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ACCURRAL PROBLEMS IN TAX ACCOUNTING

Alfred E. Holland*

Types of Uncertainty Affecting Accrual

Quite frequently at the end of a taxable year some uncertainty qualifies the eventual payment or receipt of an obligation. An obligor may refuse to pay the debt for any number of reasons. There may be disagreement as to the amount which is due; the obligation may not appear collectible; or there may be some other contingency which makes eventual receipt or payment appear uncertain at the time. This uncertainty presents a problem to the taxpayer when he closes his books at the end of the year. Should such an uncertain item be entered on the books as income for the present year, or should entry be deferred until some future year when less uncertainty may exist? Has an obligation become sufficiently certain to warrant recognition as an expense or loss incurred in the present year, or should accrual be postponed until it becomes more certain in a future year?

If the problem is not passed over completely, the answers of theoretical writers in accounting to these questions are usually deceptively simple. If an obligation is still highly contingent it is said not to be proper to recognize it as income for the present year. On the other hand, an obligation which is sufficiently definite and certain is said to deserve immediate recognition. The terms used, "highly contingent" and "sufficiently definite," are both relative and the one shades into the other by degrees. At some point along this scale the degree of contingency becomes so small that the obligation is sufficiently definite for recognition by accrual. The theoreticians make no attempt

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1 Paxon, Essentials of Accounting 326 (1938); Kester, Advanced Accounting 416 (1946).
to locate this point but merely tell the accountant to base his judgment on the circumstances of each case.

The practicing accountant, in reporting for business purposes, is forced to make a somewhat more definite decision. For the balance sheet or the profit and loss statement to reflect properly the true condition of the business, accrual is necessary in some instances. Obligations which involve only a small degree of contingency should be recognized by accrual. Such an accrual is usually explained in a footnote describing the situation in whatever detail is thought necessary. If more than a slight contingency is present the item will not be accrued, but a footnote will be used to show that a contingent item of income or expense exists. In this manner the ultimate decision is passed on to the persons for whom the balance sheet or profit and loss statement is prepared. This is not an evasion of responsibility by the accountant but a well-recognized method of achieving a desired result. While the accepted functions of accounting include both interpretation and reporting, the ultimate interpretation must be made by the persons who use the material furnished by the accountant. Thus, in a doubtful case, by presenting the facts of the situation and a suggested solution, the accountant gives the ultimate interpreters a more accurate report upon which to base their conclusions than would be possible without the use of such footnotes.

In accounting for income tax purposes the questions posed must be answered and decisions must be made. The taxpayer must decide whether an item is to be accrued, and the courts must pass on the correctness of his decision. No refuge can be taken in theoretical statements, nor can footnotes be used to pass the responsibility for the decision to someone else. At the end of the taxable year the taxpayer (usually the attorney or accountant advising him) must decide whether the obligation is “too highly contingent” or “sufficiently definite” for accrual. Frequently the taxpayer acts at his peril. If a decision to postpone accrual of a liability is in later years found in error by the courts, the statute of limitations may prevent amendment of the return for the taxable year in which the deduction should have been claimed. If a decision to report a receivable in the present year is later found to be in error, claim for refund may be barred. In this manner the taxpayer is forced to make a definite decision and is held to his election.

2 KESTER, ADVANCED ACCOUNTING 419 (1946).
There is, however, in some situations, one method by which the taxpayer may pass the responsibility for the decision to the bureau or the courts. He may claim a deduction for an expense in each of the several years and let the bureau disallow all but one deduction. This is an expensive method of solving the problem because interest must be paid on the deficiencies which will be found for all but the proper year. Thus in some situations relief from the responsibility of acting at his peril may be purchased by the taxpayer, but at a considerable price.

Since the taxpayer must decide, he looks to the previous decisions to see whether the courts have found similar obligations sufficiently definite for accrual. As there are thousands of decided cases in which this question has been considered, either directly or indirectly, decisions concerning analogous situations often are found. Frequently, however, altogether too many precedents exist, and the searcher may then become lost in a maze of contradictory decisions and statements, as there are many conflicts between decisions of the various circuits, between circuits and the Tax Court, and between dicta and the actual holdings. Or, since the possible fact situations when considered in relation to the circumstances appear to be numberless, a precedent may not be found at all. And above all, it must be realized that the question is really one of degree; what one person or court will consider contingent, another will call definite.

While for all these reasons the use of previously decided cases is unsatisfactory, the taxpayer has nothing else which he can use. The general statements of the accountants and courts are of little value in deciding the specific problem confronting him—namely, is this particular item sufficiently definite for accrual? His only recourse is to survey the previous decisions of the courts in analogous situations, if any can be found, and hope that the court passing on his case will agree.

In many situations there have been sufficient cases in which the courts have agreed that general trends in the decisions can be observed and some of these trends are so distinct and pronounced that they may be considered to have become rules of law. In some situations the courts have evolved legal tests which they apply in determining whether items are sufficiently definite for accrual. In other situations no trends can be discerned, and all that can be said is that the courts will consider the whole situation and will allow accrual if the obligation is not too highly contingent.
There are five principal manners in which an obligation, receivable or payable, may be too highly contingent to warrant accrual: (1) the existence of any liability at all may be uncertain; (2) the liability may be contingent because its existence depends on the happening of a future contingent event; (3) both the taxpayer and a third party may claim the right to receive the payments; (4) the amount to be received or paid may be uncertain; or (5) the obligation may not appear collectible.

The purpose of this article is to survey the general trends which do exist in the handling of each of these situations by the courts and to set out those in which a court’s disposition of a case can, to some extent, be predicted. While this will be of limited value to a taxpayer in a specific situation faced with the necessity of choosing the proper year for accrual, it should afford something of a standard by which he can measure the contingency and upon which he can base his choice.

A. Existence of Any Liability Uncertain

In attacking the problem of whether an item of income or expense may be accrued, the first consideration usually is whether a definite liability exists. It is frequently stated by writers and courts that existence of a definite liability is necessary prior to accrual of any obligation.

The origin of this view is easily traced to a statement of the Supreme Court in *United States v. Anderson.* However, when carefully examined, the statement in that case seems to be a dictum. There the taxpayer was engaged in manufacturing and selling munitions. A tax was levied on the sale of munitions made in 1916 but was not due and payable until 1917. The taxpayer set up a reserve for the tax in 1916 but claimed a deduction of the amount as an expense in its

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3 It is recognized by the writer that under the present system of review of tax cases a question cannot safely be considered as settled until it has been passed upon by the Supreme Court. However, the long delay usually involved in getting a Supreme Court decision on a tax question makes it necessary that meanwhile decisions of the lower courts be accepted in many instances as qualitatively settling the question. For this reason some questions will be considered reasonably well settled in the absence of a Supreme Court holding if a sufficient number of decisions of the lower courts have agreed.

4 2 MERTENS, LAW OF INCOME TAXATION, §12.61 (1942): "EXISTENCE OF DEFINITE LIABILITY AS ESSENCE OF ACCRUAL. A non-existent liability cannot be accrued. Accordingly it is necessary in each case to determine whether a liability has been created." MAGILL, TAXABLE INCOME 198-200 (1945); Security Flour Mills v. Comr., 321 U.S. 281, 64 S.Ct. 596 (1944).

5 269 U.S. 422, 46 S.Ct. 131 (1926).
return for 1917, the year in which the tax was actually paid. In holding that the deduction could be taken only in 1916 the Court seemingly based its decision on the broad principle that related items of income and expense must be accounted for in the same fiscal year, and stated that 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.” But, since the taxpayer had argued that the tax could not be accrued as an expense prior to when it was assessed and became due, the Court went on to say that it was 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 a taxpayer to pay it.”6 Other courts quickly seized upon this statement as establishing a basic rule that an obligation is not sufficiently definite for accrual until all events occur which fix the amount and determine the liability.7 Consideration of the requirement of a fixed amount as a necessary antecedent to accrual will be deferred for the present and attention given to the requirement of a definite liability.

