entries sometimes produce deficiency or refund for the unwary taxpayer.

The law is clear that mere bookkeeping entries of the taxpayer, or

236. *Bremerton-Tacoma Stages, Inc. v. Squire*, 96 F. Supp. 718 (W.D. Wash. 1951); *National Airlines, Inc.*, 9 T.C. 159 (1947); *East Penn. Transp. Co.*, 16 P-H Tax Ct. Mem. 917 (1947). But see *Mutual Tel. Co. v. United States*, 204 F.2d 160 (9th Cir. 1953).

237. See also *Helvering v. Edison Bros. Stores*, 133 F.2d 575, 579 (8th Cir. 1943); *Atlantic Coast Line R.R.*, 31 B.T.A. 730, 737 (1934), *aff'd*, 81 F.2d 309 (4th Cir.), *cert. denied*, 298 U.S. 656 (1936).

238. *Winter Garden Prod. Credit Ass'n v. Phinney*, 139 F. Supp. 213, 216 (S.D. Tex. 1955). Favoritism is not altogether peculiar to agencies other than the Internal Revenue Service. See, e.g., the provisions for bad debt deductions of savings and loan associations, *Int. Rev. Code of 1954*, § 593.

239. *Kansas City So. Ry.*, 22 B.T.A. 949, 961 (1931), *rev'd*, 75 F.2d 786 (8th Cir. 1935). See also *Kansas City So. Ry. v. Commissioner*, 52 F.2d 372 (8th Cir., *cert. denied*, 284 U.S. 676 (1931), cited with approval in *Old Colony*).

240. *National Airlines, Inc.*, 9 T.C. 159, 162 (1947). Failure to keep books as required by the ICC may subject the taxpayer to criminal penalties. *Advance Truck Co.*, 29 T.C. 666, *aff'd*, 262 F.2d 388 (9th Cir. 1958). See generally 3 CCH 1959 Stand. Fed. Tax Rep. ¶ 2815.012.

241. *Commissioner v. Coastwise Transp. Co.*, 71 F.2d 104, 106 (1st Cir. 1934); *Robert P. Hyams Coal Co. v. United States*, 26 F.2d 805 (E.D. La. 1928); *Cook v. United States*, 77 Ct. Cl. 343, 3 F. Supp. 47 (1933). Accountants probably cannot blame the law for this nomer. See *Hatfield*, cited in 7 *Certified Public Accountant* 355 (1927).

those of a third party,²⁴² cannot preclude the Government from collecting its revenues.²⁴³ "To say that book entries control would permit tax statutes to be circumvented by skillful accountants."²⁴⁴ Bookkeeping entries in some circumstances are of evidential value, but they are not determinative of tax liability,²⁴⁵ being neither indispensable nor conclusive.²⁴⁶ Bookkeeping entries do not create income where none in fact exists;²⁴⁷ they do not enlarge the scope of the statutory deductions.²⁴⁸ The manner in which the accounts are kept will be disregarded for tax purposes if the manner of keeping the records distorts realities.²⁴⁹ The actual facts must control.²⁵⁰

242. *Southern Ry. v. Commissioner*, 74 F.2d 887 (4th Cir. 1935); *In re Trustees Sys. Co.*, 30 F. Supp. 361 (W.D. Ky. 1939); *Watson-Moore Co.*, 30 B.T.A. 1197 (1934); A.R.R. 6242, III-1 Cum. Bull. 20 (1924); cf. *Duffin v. Lucas*, 55 F.2d 786 (6th Cir. 1932). Amounts credited to an accrual basis taxpayer on the books of a third party may be taxable to him when credited. Compare *Commissioner v. Hansen*, 360 U.S. 446 (1959); *Shoemaker-Nash, Inc.*, 41 B.T.A. 417 (1940); *S. W. Harris*, 2 B.T.A. 933 (1925) with *Johnson v. Commissioner*, 233 F.2d 752 (4th Cir. 1956); *Kcasbey & Mattison Co. v. United States*, 141 F.2d 163 (3d Cir. 1944); *Farmers Grain Dealers Ass'n v. United States*, 116 F. Supp. 685 (S.D. Iowa 1953).

243. *Doyle v. Mitchell Bros.*, 247 U.S. 179 (1918); *Southern Pac. R.R. v. Muenter*, 260 Fed. 837 (9th Cir. 1919); *Haugh & Keenan Storage & Transfer Co. v. Heiner*, 20 F.2d 921 (W.D. Pa. 1927); *Corn Exch. Bank*, 6 B.T.A. 158, 162 (1927).

244. *Commissioner v. Goldwyn*, 175 F.2d 641, 644 (9th Cir. 1949).

245. *Helvering v. Midland Mut. Life Ins. Co.*, 300 U.S. 216, 223 (1937); cf. *Goodman, Inc.*, 23 T.C. 288, 301 (1954). "The evidentiary value of a bookkeeping entry is further weakened when it obviously is one that is strange to accepted bookkeeping practice." *C. H. Wentworth*, 25 T.C. 1210, 1213 (1956).

246. *Robert P. Hyams Coal Co. v. United States*, 26 F.2d 805 (E.D. La. 1928); *In re Sheinman*, 14 F.2d 323 (E.D. Pa. 1926); *Maney Milling Co.*, 14 B.T.A. 1001 (1929).

247. *Northwestern States Portland Cement Co. v. Huston*, 126 F.2d 196, 199 (8th Cir. 1942); *Sitterding v. Commissioner*, 80 F.2d 939 (4th Cir. 1936); *B. F. Goodrich Co.*, 1 T.C. 1098 (1943); *Alexander Sprunt & Son, Inc. v. Commissioner*, 24 B.T.A. 599, 621 (1931), *aff'd and rev'd on other grounds*, 64 F.2d 424 (4th Cir. 1933); *James W. Everhart*, 26 B.T.A. 318 (1932); *Luther Elkins*, 12 B.T.A. 1058 (1928); cf. *Willcuts v. Minnesota Tribune Co.*, 103 F.2d 947 (8th Cir. 1939); *Pittsburgh Milk Co.*, 26 T.C. 707 (1956).

248. *Harry N. Gifford*, 3 B.T.A. 334, 339 (1926).

249. *Adams Bros. Co. v. Commissioner*, 222 F.2d 501, 505 (8th Cir. 1955).

250. *Lashell's Estate v. Commissioner*, 208 F.2d 430, 434 (6th Cir. 1953); *Zimmerman Steel Co. v. Commissioner*, 130 F.2d 1011, 1012 (8th Cir. 1942); *Farmers Grain Dealers Ass'n v. United States*, 116 F. Supp. 685 (S.D. Iowa 1953); *Huning Mercantile Co.*, 1 B.T.A. 130, 132 (1924). But cf. *Sam E. Wilson, Jr.*, 20 T.C. 505, 509 (1953).

Erroneous accounting treatment does not preclude establishment of the true facts. *In re Wolslagel*, 104 F. Supp. 68 (N.D. Ohio 1952); *Robert J. Dial*, 24 T.C. 117, 126 (1955); *George S. Groves*, 38 B.T.A. 727, 736 (1938); *E. P. Greenwood*, 34 B.T.A. 1209 (1936); *Henry Myer Thread Mfg. Co.*, 2 B.T.A. 665 (1925). But cf. *Sammons v. Commissioner*, 177 F.2d 837 (7th Cir. 1949). If the error is

As a general rule, bookkeeping entries do not determine the year in which an item of income is properly taxable or a deduction properly allowable.²⁵¹ The soundness of the method of accounting employed is no sesame as to items in respect of which entries are made in disregard thereof.²⁵² The failure to accrue items of income and expense in the accounts of the taxpayer²⁵³ does not preclude their includability in or deductibility from taxable income.²⁵⁴ However, entries transferring to profit and loss or surplus accounts credit balances in deposit accounts,²⁵⁵ accrued liability accounts,²⁵⁶ and unclaimed wages ac-

corrected within the taxable year, the taxpayer is not bound by the original erroneous entry. *Huntington-Redondo Co.*, 36 B.T.A. 116 (1937); *George E. Mickel*, 5 B.T.A. 979 (1926).

251. *United States v. Huntington Labs., Inc.*, 82 F.2d 356 (7th Cir. 1936); *Commissioner v. North Jersey Title Ins. Co.*, 79 F.2d 492 (3d Cir. 1935); *Gould Paper Co. v. Commissioner*, 72 F.2d 698 (2d Cir. 1934); *Heinz v. Granger*, 147 F. Supp. 664 (W.D. Pa. 1956); *Evergreen Cemetery Ass'n*, 25 B.T.A. 544, 552 (1932); *Ohio Brass Co.*, 17 B.T.A. 1199, 1203 (1929); *A. J. Schwarzler Co.*, 3 B.T.A. 535, 538 (1926); cf. *Fort Wayne Eng'r & Mfg. Co.*, 2 B.T.A. 1223 (1925).

