Michigan Law Review

Volume 56 | Issue 5

1958

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Harrop A. Freeman
Cornell University

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Recommended Citation

Harrop A. Freeman, *Tax Accrual Accounting for Contested Items (Without the Benefit of I.R.C. Sections 452 and 462)*, 56 MICH. L. REV. 727 (1958).

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TAX ACCRUAL ACCOUNTING FOR CONTESTED ITEMS

*(Without the Benefit of I.R.C. sections 452 and 462)**Harrop A. Freeman†*

A SPATE of cases in 1956-1957* has required us to examine again the tax handling of accrual accounting in an attempt to find some way through the judicial morass. This study is concerned primarily with proper income and expense accrual reporting in cases in which some form of controversy exists or may exist between the taxpayer and another party concerning the item to be accrued.

General Principles

It is frequently recognized that tax accounting does not have to coincide with business accounting.¹ Nevertheless the Internal Revenue Code depends on concepts of "cash" and "accrual," and it accepts the "method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books," subject only to the power of the Internal Revenue Service to substitute another method "if the method used does not clearly reflect income."² Tax decisions must, therefore, incorporate as much sound accounting as possible. Departure from accounting principles should be the exception rather than the rule.³

The recognized purpose of accrual accounting is to determine income properly by matching appropriate costs against the related earning process. This requires reporting reasonable expectations

†Professor of Law, Cornell University.—Ed.

*See Appendix, p. 748 *infra*.

¹ See *Commissioner v. Wheeler*, 324 U.S. 542 at 546 (1945); *Commissioner v. Phipps*, 336 U.S. 410 (1949); *Putnam v. United States*, (1st Cir. 1945) 149 F. (2d) 721; 1 MERTENS, *LAW OF FEDERAL INCOME TAXATION* §9.33 (1942); "Accounting Principles and Taxable Income," 27 *ACCOUNTING REV.* 427 (1952); Reimer, "Major Differences Between Net Income for Accounting Purposes and for Federal Income Taxes," 23 *ACCOUNTING REV.* 305 (1948); Lasser and Peloubet, "Tax Accounting v. Commercial Accounting," 4 *TAX L. REV.* 343 (1949); Wernitz, "The Influence of Changing Tax Rates on Accounting and Auditing Procedures," 28 *TAXES* 658 (1950).

"In an ideal system of accounting, net income would be determined by deducting from gross income the expenses actually incurred in earning the gross. It is frequently impossible or impracticable to do this precisely in practice. Nevertheless, the Government must have its revenues even at the expense of some niceties of accounting." *Bradstreet Co. of Maine*, 23 B.T.A. 1093 at 1102-1103 (1931).

² I.R.C., §446.

³ AMERICAN ACCOUNTING ASSOCIATION, *ACCOUNTING AND REPORTING STANDARDS FOR CORPORATE FINANCIAL STATEMENTS*, 1957 revision.

of both revenues and costs.⁴ Even in tax accounting, where the yearly demand of a tax is controlling, the usual statement is that income is reported when earned and deductions are allowed in the year incurred.⁵ It is well known that prior to 1916 the only method of accounting acceptable for tax reporting was the cash method.⁶ The accrual and hybrid methods were approved by the Revenue Act of 1916 and subsequent statutes, and the Treasury Department wrote generally-accepted accrual accounting into its original interpretative Treasury Decision.⁷ Thus it would appear that the Supreme Court was right in stating: "We think that the statute was correctly interpreted by the Commissioner. . . ."⁸ Recently the legislative intent to bring tax law into harmony with accepted accounting principles has been clear, and this in spite of the necessity for repealing sections 452 and 462 of the Internal Revenue Code. The proposed regulations under the 1954 code, though cautious, have tried to develop such harmony.⁹

⁴ SHANNON, *LEGAL ACCOUNTING* 162 (1951); PATON, *ACCOUNTANTS' HANDBOOK* 113 (1950); FINNEY AND OLDBERG, *LAWYER'S GUIDE TO ACCOUNTING* 78 (1955); KATZ, *ACCOUNTING* 43 (1954); KESTER, *ADVANCED ACCOUNTING* 415 (1946); *Brown v. Helvering*, 291 U.S. 193 (1934); *United States v. Anderson*, 269 U.S. 422 at 440 (1926): "The appellee's true income for the year 1916 could not have been determined without deducting from its gross income for the year the total cost and expenses attributable to the production of that income during the year." *AMERICAN INSTITUTE OF ACCOUNTANTS, ACCOUNTING RESEARCH BULLETIN* No. 43, p. 9 (1953): ". . . the burden of justifying departure from accepted procedures, to the extent that they are evidenced in committee opinions, must be assumed by those who adopt another treatment." See also editorial, 79 *J. ACCOUNTANCY* 90 (1945): ". . . it is a brave man in the accounting profession who is willing to take on the task of justifying a disregard of the releases."

⁵ CCH 1956 *STAND. FED. TAX REP.* ¶2820.025; *United States v. Anderson*, 269 U.S. 422 at 437, 442 (1926). See words "paid or accrued" and "paid or incurred" in statutes and regulations since 1916. Revenue Act of 1918, §§200-234, 40 Stat. 1058; 2 MAY, *TWENTY-FIVE YEARS OF ACCOUNTING RESPONSIBILITY* 267-285 (1936).

⁶ Revenue Act of 1916, §13(d), 39 Stat. 771; *Maryland Casualty Co. v. United States*, 251 U.S. 342 (1920); Treas. Reg. 31, arts. 1-5 (1909); Treas. Reg. 33, art. 100ff. (1913).

⁷ T.D. 2433, 19 TREAS. DEC. INT. REV. 5-6 (1917): ". . . it will be permissible for corporations which accrue on their books monthly or at other stated periods amounts sufficient to meet fixed annual or other charges to deduct from their gross income the amounts so accrued, provided such accruals approximate as nearly as possible the actual liabilities for which the accruals are made. . . ." This is quite apart from the question whether the above statute, regulations and decisions now control as to "reserves" since the 1916 act was the only one (except for I.R.C. 1954 §§452 and 462 now repealed) specifically to allow reserve. See Reiling, "Practical Legal Aspects of Tax Accounting," 30 *TAXES* 1028 (1952); 2 MONTGOMERY, *FEDERAL TAXES, CORPORATIONS AND PARTNERSHIPS* 406 (1950-1951).

⁸ *United States v. Anderson*, 269 U.S. 422 at 438 (1926).

⁹ Treas. Reg. 1.446-1(c)(1)(ii): "Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Under such a method, deductions are allowable for the taxable year in which all the

It is, therefore, rather surprising that we continue to have so much difficulty in fitting correct accounting principles into our tax decisions. At the end of this article is an *Appendix* listing some forty cases decided within the past year in which the court was in some way involved in this confusion.

The analysis in this article depends largely on the following new decisions: *Automobile Club of Michigan v. Commissioner*,¹⁰ *Irwin v. Commissioner*,¹¹ *Schuessler v. Commissioner*,¹² and *Cold Metal Process Co. v. Commissioner*.¹³ The reader may draw on the *Appendix* for further illustrations. Older cases will be discussed merely to show the derivation of rules or the degree to which a more realistic approach was attempted. The section on the all-events test traces in detail the Supreme Court cases, but otherwise builds on the article by Alfred Holland, "Accrual Problems in Tax Accounting," which appeared in this *Review* in 1949.¹⁴ There is already a quantity of excellent law review

events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy. The method used by the taxpayer in determining when income is to be accounted for will be acceptable if it accords with generally recognized and accepted income tax accounting principles and is consistently used by the taxpayer from year to year. For example, a taxpayer engaged in a manufacturing business may account for sales of his product when the goods are shipped, when the product is delivered or accepted, or when title to the goods passes to the customer, whether or not billed, depending upon the method regularly employed in keeping his books. . . ." Treas. Reg. 1.451-1(a). See the same words as above, and "Where an amount of income is properly accrued on the basis of a reasonable estimate and the exact amount is subsequently determined, the difference, if any, shall be taken into account for the taxable year in which such determination is made."

