[JOINT COMMITTEE PRINT]

TAX REFORM PROPOSALS: ACCOUNTING ISSUES

FOR THE USE

OF THE

COMMITTEE ON WAYS AND MEANS

AND THE

COMMITTEE ON FINANCE

PREPARED BY THE STAFF

OF THE

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INTRODUCTION

This pamphlet [1] was prepared by the staff of the Joint Committee on Taxation for the House Committee on Ways and Means and the Senate Committee on Finance in connection with the respective committee reviews of comprehensive tax reform proposals. This pamphlet, one of a series of tax reform proposal pamphlets, describes and analyzes tax provisions and proposals relating to accounting issues.

The pamphlet describes present-law tax provisions and the tax reform proposals made by President Reagan ("The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity," May 1985, referred to as the "Administration proposal"), the 1984 Treasury Department recommendations to the President ("Tax Reform for Fairness, Simplicity, and Economic Growth," November 1984, referred to as the "1984 Treasury report"), Congressional proposals (identified by the primary sponsors), and other related proposals. The pamphlet also includes analysis of the issues raised by tax reform proposals relating to accounting issues.

The first part of the pamphlet is an overview. The second part describes and analyzes accounting issues raised by the Administration proposal, the 1984 Treasury report, and the Congressional proposals.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Tax Reform Proposals: Accounting Issues* (JCS-39-85), September 13, 1985.

I. OVERVIEW

In general

Because the Federal income tax is imposed on an annual basis, it is necessary to devise rules that allocate the economic activities of a taxpayer to a particular taxable year in order to determine the income of that taxpayer for that year. These rules for allocating economic activities to particular years collectively are called the taxpayer's method of accounting.

The particular method of accounting used by a taxpayer can significantly affect the timing of the recognition of the taxpayer's income. Because of the time value of money, the timing of recognition can significantly affect the effective rate of tax on a taxpayer.

Limitations on the use of the cash method of accounting

One of the permissible methods of accounting under present law for taxpayers that are not required to use inventories is the cash receipts and disbursements method of accounting. Under that method, income generally is recognized when the cash is constructively or actually received. A deduction generally is allowed when the expense is paid.

Under the Administration proposal, the cash method of accounting could not be used by businesses that have annual gross receipts of more than $5 million. The Administration proposal generally would apply to taxable years beginning on or after January 1, 1986.

Pledges of installment obligations

Under present law, if property is sold on the installment method (i.e., if payments for the sale of property are to be received after the taxable year that the sale is made), gain from the sale of the property generally may be reported on the installment method. Under the installment method, a proportionate part of each payment is reported as income. In addition, any unreported income generally is recognized when the installment obligations are sold or otherwise disposed of.

The Administration proposal would provide that the pledging of installment obligations for a loan would result in recognition of deferred income on those installment obligations. In the case of property sold in the ordinary course of business where the borrowing is incurred in the ordinary course of business, the amount of gain to be recognized upon the pledge of the installment receivables would be the excess, if any, of the borrowed amount over the taxpayer's basis in the installment obligation. In other cases, the amount of gain to be recognized upon the pledge of the installment obligation would be same as if the borrowed amount had been received as a payment on the installment obligation. The Administration proposal generally would apply to pledges of installment obligations after

December 31, 1985. Installment obligations pledged on or before that date would be subject to the rule on January 1, 1991.

Inventory valuation

Present law requires the use of inventories in a business where the production, purchase, or sale of merchandise is an income-producing factor. Generally, inventories are valued at cost. The cost of goods in an inventory is determined by assuming that the first goods acquired are the first goods sold (i.e., FIFO). However, if the taxpayer so elects and uses the same method for financial purposes, the dollars amount of an inventory may be determined by assuming that the last goods acquired are the first goods sold (i.e., LIFO).

The Administration proposal would provide that the amount of an inventory determined under the FIFO method would be indexed for inflation. In addition, the Administration proposal would allow a taxpayer to elect to use the LIFO method for Federal income tax purposes even if that taxpayer uses another method for financial purposes. The Administration proposal generally would apply to taxable years beginning after January 1, 1987.

Capitalization of production costs

Under present law, there are a number of instances where the measurement of income requires a deferral of the deduction of certain costs. For example, where a taxpayer manufactures goods and is required to maintain inventories, there are rules that determine what costs incurred by the taxpayer are included in that inventory. Similarly, where a taxpayer uses the completed contract method of accounting for long-term contracts, a different set of rules determines which costs may be deducted currently and which costs may be deducted at the completion of the contract.

The Administration proposal provides a uniform set of rules for determining when deductions are allowed for all production costs. The proposed rules generally follow the rules applicable to the taxation of extended-period long-term contracts under the completed contract method of accounting. These rules would require the capitalization of all costs allocable to (1) the production or manufacture of inventory goods or property held primarily for sale to customers in the ordinary course of business, (2) production under a long-term contract, (3) the construction or other production of real property or personal property, and (4) the growing of timber.

In the case of costs incurred in the production or manufacture of inventory goods, the Administration proposal would provide special rules for farmers. Generally, farmers would not be required to keep inventories. Nonetheless, where the preproductive period of a plant or animal (other than an animal held for slaughter) is more than two years, the preproductive costs would have to be capitalized and amortized over the life of the plant or animal. In lieu of capitalizing those costs, taxpayers would be permitted to use a farm-price or unit price accounting method. These rules would also apply to the growing of timber.

In the case of taxpayers using the completed contract method of accounting for long-term contracts, the Administration proposal would repeal the less comprehensive cost deferral rules applicable to small contractors and contracts of less than three years' duration. In addition, the Administration proposal would require the deferral of general and administrative expenses allocable to cost-plus contracts or contracts with Federal agencies requiring certified costs.

In the case of taxpayers engaged in the construction of real property or personal property, the Administration proposal would require the capitalization of all construction period interest if the construction period is extended or the property is long-lived.

The Administration proposal generally would apply to costs and interest paid or incurred after December 31, 1985.