The deduction for partially worthless bad debts is a statutory exception to this rule, the law permitting their deduction only to the extent charged off during the year. Int. Rev. Code of 1954, § 166(a). Prior to the Revenue Act of 1942, the charge-off requirement was applicable to both partially worthless and wholly worthless bad debts. A taxpayer having no books was required only to claim the amount as a deduction on his tax returns. See *Cammack v. United States*, 113 F.2d 547 (8th Cir. 1940); *Harder v. Helvering*, 106 F.2d 153 (D.C. Cir.), cert. denied, 308 U.S. 617 (1939).

See the function of the taxpayer's method of accounting, note 132 *supra* and text supported thereby.

252. *Boston & M.R.R.*, 16 T.C. 1517, 1552 (1951).

253. Or their entry in the books of the wrong taxpayer. *Norwich Woolen Mills Corp.*, 18 B.T.A. 303, 306 (1929).

254. Income: *Commissioner v. Goldberger's Estate*, 213 F.2d 78 (3d Cir. 1954); *Commissioner v. Union Pac. R.R.*, 86 F.2d 637 (2d Cir. 1936); *Permanent Home Lands Co.*, 27 B.T.A. 142 (1932); *G. M. Standifer Constr. Corp.*, 30 B.T.A. 184 (1934); cf. *M & E Corp.*, 7 T.C. 1276 (1946).

Deductions: *Black Motor Co. v. Commissioner*, 41 B.T.A. 300 (1940), aff'd, 125 F.2d 977 (6th Cir. 1942); *Wolf Mfg. Co.*, 10 B.T.A. 1161 (1928); *Savinar Co.*, 9 B.T.A. 465 (1927); *Canton Art Metal Co.*, 6 B.T.A. 446 (1927). Bookkeeping entries do not constitute payment so as to entitle a cash basis taxpayer to a deduction in the year the entry is made. *Nehring v. Commissioner*, 131 F.2d 790 (7th Cir. 1942); *J. & J. W. Williams, Inc.*, 9 P-H Tax Ct. Mem. 191 (1940).

255. *Wichita Coca-Cola Bottling Co. v. United States*, 152 F.2d 6 (5th Cir. 1945), cert. denied, 327 U.S. 806 (1946); *Boston Consol. Gas Co. v. Commissioner*, 128 F.2d 473 (1st Cir. 1942). But see *Northwestern States Portland Cement Co. v. Huston*, 126 F.2d 196 (8th Cir. 1942).

256. *Amsco-Wire Prods. Corp.*, 44 B.T.A. 717 (1941); *Howard Paper Co.*, 43 B.T.A. 545 (1941); *Beacon Auto Stores, Inc.*, 42 B.T.A. 703 (1940). But see *Troy Mfg. Co.*, 7 B.T.A. 119 (1927).

counts²⁵⁷ are generally deemed to result in income in the year transferred, ostensibly because they "free assets to the unfettered use of the taxpayer."²⁵⁸

Bookkeeping entries adjusting controlling account balances in accounts receivable and accounts payable to agree with the details of subsidiary records constitute taxable income or allowable deductions only if the adjustments are shown to pertain to the taxable year in question.²⁵⁹ Journal entries representing adjustments for income improperly accrued in prior years do not give rise to allowable deductions in the year made.²⁶⁰ In requiring that the adjustments relate to the taxable year, the taxing authorities, perhaps unwittingly, have thus evidenced a preference for the net operating concept, as distinguished from the "clean surplus" theory of prior years' adjustments.²⁶¹

It is difficult to surmise whether the long-standing judicial reluctance to accept the taxpayer's accounts as the best evidence of his

257. *Charleston & W.C. Ry. v. Commissioner*, 50 F.2d 342 (D.C. Cir. 1931); *Providence Coal Mining Co. v. Glenn*, 88 F. Supp. 975 (W.D. Ky. 1950); *Atlantic Coast Line R.R.*, 23 B.T.A. 888 (1931).

258. *Lime Cola Co.*, 22 T.C. 593, 602 (1954); accord, *Roxy Custom Clothes Corp. v. United States*, 171 F. Supp. 851 (Ct. Cl. 1959); *Texas Gas Distrib. Co.*, 3 T.C. 57 (1944); cf. *United States v. White Dental Mfg. Co.*, 274 U.S. 398 (1927); *Michigan Cent. R.R.*, 28 B.T.A. 437, 460 (1933). But see *S. Rossin & Sons, Inc. v. Commissioner*, 113 F.2d 652 (2d Cir. 1940); *North Am. Coal Corp. v. Commissioner*, 97 F.2d 325 (6th Cir. 1938) (write-off of accounts payable); *Palm Beach Mather Co.*, 24 B.T.A. 536 (1931) (write-off of bad debt reserve balances); *New York, C. & St. L.R.R.*, 23 B.T.A. 177 (1931) (transfer from suspense to profit and loss); and *Summit Coal Co.*, 18 B.T.A. 983 (1930) (transfer from unearned income to profit and loss), all of which hold in effect that amounts become income in the year in which the reason for the liability account ceases to exist, not in the year in which the taxpayer chooses to transfer the balance to income.

259. *Milligan & Sons, Inc. v. United States*, 48 Am. Fed. Tax R. 1265 (N.D. Iowa 1954); *Pittsburgh Industrial Eng'r Co.*, 19 P-H Tax Ct. Mem. 1038 (1950); *Hart Furniture Co.*, 12 T.C. 1103 (1949), rev'd on other grounds, 138 F.2d 968 (5th Cir. 1950); *Albert Nelson*, 6 T.C. 764 (1946); *Wilson Furniture Co.*, 10 B.T.A. 1294 (1928); *Cooper-Brannan Naval Stores Co.*, 9 B.T.A. 105 (1927); cf. *Renier Music House, Inc.*, 15 B.T.A. 241 (1929). Similarly, as to adjustments to the bank account. *Reinschmidt v. Commissioner*, 28 F.2d 660 (5th Cir. 1928).

260. *Sunburst Oil & Ref. Co.*, 23 B.T.A. 829 (1931); cf. *Joyce-Koebel Co.*, 6 B.T.A. 403 (1927).

261. See *Finney & Miller, Principles of Accounting* 111 (4th ed. 1951). In *Evens & Howard Fire Brick Co.*, 8 B.T.A. 867 (1927), the Board permitted the deduction of a debit balance in an account called "current surplus," in which the taxpayer recorded all prior year adjustments, the taxpayer having followed the practice of reporting any credit balances as income. The practice was deemed to be permissible under *Treas. Reg. 62, art. 111* (1922), which sanctioned "certain overlapping in income and deductions, so long as they do not materially distort income." See *Kansas City So. Ry. v. Commissioner*, 75 F.2d 786 (8th Cir. 1935).

income stems from an inherent distrust of the taxpayer, suspicion of his accountant, a lack of knowledge of accounting, a knowledge of same, or simply a desire to retain within the realm of legal mysticism, and hence within the control of the judiciary, the infinite details of the administration of the federal income tax law. Whatever the reason, the result is the same—an ever-increasing volume of dollar litigation in forums whose time and efforts might better be devoted to more pressing problems of policy.

III. CASH AND ACCRUAL METHODS

Accounting measurements of income on a cash basis generally have followed closely the view that such determinations should reflect only cash input and outflow, without modifications.²⁶² In the federal income tax law the cash method for the assignment of income to a particular taxable year invariably has been less sharply defined; the cash corporeality has been assuaged in some degree by such modifications as the tax enforcing authorities have deemed appropriate to safeguard the revenues, or in some instances, merely have deemed appropriate.