S. Rep. 372, 84th Cong., 1st sess., 6 (1955): ". . . your committee believes that it is essential that the income tax laws be brought into harmony with generally accepted accounting principles." [After approving Beacon Publishing Co. v. Commissioner, (10th Cir. 1955) 218 F. (2d) 697 and Pacific Grape Products Co. v. Commissioner, (9th Cir. 1955) 219 F. (2d) 862, the committee added: "An extension of the principles laid down in this case might well lead the courts in the future to permit the accrual of most estimated expenses which would be covered by section 462 even though this section is repealed."] S. Rep. 1622, 83d Cong., 2d sess., 62 (1954): "The changes embodied in the . . . bill are designed to bring the income-tax provisions of the law into harmony with generally accepted accounting principles. . . ." See also H. Hearings on General Revenue Revision Before the Committee on Ways and Means, 83d Cong., 1st sess., Vol. 2, pp. 575-610 (1954); S. Hearings on the I.R.C. of 1954, Committee on Finance, 83d Cong., 2d sess. (1954); H. Rep. 1337, 83d Cong., 2d sess. (1954); S. Rep. 1622, 83d Cong., 2d sess. (1954). It was long recognized that the difficulty lay, not with the statute, but with administrative and court interpretation, MONTGOMERY, FEDERAL TAX HANDBOOK (all editions), but see 1940 edition, Vol. 1, p. 833.

¹⁰ 353 U.S. 180 (1957).

¹¹ (3d Cir. 1956) 238 F. (2d) 874.

¹² (5th Cir. 1956) 230 F. (2d) 722.

¹³ (6th Cir. 1957) 247 F. (2d) 864. Cf. Rev. Rul. 57-105, 1957 INT. REV. BUL. No. 11, p. 31.

¹⁴ 48 MICH. L. REV. 149 (1949).

material on accrual accounting; a partial list of the more recent articles appears in the footnote.¹⁵

"Claim of Right" and Its Relation to Accrual

It is generally recognized that the "claim of right" concept was introduced into the law—much as was the "constructive receipt" theory—to tax a cash basis taxpayer with the receipt of amounts which might be under litigation or which he might later have to repay.¹⁶ It was intended to determine *whether* an item was taxable, not *when*. The application of the doctrine to accrual taxpayers developed almost entirely from opinions of Judge Rice in the Tax Court,¹⁷ and these opinions were usually reversed when they came before the courts of appeals.¹⁸ Most law review articles commended refusals to apply the claim of right test.¹⁹ In *Automobile Club of Michigan v. Commissioner*²⁰ membership dues paid yearly were deposited in the Auto Club's general bank account and an offsetting liability account, "Un-

¹⁵ Holland, "Accrual Problems in Tax Accounting," 48 MICH. L. REV. 149 (1949); Bowe, "Cash and Accrual Methods of Income Tax Accounting," 3 VAND. L. REV. 60 (1949); Lasser and Peloubet, "Tax Accounting v. Commercial Accounting," 4 TAX L. REV. 343 (1949); Wernitz, "The Influence of Changing Tax Rates on Accounting and Auditing Procedures," 28 TAXES 658 (1950); Income Tax—Accrual Accounting in Taxation, 1955 UNIV. ILL. L. FORUM 163; Boughner, "Accounting for Items in Dispute," 30 TAXES 1038 (1952); "Accounting Principles and Taxable Income," 27 ACCOUNTING REV. 427 (1952); "Accrual: The Uncertain Concept of Certainty—A History of the All Events Test," 21 UNIV. CHI. L. REV. 293 (1954); Gelfand, "The 'Claim of Right' Doctrine," 33 TAXES 726 (1955); Wagman, "Sections 452 and 462: Stormy Past But a Bright Tomorrow," 33 TAXES 711 (1955); Heffern, "Claim-of-Right and Other Tax Doctrines Are Distorting Proper Accounting," 5 J. TAXATION 20 (1956); "Taxation—The 'Claim of Right' Doctrine vs. Accrual Accounting," 9 ALA. L. REV. 143 (1956); Sporrer, "The Past and Future of Deferring Income and Reserving for Expenses," 34 TAXES 45 (1956); Wolder, "Deduction of Reserves for Future Expenses and Deferring of Prepaid Income," 34 TAXES 524 (1956); "Income Tax—Accrual Accounting for Prepaid Income and Estimated Expenses," 17 LA. L. REV. 628 (1957).

¹⁶ N. American Oil Consolidated v. Burnet, 286 U.S. 417 at 424 (1932): "If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent." See also United States v. Lewis, 340 U.S. 590 (1951); Healy v. Commissioner, 345 U.S. 278 (1953); Rutkin v. United States, 343 U.S. 130 (1952).
¹⁷ Wallace A. Moritz, 21 T.C. 622 (1954); Beacon Publishing Co., 21 T.C. 610 (1954); Curtis R. Andrews, 23 T.C. 1026 (1955); E. W. Schuessler, 24 T.C. 247 (1955). The Moritz and Andrews cases were not appealed.

¹⁸ The Beacon and Schuessler cases were both reversed. Beacon Publishing Co. v. Commissioner, (10th Cir. 1955) 218 F. (2d) 697, and Schuessler v. Commissioner, (5th Cir. 1956) 230 F. (2d) 722.

¹⁹ See, for example, Heffern, "Claim-of-Right and Other Tax Doctrines Are Distorting Proper Accounting," 5 J. TAXATION 20 (1956); "Taxation—The 'Claim of Right' Doctrine vs. Accrual Accounting," 9 ALA. L. REV. 143 (1956).

²⁰ 353 U.S. 180 (1957).

earned Membership Dues," was credited. Each month one-twelfth of the dues were transferred to a "Membership Income" account, which thus became a part of the yearly reported income. The majority of the Supreme Court, relying both on the "claim of right" theory and on the conclusion that the method of monthly allocation was "purely artificial," required the total accrual when the amounts were received. The dissent denied that "claim of right" had any legitimate application and that the Commissioner could depart from the taxpayer's method of accounting, unless he found (which he could not) that "'the method employed does not clearly reflect' the taxpayer's income."

The *Automobile Club of Michigan* case may seem at first to add confusion to an already confused area.²¹ In the *Andrews* case²² the Tax Court noted that its dilemma was between deciding contrary to sound accounting or contrary to the "firmly established 'claim of right' doctrine." If in the *Automobile Club of Michigan* case the Supreme Court has chosen the claim of right rule in preference to sound accrual accounting, then the case is to be lamented. But it is possible that the Supreme Court did not go this far. First, it may be saying that income must be reported as soon as received, even by an accrual taxpayer, but that he may be entitled to an offsetting expense accrual unless it "is purely artificial and bears no relation to the services which petitioner may in fact be called upon to render. . . ."²³ Second, by citing the *Beacon* and *Schuessler* cases²⁴ as distinguishable, while refusing to comment on their correctness, the Court seems to have recognized the right to accrue an offsetting expense for real services to be performed at specified later times. Third, it may have rested its decision on the discretionary power of the Commissioner to determine that the taxpayer's accounts did not "clearly reflect the income" for tax purposes. It is to be hoped that this third basis will not be pressed, if it is to hold that the I.R.C. thus divorces tax and business accounting.

If we revert to the two previous Supreme Court cases which have some similarity to the *Automobile Club of Michigan* case, we may be able to determine the likely application of the holding. In *North American Oil Consolidated v. Burnet*²⁵ a receiver

²¹ S. Rep. 372, 84th Cong., 1st sess., 6 (1955).

²² Curtis R. Andrews, 23 T.C. 1026 (1955).

²³ *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180 at 189 (1957).