Reserves for bad debts

In lieu of a deduction for specific bad debts at the time they become partially or wholly worthless, present law allows taxpayers a deduction for reasonable additions to a reserve for bad debts.

The Administration proposal would repeal the rules permitting deductions for additions to a reserve for bad debts. Under the Administration proposal, deductions for bad debts would be allowed when the debt becomes partially or wholly worthless. The Administration proposal generally would apply to taxable years beginning on or after January 1, 1986.

Mining reclamation costs

Present law provides special treatment of mining reclamation costs. Under these special rules, taxpayers are allowed deductions for reclamation costs as the land is disturbed, instead of when the reclamation is done.

The Administration proposal would repeal the special treatment for mining reclamation costs. The Administration proposal would apply beginning on January 1, 1986.

Returns of magazines, books, and records

Present law allows taxpayers to elect to exclude from income sales of magazines, books, and records to the extent that the magazines, books, or records are returned to the taxpayer within a specified period. In the case of magazines, the specified period is two and one-half months after the end of the taxpayer's taxable year. In the case of paperback books and records, the specified period is four and one-half months after the end of the taxpayer's taxable year.

The Administration proposal would repeal this special treatment for returns of magazines, books, and records. The Administration proposal would apply to taxable years beginning on or after January 1, 1986.

Qualified discount coupons

Present law allows accrual-basis taxpayers a deduction for discount coupons actually redeemed during the taxable year and an amount equal to the net addition to a reserve account necessary to reflect anticipated redemption of currently issued coupons that are redeemed within six months after the end of the taxpayer's taxable year.

The Administration proposal would repeal the deduction for additions to the reserve for anticipated redemption of discount coupons.

The Administration proposal would apply to taxable years beginning on or after January 1, 1986.

II. EXPLANATION OF PROPOSALS

A. Limitations on the Use of the Cash Method of Accounting

Background

Under the Federal income tax system, net income is calculated in terms of items of income and expense that are assigned to a discrete period of time, termed the taxable year. Each taxpayer must adopt a method of accounting which establishes the framework for assigning income and deduction items to particular taxable years. The choice of accounting method may have a significant effect on the ultimate tax liability of the taxpayer. As a result of the assignment of income and expense to different periods, two enterprises having identical economic activities but using different accounting methods may have different tax liabilities.

The primary goal of any tax accounting method is to provide a system for assigning items of income and expense to a taxable year so that the net income of the enterprise for that period is clearly reflected. However, there are several concerns involved in achieving a clear reflection of income, not all of which can be completely satisfied by any one method of accounting.

One of these concerns is certainty—the concept that before an amount is recorded as income or expense, it should be supported by objective, verifiable evidence, and not merely represent a subjective "best guess" of what might happen in a later period. The concern for certainty is reflected in the principle that gain or loss due to a change in asset value should not be recognized for Federal income tax purposes until some transaction confirming that change in value is completed, i.e., until the gain or loss is realized.

Another concern, usually referred to as the matching principle, is that items of income and the items of expense contributing to that income should be recognized in the same taxable year. This concern derives from the concept that the measurement of net income requires identification both of the receipts of the taxpayer and also of the costs that were associated with generating those receipts. If related items of income and expense are assigned to different taxable years, neither year's net income will be properly stated. Another aspect of the matching principle is that items of income and expense should be assigned to the appropriate taxable year in terms of the underlying economic activity that generated the receipts or expenditures. The accrual method of accounting is generally considered to reflect the matching principle more accurately than the cash method because the accrual method measures the activities of a period and not merely the cash flows occurring within the period.

A third concern is that the method of accounting should provide a measure of net income which reflects how much "better off" the taxpayer is at the end of the taxable year than at the beginning. Neither the cash nor the accrual method fully accomplishes this objective. The cash method does not recognize items until they are received or paid irrespective of whether an enterprise may benefit or lose financially as a result of having incurred an enforceable right to a receipt or a fixed obligation to make a payment. The accrual method treats some items which are expected to be received or paid in the future the same as cash received or paid in the current taxable year, without taking into account the time value of money in measuring the change in the taxpayer's economic well-being. Also, by virtue of the realization principle, neither the cash nor the accrual method attempts to measure changes in net wealth attributable to open transactions, such as unrealized appreciation or depreciation in assets.

There are several other considerations in determining whether a particular accounting method is appropriate for tax purposes. The method should be reliable and not subject to manipulation by the taxpayer. The method should be relatively easy to use. Extremely complex methods of accounting, while perhaps providing a more precise measurement of income, may be so difficult to use that their very complexity causes erroneous results, and may be so expensive to implement that the taxpayer may seek to avoid compliance. Finally, the method adopted should be used consistently.

Present Law

In general

Under present law, a taxpayer generally may elect (on its first income tax return) to use any method of accounting that clearly reflects income and that is regularly used in keeping the taxpayer's books (sec. 446). The latter requirement is considered satisfied even if the tax accounting method differs from that used by the taxpayer in keeping its books so long as sufficient records are maintained to allow reconciliation of the results obtained under the two methods.[2]

If the method chosen by the taxpayer fails to reflect income clearly, the IRS may require the taxpayer to use a method meeting the statutory standard (sec. 446(d)). The U.S. Supreme Court has held that the IRS has wide discretion in determining whether a particular method of accounting should be disallowed as not clearly reflecting income.[3] Treasury regulations provide, however, that a method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business ordinarily will be regarded as clearly reflecting income.[4] Once a method of accounting has been selected, a change to a different method requires IRS consent (sec. 446(e)).

Various methods of accounting are allowed under present law, including the cash receipts and disbursements method (cash method), the accrual method, certain industry specialized methods,

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[2] Rev. Rul. 68-35, 1968-1 C.B. 190; Rev. Rul. 68-83, 1968-1 C.B. 190.
[3] *Hansen* v. *Comm'r*, 360 U.S. 446 (1959).
[4] Treas. Reg. sec. 1.446-1(a)(2).

and, within certain limitations, hybrid methods combining several of the approaches of these and other methods.