Accounting concepts of the accrual basis of accounting have developed largely in conjunction with the rising prominence of the income statement and the resulting emphasis upon the matching of costs and revenues.²⁶³ Accounting's solutions to the problems of year-end adjustments designed to sharpen the periodic determinations of revenue largely have accompanied rather than preceded the development of the accrual method of accounting for federal income tax purposes. Faced with the necessity of an immediate answer to its questions and unable to await the leisurely mold of accepted accounting practice, the tax law has often promulgated its own criteria in its own inimitable fashion. The resulting divergencies have created stress and strain between the legal and accounting professions,²⁶⁴ have fostered well-

262. Cf. Finney & Miller, *Principles of Accounting* ch. 23, *Statements of Application of Funds* (4th ed. 1951).

263. See *Matching Costs and Revenues*, *supra* p. 9.

264. Lasser & Peloubet, *Tax Accounting v. Commercial Accounting*, 4 *Tax L. Rev.* 343 (1949); May, *Accounting and the Accountant in the Administration of Income Taxation*, 47 *Colum. L. Rev.* 377 (1947); Gutkin & Beck, *Tax Accounting v. Business Accounting: The Emasculation of Section 41*, 79 *J. Accountancy* 130 (1945). For a time, at least, this popular diversion lost its first place rating to the topic of the unwarranted invasion of the accountant's federal income tax practice by the bar committees on unauthorized practice, a subject ostensibly dearer to heart and purse. See, e.g., Carey, *CPA's in Treasury Practice*, 5 *J. Taxation* 42 (1956); Jameson, *Co-operation Between the Legal and Accounting Professions*, 102 *J. Accountancy* 42 (Nov. 1956); Editorial, *The Agran Case in Perspective*, 102 *J. Accountancy* 29 (Dec. 1956).

meaning if ill-fated legislative reform,²⁶⁵ and generally have overshadowed the substantial similarities between the two.

Cash Bases of Accounting

On its surface, at least, the cash basis of accounting boasts a great deal of seductive simplicity. Reduced to its simplest form,²⁶⁶ the cash method consists merely of determining the amount of cash received and the amount disbursed.²⁶⁷ Income is not recognized until it has been received in cash, and expenses are ignored until paid in cash.²⁶⁸ Cash receipts less disbursements constitute the profit, disbursements less receipts the loss.²⁶⁹ Unfortunately, much of this crystalline clarity has been dissipated by accountants careless of pen, lawyers chary of accounting, and commissioners careful of revenue.

The nomadic nomenclature suggests that there are at least two cash bases²⁷⁰ of accounting: the "pure" or "cash" cash basis, and the "impure" or "accrual" cash basis. The former sets its terms and limitations by the transactions of the bank account. Income, from whatever source derived, is taken into account only when received in cash. Purchases are regarded as costs chargeable against income in the period in which made; no consideration is given to inventories. Performance of services is not deemed to give rise to income until such services are collected for in cash; cash collections for services to be performed

265. Sections 452 and 462 of the 1954 Code, as it was originally enacted, were "designed to bring the income tax provisions of the law into harmony with generally accepted accounting principles." H.R. Rep. No. 1337, 83d Cong., 2d Sess. 48 (1954). Section 452 contained somewhat elaborate provisions permitting the deferral to a subsequent year of a portion of certain types of prepaid income received during the taxable year "until earned in the manner required by the taxpayer's method of accounting." Section 462 provided simply that a taxpayer other than one on the cash basis could elect to deduct a reasonable addition to reserves for estimated expenses.

The reformation was short-lived, apparently because the Secretary of the Treasury had failed to estimate accurately the potential loss of revenues arising primarily from the enthusiastic adoption by the taxpayers and their accountants, or at least their "tax advisers," of the reserves for estimated expenses. In any event the sections were retroactively repealed June 15, 1955. 69 Stat. 134. See Cohen, *The Impact of the New Revenue Code upon Accounting*, 31 *Accounting Rev.* 206 (1956); Seidman, *Taxes: Friend or Foe?*, 100 *J. Accountancy* 51 (Nov. 1955); Bierman & Helstein, *Accounting for Prepaid Income and Estimated Expenses under the Internal Revenue Code of 1954*, 10 *Tax L. Rev.* 83 (1954).

266. As perhaps there it should be.

267. Ferst, *Basic Accounting for Lawyers* 15 (1950).

268. MacFarland & Ayers, *Accounting Fundamentals* 37 (2d ed. 1947).

269. A statement of cash receipts and disbursements is in fact a mere formal rearrangement of the information contained in the cash book. Gilman 253.

270. Or perhaps one method and one basis, or one method which includes two bases. See *supra* note 131.

in the future are regarded as income when received although nothing has been done to earn them. Bad debt expense does not appear upon the income statement because no income is taken into account until the receivable is collected. Depreciation expense likewise is absent because the entire cost of the fixed asset is regarded as an expense of the period in which it is purchased.²⁷¹ This is income on a pure or cash cash basis, despite its lack of correlation with the customary accounting concepts of the profits of the business enterprise.²⁷²

The impure or accrual cash basis was not so much an accounting theory as a label, carelessly cast by accountants in their zeal to convince themselves and others of the inherent superiority of the "new" accrual method over one which accounted only for inventories, receivables, and payables.²⁷³ Its sole function has been to interpose somewhere among the "pure" cash basis, the cash method of the federal income tax law, the accrual basis of accounting, and the legal concept of the accrual method. It has contributed little except confusion to a category already abundantly supplied.²⁷⁴

"The" Cash Method

The cash method of accounting in the federal income tax law was conceived in the early confusion surrounding the conflicting law and regulations under the Revenue Acts of 1909 and 1913,²⁷⁵ nurtured by the conflict in accounting circles attendant to "cash bases of accounting,"²⁷⁶ and modulated by legislative, administrative, and judicial governors attuned to the country's needs for revenue. That it has

271. Finney & Miller, *Principles of Accounting* 19 (4th ed. 1951). See also Karrenbrock & Simons, *Intermediate Accounting* 99-100 (2d ed. 1953); Saliors & Holmes, *Basic Accounting Principles* 60-61 (1937).

272. This assumption that each period is complete within itself and that no inventory of receivables for services rendered and no inventory of services remains is "the precise antithesis of the requirement inherent in the circumstances under which a going concern endeavors to keep going indefinitely." 1 Moonitz & Staehling, *Accounting Analysis* 114 (1950).

The excess of cash receipts over cash disbursements will equal net profit if:

1. All goods bought during the period are sold, or the beginning inventory is equal in amount to the ending inventory;
2. The benefits of all expenditures accrue to the period in which made;
3. All income received is earned;
4. All sales are collected;
5. All purchases are paid for;
6. Capital assets have not been used or purchases equal depreciation.

Kohler & Morrison, *Principles of Accounting* 166 (1926).

273. *Accrual Bases of Accounting*, *infra* p. 49.

274. A condemnation which, it is hoped, the present endeavor may escape.

275. See *supra* note 97.

276. See *Cash Bases of Accounting*, *supra* p. 45.

survived in all its present strength may probably be better attributed to its stamina and inherent utility than to the care of its cultivators.

Applied to certain taxpayers, notably individuals, the cash method of accounting for taxable income possesses at least some of the pristine simplicity of the pure cash basis of accounting. But there are at once complications. Since the taxpayer's method of accounting does not determine what is income and what are allowable deductions,²⁷⁷ the charges and credits on his bank statement perforce lose their power to prescribe taxable income. Hence, the cash method of accounting does not mean that all cash receipts represent taxable income²⁷⁸ and all disbursements represent statutory deductions.²⁷⁹ It means that all items of taxable income received during the year in cash are properly includible in income;²⁸⁰ amounts paid during the year in cash for deductible expenses are properly deducted in arriving at taxable income. This is the essence of the cash "system" of accounting,²⁸¹ one which the law recognizes as furnishing the "prima facie correct test" for computing income.²⁸²

Limitations on the cash method of accounting, other than those imposed by the statute, have stemmed largely from the understandable requirement of the Commissioner and the courts that the method of accounting used by the taxpayer does not give him the power to extend the scope of the statutory deductions.²⁸³ Two of the three requirements early²⁸⁴ imposed by the regulations on all methods of accounting insulate the revenues against the wiles of the cash-basis taxpayer: expenditures made during the year for items of plant and equipment having a useful life extending beyond one year must be charged to a capital account and not deducted in their entirety in the year of pur-

277. See *supra* notes 134, 135.

278. Life insurance proceeds paid by reason of the death of the insured, certain other death benefits, cash received by way of gift or inheritance, interest on governmental obligations of states or territories, and amounts received as scholarships, are, *inter alia*, cash receipts which do not represent taxable income. See Int. Rev. Code of 1954, §§ 101, 102, 103, 117.

279. Expenditures for personal living expenses, life insurance premiums, capital expenditures, and expenses relating to tax-exempt income are not deductible. Int. Rev. Code of 1954, §§ 262-265.

280. Int. Rev. Code of 1926, ch. 27, § 212(d), 44 Stat. 23. Items received in property and those constructively received are also required to be included. See Treas. Reg. §§ 1.446-1(a)(3) (1957); 1.451-1(a) (1957); Treas. Reg. 118, §§ 39.41-1, 39.42-2, -3 (1953).