²⁴ (10th Cir. 1955) 218 F. (2d) 697, and (5th Cir. 1956) 230 F. (2d) 722.

²⁵ 286 U.S. 417 (1932).

was appointed to operate property pending the outcome of a lawsuit contesting the taxpayer's title. Income from the receiver's 1916 operation was turned over to the taxpayer in 1917, when a decree favorable to the taxpayer was entered. But the litigation was not finally determined until 1922 when the appeal was dismissed. The Court held the income must be accrued in 1917 when the taxpayer obtained unrestricted use of the money and his "right" had substance. It could not be accrued in 1916 because no right to income was certain. It could not be deferred by someone else's continued litigation after taxpayer had the income. Two years later in *Brown v. Helvering*,²⁶ the Court held that commissions received by an accrual taxpayer must be included in taxable income in the year he received them in cash, though they might not be earned until later years or might have to be refunded on cancellation of the policies. The obligation to refund was deemed too uncertain and contingent to accrue as an offsetting liability. Several cases, though involving cash basis taxpayers, use language applicable to accrual as well and establish the claim of right doctrine as "deeply rooted in the federal tax system."²⁷

In short, it is probable that these cases engraft the "claim of right" doctrine onto accrual accounting. But they still allow offsetting obligation accruals which are real and reasonably ascertainable, and they do not make accrual or non-accrual depend on continued litigation by someone other than the taxpayer. We can probably live with the claim of right doctrine if realistic accrual accounting for offsetting obligations is permitted and if the litigiousness of others than the taxpayer is not allowed to control the taxpayer's books. Otherwise, the cases would seem to require that income be reported on the "cash" basis and deductions on the "accrual" basis, which would incur the condemnation expressed elsewhere by the Court, that such a system did not clearly reflect income.²⁸

The "All-Events" Test

I have come to the conclusion that a sharp distinction must be made between the Supreme Court decisions stating the all-events

²⁶ 291 U.S. 193 (1934).

²⁷ *United States v. Lewis*, 340 U.S. 590 at 592 (1951); *Rutkin v. United States*, 343 U.S. 130 (1952); *Healy v. Commissioner*, 345 U.S. 278 at 281 (1953).

²⁸ *Commissioner v. South Texas Lumber Co.*, 333 U.S. 496 (1948).

test and the application of that test by lower courts. It appears from the actual Supreme Court decisions that they do not stand in the way of proper accrual accounting, but may even further it. On the other hand, especially in the area of disputed items to which we are giving our attention, the lower court cases are confusing, illogical and unsound accounting-wise. Each Supreme Court case will be analyzed but the lower court cases will only be grouped and characterized.

It is generally recognized that the father of the "all-events" test was *United States v. Anderson*.²⁹ In that case an accrual taxpayer attempted to deduct munitions taxes with regard to 1916 income in 1917, when they were assessed after the 1916 net income became known, rather than in 1916 when *he* had first set up a reserve for these taxes. The all-events test was stated precisely to prevent litigation and other asserted legal niceties from interfering with sound accrual accounting: "... appellee's true income for the year 1916 could not have been determined without deducting from its gross income for the year the total cost and expenses attributable to the production of that income during the year."³⁰ It then met the taxpayer's attempt to distort accounting concepts by saying:

"In a technical legal sense it may be argued that a tax does not accrue until it has been assessed and becomes due; but it is also true that in advance of the assessment of a tax, all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it. . . . In the economic and bookkeeping sense with which the statute and Treasury decision [T.D. 2433] were concerned, the taxes had accrued."³¹

In *American National Co. v. United States*³² the taxpayer negotiated five-year loans for investors. Its compensation was a percentage of the loan. The investors received four percent yearly from the debtor and were to get one percent additional each year from the taxpayer unless the loan was repaid in less than five years. American National accrued the whole five year one percent bonus and was allowed this deduction in the year of loan negotiation. Again the opinion was based on the accounting concept of match-

²⁹ 269 U.S. 422 (1926).

³⁰ *Id.* at 440.

³¹ *Id.* at 441. See also *Fawcus Machine Co. v. United States*, 282 U.S. 375 (1931).

³² 274 U.S. 99 (1927).

ing income and expense items; the contingencies of repayment were deemed too remote to prevent accrual. *Lucas v. American Code Co.*³³ denied taxpayer's deduction for a loss due to breach of a contract by the taxpayer. The taxpayer (except in the tax proceeding) was denying and litigating its liability. The Court found insufficient certainty of liability or amount to permit a monetary accrual. It is quite clear that the Court did *not* say that litigation or all uncertainties of amount would prevent accrual, for it referred to the fact that the breach of contract or contesting of liability might or might not justify the deduction and seemed to approve deductions where "the approximate amount of the damages was reasonably predictable" and "a liability [was] reasonably estimated."

In *Lucas v. N. Texas Lumber Co.*³⁴ a ten-day option to buy real estate was given. On December 30, 1916, the purchaser exercised the option. The deed and other papers were delivered, title passed and cash was paid on January 5, 1917. The taxpayer (seller) tried to accrue the sale in 1916. Since there was no tender of title, possession or demand in 1916 the Court denied there was a sale or completed transaction. This was really a definition of "sale" and only incidentally a discussion of accrual. Even then the decision leaves open the possibility of otherwise showing accrual based on rights and liabilities. It has been suggested that you must look to the obligor's (third party's) actions: ". . . unconditional liability of vendee for the purchase price was not created in that year." At most, I take this expression as equivalent to saying that the taxpayer did not have a "right."

*Continental Tie and Lumber Co. v. United States*³⁵ is a key case because of its positive and negative limits. A statute in 1920 guaranteed certain income to railroads for 1917-18, during the period of government operation. Litigation as to whether any, or how great, payment should be made to this railroad was continued until 1923, when final determination and payment were obtained. The Supreme Court required accrual in 1920 because the liability and amount was then calculable "within reasonable limits." The litigation did not prevent the accrual. This seems to establish a rule of reason as to probabilities and amount—litigation against a government under a statute has high probability.

³³ 280 U.S. 445 (1930).

³⁴ 281 U.S. 11 (1930).

³⁵ 286 U.S. 290 (1932).

A later case, which goes with this since it allowed accrual though there was no absolute certainty as to amount, is *Gulf, Mobile and Northern R. Co. v. Helvering*.³⁶ A similar expression will be found in *Maryland Casualty Co. v. United States*³⁷ in referring to "claims accrued, but contingent and indefinite as to amount or time of payment."

The next case, *Brown v. Helvering*,³⁸ bears a resemblance to the *American Code* case. An insurance salesman was denied deduction for a reserve against commissions accrued and received, which commissions might have to be returned in later years on cancellation of the policies. The Court at one point used the words, "a liability does not accrue as long as it remains contingent." It is clear from the whole case that the justices considered the likelihood of cancellation and return *too* contingent and incapable of estimate "within reasonable limits."

Two cases, sometimes cited to show that taxpayer's accrual depends on the situation of the other party to the transaction are *Spring City Foundry Co. v. Commissioner*³⁹ and *United States v. Car Heating & Lighting Co.*⁴⁰ In the *Foundry* case, a taxpayer vendor was required to accrue the full sales price in the year of sale, although the purchaser was insolvent at the time. A full offsetting deduction for a worthless debt was disallowed since the debt had a value of 20-25 percent and the statute allowed deduction only for worthlessness. In the *Safety Car* case a patent infringement suit by the holder of the patent was begun in 1912; in 1915 the validity of its patent was determined. An accounting for profits was begun and was finally settled in 1925. Taxpayer attempted to exclude the pre-1913 profits as capitalized by statute on March 1, 1913. But the Regulations (deemed adopted by re-enactment of the statute) required that the item must be "unconditional" to be excluded. The extended litigation and ultimate settlement for a fraction of the claimed damages was referred to as negating the "unconditional" quality. These cases fall far short of allowing a third party's condition or actions to thwart sound accrual practices.