Cash method

The cash method generally recognizes items of income when actually or constructively received and items of expense when paid. There are numerous exceptions, however, to the general rule. For example, expenditures for business assets with lives substantially longer than the current taxable year generally may not be deducted in the year paid but must be depreciated or amortized over their tax life (if any). In determining the amount eligible for depreciation or depletion (i.e., the asset's basis), amounts to be paid in later taxable years (i.e., when borrowed funds are repaid) may be considered as well as amounts already paid. The portion of other expense items which will benefit the taxpayer more than one year from the date of payment must also be capitalized and deducted in the year of benefit (sec. 263).

By way of further illustration, interest expenses attributable to the use of money in a taxable year later than the year of payment must always be capitalized and deducted only in such later taxable year. Special rules also require cash-basis tax shelters to delay recognition of expense items until both payment and economic performance have occurred (sec. 461(i)). Deduction for expenses paid to certain related taxpayers must be delayed until the related taxpayer is required to recognize income on the transaction (sec. 267).

Accrual method

The accrual method recognizes income when all the events have occurred which establish the right of the taxpayer to receive the income.[5] Likewise, an expense is recognized at the time all the events establishing an obligation to pay have occurred.[6]

The all-events requirement is not considered satisfied until the amount of the right or obligation is determinable with reasonable accuracy. In the case of expense items, the all-events test is not satisfied prior to the time of economic performance of the service, etc., for which the expense is incurred (sec. 461(h)). With regard to certain liabilities, such as workers' compensation claims and tort liabilities, economic performance is not considered to have occurred prior to the time the amount is actually paid. As is the case with the cash method, a special rule precludes accruing an expense item owed to certain related taxpayers prior to the time that the related taxpayer is required to include the item in income (sec. 267).

Present law requires the use of the accrual method in certain cases. The most important of these is where inventories are required. All purchases and sales related to inventories must be recorded for tax purposes using the accrual method of accounting.[7] One aspect of this method is the inclusion of certain expense items in the cost of the inventory under the full absorption method, discussed in part II, D, below. The accrual method also must be used

[5] Treas. Reg. sec. 1.451-1(a).
[6] Treas. Reg. sec. 1.461-1(a)(2).
[7] Treas. Reg. sec. 1.446-1(c)(2).

in the case of certain corporate agricultural activities with gross receipts exceeding $1 million (sec. 447).

Administration Proposal

The Administration proposal would disallow use of the cash method of accounting for Federal income tax purposes by any taxpayer with annual gross receipts from a trade or business exceeding $5 million, computed on the basis of a moving average for the most recent three taxable years. For trades and businesses, other than farming, with average gross receipts not exceeding $5 million, the cash method would also be disallowed if another method of accounting has been regularly used by the taxpayer to ascertain income, profit, or loss of the business for purposes of reports or statements to shareholders, partners, other proprietors, or beneficiaries, or for credit purposes.

The provision relating to disallowance of the cash method would be effective for taxable years beginning on or after January 1, 1986. The adjustment to income resulting from the mandated change in tax accounting method would be recognized ratably over a period of six years. The adjustment would equal the difference between income as measured under the accrual and cash methods for years prior to the effective date.[8]

Other Proposals

1984 Treasury report

The 1984 Treasury report generally is the same as the Administration proposal with respect to disallowance of the cash method in certain circumstances. However, the 1984 report also recommended that disallowance of the cash method should apply to farming as well as to other types of trades or businesses (having annual gross receipts not exceeding $5 million) if the taxpayer has used a method other than the cash method for purposes of reporting to owners, beneficiaries, or creditors.

S. 409 and H.R. 800 (Bradley-Gephardt)

The Bradley-Gephardt bill generally would retain present law. The present-law rules requiring certain corporate farmers to use the accrual method would be expanded to require all taxpayers with gross farming receipts in excess of $1 million in the current or any prior taxable year to use the accrual method for their farming income.

H.R. 2222 and S. 1006 (Kemp-Kasten)

The Kemp-Kasten bill is essentially identical in this regard to the Bradley-Gephardt bill.

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[8] The formula used for determining the adjustment amount is income not previously included under the cash method which would not be included under the new method, plus expenses deducted under the old method which would be deducted again under the new method, less expenses not previously deducted under the old method which would not be deducted under the new method, less income previously included under the cash method which would be included a second time under the new method. One-sixth of the amount so derived would be included in income each year.

Analysis

Overview

The disallowance of the cash method of accounting under the Administration proposal to all taxpayers with annual gross receipts exceeding $5 million would result in most of those taxpayers shifting to the accrual method, although some might qualify to elect either hybrid or industry-specialized methods.

The Administration proposal raises a number of issues. First, does the cash method of accounting reflect income as clearly as other methods? Second, does the answer to that question depend on the nature of the taxpayer's business? Third, even if it is determined that other methods more clearly reflect income, should the cash method of accounting be retained for certain taxpayers and, if so, which taxpayers should be eligible to use it?

Reflection of income under the cash method

The Administration proposal is in large part based on the belief that "the cash method of accounting frequently fails to reflect the economic results of a taxpayer's business over a taxable year." [9] This belief rests on the ground that the cash method fails both to comply with the matching principle and also to measure economic betterment. In support of this position, it is pointed out that the cash method is not an acceptable method under generally accepted accounting principles and, therefore, is not allowed for financial accounting purposes.

The failure of the cash method to satisfy the matching principle results from its recording of items of income and expense at the time cash is received or disbursed. This generally is done without regard to the taxable year in which the economic events giving rise to the item occurred, or to whether an income item is matched with the expense items incurred to generate the income.

Consider, for example, the case of an enterprise engaged in the rental of property where charges associated with operating the property are paid currently, but rental income is received annually with payments due on the first day of the succeeding taxable year. Under the cash method, expenses attributable to the first taxable year are recognized during that year, but no rental income is included until the second taxable year. Thus, there has been a failure properly to associate items of expense (the operating costs) with the income they produced (the rental receipts). In addition, the rental income is recognized in a taxable year other than the year to which it economically relates (i.e., the year in which the tenant leased the property). The use of the accrual method would correct this mismatching by reassigning that portion of income attributable to occupancy by the tenant in the first year.