The interpretation by the lower courts of the statement as a basic requirement for accrual was confirmed by the Supreme Court’s decision in Lucas v. North Texas Lumber Co.8 There the taxpayer gave a purchaser a ten-day option to purchase its timber lands for a specified price. The purchaser was solvent and able to make the purchase. On the same day the title was examined and found satisfactory to the purchaser. Having arranged for the money needed, on December 30, 1916, the purchaser notified the taxpayer that the option would be exercised. On that day the taxpayer ceased lumbering operations and withdrew all employees from the land. On January 5, 1917, the papers required to effect the transfer were delivered, the purchaser paid the purchase price, and the transaction was closed. The taxpayer kept its accounts on the accrual basis and treated the profits as income for 1916. In a very short opinion the Court held that income did not arise in 1916 because “unconditional liability of vendee for the purchase price was not created in that year” as there had not been a tender of title or possession or a demand of the purchase price.9 If this state-

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6 Id. at 440, 441.
8 281 U.S. 11, 50 S.Ct. 184 (1930).
9 Id. at 13.
ment were to be accepted in its fullest implications there would be little reason to examine the proposition further. Neither income nor expense could be accrued until unconditional liability for the purchase price was created. Liability of the purchaser in this case was considered conditional even though everything had occurred to make a completed sale except formal tender of a title which already had been found satisfactory to the purchaser. It would be hard to imagine a stricter requirement of absolute certainty.

From the time of the Anderson and North Texas Lumber Co. cases to the present day, courts have repeatedly stated that all events must occur to fix the liability of the obligor before an obligation can be recognized by accrual on a taxpayer's books of account. However, the extremely strict requirement of unconditional liability as set forth in the North Texas Lumber Co. case has been relaxed considerably and the courts no longer speak of unconditional liability, but now say merely that liability must be present.

As this rule requiring the presence of liability is no longer challenged and efforts now are directed toward showing that liability is uncertain in the cases before the court, the next step is to examine the general types of situations in which the courts have, or have not, found liability to exist.

When either the taxpayer or the obligor expressly admits that he owes the debt, liability obviously exists.

Next comes the situation where the obligor denies that he owes anything to the taxpayer. In theory the denial of liability by the obligor does not necessarily denote its absence and, if the existence of liability is the test, it would seem that liability could be found to exist and accrual would be proper regardless of the denial. But in actual practice denial of liability by the obligor has the effect of preventing accrual of income by the taxpayer. The courts always seem to find what they declare is sufficient uncertainty as to the existence of liability to make accrual improper.

If the taxpayer denies that he owes the obligation, he cannot accrue it as an expense.\textsuperscript{13} It seems elementary that he should not be able to claim a deduction for an expense while simultaneously claiming that the obligation does not exist. This presence of conflicting positions is usually made the basis for refusing to allow accrual in such cases. Also present, but not usually articulated by the courts, is the consideration that liability may not exist in fact. However, the question has been litigated frequently and, in spite of repeated holdings that an obligation which is denied cannot be accrued, the cases continue.\textsuperscript{14} This continued insistence by taxpayers might be attributable to the denial of deductions for funds placed in reserve for eventual payment if liability of the taxpayer is admitted or established by court decree in a later year.\textsuperscript{15} The use of reserves for this purpose is so widespread and so well established that taxpayers may be unable to dismiss from their minds the conviction that it is essentially unfair not to allow them to claim some kind of deduction for expenses which they are contesting but expect to pay eventually. Whatever the reason, the cases continue to be brought before the courts.

If the obligor neither expressly admits nor denies the existence of the liability, the claim is examined to see if a legally enforceable obligation is present.\textsuperscript{16} If, in the opinion of the court, a legal obligation is present, accrual may be proper; if it is thought that no such obligation exists, accrual is forbidden. This seems so obvious that to state it appears useless, but its statement points up the effect of a denial of liability on the proper time for accrual. If there is no denial the situation is closely examined to discover whether a legally enforceable obligation is present; if a denial is interposed the situation is not examined but the denial itself has the effect of preventing accrual. This indicates that more is required than a situation in which liability probably will be found by a court, and that accrual will not be proper unless the situation is such that a denial is so improbable that the obligor's silence is considered an implied admission of liability. Then the existence of a right to receive payment and a duty of the obligor to make payment seems not to be enough; it appears necessary also that

\textsuperscript{14} Baltimore & O. R. Co. v. Magruder, (D.C. Md. 1948) 77 F. Supp. 156.
either the duty be expressly admitted or the claim be such that an implied admission is found. The statement of the courts that before accrual is proper "all events must occur to fix the liability of the obligor" now appears to mean that liability must not only exist but all doubt of its existence must have been removed by express or implied admission of the obligor. This theory of the meaning of the expression "all events necessary to fix liability" has not been voiced by the courts but seems to be the net effect of the decisions. As it is a general statement derived from consideration of the results of the decisions, not the statements of the courts in the decisions, there is no convenient way to support it by citation.

Where the obligor not only denies liability but contests the existence of liability by court action, there can be no accrual of income by the taxpayer as the courts always find the existence of liability too uncertain. This is not to say that the existence of any court action pertaining to the obligation is sufficient evidence of uncertainty to make accrual improper in all cases. There are situations in which the obligor may be contesting the amount of the obligation or some other factor and accrual will still be proper. Consideration of such cases will be deferred until the requirement of certainty in amount is discussed. But, whenever the existence of liability has been contested in a court action no accrual has ever been found proper. Courts which refuse to find a legal liability when the obligor merely denies that he is liable would hardly be expected to hold otherwise when he actually contests liability in court.

In the opposite situation, where the taxpayer contests his liability in a court action, accrual is always refused. Here, along with the feeling that a definite obligation cannot exist while liability is being disputed in court, there is also involved the rule that a taxpayer may

19 Dixie Pine Products Co. v. Comr., 320 U.S. 516, 64 S.Ct. 364 (1944); Lucas v. Am. Code Co., Inc., 280 U.S. 445, 50 S.Ct. 202 (1930); Atlantic Coast Line R. Co., 4 T. C. 140 (1944). When the taxpayer is seeking to postpone the deduction to a later year than that in which the claim arises it is necessary that the liability be disputed in good faith. If the court finds no grounds for the dispute a postponement of accrual to the date of the final judgment will be denied. Thorne, Neale & Co., 13 B.T.A. 490 (1928); McCabe Lathe & Machine Co., 9 B.T.A. 1137 (1928).
not claim a deduction for an expense which he is simultaneously claim­ing he should not pay.

Whether liability is contested by the taxpayer or the obligor, accrual is not proper until the termination of the litigation or until a settlement is reached.\textsuperscript{20} Litigation is not terminated for this purpose until all possible appeals have been taken or liability has become final by the expiration of time to appeal.\textsuperscript{21} In other words, a final judgment which cannot be carried further is required.

It would seem that if a taxpayer, after having been adjudged liable to pay an obligation, decided not to appeal, he could deduct the expense at once rather than wait until the expiration of the time allowed for appeal. No case has been found by the writer in which this possibility was considered. If the taxpayer definitely acknowledged liability there would seem to be no objection to accrual before expiration of time to appeal.

In one type of case the Tax Court appears to have made an exception to the rule that accrual is not proper so long as existence of liability is contested in court. If the suit is such that the decree can be considered a declaration that the obligor has withheld property already owned by the taxpayer, accrual prior to final termination of the litigation has been allowed.\textsuperscript{22} The theory is that in such a case the court decree adds nothing to the rights which already exist but is merely a confirmation of rights already in being. In this manner a distinction is made between denial of liability to pay an obligation running to the taxpayer and a denial of a duty to turn over to the taxpayer property which already belongs to him. In the first situation denial is found sufficient to prevent accrual; in the second it is not. This theory, sometimes called the “pre-existing rights” theory, has met with only limited approval by the courts. Even in the few cases where it has been accepted its application gives much trouble because of the uncertainty which exists during the course of any litigation as to the form the final decree of the court will take and the difficulty in distinguishing a final

\textsuperscript{22} Est. of Alexander, 47 B.T.A. 50 (1942), affd., (C.C.A. 6th, 1943) 137 F. (2d) 100; William R. Hopkins, 41 B.T.A. 1292 (1940); Goforth et al., 32 B.T.A. 1206 (1935).
decree which merely declares ownership from one which is an adjudication of liability for a claimed obligation.