In 1944 two similar cases came before the Supreme Court:

³⁶ 293 U.S. 295 (1934), affirming (D.C. Cir. 1934) 71 F. (2d) 953.

³⁷ 251 U.S. 342 at 350 (1920).

³⁸ 291 U.S. 193 (1934).

³⁹ 292 U.S. 182 (1934).

⁴⁰ 297 U.S. 88 (1936).

*Dixie Pine Products Co. v. Commissioner*⁴¹ and *Security Flour Mills Co. v. Commissioner*.⁴² In the first case the Mississippi taxing authorities in 1936 determined that the solvent used by the taxpayer was subject to a gasoline tax. Taxpayer paid the tax and sued for a refund and to enjoin further collection. In 1937 the Supreme Court of Mississippi, on the pleadings, overruled the state's demurrer, and recognized that if the plaintiff could prove its case there would be no tax. Thereupon taxpayer refused to pay further. On advice of counsel it accrued taxes in 1937. In 1938 and 1939 on an agreed statement of facts the taxpayer successfully proved his case and the solvent was held to be not taxable. The Supreme Court refused to allow the accrual in 1937 for federal tax purposes, saying:

"It has never been questioned that a taxpayer who accounts on the accrual basis may, and should, deduct from gross income a liability which really accrues in the taxable year. It has long been held that in order truly to reflect the income of a given year, all the events must occur in that year which fix the amount and the fact of the taxpayer's liability for items of indebtedness deducted though not paid; and this cannot be the case where the liability is contingent and is contested by the taxpayer. Here the taxpayer was strenuously contesting liability in the courts and, at the same time, deducting the amount of the tax, on the theory that the state's exaction constituted a fixed and certain liability. This it could not do. It must, in the circumstances, await the event of the state court litigation and might claim a deduction only for the taxable year in which its liability for the tax was finally adjudicated."⁴³

Security Flour Mills likewise denied a taxpayer the right to accrue processing tax liability in 1935. There the taxpayer had contested liability and the processing tax had been declared unconstitutional the following year. In both cases enough had developed prior to accrual to make the liability highly unlikely, no liability finally resulted, and it was the taxpayer who was asserting inconsistent positions.

*Lewyt Corp. v. Commissioner*⁴⁴ reaffirmed the *Anderson* con-

⁴¹ 320 U.S. 516 (1944).

⁴² 321 U.S. 281 (1944).

⁴³ 320 U.S. 516 at 519 (1944).

⁴⁴ 349 U.S. 237 (1955).

cept of accruing tax liability in accordance with sound accrual accounting. Said the Court:

"Finally, the tax that 'accrued' within a given year is not the tax finally determined to be due but the tax before ultimate adjustments are made. That is elementary in tax law. . . . In short, the amount of tax accrued within the taxable year under section 122(d)(6) is to be determined in accord with the normal accounting concepts relevant to the accrual basis. That amount is not, of course, to be ascertained solely by reference to the figure set forth in the taxpayer's return, for that figure may be erroneously computed on the accrual basis. But when an amount is arrived at by proper application of recognized accounting principles on the accrual basis, the test of section 122(d)(6) has been met. Events and transactions of later years, irrelevant to a determination of income on the accrual basis, do not warrant alteration of the figure computed under section 122(d)(6) for the year in question."⁴⁵

The 1957 *Automobile Club of Michigan* case must also be added because of its reference to the *Beacon* and *Schuessler* cases which applied the all-events test to allow sound accrual practices.

By comparison to these United States Supreme Court cases, the lower court decisions are in almost hopeless confusion and, with a few noteworthy exceptions, do not embody sound accrual practices. In 1949 Alfred Holland, in a fairly complete survey of the cases, could conclude "that this is another instance where the legal profession has substituted legal technicalities for principles of accounting. . . ."⁴⁶ Mr. Holland catalogued the court holdings as: (A) Non-accrual where the existence of any liability is uncertain, which is shown by taxpayer's denial, the other party's denial, litigation by either party, or by an independent court examination of the facts, with the uncertainty continuing until final determination, e.g., by appeal.⁴⁷ (B) Non-accrual where the liability is subject to a contingency.⁴⁸ (C) Non-accrual where a dispute exists as to which of two parties has the right to receive payment, though the liability to some person is fixed.⁴⁹ (D) Accruability of obligation though the amount is uncertain, if

⁴⁵ Id. at 242-243.

⁴⁶ 48 MICH. L. REV. 149 at 181 (1949).

⁴⁷ Id. at 152-159.

⁴⁸ Id. at 159-161.

⁴⁹ Id. at 161-165.

it can be "fixed within reasonable limits."⁵⁰ (E) Confusion of the courts as to accrual when collectibility is uncertain, e.g., due to insolvency.⁵¹ Although I do not agree with all of the conclusions or case interpretations, this article was a comprehensive review of cases. It did not, however, point out all the discrepancies and confusion then existing.⁵²

Since 1949 the lower court cases have tended in two conflicting directions. A series of cases have much more realistically embodied accrual accounting practices and have found the "all events" test no hindrance.⁵³ On the other hand further confusion

⁵⁰ *Id.* at 165-172.

⁵¹ *Id.* at 172-180.

⁵² Contests by third parties had not always prevented accrual, *Pittsburgh Hotels Co. v. United States*, 63 Ct. Cl. 475 (1927), cert. den. 275 U.S. 546 (1927). See also the modification of the rule of non-accrual during litigation, if money was actually received before litigation was ended [*Board v. Commissioner*, (6th Cir. 1931) 51 F. (2d) 73, cert. den. 284 U.S. 658 (1931); *Topeka Flour Mills Co.*, 12 B.T.A. 147 (1928), and cases listed 1 P-H 1958 FED. TAX SERV. ¶6302] or money was paid and litigation continued, e.g., *Chestnut Securities Co. v. United States*, (Ct. Cl. 1945) 62 F. Supp. 574.

The distinction between conditions subsequent and precedent [*Brooklyn Union Gas Co.*, 22 B.T.A. 507 (1931), affd. 62 F. (2d) 505 (1933); *Crossett Timber and Development Co.*, 29 B.T.A. 705 (1934); *Helvering v. Russian Finance and Construction Corp.*, (2d Cir. 1935) 77 F. (2d) 324] still persists [*Grand Ave. Motor Co. v. United States*, (D.C. Minn. 1954) 124 F. Supp. 423].

For inconsistent views on whether "reserves" were non-allowable or could be treated as accruals, see *Houghton & Dutton Co.*, 26 B.T.A. 52 (1932), and *Willoughby Camera Stores, Inc. v. Commissioner*, (2d Cir. 1942) 125 F. (2d) 607; *Wayne Title and Trust Co.*, 16 T.C. 924 (1951), affd. (3d Cir. 1952) 195 F. (2d) 401; *Morrison-Ricker Mfg. Co.*, 2 B.T.A. 1008 (1925); and see also 1 P-H 1958 FED. TAX SERV. ¶¶6437-6449.

In cases involving accrual of compensation to railroad companies during the period of federal control, back mail pay to railroads, compensation for requisitioning vessels, and like claims, there has been a split depending on whether the "amount" or the "liability" was being settled by subsequent litigation or negotiation. 1 P-H 1958 FED. TAX SERV. ¶¶6314-6324. See also Wagman, "Sections 452 and 462: Stormy Past But a Bright Tomorrow," 33 TAXES 711 at 712 (1955).

⁵³ For example: (1) The recent cases have tended to allow accrual though the amount is uncertain: *Harrold v. Commissioner*, (4th Cir. 1951) 192 F. (2d) 1002; *Central Cuba Sugar Co. v. Commissioner*, (2d Cir. 1952) 198 F. (2d) 214; *Avco Mfg. Co.*, 25 T.C. 975 (1956). Taking realistic views of when the amount can be reasonably estimated: *Commissioner v. Henry Hess Co.*, (9th Cir. 1954) 210 F. (2d) 553; *Boston Elevated Ry. Co.*, 16 T.C. 1084 (1951), affd. (1st Cir. 1952) 196 F. (2d) 923.