The ultimate tax effect of the deferred income in this example will depend on whether the level and the timing of items of income and expense remain constant over time and the life of the enterprise. If the level and timing remain constant over an unlimited time period, the effect is one of permanent deferral of that portion

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[9] See Administration proposal, p. 213.

of net income which is not recognized in the first year because of the use of the cash method.

The following example shows this permanent deferral effect. Assume that taxpayers A, B, and C own identical properties. Each rents the property for $10,000 per year, payable on the first day of the next taxable year, and each expends $10,000 per year in maintenance, payable during the taxable year. Taxpayer A reports on the accrual method, while taxpayers B and C report on the cash method. Assume futher that taxpayers A and B continue to hold their properties, and taxpayer C sells his for no gain or loss at the beginning of year 5, after the rent for year 4 is received but before any expenses for year 5 are paid.

Under these assumptions, the net taxable income for taxpayers A, B, and C for years 1 through 5 attributable to their properties is shown by the following table:

[In thousands of dollars]

Year:	1	2	3	4	5	Total
Taxpayer A (accrual)						
Rental income	10	10	10	10	10	50
Expense	(10)	(10)	(10)	(10)	(10)	(50)
Net taxable income	0	0	0	0	0	0
Taxpayer B (cash)						
Rental income	0	10	10	10	10	40
Expense	(10)	(10)	(10)	(10)	(10)	(50)
Net taxable income	(10)	0	0	0	0	(10)
Taxpayer C (cash)						
Rental income	0	10	10	10	10	40
Expense	(10)	(10)	(10)	(10)	0	(40)
Net taxable income	(10)	0	0	0	10	0

Taxpayer B has deferred $10,000 of taxable income by choosing the cash method of accounting and will continue to defer that amount as long as the streams of income and expense remain unchanged as to amount and timing. Only where the income streams come to an end, as they do for C when the building is sold, will the deferral amount finally be taken into taxable income. Taxpayer C's eventual recognition of the deferral amount as income under the cash method, however, does not mean his tax situation has been the same as taxpayer A's under the accrual method. Because of the time value of money, the deduction from income in year 1 is of greater value to taxpayer C than the income in year 5 (i.e., the rent paid for leasing the property during year 4), unless taxpayer C was unable to use the loss generated in year one against other income, or he is in a higher tax bracket in year 5 than the year in which he used the first-year loss.

The deferral of income under the cash method is undesirable not because it gives a result different from the accrual method, but because it does not accurately reflect the economic results of the business. Thus, in each year in the above example, the building was rented for an amount equal to the expenses of owning the building. The taxpayer's position was neither better nor worse off at the end of each taxable year as a result of engaging in the activity, and should recognize no net income or loss for Federal tax purposes for any taxable year.

Reflection of income under the accrual method

In general

Those who favor use of the cash method of accounting for tax purposes respond that the accrual method required under the Administration proposal would involve some failures to clearly reflect economic income.

One of these failures relates to the time value of money. Items of income and expense are accrued in nominal dollar amounts. Yet, if actual payment is delayed, the present value of the payment will be less than the nominal amount at which it has been accrued. Where items of income are collected or items of expense paid later than their accrual, economic income or expense will have been overstated by the difference between the nominal amount and its actual present value. A similar result occurs when items are collected or paid prior to the appropriate time of accrual. In this case, the nominal dollar amount used at the time of accrual understates the actual income or expense experienced. This problem will not arise, however, in cases where the parties explicitly pay and receive interest from the time of accrual to the time of payment.

An additional measurement problem arises under the accrual method because of the inherent uncertainty in recording items of income and expense prior to their actual payment. Although all the events may have occurred to establish a taxpayer's right to receive income, it cannot be said with certainty that the income will be received until cash is actually in hand.

Accrual tax accounting under present law deals with this problem by the use of a reserve account to estimate an average annual portion of moneys due the taxpayer which in fact will not be paid, and provides a current exclusion from income for the amount necessary to maintain such a reserve. The effect of this reserve is to allow a current deduction for an estimate of actual bad debt experience in the following year. Under the Administration proposal, these reserves would not be allowed,[9a] thus requiring taxpayers to recognize income currently which may never be collected. Although a deduction would be allowed at the time the receivable is proved to be uncollectible and written off, this could be several years in the future.

[9a] See discussion of reserves for bad debts in Part II, E, 1, below.

It has been suggested that several types of businesses may have particular problems in obtaining an accurate measurement of income under the accrual method proposed by the Administration. Providers of professional services (such as law firms and accounting firms), who generally would be required to recognize income at the time they bill their clients, have argued that the required use of the accrual method, combined with the prohibition of the use of bad debt reserves, does not recognize the realities of their businesses.

Their claim is that, because of their professional relationship with their clients, they are not able to pursue collection of amounts receivable in the aggressive manner that providers of goods can utilize. Since the work product provided is intangible, it is argued, the perception of its value is by necessity somewhat subjective. This may result in the firm's writing down the original amount billed in order to satisfy the client and obtain collection, and could lead to a period of negotiation after billing which delays collection. For these reasons, it is argued, the sending of a bill by a provider of professional services may not have the same indicia of the satisfaction of the all-events test as does the sending of a bill by a provider of goods. The amount stated on the bill may not establish the actual amount of expected collection. Also, a significant period of time may pass between the sending of the bill and any the receiving of payments.

If the time of billing does not satisfy the all-events test, then the time at which the test is satisfied must be determined. If collection of amounts billed is so uncertain that only the receipt of cash would satisfy the test, it may make little sense to disallow use of the cash method. However, in many cases, it is doubtful that the all-events test would not be satisfied until actual cash collection; instead, the test may be satisfied prior to billing, when the service provider actually performs the work. Because the time of billing is a verifiable event involving a transaction between independent parties, and because it strikes a balance between situations where the all-events test is satisfied as the work is performed and the situations where the test is not satisfied until actual collection, accrual of income at the time of billing could be viewed as a desirable timing rule in the interest of certainty and administrative simplicity.