281. *Eckert v. Commissioner*, 42 F.2d 158, 159 (2d Cir. 1930), *aff'd*, 283 U.S. 140 (1931); see *In re Newman*, 94 F.2d 108, 110 (6th Cir. 1938).

282. *Morris-Poston Coal Co. v. Commissioner*, 42 F.2d 620, 621 (6th Cir. 1930).

283. Extension of the scope of taxable income these parties have left primarily to Congress.

284. See Treas. Reg. 45, art. 24 (1919); Reg. 33, rev. art. 91, 92 (1918).

chase;²⁸⁵ in all instances in which the production, purchase, or sale of merchandise is an income-producing factor, beginning and ending inventories of merchandise on hand must be used in the computation of net income for the year.²⁸⁶

While the necessity of these specifications may not be in doubt,²⁸⁷ their theoretical consistency may be. Since they apply to both cash and accrual basis taxpayer alike, they yield the somewhat incongruous result that a taxpayer on the cash basis may be required to use both inventories²⁸⁸ and depreciation,²⁸⁹ concepts which have been termed the essence of the accrual method.²⁹⁰ The regulations thus serve to blur in some degree the distinction between the cash and the accrual basis, from either the accounting or the legal viewpoint.²⁹¹ They do make one thing abundantly clear, however; the taxpayer does not have an option to report on the "pure" cash basis of accounting.²⁹²

285. See *Julia Stow Lovejoy*, 18 B.T.A. 1179 (1930); *Marjorie Post Hutton*, 12 B.T.A. 265 (1928), *aff'd*, 39 F.2d 459 (5th Cir. 1930); *Washington Land Co.*, 10 B.T.A. 503 (1928). Cf. Int. Rev. Code of 1954, § 263(a)(1); Int. Rev. Code of 1939, ch. 1, § 24(a)(2), 53 Stat. 16; Revenue Act of 1918, ch. 18, § 215 (b), 40 Stat. 1069.

This specific disallowance of capital expenditures for "plant and equipment" has lured the Commissioner into some strange classifications. See *Waldheim Realty & Inv. Co.*, 25 T.C. 1216 (1956), *rev'd*, 245 F.2d 823 (8th Cir. 1957) (prepaid insurance); cf. *Robert S. Bassett*, 26 T.C. 619 (1956) (prepaid medical expenses); Rev. Rul. 58-53, 1958-1 Cum. Bull. 152 (prepaid trustee fees).

286. See *American Can Co. v. Bowers*, 35 F.2d 832, 836 (2d Cir. 1929); *J. P. Bass Publishing Co.*, 12 B.T.A. 728 (1928); *Newlove, Smith & White, Intermediate Accounting* 138 (1939); cf. Int. Rev. Code of 1954, § 471; Int. Rev. Code of 1939, ch. 1, § 22(c), 53 Stat. 11; Revenue Act of 1918, ch. 18, § 203, 40 Stat. 1060. See *supra* note 152.

The third requirement specifies that if the cost of assets is being recovered through depreciation, any expenditure made to restore the property or prolong its useful life must be charged to the depreciation reserve account or to a capital account. Cf. Int. Rev. Code of 1954, § 263(a)(2); Int. Rev. Code of 1939, ch. 1, § 24(a)(3), 53 Stat. 16; Revenue Act of 1918, ch. 18, § 215 (e), 40 Stat. 1069.

287. But see *Glenn v. Kentucky Color & Chem. Co.*, 186 F.2d 975 (6th Cir. 1951).

288. Treas. Reg. § 1.446-1(b)(2)(i) (1957): cf. Treas. Reg. 118, § 39.41-2 (1953); Treas. Reg. 45, art. 23(1) (1919). Under the 1954 Code the taxpayer may use the accrual method for purchases and sales and report other items on a cash basis, thus adopting the "impure" cash basis: Treas. Reg. § 1.446-1(c)(1)(iv) (1957); H.R. Rep. No. 1337, 83d Cong., 2d Sess. 835 (1954); see *Omah MacDonald*, 18 P-H Tax Ct. Mem. 179 (1949); *Bob H. McGinnis*, 4 B.T.A. 209 (1926); *Dohr, The Board of Tax Appeals and Net Income*, 41 J. Accountancy 427-430 (1926).

289. Int. Rev. Code of 1954, § 167(a).

290. See *Diamond A Cattle Co. v. Commissioner*, 233 F.2d 739, 741 (10th Cir. 1956); *Saliers, Depreciation Accounting Principles and Application* 252 (1939); *Accountants' Handbook* 1082 (Paton ed. 1934).

291. *Kohler, Accounting Principles* 34 (1924).

292. *D. E. Alexander*, 22 T.C. 234, 241 (1954).

Accrual Bases of Accounting

As a process of the accrual of income from sales through the recognition of accounts receivable arising at the time of the sales and the accrual of liabilities by the entering of accounts payable at the time the expenditures are incurred, the accrual basis of accounting was generally accepted in the United States prior to 1900.²⁹³ Recognition of deferred items of income and expense as a process of year-end adjustment and promulgation of definite standards for the accruals of income and expenditures were so long delayed, however, that these phases of accrual accounting have furnished little, if any, assistance to the Commissioner, the Board of Tax Appeals, and the judiciary in the determination of taxable income.

Even as accountants were raising their vehement protests over the cash basis provisions of the 1909 Revenue Act,²⁹⁴ they were themselves debating the relative merits of the accrual cash basis²⁹⁵ and the "pure" or complete accrual basis. The former gave recognition to accounts receivable, accounts payable, and inventories. To these the latter added a series of accounting adjustments designed to sharpen yearly determinations of income. Journal entries were to be made for items of accrued income which were earned in advance of being received; for items of unearned income received in advance of being earned; for prepaid expenses, paid but not incurred; and accrued expenses incurred but not paid.²⁹⁶

While accounting texts began to discuss these various items of deferred assets and liabilities about 1910,²⁹⁷ their universal acceptance was slow in coming. Determinations of the various accruals frequently involved an appreciable amount of individual judgment, and constructive criteria were sorely lacking. Some accountants feared that the complete accrual method "opened the door for errors of judgment and for deliberate misrepresentations, defended by plausible arguments."²⁹⁸ Although the exact date of conversion is elusive,²⁹⁹ it

293. See Littleton, *Accounting Evolution* 150 (1933).

294. See *supra* note 97.

295. See *supra* note 271. This has been termed the "partial accrual" basis. Fitzgerald & Schumer, *Classification in Accounting* 24 (1952).

296. Kester, *Principles of Accounting* 517-19 (4th ed. 1939).

297. See Greendlinger, *Accounting Theory and Practice* 6 (1910); Rowe, *Bookkeeping and Accounting* 133-35 (1910); MacFarland & Rossheim, *Bookkeeping and Accounting* 142 (1913).

298. Finney, *General Accounting* 350 (1941); cf. Finney & Miller, *Principles of Accounting* 20 (1951).

299. The Accountants' Handbook 1513 (Saliers ed. 1923), and Bliss, *Management Through Accounts* 117 (1924) gave recognition to the processes of allocating income and costs to accounting periods by means of year-end adjustments. Hewett, *The Definition of Income* 81-82 (1925) rejects the accrual basis of accounting for

appears probable that this "primary factor in converting fifteenth-century record keeping" into the "quasistatistical technology" of accounting³⁰⁰ assumed the rigidity of accounting principle as a part of the shift in emphasis to the income statement and the matching of costs and revenues.³⁰¹

To the completed product, income recorded when earned and expenditures when incurred, plus the year-end adjustments necessary to match properly costs against revenues, accounting has in recent years applied the label of the accrual basis of accounting.³⁰² The accrual basis requires that income be taken up in the period in which it is earned by sales or services, regardless of when collected. Expenses are charged to income in the period in which they are incurred, regardless of when paid.³⁰³ Bad debts, depreciation, amortization, accrued income, accrued expenses, income collected in advance, and expenses paid in advance are properly allocated by adjusting journal entries.³⁰⁴ The central purpose of the method is thus to bring into contrast the inflowing services acquired and used, as measured by expenses and costs, and the corresponding outflowing services rendered, as measured by income and earnings.³⁰⁵ It effects a non-cash allocation of income to the period responsible for the receipts, and a similar allocation of expenditures to the period which receives the benefit of the disbursement.³⁰⁶

income taxation as impracticable because of "the relatively unsatisfactory nature of accounting practice in its present stage of development." The writings of the thirties indicate its further development. The statement in Scott, *The Cultural Significance of Accounts* 246 (1931), that the substitution of the accrual basis for the cash basis in the determination of income "is a change which definitely has taken place in accounting theory" is probably somewhat premature. See Husband & Thomas, *Principles of Accounting* ch. IX, *Adjusting the Accounts* (1935); Scovill & Moyer, *Fundamentals of Accounting* 352-53 (1940).