(2) Contest by the government on the basis of sales over ceiling does not prevent accrual of sales: *National Beverage Laboratories, Inc. v. United States*, (Ct. Cl. 1953) 116 F. Supp. 724, cert. den. 348 U.S. 815 (1954).

(3) Even taxpayer's continued litigation does not prevent accrual of income. *Albin Johnson*, P-H T.C. MEMO. DEC. ¶47,057 (1947).

(4) Payment subject to condition (e.g., filing claim, expiration notice period) does not prevent accrual. *Clark v. Woodward Construction Co.*, (10th Cir. 1950) 179 F. (2d) 176; *Roy Moody Bell*, P-H T.C. MEMO. DEC. ¶53,369 (1953); *Cloverleaf Creamery Co. v. Davis*, (D.C. Ala. 1951) 97 F. Supp. 121; *Fisher Brown*, P-H T.C. MEMO. DEC. ¶50,288 (1950).

(5) Although the person to whom the obligation runs is uncertain due to litigation, accrual is possible. *Hershey Creamery Co. v. United States*, (Ct. Cl. 1952) 101 F. Supp.

has developed from legalistic logic, particularly as related to disputed items.⁵⁴ Some of the detailed and technical distinctions can be seen from cases during the past year which are summarized in the *Appendix*.

The part of the above stated rules and conflicts to which we should give particular attention are (1) the apparently clear American rule of non-accrual of contingent liabilities (Mr. Holland's "B"); (2) Mr. Holland's portion of rule "A" above which prevents accrual, particularly if applied where a person other than the taxpayer is denying liability or litigating liability; (3) any treatment which considers accrual of income and expense items alike and fails to distinguish between situations in which the taxpayer seeks to accrue or refuses to accrue, and those in which he asserts, or merely defends against, controversy as to liability; (4) any rule preventing accrual though the liability is fixed, if the obligee is uncertain.

(1) It may now be too late, in the light of countless court expressions to the contrary, to establish a rule that "contingencies"

877; *Foster Wheeler Corp.*, 20 T.C. 15 (1953). It is uncertain that the rule was ever otherwise as stated above (note 49), *Tobin Packing Co.*, 43 B.T.A. 642 (1941). The recent cases are sounder accounting.

(6) See the general commendation by accountants and tax lawyers of cases like the following: *Beacon Publishing Co. v. Commissioner*, (10th Cir. 1955) 218 F. (2d) 697; *Schuessler v. Commissioner*, (5th Cir. 1956) 230 F. (2d) 722; *Pacific Grape Products Co.*, 17 T.C. 1097 (1952), *revd.* (9th Cir. 1955) 219 F. (2d) 862; *Patsch v. Commissioner*, (3d Cir. 1953) 208 F. (2d) 532; *Harrold v. Commissioner*, (4th Cir. 1951) 192 F. (2d) 1002; *Capital Warehouse Co. v. Commissioner*, (8th Cir. 1948) 171 F. (2d) 395; *Commissioner v. Gregory Run Coal Co.*, (4th Cir. 1948) 212 F. (2d) 52; *Central Cuba Sugar Co. v. Commissioner*, (2d Cir. 1952) 198 F. (2d) 214; 17 L.A. L. REV. 628 at 634 (1957); *Sporrer*, "The Past and Future of Deferring Income and Reserving for Expenses," 34 TAXES 45 (1956); *Wagman*, "Sections 452 and 462: Stormy Past But a Bright Tomorrow," 33 TAXES 711 (1955).

⁵⁴ Rev. Rul. 54-608, 1954-2 CUM. BUL. 8, reversing I.T. 3956, 1949-1 CUM. BUL. 78, and G.C.M. 25261, 1947-2 CUM. BUL. 44 (accrual vacation pay).

The conflict as to accrualability and non-accrualability of liabilities to offset claim-of-right income has already been noted: *S. Loewenstein & Son*, 21 T.C. 648 (1954), *affd.* (6th Cir. 1955) 222 F. (2d) 919; *Beacon Publishing Co. v. Commissioner*, (10th Cir. 1955) 218 F. (2d) 697; *Schuessler v. Commissioner*, (5th Cir. 1956) 230 F. (2d) 722; *Curtis R. Andrews*, 23 T.C. 1026 (1955). And fine distinctions as to what was not under claim-of-right: *Bates Motor Transport Lines, Inc.*, 17 T.C. 151 (1951), *affd.* (7th Cir. 1952) 200 F. (2d) 20; *Mutual Tel. Co. v. United States*, (9th Cir. 1953) 204 F. (2d) 160. Continued distinction allowing accrual if paid and continue to litigate, but not if no payment: *Consolidated Edison Co. v. United States*, (Ct. Cl. 1955) 135 F. Supp. 881, *cert. den.* 351 U.S. 909 (1956).

Continued fiction that renegotiation of contracts, like backpay to transportation systems, relates to uncertain amount rather than contest of liability (result good): *Holmes Projector Co. v. United States*, (Ct. Cl. 1952) 105 F. Supp. 690, *cert. den.* 344 U.S. 912 (1953); *Junior Toy Corp. v. United States*, (Ct. Cl. 1953) 116 F. Supp. 730, *cert. den.* 348 U.S. 815 (1954). Cf. I.T. 3851, 1947-1 CUM. BUL. 32; Rev. Rul. 169, 1953-2 CUM. BUL. 139; Rev. Rul. 55-369, 1955-1 CUM. BUL. 68 (airmail rates).

may be accrued if they are such that estimate within reasonable limits is possible. Certainly this rule would be sound accounting. It is also the rule in England, as shown in a subsequent section of this paper. Even though my efforts to gain acceptance of the view that some contingencies may be accrued may go for naught, I feel it necessary to point out that all the Supreme Court cases could be harmonized with such rule. If there is a minor or slight contingency, it does not prevent determination within reasonable limits, and therefore accrual occurs—of liability (*Anderson* and *Lewyt* cases), or of income (*American National*, *Continental Tie*, *Gulf M. & N. R.*). On the other hand, a substantial contingency prevents accrual—of liability (*American Code*, *Brown*, *Dixie Pine* and *Security Flour Mills*) or of income (*N. Texas Lumber*). It is possible to see how this works in the British cases. We do not escape this same kind of evaluation whatever number of subdivided rules as to litigation, uncertain amount, or other contingencies we devise.

(2) The above analysis of the Supreme Court cases shows that I do not believe the test is whether there is continued litigation. The Court denied accrual when the taxpayer was denying liability and litigating (*American Code*, *Dixie Pine*, *Security Flour Mills*) and accrual was required though the taxpayer was continuing to litigate (*Continental Tie*). To adopt a rule that if taxpayer litigates a claim in non-tax proceedings he loses his tax right of accrual is to tell him he must surrender a legal right in order to gain a tax right. Take two simple examples:

In January 1956 the taxpayer, *A*, who uses his car in business, buys a new Chevrolet from *B* dealer. In December the car went through a guard rail and was wrecked. *B* repairs it and sends *A* a bill for \$350. *A* refuses to pay all the bill because he claims the accident occurred from faulty steering mechanism and faulty maintenance (*B* did all maintenance work). *A* has no proof as to how the accident occurred; the car simply went out of control. *B* sues *A*. *A*'s lawyer tells him he will probably lose the case.

In January 1956 the taxpayer, *A*, leases *B* an apartment under a year lease. *B* occupies it for two months, pays no rent, moves out. *A* tries but is unable to re-rent it. There are no defenses to *A*'s action on the lease. *B* has a good job and is able to pay. Because *B* wants to make *A* trouble he makes *A* sue him and asserts a series of "defenses": lack of heat, untenable conditions, that the signature on the lease is not his. The case is still in litigation at the end of 1956. *A*'s expenses with regard to the lease have all occurred in 1956.