Providers of services also argue that the above considerations make it more difficult for them to factor (sell to outside parties) receivables in order to obtain present cash flow to pay the earlier taxes which might result from required use of the accrual method. On the other hand, while it may be true that the specific receivables themselves are not factorable, it is may be assumed that the amount of receivables contributes to the general borrowing power of the firm, thereby aiding its ability to generate current cash flow.

It also is pointed out that sellers of goods have access to the installment method of accounting, but that this method is denied to providers of services. The installment method delays recognition of income and cost of sales until the time of actual collection and thereby eliminates many of the problems associated with delayed collection. It may be appropriate to consider extending the use of the installment method to providers of services. A seller of goods using the installment method, however, not only delays recognition of income but also the recognition of the costs associated with those sales. Extension of the installment method to service-providers on terms equivalent to those applicable to providers of goods would require service-providers to capitalize costs associated with generating receivables.

The problems which service-providers find with the Administration proposal relate to the timing of income items and not to the recognition of expenses. The effect of requiring accrual accounting for expense items would depend upon the time they are normally paid. Deductions for prepaid expenses would be deferred, while deductions for expenses paid after the goods or services are received would be accelerated. Regardless of when paid, deductions under the accrual method would be recognized for tax purposes in the period in which the liability for them becomes fixed and they are economically performed, providing a better reflection of their contribution to net income than under the cash method.

The proper reflection of income is best served by recording items of revenue and expense under the same method. Since expenses generally are considered to be better reflected under the accrual method, and since there may be difficulties in clearly reflecting revenues under both the cash and accrual methods, the accrual method is, on balance, the preferable method for Federal income tax purposes.

Financial accounting methods

Preference for accrual method

One of the arguments for disallowing use of the cash method is that this method is not allowed for financial accounting purposes under generally accepted accounting principles (GAAP). The accrual method is preferred for financial accounting purposes. "Information about enterprise earnings and its components measured by accrual accounting generally provides a better indication of enterprise performance than information about current cash receipts and payments. . . . Accrual accounting is concerned with the process by which cash expended on resources and activities is returned as more (or perhaps less) cash to the enterprise, not just with the beginning and end of that process. It recognizes that the buying, producing, selling and other operations of an enterprise during a period, as well as other events that affect enterprise performance, often do not coincide with the cash receipts and payments of the period." [10]

Although the cash method is not a preferred method, its use is not absolutely prohibited for financial accounting purposes. In the case of some relatively small organizations, it is recognized that the benefits of the better information obtained from accrual accounting may not justify the costs of obtaining the information.[11] In such cases, use of the cash method is allowed.

The Administration proposal recognizes this cost/benefit analysis by allowing taxpayers with average annual gross receipts of $5 million or less, who do not already use a method other than the cash method for financial purposes, to continue to use the cash method.

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[10] Financial Accounting Standards Board, Statement of Concepts No. 1 (1978), para. 45.
[11] Financial Accounting Standards Board, Statement of Concepts No. 4, (1950), para. 50.

In the case where it is probable that amounts due a taxpayer will not all be collected, GAAP requires that a reserve be established and that current income be reduced. Since the Administration proposal would not allow a deduction in connection with such a reserve, it cannot be said that the Administration proposal is consistent with GAAP.

Conformity issue

It is not clear whether conformity with generally accepted accounting principles should be used in determining what is a proper method of accounting for Federal income tax purposes. While one objective of financial reporting under generally accepted accounting principles is to provide a periodic earnings measurement (net income for the year), this objective is only part of the overall objective to provide information useful to the making of business and economic decisions and provide a basis for making reasoned choices among alternative uses of scarce resources in the conduct of business and economic activities. To the extent that the demands of this overall objective may conflict with needs satisfied by the periodic measurement of income, the financial accounting system under generally accepted accounting principles may measure activity in a manner that is not appropriate for income tax purposes.

Many of the uses of financial statement information are more dependent on the data on the balance sheet than they are on the data on the income statement. As the income statement must agree with the net change in the balance sheet for the year, any conflicts in presentation which are reconciled in favor of the balance sheet can negatively affect the proper presentation on the income statement. The use of the financial statement by lenders requires the disclosure of potential as well as current claims against the assets of the entity. The recording of these potential claims requires either a reduction of accumulated earnings or a current reduction of income. Although necessary to preserve the integrity of the balance sheet, this may render the GAAP income statement less suitable for current income tax purposes.

Investors as well as lenders may be concerned with current values of assets and liabilities as a measure of the "break-up" value of the entity. To satisfy this need, financial accounting restates the carrying values of certain assets to the lower of cost or market value, and record an offsetting entry on the income statement. To the extent that the gain or loss from the restatement of these assets is not appropriate for current recognition for income tax purposes, the financial accounting income statement may not accurately reflect taxable income.

Although not specifically stated as a concept or objective of financial reporting, a practical consideration of financial accounting is that of conservatism. Both for the balance sheet and the income statement, it is considered more important not to overstate net assets or income than it is not to understate them. Thus, reserves are established for loss contingencies, but not for gain contingencies. Likewise, the value of inventory and investments is reduced for declines in market value, but increases in market value are recognized only to the extent necessary to restore prior reductions. The concept of conservatism may be a necessary part of financial accounting in order to offset the natural tendency of reporting entities to present as optimistic a picture of their financial position as possible. To the extent the conservatism built into GAAP reduces the accuracy of current income measurement, however, it renders the financial accounting numbers less suitable as a guide for taxable income computation.

Effect of the $5 million threshold

The Treasury Department estimates that 103,000 corporations (eight percent of all corporations), 4,000 partnerships (one percent of all partnerships), and 1,800 sole proprietorships (less than one percent of all sole proprietorships) would have average annual receipts exceeding $5 million, and thus would be subject to disallowance of the cash method. The Treasury Department states that some of these entities already are using the accrual method for tax purposes. Nonetheless, many businesses with average annual receipts below $5 million would be required to switch from the cash method if they regularly used another method to report to owners, beneficiaries or creditors.