300. Littleton, *Extensions of Accrual Principles Would Help Depreciation Accounting*, 86 *J. Accountancy* 21 (1948).

301. Ascher, *Survey of Accounting* 462 (1952).

302. Kester, *Advanced Accounting* 10 (4th ed. 1946); Finney, *supra* note 298, at 349; Prickett & Mikesell, *Principles of Accounting* 140-41 (rev. ed. 1937).

303. Finney & Miller, *supra* note 298, at 19.

304. *Id.* at 20; see Ascher, *Survey of Accounting* 86-87 (1952). Kester, *supra* note 302, at 80, defines the accrual method in well-nigh judicial fashion: "the method of showing all earnings in the period in which they actually accrue is the 'accrual method'."

305. Littleton, *Contrasting Theories of Profit*, 11 *Accounting Rev.* 10 (1936). See also Holmes & Meier, *Elementary Accounting* 56 (1949); Fitzgerald & Schumer, *supra* note 295, at 28.

306. Husband, *That Thing Which the Accountant Calls Income*, 21 *Accounting Rev.* 247 (1946); Copeland, *Suitable Accounting Conventions to Determine Business Income*, 87 *J. Accountancy* 107, 111 (1949). The accrual basis has been termed "a periodically corrected cash basis procedure." I Moonitz & Staehling, *Accounting Analysis* 203 (1950).

Accrual Methods

Unlike the cash receipts and disbursements method, the accrual method of accounting enjoyed no express statutory recognition prior to 1954.³⁰⁷ Nor was such method defined by the regulations.³⁰⁸ Left to the vagaries of judicial definition, the "accrual method of accounting" has been somewhat neglected. While not at all hesitant to promulgate a formidable array of decisions determining when particular items of income and deduction accrue, the courts have not been overly ambitious in setting forth definitive concepts of the accrual method as such.

Early explanations of the term were the by-product of the confusing bit of tax administration embodied in the early revenue acts. Since the 1916 Act permitted a taxpayer keeping his accounts "upon any basis other than that of actual receipts and disbursements" to make his returns upon the basis upon which his accounts were kept,³⁰⁹ the label "accrual method" has sometimes been applied to any method other than the cash receipts method.³¹⁰ The language in *United States v. Anderson* that the purpose of the 1916 provisions was "to enable taxpayers to keep their books and make their returns according to scientific accounting principles, by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period"³¹¹ has from time to time inspired judicial declarations that the accrual method of accounting is synonymous with the accounting process of matching costs and revenues.³¹² Likewise, the regulations promulgated under the early acts permitting the treatment of accounts receivable as cash received and accounts payable as cash disbursed have given rise to a definition of the accrual system in terms of a contrary-to-fact approach. If the receipts be deemed to be received when accrued and disbursements considered disbursed when incurred, then the system was on the accrual basis.³¹³ Still another definition

307. Ernest M. Bull, 7 B.T.A. 993, 994 (1927); see Int. Rev. Code of 1954, § 446(c).

308. Treas. Reg. 45, art. 23 (1919); Treas. Reg. 118, §§ 39.41-2, -3 (1953).

309. Revenue Act of 1916, ch. 463, §§ 8(g), 13(d), 39 Stat. 763, 771.

310. American Institute of Accountants Committee on Terminology, *Accounting Terminology* 6 (1931). Presumably in this sense the term would also include the long-term contract method, the crop method, and the several other special methods authorized by law, as well as perhaps the installment method.

311. 269 U.S. 422, 440 (1926).

312. *Citizens Hotel Co. v. Commissioner*, 127 F.2d 229, 230 (5th Cir. 1942); *Lichtenberger-Ferguson Co. v. Welch*, 54 F.2d 570, 572 (9th Cir. 1931); *Galatoire Bros. v. Lines*, 23 F.2d 676 (5th Cir. 1928); *American Express Co.*, 2 B.T.A. 498, 504 (1925).

313. *United States v. American Can Co.*, 280 U.S. 412, 417 (1930); *H. Liebes & Co. v. Commissioner*, 90 F.2d 932, 936 (9th Cir. 1937); *American Can Co. v.*

has been posed in terms of the admissibility of the entries to the books of account. If entries are made of credits and debits as the income or liability arises, whether then received or disbursed, then the books may be said to be kept on an accrual basis.³¹⁴

Judicial insistence that the Revenue Act of 1918 authorized *two* methods of accounting, *the* cash and *the* accrual method,³¹⁵ nevertheless did not promptly produce a definition of "accrual method," as distinguished from a wild flurry of delineations of the word "accrue."³¹⁶ After displaying a notable reluctance in earlier cases to assist in the compilation of the lexicon,³¹⁷ the Supreme Court at length ventured two tentative premises in its 1934 decisions in *Brown v. Helvering*³¹⁸ and *Spring City Foundry Co. v. Commissioner*.³¹⁹ If the accounts are kept on an accrual basis, the court opined in the former, income is to be accounted for in the year in which it is realized, even if it is not then actually received, and deductions are to be taken in

Bowers, 35 F.2d 832, 834 (2d Cir. 1929); cf. *Eckert v. Commissioner*, 42 F.2d 158, 159 (2d Cir. 1930).

314. *Aluminum Castings Co. v. Routzahn*, 24 F.2d 230, 231 (N.D. Ohio 1927), aff'd, 282 U.S. 92 (1930); *Selwyn Eddy Co.*, 25 B.T.A. 1341, 1347 (1932); *H. H. Brown Co.*, 8 B.T.A. 112, 117 (1927); see *Flynn v. Commissioner*, 77 F.2d 180 (5th Cir. 1935). But cf. *Badgley v. Commissioner*, 59 F.2d 203 (2d Cir. 1932); *Atlantic & C. Airlines R.R.*, 36 B.T.A. 558 (1937).

315. See "The" Methods of Accounting, supra p. 16.

316. On this score the courts have been unrestrained. The etymology of "accrue" is discussed at length, inter alia, in *Hartsfield Co. v. Shoaf*, 184 Ga. 378, 191 S.E. 693, 695 (1937) and *H. Liebes & Co. v. Commissioner*, 90 F.2d 932 (9th Cir. 1937). See also American Institute of Accountants Committee on Terminology, *Accounting Terminology* 7 (1931).

Despite the extended endeavor, however, the product appears to have been unrewarding. While "accrue" and its various derivatives are not new to the nomenclature of accounting or taxation, its use has not sufficed to build it into a word of art when employed in describing items of gross income. *Helvering v. Enright*, 312 U.S. 636, 643 (1941). The word is fraught with confusion because it expresses no certain concept. It implies the exclusion of "received" or "paid" but short of this, what is meant when an item is accounted for as accrued depends upon the system of accounting in which it appears and the breadth of the accountant's concept. *Ernest M. Bull*, 7 B.T.A. 993, 995 (1927).

317. See, e.g., *Continental Tie & Lumber Co. v. United States*, 286 U.S. 290 (1932); *Eckert v. Burnet*, 283 U.S. 140 (1931); *Lucas v. Ox Fibre Brush Co.*, 281 U.S. 115 (1930); *Lucas v. Alexander*, 279 U.S. 573 (1929); *American Nat'l Co. v. United States*, 274 U.S. 99 (1927). The direction that net income be computed according to the method of accounting regularly employed by the taxpayer was, according to this body, "expressly limited to the cases where the Commissioner believes that the accounts clearly reflect the income." *Lucas v. American Code Co.*, 280 U.S. 445, 449 (1930). Cf. *United States v. American Can Co.*, 280 U.S. 412, 417 (1930).

318. 291 U.S. 193 (1934).

319. 292 U.S. 182 (1934).

the year incurred.³²⁰ Its language in *Spring City Foundry*, although perhaps less complete, has been much quoted:

Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the *right* to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrues.³²¹

In *Commissioner v. South Tex. Lumber Co.*³²² the court defined the accrual basis as one under which all the obligations of a company applicable to a year are listed as expenditures, whether paid that year or not, and all obligations to it incurred by others applicable to the year are set up as income on the same basis.³²³

Despite the sparsity of definitions of the accrual method, as such, the courts have spawned a host of legal touchstones for the determination of when particular items of income and deductions accrue. Of these it may be said generally,³²⁴ that income accrues when there arises a fixed or unconditional right to receive³²⁵ an ascertained or ascertainable amount,³²⁶ coupled with a reasonable expectation that such right will be converted into money or its equivalent.³²⁷ A liability accrues when all events have occurred during the year which

320. 291 U.S. at 199.