Is there any reason why accrual should not be permitted in either case? In one the taxpayer is denying liability; in the second the other party makes the denial. In both the taxpayer's liabilities and rights are as certain as most any other event in business. Can it be said that when a seller makes a sale it is any more certain (for the buyer may litigate) than the lease or repair? Yet the cases without exception require accrual of sales when made. It seems particularly objectionable to make a taxpayer lose the consistency of accrual accounting because a third party, who may be acting from sheer cussedness, challenges his right.

(3) Even if we are to concede that some litigation precludes accrual, and even if we interpret the *Dixie Pine* and the *Security Flour Mill* cases as holding that the taxpayer must be consistent in his accounting and civil litigation positions (that *he* cannot both assert and deny liability)—a sound logical but an unsound accounting view—we cannot excuse ourselves from a very discriminating examination of the facts. Are we dealing with an income or a deduction accrual problem? Does the taxpayer seek to accrue or resist accrual? If a controversy exists concerning the liability, is the taxpayer asserting or defending? Is the taxpayer's position in the tax-accounting problem the same as, or inconsistent with, his civil law stand?

Examine the last of these first, even under the "inconsistent stand" theory ascribed to the *Dixie Pine* and the *Security Flour Mills* cases. If the taxpayer asserts his right to income and accrues it while he is suing for it, he is wholly consistent. To prevent his accruing the income is to allow a third party to govern taxpayer's books and to cause disharmony with the usual accrual concept of matching expenses and income. As shown in the next major section of this article, the result thus reached in some recent cases is most objectionable.

We have already partially analyzed the problems inherent in the taxpayer asserting or defending a liability controversy. If the taxpayer is merely defending and accrual is refused, the initiative has again passed to another to determine the taxpayer's taxability. Further, to deny accrual is to demand that the taxpayer surrender either his tax rights or his general legal rights.

Similarly, different considerations should obtain when the taxpayer seeks to accrue and when he resists accrual. If taxpayer's books embody a sound accrual system then it should be respected unless the Commission carries the burden of showing that it does

not truly reflect income; this is the statutory requirement.⁵⁵ If proper accrual procedure requires inclusion and the taxpayer refuses, then the burden is his to justify this hybrid.

It is to state the obvious to say that different considerations apply to income and deduction items. Income is all inclusive and to be reported at the earliest possible time; deductions are a matter of legislative grace, placing on the taxpayer the burden of coming within their protection.⁵⁶ The *N. Texas Lumber*, *Spring City Foundry* and *Safety Car Heating* are all cases where (even if accrual were permitted) the accrual would not qualify for the statutory deduction.

(4) In so far as an obligor recognizes his obligation in the alternative to the taxpayer or another (Holland's category "C"), the taxpayer is in a slightly more favorable position than an obligee as to whom the obligor denied liability, and might come under the doctrine of contingencies. It is doubtful whether trustee, receivership and similar cases represent the rule as to accrual by virtue of uncertainty. The terms of the trust or receivership determine the rights of the beneficiary, and accrual, except in accordance with those terms, would be unjustified.⁵⁷ As to accruals by the taxpayer obligor, it should make no difference to whom the obligation is payable, and this seems to be recognized.⁵⁸

The Meaning of "Both Sides of the Books Must Be Treated Alike"

We might still be able to operate a reasonable system of accrual accounting, even with the burden of the "claim of right" and "all factors" tests, but the straw that breaks the camel's back may be the new emphasis on how the other party to the transaction treats it. Two very recent cases—a Sixth Circuit case⁵⁹ and one from the Third Circuit⁶⁰—illustrate the additional confusion.

The courts have frequently used expressions such as, "Both sides of the ledger must be treated alike."⁶¹ Most of these com-

⁵⁵ I.R.C., §446.

⁵⁶ *Interstate Transit Lines v. Commissioner*, 319 U.S. 590 at 593 (1943); note, Griswold, "An Argument Against the Doctrine That Deductions Should Be Narrowly Construed as a Matter of Legislative Grace," 56 HARV. L. REV. 1142 (1943).

⁵⁷ Cases cited in Holland, "Accrual Problems in Tax Accounting," 48 MICH. L. REV. 149 at 162-164 (1949).

⁵⁸ *Tobin Packing Co.*, 43 B.T.A. 642 (1941); *Foster Wheeler Corp.*, 20 T.C. 15 (1953); *Hershey Creamery Co. v. United States*, (Ct. Cl. 1952) 101 F. Supp. 877.

⁵⁹ *Cold Metal Process Co. v. Commissioner*, (6th Cir. 1957) 247 F. (2d) 864.

⁶⁰ *Irwin v. Commissioner*, (3d Cir. 1956) 238 F. (2d) 874.

⁶¹ *Ohmer Register Co. v. Commissioner*, (6th Cir. 1942) 131 F. (2d) 682; *Bonded*

ments were for the purpose of requiring tax accounting to conform to the business accounting concept that expenses attributable to income items should be deducted in the same period as the report of income.⁶² Until recently this had not generally been taken to prevent a taxpayer from accruing an item merely because a third party contested liability. It is true that in some cases where a third party contested liability the courts had previously found sufficient uncertainty to disallow accrual.⁶³ Now the rule appears, not as a matter of degree but as one of preclusion, in the *Cold Metal Process* case, and particularly in *Irwin v. Commissioner*. In the *Cold Metal Process* case the taxpayer was sole stockholder in dissolution of a corporation which had owned patents for hot and cold rolling of metals. These patents had been infringed, but from 1943 to 1949 the government was suing to cancel them. The court held that infringement royalties paid into court from 1943 to 1949 could not be accrued prior to 1949. The court put the decision on the basis that the amount "was not accruable . . . because of litigation instituted by the Government which strenuously contested the legal right of the corporation to such income until the termination of the litigation in 1949." But the case may actually be viewed as one in which the taxpayer was not clear in its own accrual, because the taxpayer had previously defeated an attempted government accrual in 1945 by asserting that the income was not accruable while challenged.⁶⁴

No such extenuation can be found in the *Irwin* case. There the taxpayer entered into a contract with the United States to build Howard University library. The contract contained a clause providing for liquidated damages in case of delay. A loss occurred by reason of governmental delay. On the completion of the contract the builder accrued damages of \$25,700 (\$100 for 257 days). In 1946 an award of about \$13,000 was made and the

Mortgage Co. v. Commissioner, (4th Cir. 1934) 70 F. (2d) 341. These expressions have been for the purpose of saying that income should not be accrued and expenses reported on a cash basis or vice versa, e.g., *Commissioner v. South Texas Lumber Co.*, 333 U.S. 496 at 501 (1948), and *Air-Way Electric Appliance Corp. v. Guitteau*, (6th Cir. 1941) 123 F. (2d) 20. It is also true that some cases have referred arguendo to the fact that "both the petitioner and its agents have treated [the agents'] commissions as earned and as definite obligations. . . ." *Ohmer Register Co.*, supra this note, at 686.

⁶² *United States v. Anderson*, 269 U.S. 422 (1926); *Security Flour Mills Co. v. Commissioner*, 321 U.S. 281 (1944); *American National Co. v. United States*, 274 U.S. 99 (1927); and notes 4-9 supra.

⁶³ *American Hotels Corp.*, 46 B.T.A. 629 (1924); *Ky. and Ind. Term. Ry. Co. v. Commissioner*, (6th Cir. 1931) 54 F. (2d) 738, cert. den. 286 U.S. 557 (1932).