The stated reason for the $5 million threshold is to prevent smaller, less sophisticated businesses from being forced to shoulder the burden of changing to a different method of accounting. On the other hand, to the extent that taxpayers are already using another method of accounting for nontax purposes, there would appear to be little or no increase in burden in using that method of accounting for tax purposes as well.

Several arguments have been made against a rule which limits the use of the cash method depending upon the gross receipts of the business. It is suggested that entities currently using the cash method may divide themselves in order to qualify for the $5 million threshold. Entities approaching the $5 million amount could limit their growth in order to avoid crossing the line and losing the use of the cash method. In either case, it is argued, these decisions might be made solely on the basis of tax consequences, without regard to whether economic efficiency is served. On other hand, the division of entities in order to avoid this rule can be prevented by adopting rules which would aggregate related businesses. In addition, it is unlikely that taxpayers would turn down profitable business in order to avoid the operation of the $5 million threshold. As the $5 million threshold is not indexed for inflation, there is concern that in time nominal growth in gross receipts could subject taxpayers to the loss of the cash method, when the real value of their receipts had not changed. If this is a concern, the $5 million amount could be indexed for inflation.

It is also suggested that because some entities in the same line of business would be forced to abandon the cash method while others would be allowed to retain it, an unlevel "playing field" would be created with attendant anticompetitive results. Whenever the application of a tax rule depends on a specified level of activity being reached, a fairness issue may exist between those subjected to the tax rule and those exempted from it. Present law applies graduated rates of tax which can have a significant effect on the tax liabilities of entities depending on their size and profitability. In such cases, the appropriateness of a threshold for application of the tax rule depends on whether there is a valid reason for exempting those below the threshold and whether the threshold has been placed at an appropriate level.

In the case of the cash method of accounting, the relative simplicity of compliance under the cash method and the goal of not burdening smaller taxpayers with the required adoption of a new accounting method are cited to support use of a threshold. As simplicity is the primary purpose behind the threshold, the use of a phase-in approach to limit the difference in treatment between those with roughly similar levels of activity, but who fall just on either side of the threshold, would not seem appropriate. A phase-in approach would require a hybrid method of accounting embodying elements of both cash and accrual methods or, alternatively, the computation of tax liabilities under both methods and the blending of results. Such an approach, would be more burdensome from a compliance standpoint than a full shift from the cash method of accounting.

It is recognized that, where the cash and accrual methods produce substantial differences in any year's tax liability, the competitive effect of different treatment may be a concern. If the substantial difference is a result of deficiencies in the ability of the accrual method to accurately measure economic income, it would appear that the issue is not the $5 million threshold, but rather the appropriateness of disallowing use of the cash method. If the substantial difference is related to the failure of the cash method properly to match income and expense, or is due to the ability of the cash-basis taxpayer to manipulate tax liability, the issue is whether this creates an unacceptable cost of allowing the cash method to any taxpayer.

B. Pledges of Installment Obligations

Present Law

In general

In general, gain or loss from "dealings in property" (sec. 61(a)(3)) is recognized only upon the "sale or other disposition" of the property (sec. 1001(a)). As discussed below, income from an installment sale of property generally may be reported on the installment method.

Where property is pledged as collateral for a loan, there is generally no sale or other disposition that would require the taxpayer to recognize gain or loss. This is true even if the loan is nonrecourse and the borrowed amount exceeds the taxpayer's basis in the pledged property.[13]

Installment sales

Under present law, income from an installment sale of property generally may be reported on the installment method, unless the taxpayer elects otherwise (sec. 453). An installment sale is a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs.

[13] *Woodsam Assocs.* v. *Comm'r*, 198 F.2d 357 (2d Cir. 1952).

Installment reporting is also permitted for dispositions on the installment plan by taxpayers who regularly sell or otherwise dispose of personal property on the installment plan, and for dispositions of personal property of a kind that is required to be included in the taxpayer's inventory. The installment method may not be used where a sale results in a loss.

Under the installment method, a taxpayer recognizes income resulting from a disposition of property in any taxable year, equal to that proportion of the payments received in that year that the gross profit under the contract bears to the total contract price. For example, assume an individual makes a casual sale of personal property that has a basis of $50,000. The individual receives $40,000 immediately and will receive $60,000 (plus interest) in the next taxable year. Under the installment method, the individual recognizes $20,000 of gain immediately—$50,000/$100,000 (gross profit ratio) times $40,000 (payments received). The seller recognizes the remaining $30,000 of gain when the final payment is received—$50,000/$100,000 times $60,000.

Dispositions of installment obligations

Generally, if an installment obligation is disposed of, gain (or loss) is recognized equal to the difference between the amount realized and the basis of the obligation, in the case of satisfaction at other than face value, or equal to the difference between the fair market value of the obligation at the time of the disposition and the basis of the obligation, in the case of any other disposition. The basis of the obligation is equal to the basis of the property sold plus amounts of gain previously recognized. In general, the mere pledge of an installment obligation as collateral for a loan is not treated as a disposition.[14]

Assumptions of outstanding indebtedness

If property subject to outstanding indebtedness is sold on the installment method and some or all of such debt is assumed in connection with the sale, the timing of gain recognized under the installment method depends on whether the assumed debt is "qualifying indebtedness."

Qualifying indebtedness relating to an item of property is a mortgage or other indebtedness, whether or not secured by the property, that was incurred or assumed by the owner incident to the owner acquisition, holding, or operation of the property in the ordinary course of business or investment. Indebtedness that is incurred incident to the disposition of the property (including certain indebtedness incurred in contemplation of the sale of the property) or that is unrelated to the acquisition, holding or operation of the property is not qualifying indebtedness.

If the assumed debt is not qualifying indebtedness, then the entire principal amount of the debt is treated like a payment in the year of sale, and any gain is recognized accordingly. If the assumed debt is qualifying indebtedness, gain is recognized only to the extent that the principal amount of the debt exceeds the basis

[14] *See, e.g., Town and Country Food Co., Inc.,* 51 T.C. 1049 (1969), acq. 1969-2 C.B. XXV; *United Surgical Steel Company, Inc.,* 54 T.C. 1215 (1970), acq. 1971-2 C.B. 3.

of the property. In such a case, the gross profit ratio applicable to payments that subsequently would be made on the installment obligation (i.e., the percentage of such payments that would be treated as income), is adjusted upward so that any gain that is not recognized at the time of sale, because the special treatment of qualifying indebtedness, is recognized as later payments are made.