321. 292 U.S. at 184-85. See *United States v. Harmon*, 205 F.2d 919, 920 (10th Cir. 1953); *Ohmer Register Co. v. Commissioner*, 131 F.2d 682, 686 (6th Cir. 1942).

322. 333 U.S. 496 (1948).

323. *Id.* at 498. The right to receive a definite sum as distinguished from its receipt, and the fixed obligation to pay expenses as distinguished from actual payment, accrue items for income tax purposes if the taxpayer uses the accrual system of keeping its books of account. *United States v. Amalgamated Sugar Co.*, 72 F.2d 755, 759 (10th Cir. 1934); see *United States v. Utah-Idaho Sugar Co.*, 96 F.2d 756, 758 (10th Cir. 1938).

324. And probably only very generally.

325. See *Franklin County Distillery Co. v. Commissioner*, 125 F.2d 800, 804 (6th Cir. 1942); *Rev. Rul. 58-474*, 1958-2 Cum. Bull. 158.

326. See *Craig v. Thompson*, 177 F.2d 457, 460 (8th Cir. 1949); *H. Liebes & Co. v. Commissioner*, 90 F.2d 932, 937 (9th Cir. 1937); see *Midwest Motor Express, Inc. v. Commissioner*, 251 F.2d 405 (8th Cir.), cert. denied, 358 U.S. 875 (1958); *H. J. Heinz Co. v. Granger*, 147 F. Supp. 664 (W.D. Pa. 1956).

327. *Swastika Oil & Gas Co., v. Commissioner*, 123 F.2d 382, 384 (6th Cir. 1941); *H. Liebes & Co. v. Commissioner*, 90 F.2d 932, 938 (9th Cir. 1937); *Automobile Ins. Co. v. Commissioner*, 72 F.2d 265 (2d Cir. 1934). See *Edwards v. Commissioner*, 242 F.2d 142 (5th Cir. 1957); *Graham Mill & Elevator Co. v. Thomas*, 152 F.2d 564, 565 (5th Cir. 1945). Is knowledge of the facts giving rise to the accrual an essential ingredient? Compare *Camilla Cotton Oil Co. v. Commissioner*, 31 T.C. 560 (1958) with *Harrisburg Steel Corp. v. United States*, 142 F. Supp. 626 (M.D. Pa. 1956).

fix the amount³²⁸ and determine the existence of the liability.³²⁹ These criteria met, the income or expense must be accrued, whether or not such items are then payable.³³⁰

Determination of Method

Since the year in which an item is properly reportable as income or allowable as a deduction is by statute expressly dependent upon the method of accounting employed by the taxpayer, the initial task in determining temporal propriety is frequently the ascertainment of the method employed by the taxpayer in keeping his accounts and reporting his income.³³¹ The assignment is oftentimes difficult, not only because the distinction between the cash and accrual method is not always clearly drawn,³³² but also because few taxpayers use either method exclusively.³³³ The extent to which a taxpayer may depart from the method he customarily employs to afford varying treatment to individual items of income and deduction has been loosely, if at all, defined.³³⁴

The label applied by the taxpayer is not controlling. The law is well settled that statements on the return that it was prepared on the cash or the accrual basis are not controlling if the facts indicate

328. The amount of the liability need not be definitely ascertained. *Brown v. Helvering*, 291 U.S. 193, 200 (1934); *Dingle-Clark Co.*, 26 T.C. 782 (1956).

329. *Commissioner v. Blaine, Mackay, Lee Co.*, 141 F.2d 201, 203 (3d Cir. 1944); *Stern-Slegman-Prins Co. v. Commissioner*, 79 F.2d 289 (8th Cir. 1935); *Bauer Bros. v. Commissioner*, 46 F.2d 874, 875 (6th Cir. 1931). And assumed a reasonable expectancy of payment. *Helvering v. Russian Fin. & Constr. Corp.*, 77 F.2d 324, 327 (2d Cir. 1935). This cannot be the case where the liability is contested by the taxpayer. *Fifth Ave. Coach Lines, Inc.*, 31 T.C. 1080 (1959).

330. *Willoughby Camera Stores v. Commissioner*, 125 F.2d 607, 609 (2d Cir. 1942); *Cecil v. Commissioner*, 100 F.2d 896, 902 (4th Cir. 1939); *Alexander H. Kerr & Co. v. United States*, 97 F. Supp. 796, 799 (S.D. Cal. 1951). It does not follow that on an accrual method receipt or payment is never important. *C. H. Mead Coal Co.*, 31 B.T.A. 190, 192 (1934); see *Mark E. Schlude*, 32 T.C. No. 124 (Sept. 28, 1959); *Guantanamo & W.R.R.*, 31 T.C. 842 (1959).

331. Not infrequently the taxpayer's method of keeping his accounts may differ from his method of reporting income. See *Change of Accounting Method*, supra p. 30.

332. See *Bowers, Tests of Income Realization*, 16 *Accounting Rev.* 139, 154 (1941); *Kohler, Accounting as Affected by Federal Income Taxation*, 1 *Taxes* 5 (1923).

333. *Squire v. Denman*, 18 F. Supp. 287, 288 (N.D. Ohio 1936), *aff'd*, 111 F.2d 921 (6th Cir. 1940); *Schuman Carriage Co.*, 43 B.T.A. 880, 887 (1941).

334. Presumably under 1954 Code, he may now in some cases employ a hybrid basis. See supra note 154. A finding by the trial court that the accounts are kept on a particular basis is controlling upon appeal. *Jones v. Trapp*, 186 F.2d 951 (10th Cir. 1950).

otherwise.³³⁵ No presumption arises from the failure to state the method upon which the return was prepared.³³⁶ The method actually employed by the taxpayer to record the financial transactions of his principal business activity is conclusive,³³⁷ unless his intent is frustrated by an unskillful or incompetent bookkeeper.³³⁸

Both the cash and the accrual methods of accounting are customarily evidenced by the presence of certain account titles and certain techniques in recording financial transactions. Such indices rarely afford conclusive evidence, however. The presence in the accounts of inventories, accounts receivable, accounts payable, accrued income, and accrued expenses collectively constitutes a reasonable assurance that the accrual method of accounting has been employed.³³⁹ Inventories, receivables, and payables alone may suffice in some instances.³⁴⁰ The failure to accrue "minor" items of income and expenses³⁴¹ or to

335. *Aluminum Castings Co. v. Routzahn*, 282 U.S. 92, 99 (1930); *Denman v. Squire*, 111 F.2d 921 (6th Cir. 1940); *Consolidated Tea Co. v. Bowers*, 19 F.2d 382 (S.D.N.Y. 1927); *Bancroft v. United States*, 49 F. Supp. 476 (Ct. Cl. 1943); *Arrington's, Inc.*, 15 P-H Tax Ct. Mem. 632 (1946); cf. *Daley v. United States*, 243 F.2d 466 (9th Cir.), cert. denied, 355 U.S. 832 (1957); *George L. Castner Co.*, 30 T.C. 1061 (1958).

336. *Davison-Joseph-Campau Realty Co.*, 41 B.T.A. 675 (1940). Failure to state that a return was prepared on a fiscal year basis does not raise a presumption of the calendar year. *Bastrop Mercantile Co.*, 7 B.T.A. 529 (1927).

337. *Diamond A Cattle Co. v. Commissioner*, 233 F.2d 739 (10th Cir. 1956).

338. *Melville W. Thompson*, 18 B.T.A. 1192 (1930); *Russell G. Finn*, 22 B.T.A. 799 (1931); cf. *Jones v. Trapp*, 186 F.2d 951 (10th Cir. 1950).

339. *Aluminum Castings Co. v. Routzahn* 282 U.S. 92 (1930); *Diamond A Cattle Co. v. Commissioner*, 233 F.2d 739 (10th Cir. 1956), affirming 21 T.C. 1 (1953); *Henry S. Parker*, 11 B.T.A. 1336, 1346 (1928).

340. *James J. Standing*, 28 T.C. 789 (1956), aff'd, 259 F.2d 450 (4th Cir. 1958); *Sunset Color Works*, 21 B.T.A. 304, 307 (1930); *Wallace Plumbing Co.*, 8 B.T.A. 1060 (1927); *Green Oil Soap Co.*, 3 B.T.A. 467 (1926). But see *Boca Ceiga Dev. Co.*, 25 B.T.A. 941 (1932), rev'd on other grounds, 66 F.2d 1004 (3d Cir. 1933).