Liability is generally taken to require the presence of a legally enforceable obligation. Only one case has been found by the writer in which this was not required.23 There the taxpayer had accrued on its books uncollected usurious interest due it from a corporation owned and controlled by the same interests which controlled the taxpayer. The circumstances were such that it was expected that the accrued interest would be paid. In ruling that the amounts so accrued constituted taxable income for that year, the court stated that the question depended “not so much . . . upon the legal right to enforce collection as upon the existing probability of its being received.”24 The court rejected the accepted test of the existence of definite liability, generally taken to mean a legally enforceable obligation, and considered the presence of a legally enforceable obligation merely one of the factors bearing on the real consideration, whether there was a reasonable expectancy of payment. While this is perhaps the view of many business men—that the value of the promise lies more in the expectation that it will be performed than in the legal remedies available in case of non-performance—it does not seem likely that the courts will depart from the more definite and easily applied test of the presence of a legal obligation. The result reached in this particular case might be passed over because, in the very peculiar situation present, payment of the obligation was assured by the identity of the interests controlling both the obligor and the taxpayer. In such a situation the presence of a legally enforceable obligation would not serve to increase the probability of payment.

It is apparent from the preceding discussion that the courts have evolved a definite requirement that legal liability must exist before accrual will be found proper. There are strong indications that not only must this liability exist but either its existence must be recognized by express admission or the situation must be such that denial is so improbable that the obligor’s silence is considered an implied admission. In any event more is required than merely the presence of a situation where, if the proposition were to be submitted to a court, liability of the debtor would be found. The existence of liability must

24 Id. at 123.
be made definite and certain. For this it is required (in the opinion of the writer) that either the debtor must expressly admit liability, or such a situation must be present that admission will be implied, or a court must have found liability in a final adjudication. This is the legal test which has been evolved over the years. It is used by the courts, perhaps sometimes unconsciously, in all situations where there is an uncertainty qualifying the eventual payment of an obligation. Unless the obligation is found to meet this test, accrual will be held improper.

B. Liability Subject to a Contingency

An employer may agree to pay an employee a bonus based on a percentage of the profits made during the year, but with a provision that if the employee does not remain with the firm for the following five years he will lose his right to receive it. A baseball club may contract to pay a certain amount to another club for a player, but with a provision that the obligation will be cancelled if the player should fail to report for the next season. A client may agree to pay an attorney a definite fee, but only if the suit is won and recovery is had. The condition may be expressed as either subsequent or precedent. The factor which distinguishes the problem illustrated by these hypothetical situations is that the liability of the taxpayer or obligor is subject to the happening of a contingent event which may occur after the end of the taxable year. This is not to be confused with the situation where liability is doubtful at the end of the taxable year because of events which have already occurred. If events have already occurred which raise doubt of the existence of liability, the liability should not be spoken of as contingent (although it frequently is so described) but should be termed doubtful or uncertain. In the class of cases now to be considered, the liability can properly be designated as contingent because its existence depends on the occurrence or non-occurrence of a future contingent event. In such cases is it proper to accrue income or expense at the end of the taxable year?

A general answer to this question would be that accrual is improper where liability is contingent. 25 The usual statement is that a deduction

for an expense or a loss is not to be allowed until the liability becomes fixed and certain, and that income may not be recognized by accrual so long as the right to receive it is contingent. While this is well established as a statement of the general rule, the statement must be qualified by the requirement that the contingency be a substantial one. Some contingencies are sufficient to prevent accrual prior to their occurrence or the expiration of the time allowed for their occurrence. Others are considered not sufficiently substantial to warrant deferment of accrual.

Care must be taken to distinguish the situation in which the contingency exists from the time liability first arises from that in which there is an entirely new transaction which reduces or extinguishes liability. Such new transactions are entirely separate and have no effect on the accrual of income or expense arising out of the original deal. As in all problems where the distinction is one of degree, the results of the decided cases are far from consistent. What will appear to one court as a substantial contingency will be declared inconsequential by another. There are only a few types of situations where the courts have been sufficiently consistent and enough cases have been decided to allow generalizations to be made.

When an attorney takes a case under a contingent fee arrangement no income can be accrued until a final decree has been rendered and time for appeal has expired. Nor can the client accrue any obligation to an attorney under such an arrangement prior to final disposition of the case. Such a contingency is considered too substantial to allow accrual by either party.

Where the taxpayer receives payments under an option to purchase

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28 Comr. v. Blaine, McKay, Lee Co., (C.C.A. 3d, 1944) 141 F. (2d) 201. In Tobin Packing Co., 43 B.T.A. 642 (1941), the taxpayer agreed in 1935 to pay attorneys a certain percentage of the processing taxes saved if and when the Agricultural Adjustment Act was held invalid. After the tax was found unconstitutional on January 6, 1936, the taxpayer eliminated from its deductions the unpaid processing taxes for 1935 but accrued its obligation to pay the attorneys the percentage promised, and claimed a deduction therefor as an expense for 1935. The Board of Tax Appeals allowed the deduction stating that at the end of 1935 the taxpayer had incurred a liability for at least the amount of the deduction claimed. "At the end of 1935 all the events had occurred fixing the amount of a definite liability and the contingency settled by the decision of the Supreme Court was that the amount was to be paid to the attorneys instead of the Government." Id. at 644.
which are to be applied on the purchase price in case the option is
exercised, but which are to be retained as damages or rent if the option
is not exercised, the amounts received are not income in the year
received but become income only after the option has been exercised
or the time for exercise has expired. Prior to that time it cannot be
told whether the payments represent income or a part of the purchase
price in a capital transaction. While this is not strictly a question of
accrual, it is a good illustration of a situation in which the realization
of income depends on a future contingency that is sufficiently substan­
tial to prevent immediate recognition. No case has been found where
the courts have passed on the opposite situation, that is, where pay­
ments are made by the taxpayer under an option to purchase, but it
is presumed that the same result would be reached.

Other than in these few situations little can be gained by reviewing
the decisions of the courts. To do so would only bear out the general
rule that accrual is improper where liability is contingent but proper
where the contingency is insubstantial. As the question is one of
degree, the result in any case will depend upon the factual situation
and the theory of the court trying the case as to what constitutes a
substantial contingency.

C. A Third Party Claims Right to Receive Payment

Many times a situation arises wherein liability of the obligor is
established but a third party and the taxpayer both claim the right
to receive the payment. To protect himself in such cases the obligor
usually either withholds payment until the conflicting claims are
settled or pays the money into a depository or to a receiver to be held
pending settlement of the dispute. Many years may pass before the
dispute is finally settled and funds accumulated by the obligor or the
receiver during these years may amount to a very large sum. In such
a situation, if the income is not taxable to the fiduciary, may the tax­
payer accrue as income for the year the amount withheld or paid to
the receiver, or must he wait until the final decree of the court uphold­
his right to receive the income?

29 Hunter v. Comr., (C.C.A. 5th, 1944) 140 F. (2d) 954; Doyle et ux. v. Comr.,
(C.C.A. 2d, 1940) 110 F. (2d) 157, cert. den., 311 U.S. 658, 61 S.Ct. 13 (1940); Birch
(2d) 874.