Background

A typical transaction in which installment obligations are pledged involves a taxpayer who sells property in the ordinary course of business in exchange wholly or partly for installment obligations of the buyer. For example, such a taxpayer may be a homebuilder, or may be a dealer in consumer durables. Since such a taxpayer transfers the property sold in exchange for installment notes due after the close of the taxpayer's taxable year, the income from the sale may be reported under the installment method.

The taxpayer typically transfers the installment obligations arising from its installment sales to a wholly owned subsidiary with which the taxpayer files a consolidated Federal income tax return. The subsidiary issues debt to a third party secured by the installment obligations in a manner such that the transaction would not be treated as a disposition of the installment obligations that would require the taxpayer or the subsidiary to recognize gains that are deferred under the installment method. The subsidiary then distributes the proceeds of the borrowing to its parent.

Payments on the underlying installment obligations are used for the subsidiary's debt service. The consolidated group recognizes income from the installment obligations upon the receipt of principal payments on the installment obligations, as if the parent still held the obligations. In the case of installment obligations that have long maturities (which is particularly common in the case of sales of homes), only minimal amounts of principal are received in the first several years.

For Federal income tax purposes, the installment obligations are not treated as having been disposed of. Under generally accepted accounting principles, however, the taxpayer may be able to treat the transaction as a disposition of the obligations and, accordingly, may neither account for the installment obligations as assets nor account for the subsidiary's debt as liabilities on the taxpayer's balance sheet.[15]

Thus, as a result of such transactions, a taxpayer may receive in cash all or a significant portion of the value of the installment obligations (and treat the obligations as having been disposed of for accounting purposes), yet not recognize any significant amount of gain related to the installment obligations for tax purposes for several years. Further, taxpayers who use the technique of pledging installment receivables to defer the recognition of income are often able to deduct currently certain expenses not allocated to the property sold. These taxpayers, although reporting income for account-

[15] *See* Financial Accounting Standards Board, Technical Bulletin 85-2, Accounting for Collateralized Mortgage Obligations (CMOs) (March 18, 1985). While the installment obligations often are transferred to a financing subsidiary for nontax reasons, the transfer to a financing subsidiary is not necessary for the Administration proposal to apply.

ing purposes, often have been able to generate large net operating losses.[16]

For example, in a taxable year, a homebuilder may sell 100 homes for $100,000 each, taking a $10,000 down payment and a $90,000 purchase money mortgage from each of the purchasers. The total costs that the builder was required to capitalize with respect to each home were $80,000 and the builder was able to deduct currently an average of $15,000 per home.

The builder then places all of the mortgages, total face amount of $9 million, in a finance subsidiary that issues debt for close to the full face amount of the mortgages. As a result of these transactions, the builder, who realized an average profit of $5,000 per home on the sale of the 100 homes and has received most of the cash attributable to the sales (representing both a profit element and a recovery of capitalized costs) by pledging the mortgages, will report a net operating loss of $1,300,000. This loss is attributable to the builder's having deducted $1,500,000 in current expenses, while recognizing only $200,000 of gain from the down payments on the home sales (i.e., $20,000 gross profit divided by $100,000 selling price, times $10,000 down payment per home) and recognizing no gain on the pledge of the mortgages.

Administration Proposal

Property sold in the ordinary course of business

Under the Administration proposal, if an installment obligation received in exchange for property sold in the ordinary course of business is pledged as collateral for an amount borrowed in the ordinary course of business, then the taxpayer generally would report gain equal to the excess (if any) of the amount borrowed over the basis of the pledged obligation. Receipt by the taxpayer of payments on the pledged installment obligations would not result in recognition of gain except to the extent that the gain that otherwise would be recognized on account of such payments exceeds the gain, if any, recognized as a result of the pledge. The rule relating to nonrecognition of gain from subsequent payments would apply regardless of whether such payments are used to pay any portion of the indebtedness secured by the installment obligation.

Casual sales of property

Under the Administration proposal, if installment obligations arising from casual sales of property (i.e., sales other than those arising from the disposition of property held primarily for sale in the ordinary course of business) are pledged as collateral for a loan, the proceeds of the loan generally would be treated as a payment received on the obligation. Gain would be recognized equal to the product of the loan proceeds and the gross profit ratio. As in the case of installment obligations arising from dispositions of property in the ordinary course of business, where payments on the obligation are subsequently received, gain would be recognized on account of such payments only to the extent the gain exceeds the

[16] Issues relating to accounting for production costs are discussed in Part II. D. below.

amount of gain arising from the pledge of the obligation, regardless of the use of the proceeds.

Exceptions

The provisions of the Administration proposal would not apply to the pledge of an obligation that was received by the taxpayer in exchange for property held primarily for sale by the taxpayer in the ordinary course of its trade or business and which by its terms requires payment in full within a period not exceeding one year. In addition, the rules also would not apply to the pledge of obligations arising from sales on a revolving credit plan the terms of which contemplate that all charges for a purchase will be paid within a year.

The rules also would not apply to the pledge of an installment obligation pursuant to a general lien on all of the borrower's trade or business assets securing amounts borrowed from a financial institution (except where substantially all of the borrower's assets are installment obligations). Nor would the rules apply to the pledge of an installment obligation in connection with any indebtedness the terms of which require payment in full within 90 days of its issuance, provided the indebtedness is not renewed or continued.

Effective date

The Administration proposal generally would apply to the pledges of installment obligations after December 31, 1985. Installment obligations pledged on or before that date would be treated as pledged on January 1, 1991, if still outstanding.