341. *Niles Bement Pond Co. v. United States*, 281 U.S. 357, 360 (1930); see *United States v. Anderson*, 269 U.S. 422, 442 (1926). This is an obviously flexible criterion. Compare *Nibley-Mimnaugh Lumber Co.*, 32 B.T.A. 791 (1935) (two unimportant items of receivables and taxes) and *Madison & Kedzie State Bank*, 1 B.T.A. 922 (1925) (insurance only) with *Coatesville Boiler Works*, 9 B.T.A. 1242 (1928) (interest, insurance, taxes, work in process inventory) and *John F. Cook*, 4 B.T.A. 916 (1926) (interest, insurance, salaries). See *Lawrence L. Rector*, 14 P-H Tax Ct. Mem. 1116 (1945); *Theodore Stanfield*, 8 B.T.A. 787 (1927); *Max Schott*, 5 B.T.A. 79 (1926). Does accrual or failure to accrue payroll taxes spell the difference? Compare *Merrimac Trading Co.*, 15 P-H Tax Ct. Mem. 719, aff'd per curiam, 162 F.2d 637 (3d Cir. 1947) with *Thomas W. Briggs*, 25 P-H Tax Ct. Mem. 358 (1956).

Accrual of minor items does not constitute an accrual basis. *Shoong Inv. Co. v. Anglim*, 45 F. Supp. 711 (N.D. Cal. 1942); *Thomas W. Briggs*, supra note 341; *L. W. Mallory*, 44 B.T.A. 249 (1941).

accrue items of expense which are paid as incurred³⁴² "cannot destroy the principle upon which the system of accrual bookkeeping is based."³⁴³

But accounts are not, like mournful numbers, always what they seem. Accrued income and expense accounts may not be inconsistent with a cash basis of accounting, particularly if the accounts contain no accruals for the taxable year under consideration.³⁴⁴ Accounts receivable and accounts payable do not always signify the presence of the accruals of sales and purchases. The accounts may be mere memoranda³⁴⁵ or they may arise without any effect on income.³⁴⁶ "Inextricably intertwined,"³⁴⁷ at least by administrative fiat,³⁴⁸ as the accrual method and inventories may be, the use of beginning and ending inventories does not necessarily require the conclusion that the taxpayer is on the accrual basis.³⁴⁹

342. *Hygienic Prods. Co. v. Commissioner*, 111 F.2d 330 (6th Cir. 1940); *Aluminum Castings Co. v. Routzahn*, 24 F.2d 230, 231 (N.D. Ohio 1927), *aff'd*, 282 U.S. 92 (1930); *New McDermott, Inc.*, 44 B.T.A. 1035 (1941); *Edwards Drilling Co.*, 35 B.T.A. 341 (1937), *aff'd*, 95 F.2d 719 (5th Cir. 1938). It is not necessary to set the items up only to knock them down again. *Madison & Kedzie State Bank*, 1 B.T.A. 992 (1925); *cf. C. Florian Zittel*, 12 B.T.A. 675 (1928).

343. *Bartles-Scott Oil Co.*, 2 B.T.A. 16, 18 (1925); see *Coatesville Boiler Works*, 9 B.T.A. 1242, 1255 (1928).

344. *Benjamin I. Powell*, 26 B.T.A. 509 (1932).

345. *Paul Hansen*, 14 P-H Tax Ct. Mem. 294 (1945); *Cosmopolitan Bond & Mortgage Co.*, 30 B.T.A. 717 (1934), appeal dismissed, 77 F.2d 994 (7th Cir. 1935); *D. B. Dearborn, Jr.*, 2 B.T.A. 59 (1925).

346. *Diamond A Cattle Co. v. Commissioner* 233, F.2d 739 (10th Cir 1956); *Great Bear Spring Co.*, 12 B.T.A. 383 (1928); *M. D. Rowe*, 7 B.T.A. 903 (1927). Inclusion of accounts receivable in income coupled with the deduction of the outstanding balance at the end of each year is equivalent to the cash method. *Arrington's, Inc.*, 15 P-H Tax Ct. Mem. 632 (1946). If the taxpayer records accounts payable, but holds open the cash book at the end of each month until all accounts have been liquidated, he is on a cash basis. A.R.R. 4802, III-1 Cum. Bull. 77 (1924).

May a cash basis taxpayer have accounts receivable arising in the ordinary course of business and still properly report income on the cash basis? See *Daily Record Co.*, 13 B.T.A. 458 (1928).

347. *Boynton v. Pedrick*, 136 F. Supp. 888 (S.D.N.Y. 1954), *aff'd per curiam*, 228 F.2d 745 (2d Cir. 1955). Inventories are the heart of the accrual system of accounting. The term "inventory" system is generally recognized as synonymous with the accrual system of accounting. *Diamond A Cattle Co. v. Commissioner*, 233 F.2d 739, 741 (10th Cir. 1956).

348. See *Treas. Reg. § 1.446-1 (c) (2) (i)* (1957); *Treas. Reg. § 1.471-1* (1958); *Treas. Reg. 118, §§ 39.22 (c)-1; 39.41-(a)* (1953).

349. *Glenn v. Kentucky Color & Chem. Co.*, 186 F.2d 975 (6th Cir. 1951), noted 65 *Harv. L. Rev.* 351 (1951); *Mann v. Commissioner*, 35 F.2d 873 (D.C. Cir. 1929); *Sam Greengard*, 8 B.T.A. 734 (1927), *aff'd*, 29 F.2d 502 (7th Cir. 1928); *Theodore H. Beckman*, 8 B.T.A. 830 (1927). *Contra*, *Charles M. Kilborn*, 29 T.C. 102 (1957); *George L. Castner Co.*, 30 T.C. 1061 (1958).

Advocates and Adherents

In accounting the cash basis has been relegated to an uncertain oblivion, to be used only in rare instances under rare combinations of circumstances. In the federal income tax law the cash method has continued to furnish the when-criteria for the great majority of taxpayers. In both fields the accrual basis, despite certain inherent uncertainties, has become the predominant method of the business enterprise.

The cash basis of accounting in recent years has been much criticized and condemned³⁵⁰ in accounting circles as a long-since outmoded relic of the Paciolian era.³⁵¹ In its "pure" form, it is not acceptable as even an approximately reliable measurement of effort and accomplishment.³⁵² It is the very antithesis of the avowed accounting aim of matching costs and revenues.³⁵³ The nearest thing to a cash basis which plays any important part in business enterprise today is that modification embodied in the installment basis.³⁵⁴ In general, the cash basis is limited in application to governmental and institutional accounting,³⁵⁵ or to those rare instances in which all assets and liabilities except cash are negligible in value or constant from period to period.³⁵⁶ A statement of income prepared on the cash basis does not customarily merit an accountant's unqualified opinion.³⁵⁷

Deservedly by accounting theory or not, many historical, governmental and practical influences combine to give cash receipts an important status as a measurement of income.³⁵⁸ As a criterion for the

350. The condemnation may be premature. The cash basis of accounting is a relatively unexplored field of accounting theory, perhaps because it does not fit conveniently into a neat, if in part unrealistic system. See Chambers, *Blueprint for a Theory of Accounting*, 6 *Accounting Research* 17 (1955); Rabinowitz, *Treatment of Prepaid Expenses on the Cash Basis of Accounting*, 15 *Accounting Rev.* 474 (1940).

351. Chambers, *supra* note 350; 1 Moonitz & Staehling, *Accounting Analysis* 201 (1950); Kohler & Morrison, *Principles of Accounting* 166 (1926). Kohler, *Accounting Theory as Affected by Federal Income Taxation*, *Proc. Am. Ass'n Univ. Instructors in Accounting* 73 (1923) termed the cash basis even then "as rare as single entry bookkeeping." Cf. Ferst, *Basic Accounting for Lawyers* 15 (1950), who recommends its use "whenever possible."

352. Sanders, *Progress in Development of Basic Concepts, Contemporary Accounting* 1-1, 1-17 (Leland ed. 1945).

353. See 1 Newlove & Garner, *Advanced Accounting* 402 (1950); Paton & Littleton 59.

354. Sanders, *supra* note 352.

355. *Ibid.*; cf. Husband & Thomas, *Principles of Accounting* 117 (1935).

356. Holmes & Meier, *Advanced Accounting* 199 (1950).

357. See Hill, *Problems Encountered by Accountant When Expressing an Opinion on Cash-Basis Statements*, 96 *J. Accountancy* 309 (1953).