30 If the income is taxable to the receiver this problem will never arise. But returns are
not to be made by receivers where they are in possession of part only of the property of an
From the point of view of the taxpayer, following either course may bring unpleasant results. If he does not accrue the income each year as it arises, but reports it only after his right to receive it has been confirmed by final decree of the court, his income for the year in which it is received may be so large that, under the graduated rate scale, most of the amount received must be paid out in taxes. On the other hand, if he accrues the income as it is earned each year and his right to receive it is not upheld by the court on final settlement of the dispute, he has paid income taxes on income which he will never receive.

There is an important theoretical difference between this type of situation and that in which liability of the obligor to the taxpayer is contested by court action brought by the obligor. Here liability of the obligor is not questioned but the issue is between the taxpayer and a third party who claims to be entitled to the income. In spite of this theoretical difference the disposition of the cases is the same. So long as the obligor contested liability, accrual by the taxpayer was seen to be improper. Here, so long as the third party contests the right of the taxpayer to the income and its receipt is delayed by this contest, accrual is improper.

The leading case on this point is North American Oil Consolidated v. Burnet. Among other properties operated by the taxpayer in that case was a section of oil land, legal title to which stood in the name of the United States. Prior to 1916, the government, claiming also the beneficial ownership, had instituted suit to oust the taxpayer from possession, and on February 2, 1916, it secured appointment of a receiver to operate the property and to hold the net income thereof. The proceeds from the operation were paid to the receiver as earned during 1916. After the entry in 1917 of a decree by the district court dismissing the government's bill, the receiver paid over to the taxpayer the proceeds earned during 1916. The litigation between the government and the taxpayer was finally terminated by the Supreme Court's
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dismissal of the government's appeal in 1922. The income earned from the property in 1916 had been entered on the taxpayer's books as income for that year. The taxpayer claimed that the money paid over in 1917 was income for 1916 or 1922. The Supreme Court held that the profits were not taxable to the taxpayer as income for 1916: "For the company was not required in 1916 to report as income an amount which it might never receive." 82

Since this decision, made in 1932, the prevailing view has been that a taxpayer cannot accrue income which the obligor has withheld or paid to a receiver to hold pending outcome of a legal contest for ownership between the taxpayer and a third party. 83 The courts have stated repeatedly that taxpayers need not report income which they have not and may never receive. 84 That the courts are imposing a legal test is easy to see. Accrual will not be proper so long as payment to the taxpayer is withheld pending outcome of a suit by a third party. The merits of the third party's claim are not considered; its existence is sufficient to block accrual. 85

This is substantially the manner in which the problem would be handled by most accountants. Normally the presence of litigation will cause an accountant to regard the taxpayer's claim as too contingent for recognition by accrual. If the claim of the third party has no legal foundation or is merely a nuisance claim, some accountants might accrue the income as it is earned by the property with, perhaps, a footnote showing the existence of the suit. This would serve to

82 Id. at 423.
83 Income from property was paid to a receiver to be held pending the outcome of litigation between the taxpayer and a third party claiming a right to receive it in Benton Wilson, 33 B.T.A. 649 (1933); Natl. Petroleum & Refining Co., 28 B.T.A. 656 (1933); Aubrey Umstead, 28 B.T.A. 176 (1933), affd., (C.C.A. 8th, 1934) 72 F. (2d) 328; Trojan Oil Co., 26 B.T.A. 659 (1932). Income was withheld by the obligor pending outcome of the litigation in Petit et al., 8 T.C. 228 (1947); Est. of Anthony, 5 T.C. 752 (1945), affd., (C.C.A. 10th, 1946) 155 F. (2d) 980; E. T. Slider, Inc., 5 T.C. 263 (1945); J. E. Farrell, 45 B.T.A. 162 (1941), affd., (C.C.A. 5th, 1943) 134 F. (2d) 193; London-Butte Gold Mines Co., 41 B.T.A. 852 (1940), affd., (C.C.A. 10th, 1940) 116 F. (2d) 478. In some of these cases the taxpayers were on the cash basis. The same reasoning is equally applicable to both accrual and cash basis taxpayers, that is, the income is taxable to neither until settlement of the contest, because prior to that time income has not been received and it is doubtful that it will ever be received. It has been stated that for the purpose of this problem it is immaterial whether the taxpayer is on the cash or accrual basis. No. Am. Oil Consolidated v. Burnet, 286 U.S. 417, 52 S.Ct. 613 (1932).
prevent distortion of income by the existence of a suit which had no legal foundation. Other more conservative accountants would regard the presence of any suit as interposing sufficient contingency to prevent accrual prior to final determination of the court.

At one time taxpayers were allowed in a few cases to accrue income as the payments were made to the receiver. This was on the theory that the determination of the controversy in favor of the taxpayer showed that the title to the property, hence to the income arising from it, had always been in the taxpayer and the decree dismissing the claim of the third party added nothing to the rights of the taxpayer. This has been called the "pre-existing rights" theory and substantially is the same argument that was discussed above in the cases where the obligor was contesting liability. It has met with about the same reception in both instances, that is, a few courts have agreed but most have disapproved. It was accepted by the Board of Tax Appeals in *Brooklyn Union Gas Co.*, and the following quotation from that opinion is as clear a statement of the theory as is to be found:

"We cannot agree with the theory that a taxpayer maintaining his accounts on an accrual basis may accrue as income only those uncollected accounts pertaining to the current year in respect of which there is no contested litigation . . . . We think that a taxpayer on the accrual basis who renders service in a taxable year and asserts in that year a right to payment in a given amount is then chargeable with income in that amount if, at the close of that year, all of those conditions have been met, all those things done, which give rise to the right asserted, irrespective of the fact that the right may be contested and ultimate collection may be postponed until some future year. In such case the right to receive the income is a right then perfected and the litigation later concluded merely determines the right as having existed in the former year."

In recent years no courts have accepted this theory and the law now seems well settled that accrual is not proper so long as payment to the

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36 Harris Oil Co., 13 B.T.A. 937 (1928); S. W. Harris, 2 B.T.A. 933 (1925). In Obispo Oil Co. v. Welch, (C.C.A. 9th, 1936) 85 F. (2d) 860, revd., 301 U.S. 190, 57 S.Ct. 684 (1937), proceeds from oil lands had been impounded by the United States pending settlement of conflicting claims to the property. Settlement was reached after years of operation. The taxpayer had accrued and reported the income received by the receiver during each year. The court held that the taxpayer was entitled to percentage depletion for these years, thereby indicating that the accrual of income during the period would have been proper.

taxpayer is withheld pending outcome of litigation between the taxpayer and a third party.

In this situation the courts rarely speak of the presence of liability as a prerequisite to accrual. Perhaps this is because the obligor is admittedly liable to someone, and to distinguish between liability to an unascertained person and liability to the taxpayer would only confuse matters. If such a distinction were made it would appear that the same requirement of liability of the obligor to the taxpayer is present in these cases. Furthermore, not only is such liability to the taxpayer required to be present, but its existence must not be contested by a third party in a court action. Following this line of reasoning, admittedly tenuous, it can be supposed that a mere claim by a third party, not supported by court action, would also be sufficient to prevent accrual if it caused the obligor to withhold payment. Unless there is some magic in court actions, there is no reason to distinguish between payment withheld because of the presence of a suit contesting the taxpayer's right to receive the income and payment withheld because of a claim unsupported by a suit. If the presence of a court action, no matter how devoid of legal basis, will render eventual receipt of income too contingent for accrual, then should not the presence of an unsupported claim have the same effect? No case has been found where the question has been considered.

D. Amount Due Uncertain

Frequently the obligor is admittedly liable to the taxpayer but there is a dispute as to the amount of the liability. Or, conversely, the taxpayer may have incurred a definite liability but at the end of the taxable year the amount of the liability is still uncertain. In such cases, where liability is definitely established but the amount due is uncertain, is accrual proper?