⁶⁴ *Cold Metal Process Co. v. Commissioner*, 17 T.C. 916 (1951).

taxpayer claimed a loss equal to the over-accrual of 1938. The court seemed to hold that there should have been no accrual in 1938. It is difficult to state the rationale of the court. It might be (1) "The claim for this item was presented to the government for the first time in June or July of 1939," (2) "the partnership in 1940 brought an action in the Court of Claims for an amount in excess of \$40,000," (3) "the accrual of \$25,700 in 1938 was improper because it was *extremely uncertain*," (4) "Whatever right the partnership had, or whatever liability the government had, is based not upon any specific contractual clause [note: this is factually questionable], but rather upon the breach of that contract. . . . *Such* rights or liabilities must normally be determined either by a settlement between the parties or by judicial decision." (5) "This case does not fall within the principles of *Continental Tie*. . . . The difference between that case and the one under consideration is what Judge Learned Hand called the distinction between the liquidation of a determined right, and the determination of a disputed right." Actually it was necessary only to decide that the *over-accrual* in 1938 could not be deducted in 1946. Whatever the court's reasoning, the assertion of non-liability by the government has prevented the taxpayer from following sound accounting practices though a later decision has shown the taxpayer right as to liability (though erroneous as to amount). This case should not stand. A taxpayer should, with the guidance of his lawyer, be able to make a reasonable estimate of his chances for income and the amount. The court seems to recognize this in the distinction between contract rights and contract breach. This goes to the degree of certainty. Mere assertion of non-liability by a third party should not be the deciding factor.

The British Attitude on Accruing Contingencies

It may be pointed out categorically that Britain has no such difficulty in making its accounting and tax accrual processes consistent. The courts have uniformly held that a contingency does not relieve a taxpayer of accruing either income or expense. Whether the contingency attaches to a right to earnings or to a liability, the right or the liability must be valued and accounted for year by year before the resolution of the contingency. This can be illustrated by three House of Lords cases, the latest decided in 1956: *Sun Ins. Office v. Clark*,⁶⁵ *Harrison v. Cronk & Sons*,

⁶⁵ [1912] A.C. 443.

Ltd.,⁶⁶ and *Southern Ry. of Peru, Ltd. v. Owen*.⁶⁷ In the *Sun* case the court permitted a fire insurance company to deduct against annual premiums received an estimate to meet later fire damage claims. It recognized that these fire claims were completely contingent and might never occur, but that an actuarial computation of experience in fire risks was possible. The *Harrison* case involved deposits by building contractors with lending societies. The deposits might be forfeited if the house purchasers failed to make their payments. In spite of the contingency that the contractor might never receive the deposits, the court required that they be accrued on an actuarial basis taking account of the contingency. Finally, in the *Peru* case, an English company operating a railway in Peru was required by Peruvian law to pay a retirement pension to employees equal to the monthly wage times years of service. But this employee right could be lost by insubordination or other wrongful acts. The liability was therefore both deferred and contingent. Nevertheless, the court recognized that the liability should be accrued year by year, the only question being the method of valuing. The House of Lords rejected the Crown's argument to defer accrual until actual payment because of the contingency; it also rejected the company's plan to take the annual wage plus an additional month. The statement of Lord Radcliffe may be taken as typical of the English view:

"But, whatever the legal analysis, I think that for liabilities as for debts their proper treatment in annual statements of profit depends not on the legal form but on the trader's answers to two separate questions. The first is—Have I adequately stated my profits for the year if I do not include some figure in respect of these obligations? The second is—Do the circumstances of the case, which include the techniques of established accounting practice, make it possible to supply a figure reliable enough for the purpose?"⁶⁸

Repeal of I.R.C. Sections 452 and 462

Reference has been made elsewhere in this paper,⁶⁹ and other law review articles⁷⁰ have developed this beyond the necessity

⁶⁶ [1936] All E.R. 747.

⁶⁷ [1956] 2 All E.R. 728.

⁶⁸ *Id.* at 739.

⁶⁹ Note 9 *supra*.

⁷⁰ 17 L.A. L. REV. 628 at 633 (1957); Sporrer, "The Past and Future of Deferring Income and Reserving for Expenses," 34 TAXES 45 at 56 (1956); Wagman, "Section 452

for further documentation here, that the statutes and the regulations early encouraged sound accrual practices. It was only because the cases seemed to reverse this policy and produce confusion that sections 452 and 462 were embodied in the 1954 Internal Revenue Code. When it was feared that these provisions would permit tax escape in one year beyond the normal expectations of accrual accounting, the sections were retroactively repealed.⁷¹ The proposed regulations under the sections embodied sound accrual accounting. As pointed out before, the repeal was to close the door to double deductions and too large adjustments in one year, and not to thwart sound accounting or reverse the trend to bring tax law and accounting into harmony.

The congressional committee considering repeal commended certain liberal accrual cases and expressed the hope that the courts might accomplish the legitimate purposes of sections 452 and 462 by application of these cases.⁷² It must be admitted that there are arguments in favor of a case-to-case approval of sound accruing, rather than through the wide open invitation of section 462. Because of the committee's reliance on *Pacific Grape Products Co. v. Commissioner*⁷³ that case takes on peculiar significance. Therein, a canner's season or "pack" extended from July 1st to November 1st. It sold its products under a contract that completed a sale before December 31st and caused all unshipped goods to be billed on that day. It accrued income from all these sales by December 31st and accrued expenses relating to each sale for brokerage fees, labeling, packing and shipping. The Court found the customs of the industry supported this practice, that the system had been followed consistently by the taxpayer for many years, and that "these expenses were either precisely known or determinable with extreme accuracy." It therefore considered that the Supreme Court's *Anderson* decision controlled: that the purpose of the tax law accounting provision "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."

and 462; *Stormy Past But a Bright Tomorrow*," 33 TAXES 711 at 716 (1955); 9 ALA. L. REV. 143 at 147 (1956); 35 TAXES 782 at 791 (1957).

⁷¹ 69 Stat. 134 (1955), 26 U.S.C. (Supp. IV, 1957) §§452, 462; Rev. Rul. 55-539, 1955-2 CUM. BUL. 246.

⁷² See note 9 *supra*.

⁷³ (9th Cir. 1955) 219 F. (2d) 862.

And thus we have come full circle—from the legislative declaration that sound accrual practices were to be followed, which was accepted in the *Anderson* case as the proper test, back to a commendation by the legislative committee of those cases which continue to apply this simple policy.

Guiding Principles

The following guiding principles seem to be developed by the better reasoned cases, by sound accrual accounting and by the legislature's basic policy:

1. Tax decisions should aim to allow accrual accounting sufficient leeway to accomplish the basic purpose of charging the expenses related to the production of income to the same period as that of income production.

2. Accrual is an accounting for reasonable expectancies, and the reasonableness of the expectancy should govern its accrual and allowance. This is essentially a fact, rather than a law, question.

3. It is proper to employ the "claim of right" test to tax income at least as early as it is received in unrestricted funds, provided that offsetting accruals of reasonably ascertainable liabilities or expenses relating to this earning process be allowed at the same time.

4. The "all events" test was intended, and can be made, to prevent unsound income or expense reporting by insisting that all events required by sound accrual accounting have occurred and cannot be disregarded.

5. The test was not, and should not be, a catalogue of absolutes which must be met before accruing can occur. Accruing remains a concept of "reasonably predictable" and "reasonably estimated" and it must be allowed to operate "within reasonable limits."

6. The point at which the courts have gone farthest away from the original concept is in the demand for the "absolute" of admitted liability.

7. It is submitted that a reasonably certain right or liability is all that need be required for accrual.

8. In no event should the fact, as such, that a third party denies or litigates liability, prevent a taxpayer from accruing a reasonably certain right or liability.

9. The fact, as such, that the taxpayer takes inconsistent positions as to liability in civil lawsuits and on his own books and tax

returns should not be the basis for denying accrual. It may be a factor, with other evidence, to show lack of "reasonable predictability."