358. Sanders, *supra* note 352.

measurement of taxable income the cash method has enjoyed great favor.³⁵⁹ It is, at least in theory, simple.³⁶⁰ Receipt of cash corresponds with the "commonest, common man's concept of income."³⁶¹ Further, it does not require the taxpayer to pay taxes upon income until it is actually received;³⁶² he can control to a large degree the timing of his deductions.³⁶³ The cash basis of accounting requires no books of account or very rudimentary ones.³⁶⁴ Income may be computed without laborious apportionments and accruals of items of income and expense so minor in amount as to fail to justify the labor required.³⁶⁵ For these advantages many have been willing to forego the more exacting measurements of accrual accounting. Wage earners,³⁶⁶ farmers,³⁶⁷ professional men,³⁶⁸ and public accounting firms³⁶⁹ are generally among its adherents.

The accrual basis of accounting, on the other hand, is the method generally adopted by accountants³⁷⁰ as the standard method for the

359. But see Montgomery, *Federal Tax Handbook* 9 (1st ed. 1932): "It is unfortunate that Congress or the Treasury permitted the cash basis for reporting income to become fixed in our taxing system. The cash basis should be abandoned, even at this late date." See also *B. B. Todd, Inc.*, 1 B.T.A. 762, 766 (1925).

360. Application of the doctrine that the equivalent of cash is income renders the determination of the realization of income almost as difficult as the accrual, without full advantages of the latter. Magill, *Taxable Income 192-93* (1945).

361. Fisher & Fisher, *Constructive Income Taxation* 116 (1924).

362. Receipt of income thus depends upon the vagaries of one's creditors. Amory & Hardee, *Materials on Accounting* 29 (1953). The cash basis is most often justified when the size and timing of collections from customers are highly uncertain. 1 Moonitz & Staehling, *Accounting Analysis* 229 (1950).

363. If he is able to pay them. See Rolnik, *Elections in the Income Tax Law*, N.Y.U. 6th Inst. on Fed. Tax. 748, 752 (1947); Ahern, *Getting the Best Effective Use Out of Accounting Methods and Accounting Periods*, id. at 479, 493.

364. Magill, *Taxable Income* 178 (1945).

365. Ascher, *Survey of Accounting* 84; Husband & Thomas, *Principles of Accounting* 117 (1935); Magill, *Taxable Income 192-93* (1945).

366. Ferst, *Basic Accounting for Lawyers* 15 (1950).

367. See *supra* note 125. But see Gilman 114.

368. 1 Moonitz & Staehling, *Accounting Analysis* 229 (1950). Much of the income of professional persons, independent businessmen, and farmers is known only to the recipient, his secretary and God. Two of these parties are sometimes corruptible, and the third has never been particularly concerned with income-tax administration. Groves, *Production, Jobs and Taxes* 67 (1944).

369. The cash basis is useful in any enterprise in which the furnishing of services, rather than goods is the primary activity. Services may be those furnished over a short period of time, such as transportation and amusement, or "complex services" furnished over a considerable period. See Paton & Littleton 57-59; Hill, *supra* note 357.

370. *Becker v. United States*, 21 F.2d 1003, 1004 (5th Cir. 1927).

determination of income.³⁷¹ The business world would accept no other.³⁷² Despite its greater virtues, it is not the perfect system of accounting. Any method may be warped to unhappy results if applied by untrained hands.³⁷³ The use of the accrual basis requires the exercise of a great amount of individual judgment, a matter over which the minds of reasonable men may differ.³⁷⁴ In accounting, the criteria of accrual have been left largely to the professional judgment of individual accountants.³⁷⁵ In the federal income tax law the accrual method, reluctantly recognized by the courts,³⁷⁶ has become a composite series of legal tests and standards for the measurement of degrees of uncertainty.³⁷⁷ The case law is not free from confusion and contradiction.³⁷⁸ Questions of accrual, in large part matters of accounting, are often the most difficult introduced in income-tax administration.³⁷⁹

CONCLUSION

In the business environment in which they were created, accounting and bookkeeping have served well their purpose. They have provided the requisite techniques for the recording of financial transactions; they have summarized the results of those transactions through the media of financial statements. With an occasional assist from the Securities and Exchange Commission, accounting has conveyed ac-

371. Amory & Hardee, *Materials on Accounting* 29 (1953); McFarland & Ayars, *Accounting Fundamentals* 37 (2d ed. 1947); Wade, *Fundamentals of Accounting* 29 (1951).

372. *Boynton v. Pedrick*, 136 F. Supp. 888, 891 (S.D.N.Y. 1954), *aff'd per curiam*, 228 F.2d 745 (2d Cir. 1955).

373. *In re Newman*, 94 F.2d 108, 111 (6th Cir. 1938).

374. Kaplan & Reaugh, *Accounting, Reports to Stockholders, and the SEC*, 48 *Yale L.J.* 935, 942 (1939).

375. Largely at their insistence. See Gilman 23; May, *The Choice Before Us*, 89 *J. Accountancy* 206 (1950); Committee on Auditing Procedure, *Generally Accepted Auditing Standards* 50-51 (1954).

376. Magill, *Taxable Income* 450 (1945).

377. The rules for accrual may seem simple enough, but in endeavoring to apply them one court was reminded of Captain Cuttle's famous dictum, "the bearings of the observation lies in the application of it." The test is said to be "a practical one, but when we see the different results different supposedly practical men get from applying the same test, we plainly see that what to one practical mind seems heresy, to another equally practical, seems doctrine. . . ." *Frost Lumber Indus. v. Commissioner*, 128 F.2d 693, 694 (5th Cir. 1942).

378. *Costas v. Secretary of Fin.*, 220 F.2d 651, 654 (1st Cir. 1955).

379. *Ibid.*; see Holland, *Accrual Problems in Tax Accounting*, 48 *Mich. L. Rev.* 148 (1949); Note, *Accrual: The Uncertain Concept of Certainty—A History of the All Events Test*, 21 *U. Chi. L. Rev.* 293, 306 (1954). Whatever the faults and virtues of the two methods they have this in common: if consistently applied they will yield approximately the same results in the long run. Ascher, *Survey of Accounting* 463 (1952); Kester, *Advanced Accounting* 130 (3rd ed. 1941).

curately to creditors and stockholders the fiscal information required for the protection of their interests. The demands business has made, accounting has in large measure met.

In the less familiar surroundings of the federal income tax law, the capacity of accounting, perhaps as distinguished from that of accountants, has been less evident. While the uncertainty of its status under the early revenue acts seemingly was supplanted by the clear declaration in the Revenue Act of 1918, the prescription that taxable income be determined in accordance with the taxpayer's method of accounting has not produced any lucid definition of the role of accounting in the taxing process. To the contrary, methods of accounting have become almost exclusively, pure concepts of the law, subject to the definition and discernment of the Commissioner and the courts. Accounting as such, methods of accounting are not.

It seems unfortunate that the statute has been so circumscribed. Yet the accounting profession is itself not without fault. Its failure in 1918 and now to agree upon any accepted touchstones of income determination and its insistence that income is to be determined by each accountant in the exercise of his professional judgment do not lend themselves to a workable basis of income tax assessment. The events surrounding the creation and untimely demise of the prepaid income and estimated expense provisions of the 1954 Internal Revenue Code seem to indicate that, even now, the exercise of accounting's professional judgment may leave something to be desired.

The legal and administrative interpreters of the law, on the other hand, have sometimes failed to recognize that accounting, within the framework of its accepted limitations, is capable of some greater utility in the administration of the income tax laws. Because they have found accounting lacking on some occasions, the courts and the Commissioner are not therefore justified in arbitrarily assuming that it is for naught upon all. Accounts kept in accordance with the requirements of other governmental agencies should be entitled to some status in the federal tax law, absent any patent deviations from the norm. Likewise, the unqualified-opinion reports of recognized public accounting firms will, it seems likely, in most instances reflect accurately the results of the financial events which they chronicle.

The continuing conflict of accounting and law reflects not only the inability of its practitioners to agree upon the broad policies most beneficial to the taxpayers, but also the unwillingness of both accountants and lawyers to look discerningly at the tools of their professions. Mere boasting of the virtues of their own and the vices of the other will not assist either. Nor does the answer lie in the indiscriminate merger of law and accounting. Each has its function in the

taxing process. Definition and division would seem to offer more than coalescence and combination.

It may be that some day an easy solution to the conflicts of law and accounting, and lawyers and accountants, will be found, thus resolving the octopus tax law into amoeba simplicity. But it does not seem likely. To so favor the multitude bespeaks a denial of private interest. Of this are not most men made.