It can properly be said that as a general rule an obligation may not be recognized by accrual if it is unsettled in amount, or, as it is more frequently expressed, that prior to accrual all events must occur which fix the amount due. This was first voiced by the Supreme Court in United States v. Anderson in 1926.38 There the Court indicated that accrual would be proper when all events occurred which are necessary to fix the liabilities of the parties and determine the amount of such liabilities. Since that date this statement of the general rule has been

38 269 U.S. 422, 46 S.Ct. 131 (1926).
repeated in almost every case which has involved accrual of an obligation uncertain in amount.

Equally well established is the rule that the exact amount need not be fixed prior to accrual but that accrual is proper when all events have occurred which make it possible for the taxpayer to estimate the amount due with reasonable accuracy. This limitation to the general rule was first mentioned by the Supreme Court in a dictum in *Lucas v. American Code Co.*: “It may be assumed that, since the company kept its books on the accrual basis, the mere fact that the exact amount of the liability had not been definitely fixed would not prevent the deduction.”

The first occasion on which the Supreme Court allowed accrual where the amount of the obligation was not fixed exactly but was capable of estimation with reasonable accuracy, was in *Continental Tie & Lumber Co. v. United States.* The Transportation Act of 1920 authorized payments to be made by the Interstate Commerce Commission to those railroads which were not operated by the government during the period of federal control and which competed for traffic, or connected, with one under federal control. The act directed the Interstate Commerce Commission to compare the results of such operation with those of a test period, defined as the three years ending June 30, 1917, and, if less favorable during the period of federal control than during the test period, to award an amount calculated as prescribed by the act. The Transportation Act took effect on February 28, 1920, and on June 10, 1920, the Interstate Commerce Commission issued general instructions governing the compilation and submission of data by the carriers entitled to awards. At the date of the act’s adoption no railroad had any vested claim for compensation. Until the Interstate Commerce Commission made an award nothing could be paid and no proceeding was available to compel an allowance or to determine the elements which should enter into the calculation. The instructions issued merely set out the general principles to be followed in making the award and did not cover the smaller details involved. The Continental Tie and Lumber Co. had operated its own railroad from June 3, 1918, until February 28, 1920. It promptly claimed an award, but the final finding as to the amount was not reached until 1923. The commissioner found that the compensation received under the award was income for 1920. The taxpayer claimed that it was

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40 286 U.S. 290, 52 S.Ct. 529 (1932).
41 41 Stat. L. 460 §204 (1920).
income for 1923, the year in which the final award was made. The Supreme Court held that the taxpayer should have estimated the amount of the award and reported that amount as income in 1920. It thought that at that time the taxpayer could have estimated with reasonable accuracy the amount it would receive as all the information used in the final award was then present on its books and the general instructions governing the award had been issued during that year. The discrepancy which would have existed between the estimate and the final award could then be adjusted by an additional assessment or claim for refund after final determination of the amount due. The Court stated:

"The case does not fall within the principle that where the liability is undetermined in the tax year the taxpayer is not called upon to accrue any sum (Lucas v. American Code Co. . . .), but presents the problem whether the taxpayer had in its own books and accounts data to which it could apply the calculations required by the statute and ascertain the quantum of the award within reasonable limits." 42

Most of the other earlier cases in which the courts were concerned with this problem arose out of the operation by the federal government of railroads during and shortly after the first World War. Late in 1917 or early in 1918 most of the country's railroads were taken over by the president and were operated by him until February 29, 1920. The Federal Railroad Control Act of 1918 43 provided that the carrier and the President might agree upon just compensation for the use of the properties taken over. By the act it was to be an annual sum for each year of federal control not exceeding the carrier's railway operating income for three years ending June 30, 1917. This was referred to as the "standard return," and where this was accepted by the carrier, the average annual railway operating income as determined by the Interstate Commerce Commission was conclusive. By the same statute, where the standard return was for any reason plainly inequitable as the measure of "just compensation," the President was authorized to agree with the carrier upon such amount as just compensation as he should find to be just under the circumstances of the particular case. The statute made no distinction between just compensation based on the standard return or any other basis.

42 286 U.S. 290 at 296, 53 S.Ct. 529 (1932).
The railroads claimed to be entitled to more than the standard return and practically all received more when the final settlement was reached, in many instances not until 1922 or 1923. The railroads, following the method of reporting suggested in an accounting circular of the United States Railroad Administration dated March 1, 1919, had reported the amount of the standard return each year of the operation with a notation that this amount might be increased by a final fixation of just compensation at a later period. When the compensation was finally fixed, the railroads sought to amend their returns for the years of government operation and to report the entire amount as income for those years. The commissioner contended that the excess above the standard return must be accounted for as income in the year the agreement was reached, that is, the year in which the exact amount was determined. The courts consistently found that the compensation should have been accrued as income for the years of federal operation and that amended returns should have been allowed by the commissioner. The government was found to have conceded liability to pay just compensation and not merely the standard return. Therefore, the compensation was not contingent on any future event, but only the final ascertainment of the amount was deferred. Under such circumstances the courts were of the opinion that it was reasonable to account for the compensation as income for the years of actual operation.

These federal control cases and the Continental Tie & Lumber Co. case firmly established the rule that accrual of income is not improper when the amount due can be estimated within reasonable limits. That


45 In most of the federal control cases the returns for the years of operation were still subject to review at the time of the final agreements. In one case, Helvering v. St. Louis Southwestern Ry., (C.C.A. 8th, 1933) 66 F. (2d) 633, cert. den., 292 U.S. 626, 54 S.Ct. 632 (1934), this rule was followed where the statute of limitations had run on the taxes for two years of the period of federal operation and, as a result, the railroad concerned was not taxed at all on the earnings in excess of the standard return for those years. There was a strong dissent in this case by Circuit Judge Woodrough who thought that the Midland and Old Dominion cases rested on the theory that, since the whole period was within the statutory period of administration and there was no question of the tax being collected on all the income earned, it was reasonable to allow accrual of all the earnings in the years of government operation. That the returns for the years of operation were still open to review was pointed out by the court in the Old Dominion case so there seems to be considerable basis for this dissent. However, certiorari of this case was denied by the Supreme Court.
this rule applies to expenses or losses of the taxpayer is also well es-

Since these decisions, the courts have been struggling over the prob-

lem of where to place those “reasonable limits,” and, as could be ex-
pected, have disagreed. As the question is one of degree, nothing can 
be gained by reviewing the decisions in search of a definite line of de-
marcation. Estimating an amount with reasonable accuracy is, after 
all, a relative requirement. But in many types of situations there have 
been sufficient adjudicated cases that generalizations can be made as to 
the probable disposition of such cases in the future. These are general-
izations, however, and in any of these situations a court may find, be-
cause of the facts of the particular case before it, that estimation with 
reasonable accuracy is either possible or impossible. It must also be 
remembered that in all these cases liability is definitely established and 
the only uncertainty is as to the amount due.

In most of the early cases, including the federal control cases, the 
final ascertainment of the amount due was to be made using informa-
tion which was present on the books of account of the taxpayer at the 
end of the taxable year.47 At one time there may have been an indica-
tion that this was the only situation where accrual of an estimated 
amount was proper, as the courts repeatedly pointed out in the federal 
control cases and the other early cases that all the information used in 
the final settlement was present on the taxpayer’s books at the end of 
the taxable year. However, it is now recognized that accrual prior to 
final determination of the amount due is proper in situations other than 
where the final settlement is based on the books of account of the tax-
payer.48

Many times a taxpayer will have insured property destroyed by fire 
or other casualty but at the end of the taxable year no agreement will 
have been reached with the insurer settling the amount of the compen-
sation. Accrual of an estimated amount of compensation is usually 
found proper.49

47 Continental Tie & Lumber Co. v. United States, 286 U.S. 290, 52 S.Ct. 529 (1932); 
federal control cases cited supra, note 44; Western Wheeled Scraper Co., 14 B.T.A. 496 
(1928).
Sugar Co., 43 B.T.A. 151 (1940); Am. Fork & Hoe Co., P-H T.C. MEMO. DEC. ¶43,431 
(1943).
49 Worstell Co., Ltd., 15 B.T.A. 413 (1929); Max Kurtz, 8 B.T.A. 679 (1927); G.C.M. 
Normally a loss sustained by the taxpayer as a result of a breach of contract cannot be accrued in the year of the breach because not all events have occurred which determine the liability to pay and fix the amount due. But, where within the taxable year there is a definite admission of liability, negotiations for settlement are begun, and a reasonable estimate of the amount of the loss is accrued on the books, accrual in the year of loss has been found proper. Several early decisions of the Board of Tax Appeals\(^5\) allowing accrual in this very special situation were approved by the Supreme Court in a dictum in *Lucas v. American Code Co.*\(^6\)

No recent cases allowing accrual in this situation have been found and it should be assumed that, if accrual in such a situation is still proper at all, the case must fit the exact situation presented in the early cases.