10. These rules would approach the British system while perhaps not openly accruing contingencies.

11. Accrual cannot excuse the necessity for proving that the liability comes within one of the legislatively granted deduction categories. No accounting system sets up its own tax law; it merely reflects the timing of items. It answers the question of "when," not "whether."

12. The *Cold Metal Process* and *Irwin* theories which make the actions and intent of others govern the taxpayer's accounting and tax reporting should be abandoned.

APPENDIX

Claim of Right Cases

Automobile Club of Michigan v. Commissioner, 353 U.S. 180 (1957). Membership dues paid in advance for one year must be accrued at once rather than over twelve-month period.

Irwin v. Commissioner, (3d Cir. 1956) 238 F. (2d) 874. Contractor not allowed to accrue liquidated damages for delay in construction because government was contesting liability.

Cold Metal Process Co. v. Commissioner, (6th Cir. 1957) 247 F. (2d) 864, stating same rule as to income challenged in patent litigation.

New Capital Hotel, 28 T.C. No. 77 (1957); *Jack Shaucet*, 1957 P-H T.C. Memo. Dec. ¶57,133. Prepaid rentals income to accrual taxpayer when received rather than when later earned.

Bressner Radio Inc., 28 T.C. No. 40 (1957). Television Service Company must accrue payments when received without offsetting accrual of later services. But liability to another company taking over service contract properly accrued.

Phillips v. Commissioner, (7th Cir. 1956) 238 F. (2d) 473. Attorney required to accrue income received as contingent fee, though case later reversed and fee to be paid back.

Lee McRitchie, 27 T.C. 65 (1956). Dividend declared on stock involved in title litigation cannot be accrued until released from litigation.

Thalhimer Bros., Inc., 27 T.C. 733 (1957). Insurance proceeds not accruable as income until actual receipt where amount disputed.

Charles M. Kilborn, 29 T.C. No. 14 (1957); *Arthur V. Morgan*, 29 T.C. No. 9 (1957); *Clifton E. Baird*, 1957 P-H T.C. Memo. Dec. ¶57,192; *J. H. Schaeffer, Jr.*, 1957 P-H T.C. Memo. Dec. ¶57,068; *Burl P.*

Glover, 1957 P-H T.C. Memo. Dec. ¶57,045; West Pontiac, Inc., 27 T.C. 749 (1957); Texas Trailercoach, Inc., 27 T.C. 575 (1956); Albert M. Brodsky, 27 T.C. No. 23 (1956). Accrual income credited by financing companies to dealer reserve account shall be accrued at date of credit, without offsetting estimated liability, rather than when paid over. But see Texas Trailercoach v. Commissioner, (5th Cir. 1958) 1 Am. Fed. Tax Rep. (2d) 58-533; Johnson v. Commissioner, (4th Cir. 1958) 233 F. (2d) 952; West Pontiac, Inc. v. Commissioner, (5th Cir. 1958) 1 Am. Fed. Tax Rep. (2d) 58-839; Hines Pontiac, Inc. v. United States, (N.D. Tex. 1957) 1 Am. Fed. Tax Rep. (2d) 58-734; Modern Olds, Inc. v. United States, (N.D. Tex. 1957) 1 Am. Fed. Tax Rep. (2d) 58-732.

N. Gordon Phillips, 29 T.C. No. 7 (1957). Taxpayer taxed with income from sale of stock in year of sale though compelled to pay back part in a subsequent year.

Delta Air Lines, Inc. v. Edwards, (D.C. Ga. 1957) 150 F. Supp. 589. Airline required to accrue full income for transporting mail in year of service rather than later year when retroactive rates determined and income received.

Cappel House Furnishing Co. v. United States, (6th Cir. 1957) 244 F. (2d) 525. Accrual taxpayer to accrue business interruption insurance over period of interruption rather than earlier year of receipt.

Advertisers Exchange, Inc. v. Commissioner, (2d Cir. 1957) 240 F. (2d) 958. Change from accruing income when contracts signed to period over which services to be performed could be used but required commissioner's approval.

H. J. Heinz Co. v. Granger, (W.D. Pa. 1956) 147 F. Supp. 664. Vegetable canning corporation should accrue government subsidies in later year when government determines qualification for subsidies rather than year of sale.

Peters v. United States, (S.D. Cal. 1958) 1 Am. Fed. Tax Rep. (2d) 58-956.

All Events Test

Schuessler v. Commissioner, (5th Cir. 1956) 230 F. (2d) 722. Deduction for estimated expense of servicing furnaces over five-year period from date of sale allowed.

Rev. Rul. 57-105, INT. REV. BUL. 1957-11. Additional state taxes said to accrue for federal tax purposes when determined by litigation or by acknowledgment by taxpayer.

Columbus and So. Ohio Electric Co. v. Commissioner, (6th Cir. 1957) 244 F. (2d) 79. Public utility could accrue liability to refund excess charges fixed by city though not final until state commission action.

Rev. Rul. 57-485, INT. REV. BUL. 1957-43. Expense accrual, for personal injury claims unsettled at end of year, not deductible.

Rev. Rul. 57-332, INT. REV. BUL. 1957-29. Fraud penalties must be

accrued in year return, giving rise to penalties, is filed rather than when later assessed.

Guardian Investment Co. v. Phinney, (5th Cir. 1958) 1 Am. Fed. Tax Rep. (2d) 58-1124.

Messer Oil Corp., 28 T.C. No. 124 (1957). Real estate taxes accruable when they become a lien rather than in prior year of levy (changed by 1954 code).

Robert S. Bassett, 26 T.C. 619 (1956). Deduction of medical expenses "deposits" denied on the ground there was no present liability.

Waldheim Realty and Inv. Co. v. Commissioner, (8th Cir. 1957) 245 F. (2d) 823. Allowed deduction of prepaid expenses.

Estate of Bertha V. Nottingham, Docket Nos. 42874, 42875, 1956 P-H T.C. Memo. Dec. ¶56,281. Amount accrued under profit sharing plan allowed though erroneously over-computed, but not where liability was contested by taxpayer. Cf. salesman's commissions pending dispute as to amount.

Bessie Rand, 1957 P-H T.C. Memo. Dec. ¶57,132. Cannot accrue legal and audit expenses contingent on reduction of deficiencies while tax controversy undetermined.

Rex Sorensen, 1956 P-H T.C. Memo. Dec. ¶56,234. Taxpayer contracted to supply lumber to government. Defaulted. Taxpayer denied liability and therefore could not accrue until liability determined.

Emanuel N. Kolkey, 27 T.C. 37 (1956). Interest deduction on taxes not accruable where tax liability not conceded.

James J. Standing, 28 T.C. No. 88 (1957). Can accrue interest on deficiencies and attorney's fee in year tax liability settled.

Eugene Richardson, 1957 P-H T.C. Memo. Dec. ¶57,122. Accounting fee accruable only when liability fixed and not contingent.

Natco Corp. v. United States, (3d Cir. 1956) 240 F. (2d) 398. Interest on debentures not deductible in year of payment since liability fixed in prior years though payment date deferred.

Brainard Steel Corp. v. United States, (Ct. Cl. 1956) 146 F. Supp. 461. Cannot accrue back wages increase subsequently paid, where no liability but to negotiate.

Landers, Frary and Clark v. United States, (Ct. Cl. 1957) 149 F. Supp. 202. May accrue taxes when taxpayer recognizes liability even though commissioner or taxpayer subsequently contested amount of liability.

American Bemberg Corp. v. United States, (D.C. Del. 1957) 150 F. Supp. 355, affd. (3d Cir. 1958) 1 Am. Fed. Tax Rep. (2d) 58-1133. Texas Mexican Ry. Co. v. United States, (S.D. Tex. 1958) 1 Am. Fed. Tax Rep. (2d) 58-843; Continental Foundry and Machine Co. v. United States, (Ct. Cl. 1958) 1 Am. Fed. Tax Rep. (2d) 58-1053. Interest liability while contingent not accruable, but fully accrued when liability determined.