If a sale is made and the purchase price is left to later computation, the sale may be considered concluded for tax purposes on the date of the agreement. An estimated amount may be reported for the year in which the sale was made and the estimate later corrected when the exact price is determined.\(^5\) This has been allowed when computation of the amount depended not only on information existing at the end of the year but also on information which could not be available until well after the end of the year. In the *Honokaa Sugar Co.*\(^5\) case the taxpayer shipped raw sugar to California, the sugar arriving on December 28, 1937. According to the contract between the taxpayer and the refinery the title to the sugar passed to the buyer on arrival. The amount to be paid was to be established according to the "average market price," such average being the average price for which raw sugar was selling a short time before and after the date of arrival, and certain other factors not necessary to be set out. When the taxpayer prepared its return for 1937 it reported an amount which it estimated would be received for the shipment. As provided in the sale contract the exact


\(^6\) 280 U.S. 445 at 450, 50 S.Ct. 202 (1930). "A loss occasioned by the taxpayer's breach of contract is not deductible in the year of the breach, except under the very special circumstances where, within the taxable year, there is a definite admission of liability, negotiations for settlement are begun, and a reasonable estimate of the amount of the loss is accrued on the books."


\(^5\) 43 B.T.A. 151 (1940).
amount was not determined until November 30, 1938. The taxpayer then reported the exact amount and sought to have the error corrected in the determination of its tax liability for 1937. This procedure was approved by the Board of Tax Appeals on the broad ground that since the taxpayer’s deductions for 1937 related in a large part to the production of the crop that was shipped and sold in that year, these deductions should be from the proceeds of the sales in 1937 as nearly as possible.

The Honokaa Sugar Co. case was set out in some detail for two reasons. First, it is a very liberal holding in that accrual of an estimated amount was allowed when the final determination of the amount did not depend on an appraisal of information existing at the end of the year but on the market price at a later date and other details which could not be established for a period of eleven months. It was notable also because of the broad principle on which the decision was based, namely, that related items of income and expense should be accounted for in the same year if possible. Although this general principle of accounting obviously influences the courts when considering accrual while the amount is still uncertain, it is rarely expressed as a basis for a decision.

If property of the taxpayer is condemned and taken over under eminent domain power, accrual is not proper until the amount of the award is fixed by a decree of the court or by an agreement between the parties.\textsuperscript{54} It is thought that an estimate within reasonable limits cannot be made when the final award depends upon judicial proceedings involving values placed on property by expert testimony.

That accrual is not allowed until final determination of liability in a suit for damages has already been demonstrated. What of the situation where a final decree has been issued establishing liability but an accounting before a special master is ordered to determine the amount? This situation most frequently arises in suits for patent infringements and it is well settled that accrual is improper prior to the report of the finding of a special master and approval of that finding by the court.\textsuperscript{55} This has been the holding whether the suit was for damages or to recover profits received by the infringer. The courts state that all events

have not occurred which fix the amount due, and distinguish the Continental Tie & Lumber Co. and the federal control cases on the ground that in those cases the compensation was not dependent on any future event but the books of the companies showed the income on which compensation was to be computed pursuant to the statute. Since the books of the patent infringer show the income on which the determination of the amount is made by the special master, at least in cases where the suit is to recover the profits of the infringer, the distinction seems a little unsound. What seems to be the real basis, although not articulated by the courts, is the feeling that the amount cannot be estimated with reasonable certainty, whereas a much closer estimate was possible in the federal control cases.

Thus it is seen that today the term "fix" in the statement that all events which fix the amount due must have occurred prior to accrual, must be understood to mean "fix within reasonable limits." Since the dictum in Lucas v. American Code Co. indicated that the exact amount due might not need to be fixed, this concept has developed to the point that accrual of an estimated amount was allowed, in the Honokaa Sugar Co. case, where the amount could be fixed definitely only after future events had occurred. While it is not always recognized, the basic concern of the courts seems to be whether the amount due can be estimated with reasonable certainty at the end of the taxable year.

E. Collectibility Uncertain

Where liability of the obligor is definitely established and is not contingent on any future event, where no third party claims a right to receive the payment, and where the amount due has been definitely ascertained, but where there is doubt as to the ability of the obligor to make payment, should the obligation be recognized by accrual? Stated more briefly, is accrual proper if the collectibility of the obligation is uncertain?

First, this problem must be carefully distinguished from that involved in cases such as Spring City Foundry Co. v. Commissioner where the obligation is collectible at the time for accrual but doubt as to its collectibility arises before the end of the taxable year. If an obligation is good and collectible at the time the right to receive it arises, it must be accrued and included in the taxpayer's gross income. If it later becomes worthless or of doubtful collectibility, the question

then becomes one of deduction according to the applicable statutes. Here, however, we are concerned with the situation where the collectibility of the obligation is in doubt at the time for accrual.

If collection of the item is uncertain only because of the normal risk involved in all business transactions, accrual is required. If such possibility of non-payment were to be accepted as a sufficient reason for not recognizing an item of income, the whole theory of the accrual method of accounting would fall where commercial transactions are concerned. This seems so obvious that it is surprising that the courts have found it necessary to state it on several occasions. On the other hand, if the obligation is known to be uncollectible at the time the right to receive it arises, the taxpayer is not obliged to recognize it as income as it could hardly be contended that income has arisen when the amount due can never be collected.

Between these two situations lie all those where the collectibility is merely doubtful, where risk of non-collection is greater than that in normal business transactions but uncollectibility has not been definitely established. Like many other questions involved in accrual accounting, this is one of degree. How certain must ultimate collection be to warrant accrual of the obligations? Or, as it is usually expressed, how much doubt as to collectibility must there be before the taxpayer can properly defer accrual?

Statements of the courts on this problem serve only to confuse. Accrual has been said to be proper and necessary where the taxpayer "was justified in having a reasonable expectation that payment would be made in due course," and where there was "'reasonable expectation' . . . that the right to receive the interest would 'be converted into money or its equivalent.' " The taxpayer has been allowed to defer accrual where "there exists good reason for believing that the income can not be collected", where "at no time . . . could the petitioner have anticipated the collection of interest upon the notes", where there "was no reasonable prospect that taxpayer would be able to collect",

where "later experience . . . confirms a belief reasonably held at the
time the debt was due, that it would never be paid";\textsuperscript{64} where "in all
probability the income will not be received,"\textsuperscript{65} and where payment
is not reasonably assured by "past experience, guaranty, antici­
pated provision or otherwise . . . ."\textsuperscript{66} From these statements it can
be seen that there is no established quantitative measure as to the
amount of doubt which warrants deferment of accrual. That the
courts have made no effort to set up such a standard is indicated by
the variety of statements made by the Tax Court and its predecessor,
the Board of Tax Appeals. Had the Tax Court attempted to set up
such a standard, the language of the case which it considered as stating
the proper measure would have been repeated in the subsequent cases
and the situation in the later cases would have been tested by this
measure. The absence of any great amount of similarity in the lan­
guage used in its decisions shows that the Tax Court has made no
attempt to establish such a measure.

That this method of handling the situation is desirable is readily
apparent when thought is given to the great number of factors which
must be considered in determining whether an obligation is collect­
ible. While no definite measure has been established, the general
tenor of the decisions indicates that the actions of a taxpayer will be
approved by the courts if there are reasonable grounds for his action.
If, in the opinion of the court, the taxpayer could have had at the time
the right arose a reasonable belief that the obligation could be col­
clected, his accrual will usually be upheld. Conversely, if, in the opinion
of the court, the taxpayer had good grounds at the time the right arose
for believing that the obligation was unlikely to be paid, his deferment
of accrual will usually be sustained.

In theory the court examines the situation as it existed at the time
the right to receive the income arose and sustains the action of the
taxpayer if it is thought reasonable considering the information avail­
able at that time.\textsuperscript{67} According to the theory, the court, in deciding if
the taxpayer was justified in his action, does not use information
available at the time of the litigation but which was not available at
the time the right to receive the income arose. Whether the court can
successfully refrain from being influenced by later events is open to

\textsuperscript{64} Georgia School-Book Depository, Inc., 1 T.C. 463 at 469 (1943).
\textsuperscript{65} Corn Exchange Bank v. United States, (C.C.A. 2d, 1938) 37 F. (2d) 34 at 35.
\textsuperscript{66} Great Northern Ry., 8 B.T.A. 225 at 269 (1927).
\textsuperscript{67} Automobile Ins. Co. v. Comr., (C.C.A. 2d, 1934) 72 F. (2d) 265; Finucane v.
doubt. If it cannot, the taxpayer must not only have had reasonable grounds at the time for his choice to accrue or not to accrue, but his choice must be proved correct by later events. The courts seem to have made a genuine effort to ignore information available at the time of litigation but not at the time for accrual, but the taxpayer is entitled occasionally to doubt that they are always successful. Indeed, the Tax Court once made the statement that the taxpayer "need not accrue a debt if later experience, available at the time the question is adjudged, confirms a belief reasonably held at the time the debt was due, that it will never be paid."68

There have been relatively few decisions in which the courts have been called on to decide whether or not an obligation appeared sufficiently collectible for accrual. That fact, the great number of factors which bear on the question of collectibility, and above all the vagueness of the standard of "reasonable grounds"—if such a standard may be said to exist at all—make a search for precedent almost useless. Nor have there been any general trends in the type of situations in which accrual has been allowed or disallowed. About the only situation which can be considered to establish conclusively that a taxpayer cannot reasonably expect payment is that where a petition in bankruptcy has been filed.69 While the filing of such a petition does not always mean that no part of the obligation will be paid, it does create too much uncertainty as to the amount which will be received for accrual to be proper.70

It might be supposed that if the obligor were in fact insolvent (not in itself an easy thing to determine) the taxpayer would be sustained if he chose not to accrue the item on the ground that he could not reasonably expect to receive payment. That insolvency of the obligor

68 Georgia School-Book Depository, Inc., 1 T.C. 463 at 469 (1943). This statement might have been a slip of the tongue. It certainly is merely a dictum as the court in the decision considered only the information available at the time the right to receive the income arose.
70 If the obligor is insolvent but the obligation is paid anyhow during the year, the money received must be included in the gross income of the taxpayer. This sounds like a statement of the obvious, but there was at one time considerable argument about it in instances where the taxpayer had loaned the money during the year to the obligor with which the payments (usually interest on bonds) were made. The courts consistently found the income was received when the payments were made. Here there was no question of accrual because the money had been received but the situation is so similar to that under consideration that the distinction should be pointed out. Am. Cigar Co., 21 B.T.A. 464 (1930), aff'd., (C.C.A. 2d, 1933) 66 F. (2d) 425, cert. den., 290 U.S. 699, 54 S.Ct. 209 (1933); Langley & Co., 23 B.T.A. 1297 (1931); Southern Power Co., 17 B.T.A. 962 (1929).
is evidence that the obligation may be uncollectible is admitted, but it is not a determining factor. If the debtor, whether a corporation or a person, continues in business and is making some improvement in its financial status, the courts may require accrual where there is an indication that the improvement might continue.\footnote{Greer-Robbins Co. v. Comr., (C.C.A. 9th, 1941) 119 F. (2d) 92; Bettendorf Co., 34 B.T.A. 72 (1936).}

Lack of an appropriation by Congress of funds to satisfy a judgment which the taxpayer has recovered against the government is not considered as creating a reasonable doubt that the right would ever be converted into money.\footnote{Liebes & Co. v. Comr., (C.C.A. 9th, 1937) 90 F. (2d) 932, I.T. 3165, 1938–1 Cum. Bull. 158.} The taxpayer is found to have a reasonable expectancy of receiving payment as the courts refuse to believe that Congress will fail to make the appropriation eventually.

Up to this point only those situations have been considered where the collectibility of items due the taxpayer is doubtful. What of the situation where an obligation of the taxpayer becomes due but the ability of the taxpayer to make payment is doubtful? Should the taxpayer accrue this item as an expense when there is no reasonable expectation that he will be able to pay it?

This problem was first brought to the attention of the courts in the Panhandle Refining Co. case in 1941.\footnote{45 B.T.A. 651.} There the taxpayer, an operating company, and its parent corporation were both on the accrual basis of accounting. In the taxable years involved, 1936 and 1937, the taxpayer accrued on its books large amounts of interest on its indebtedness to the parent company. The taxpayer had been insolvent for years but most of its debt was to the parent for funds advanced so that it could continue operation. The assets of the taxpayer amounted to several million dollars in value and it was engaged on a large scale in the production, refining, and marketing of crude oil and was attempting to make money to pay the indebtedness. In 1936 and 1937 its business had shown much improvement and the value of its assets had risen sharply. It was, however, still insolvent. The commissioner disallowed any deduction for the interest accrued on the debt to the parent company on the ground that there was no reasonable probability that it would be paid. The board sustained the taxpayer and said the question is whether the taxpayer "may be deprived of the deduction of accrued interest because of its precarious financial condition and the possibility, which in no event can be said
to be more than a probability, and is obviously not a certainty, that [it] will never be able to pay such interest. We agree . . . that so to hold would be to add to the statute. . . . We may well take judicial notice of the fact that the oil business is subject to great variation and that [taxpayer's] extensive properties . . . might become sufficient to pay interest and principal." It is seen that the board based its decision on the ground that there was a good possibility that the interest would eventually be paid. Where such a possibility is found this decision and its reasoning have been followed.

But is a deduction for accrued interest proper where there is no reasonable probability that the taxpayer will ever be able to pay the interest? In Zimmerman Steel Co. the Board of Tax Appeals held that it was not. The situation was similar to that of the Panhandle Oil case, the only significant difference being that there had been no recent improvement in the taxpayer's financial condition. After finding that "there was no reasonable expectation of such obligation being discharged in the normal course of business," the board refused to allow accrual of the interest. It observed that "the rule is that a taxpayer on an accrual basis is not required to report as income . . . an amount which he may never receive," and, stating that "principles pertaining to the accrual of income should also be applied to deductions," it reached the conclusion that a deduction for the interest would not be allowed. On appeal, the Court of Appeals of the Eighth Circuit reversed with this statement:

"The law is that if a method of bookkeeping employed by a taxpayer 'does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income' . . . and the real facts, not forms of entry, must measure the tax. But where interest actually accrues on a debt of a taxpayer in a tax year the statute plainly says he may deduct it. That he has no intention or expectation of paying it, but must go into bankruptcy as this taxpayer was obliged to do, can not of itself justify denial of deduction in computing the taxpayer's net income. It is true that if a man's gains at the end of the year consist of bad debts he can have no net income to tax. But neither does he have such net income if the interest on what he owes amounts to more than his gains."
The Tax Court has indicated that it intends to stand by its decision in the Zimmerman Steel Co. case regardless of the reversal.\textsuperscript{79} In Millar Brainard, having found that there was no likelihood that it would be paid, it approved the commissioner's disallowance of a deduction for accrued interest "on the authority of Zimmerman Steel Co. . . ."\textsuperscript{80}

When confronted with this problem the Tax Court would examine all the facts of the case to determine to what extent there is a reasonable prospect that the payments will actually be made. If it should find that there was no likelihood that the items accrued would ever be paid, no deduction would be allowed. The Court of Appeals for the Eighth Circuit would make a distinction between presently accruing obligations which the taxpayer is unable to collect and presently accruing claims which he is unable to pay. According to it, good business practice might require that the first not be reported as income, but a debt cannot be written off by the taxpayer merely because it falls due at a time when he is unable to meet it. The circuit court also points out that insolvency does not in any way lessen the obligation of the taxpayer and the liability continues to modify the condition of the estate into bankruptcy.

On strictly legalistic and logical bases it is hard to refute the argument of the circuit court of appeals that a taxpayer does not have net income "if the interest on what he owes amounts to more than his gains."\textsuperscript{81} But there may be considerable merit to the position of the Tax Court, although the reasoning of the board in the Zimmerman case, that the taxpayer should not be allowed to deduct the interest as an expense because the creditor could not accrue it as income, is without much value. Consider the case where a corporate taxpayer is insolvent but a very large part of its debt is to a parent corporation and the interest due on this debt, amounting to a large sum each year, has not been paid for several years. The parent may not seek to enforce the obligation for any number of reasons. If such a taxpayer makes an operating profit for the year, should not it be taxed on this profit without benefit of a deduction for the interest which it never expects to pay and which the parent never expects to collect? To hold

\textsuperscript{79} Florence Pearlman, 4 T.C. 34 at 54 (1944), "With all due deference to the Circuit Court of Appeals of the Eighth Circuit, we adhere to the view expressed in Zimmerman Steel Co. . . . notwithstanding the reversal in Zimmerman Steel Co. v. Commissioner. . . ." See Butler Consolidated Coal Co., 6 T.C. 183 at 191 (1946).

\textsuperscript{80} 7 T.C. 1180 at 1184 (1946).

\textsuperscript{81} Zimmerman Steel Co. v. Comr., (C.C.A. 8th, 1942) 130 F. (2d) 1011 at 1012.
otherwise would be to allow a mere bookkeeping entry to control substance in many cases.

Final resolution of this conflict appears to lie with the Supreme Court.

To generalize, then, if a taxpayer could have had a reasonable belief that an obligation was collectible, his recognition of it by accrual will be approved. On the other hand, if he could have had reasonable grounds for believing that it was unlikely to be paid, his deferment of accrual will be approved. The taxpayer seems to be given considerable freedom of choice and his action is usually approved unless there is a rather clear showing that it was without reasonable basis. This, like all generalizations, is subject to exceptions in individual cases and on occasion courts disapprove of the action of a taxpayer on seemingly slight grounds. In testing the reasonableness of the taxpayer's choice the courts use, or try to use, only the information that was available at the time the right to receive the income arose. There has been no quantitative measure set up, but in each case the action of the taxpayer is considered in the light of the circumstances. There have been few decided cases and as a result trends in the decisions cannot be observed.

Many accountants would handle this problem in a similar manner. If an obligation appeared reasonably collectible, an entry of the full amount would be made in the appropriate receivable account at the time the right to receive the income arose. The contingency of non-payment would be taken care of at the end of the accounting period by an entry in a reserve account for bad debts of a blanket allowance based on experience. Under this plan individual accounts would be charged off against the reserve as their worthlessness was demonstrated. Other accountants might handle it in a different manner by scaling down the obligation at the time of the first entry so that the receivable entered would reflect the doubt as to the collectibility of the item. Still other accountants would enter the item at its full or face value but would make an addition to the proper reserve account at the same time. The last two methods would not force a choice between accrual of the face value of the obligation and no accrual of any amount, but would allow accrual of the estimated real

82 Paton, Essentials of Accounting 411 (1938).
83 Ibid.
84 Gilman, Accounting Concepts of Profit 177 (1939); Kester, Advanced Accounting 184 (1946).
value of the receivable. This method of placing a valuation on the receivable which would reflect the doubtfulness of its collectibility has much to recommend it. It is considerably more flexible than the “all or nothing” method required by the income tax laws and would seem to produce a more accurate picture of the income of the taxpayer for the period. Its very flexibility, desirable in accounting for business purposes, would make unsatisfactory its use in accounting for income tax purposes. The difficulties encountered by the courts when attempting to decide whether the taxpayer had reasonable grounds for his decision to accrue the entire item are slight when compared with the difficulties which would be encountered in attempting to decide whether the taxpayer had put a valuation on the item which properly reflected the degree of doubt as to its collectibility.

CONCLUSION

It has been seen that definite trends do exist in the handling of these cases by the courts and that in many situations predictions can be made as to whether accrual will be found proper. Not only are these general trends discernible, but in many situations the courts seem to have evolved rather definite legal tests by which the uncertainty qualifying the payment or receipts of a particular obligation may be measured.

First, the courts require before accrual that liability must exist and also must be recognized by express admission or the situation must be such that denial of liability is so improbable that the obligor’s silence is considered an implied admission. Second, if any third party claims a right to receive payment and payment is withheld pending the outcome of the dispute, accrual is found improper. In neither of these situations do the courts consider the merits of the dispute or weigh the probability of ultimate triumph by the taxpayer, but the mere presence of any dispute is sufficient to render accrual improper. The inflexibility of these requirements indicates that they have become definite legal tests and that accrual is proper only where there is a legally enforceable obligation which has been admitted by the obligor or the situation is such that admission is implied from silence, and where there has not been any claim to the obligation made by a third party which will cause delay in receipt of the payment by the taxpayer.

If there exists any uncertainty as to the amount due, accrual is allowed only where all events have occurred which make it possible for the taxpayer to estimate the amount due with reasonable accuracy.
Here also the courts have set up a standard by which the particular obligation before the court can be measured but the measure is one of degree and cannot be considered a legal test. A similar standard of measure has been set up by the courts' requirement that the liability of the obligor not be subject to any substantial contingency. While both these standards of measure admittedly involve measurement of the degree of uncertainty, they are none the less standards of measure merely because the dividing line is broad and seemingly flexible.

Only where the collectibility of the obligation is uncertain do the courts appear to have failed to set up a standard of measure. It may be that the number of cases is still too small for any standard to have developed and that one will be forthcoming in the future, but the courts' failure appears deliberate and probably results from a feeling that a quantitative measure of uncollectibility would be impractical in application. Instead the courts seem to examine the situation in each case as it existed at the time the right to receive the income arose and to sustain the action of the taxpayer if it is thought reasonable considering the information as to collectibility existing at that time.

This development by the courts of legal tests and standards for measurement of the degree of uncertainty can be criticized as an attempt to render definite and certain something which is fundamentally indefinite and uncertain. It may be said that this is another instance where the legal profession has substituted legal technicalities for principles of accounting in what is basically an accounting question involving facts only.

All these criticisms are sound. The question of whether there is sufficient uncertainty qualifying an obligation to render recognition by accrual improper is fundamentally a question of accounting and involves a choice based on a survey of facts. The courts have developed some legal tests and standards of measurement (in many cases unconsciously, perhaps) and have substituted measurement by these for a survey of all the facts involved in the case and a decision based on a weighing of the probability anew in each case. Too much dependence has been put on previously decided cases and this has resulted in the development and use of legal technicalities.

But, valid as these criticisms are, they ignore the fact that the development of legal tests and standards of measurement is perhaps desirable. While this development makes for inflexibility and frequently may result in considerable hardship in particular cases, it does
make for certainty. It allows the taxpayer to make a choice of the year for accrual with considerably more assurance that his choice will be sustained than would otherwise be possible. Inflexibility is never to be desired in tax matters, but neither is uncertainty. The critics of the development of rigidity in the tax laws usually ignore the fact that the price of flexibility is uncertainty for the taxpayer.