Other Proposal

S. 624 (Metzenbaum)

S. 624 would provide that (except as prescribed by Treasury regulations) if any installment obligation is pledged as security for a loan, the proceeds of the loan would be treated as a payment on the obligation. This rule would apply regardless of whether the obligation arose from the disposition of property in the ordinary course of business.

Analysis

In general

The treatment under present law of the pledge of installment obligations generally is consistent with the present law treatment of other borrowings, i.e., the taxpayer recognizes no gain or loss unless the property is treated as having been disposed of. One distinction that many consider important, however, is that an installment obligation is itself the evidence of a previous sale of appreciated property, the gain from which is deferred by virtue of a special provision of the Code. Thus, those who favor altering the present law treatment of pledges of installment receivables would argue that installment reporting should be permitted where installment obligations are pledged only if the rationale for initially permitting deferral under the installment method still remains after the pledge.

Such advocates note that a primary justification for permitting use of the installment method is that a taxpayer who exchanges property for an installment obligation may not have available cash with which to pay an immediate tax on the gain realized. Such a taxpayer could have this problem in some cases because the installment obligation may not be acceptable collateral for a loan, and in others, because the taxpayer might be required to pay interest on a loan at a rate considerably higher than the rate that the installment obligation bears. In recognition that installment reporting is not intended for situations where a recipient of an obligation is not burdened with an illiquid instrument, the Treasury regulations provide that a seller of property generally must treat the receipt of an obligation of the buyer that is in readily tradable form as an immediate payment rather than as an installment obligation (Treas. Reg. sec. 15a.453-1(e)(1)).

A taxpayer who borrows against an installment obligation arguably is not faced with the liquidity problem that installment reporting is intended to alleviate, at least to the extent of the amount borrowed. Such a taxpayer is not situated much differently from one who has received only cash or a marketable security for the property and could not defer the taxation of any of the gain from the underlying transaction. Accordingly, the receipt of cash resulting from pledging an installment obligation may be an appropriate time to tax at least a portion of the deferred gain.

On the other hand, advocates of retaining present law point out that frequently, installment receivables, rather than other property of the taxpayer, are pledged as collateral for a loan simply because the receivables are the collateral favored most by lenders, thus making the taxpayer's borrowing cheaper. In such circumstances, these advocates argue that it is unfair to treat the installment receivables necessarily as generating the cash, since it may be fortuitous that the receivables rather than other assets are pledged. In addition, the homebuilding industry argues that their ability to pledge installment receivables without triggering recognition of gain permits them to offer financing to their customers at rates below prevailing mortgage rates. It is not clear, however, that any savings to homebuyers in such circumstances is of the same magnitude as the revenue loss to the Treasury resulting from deferral of the tax on the gain.

Interest-free deferral

A taxpayer's ability to defer recognition of gain by using the installment method may be said to have the same effect as an interest-free loan by the Treasury to the taxpayer equal to the amount of the deferred tax liability. A taxpayer who receives such a loan is effectively able to realize a larger investment return than would have been possible if the tax had been payable immediately upon the sale.

For example, if an individual with a 50-percent marginal tax rate sells ordinary-income property with a basis of zero to a corporation and receives in return a $100,000 installment obligation bearing interest at 12 percent, the taxpayer will earn $12,000 per year on the obligation before taxes. If the gain on the sale were taxed immediately, however, the taxpayer could "invest" only $50,000 in the same corporation and earn only $6,000 per year before taxes. This $6,000 difference is, in effect, the interest that the taxpayer earns on the investment of the interest-free "loan" from the Treasury of the amount of deferred tax liability. If an appropriate interest charge were placed on the privilege of deferral under the installment method, then taxpayers generally would receive no benefit from borrowing against installment obligations in order to generate cash without triggering gain.

Administration proposal

The Administration proposal attempts to address some of the problems raised by the use of installment reporting under present law. Modifications of certain aspects of the proposal, however, could be considered.

Return-of-basis rule

The Administration proposal provides different treatment for the pledge of an installment receivable that was received in exchange for property sold in the ordinary course of business than for an installment receivable that was received in exchange for a casual sale of property. The apparent justification for this distinction lies in the present-law rules relating to the treatment of qualifying indebtedness.

As discussed above, these rules in effect permit sellers to recover basis prior to recognizing gain to the extent that any qualifying indebtedness is outstanding and is assumed (or is taken subject to) in connection with the sale. Although property sold in the ordinary course of a trade or business is by its nature unlikely to be sold subject to qualifying indebtedness, the return-of-basis rule in the Administration proposal may be justified as a means of effectively permitting installment sales of such property to take advantage of the qualifying indebtedness rules.

Several questions may be raised by this analogy. The first question is whether the return-of-basis rule in the Administration proposal is significantly broader than the qualifying indebtedness rule to which it is analogized. The qualifying indebtedness rule allows basis recovery only to the extent of the outstanding amount of qualifying indebtedness. Thus, a seller generally cannot take advantage of the qualifying indebtedness rule except to the extent that the property sold was debt-financed. Nevertheless, the Administration proposal allows the entire basis of property to be recovered without recognition of gain regardless of the extent to which a seller's operations are debt-financed. Accordingly, the Administration proposal could be seen as providing more liberal treatment than the qualifying indebtedness rules under present law.

A second question is whether the rule is consistent with a basic concept of installment sales reporting—that a portion of each payment is gain and not first treated as a return of basis. In 1981, after a long series of litigated cases, the Treasury Department issued temporary regulations that attempted to limit the use of the return-of-basis rule (Treas. Reg. sec. 15a.453-1(d)(2)). Under these regulations, a cash-method taxpayer who elected not to report gain on the installment method could under no circumstances defer gain until after recovering basis. Gain or loss in such a situation is to be recognized based on the fair market value of the obligation, which in no case is to be treated as less than the fair market value of the property sold (less other consideration received).

These regulations were a response to situations where cash-basis taxpayers would elect not to report income on the installment method and would take the position that they were not required to report any gain until they received cash in excess of basis. These taxpayers relied on the so-called "cash equivalent" cases which generally held that a cash-method taxpayer was taxable only on the receipt of cash or its equivalent and that nontradable notes of the purchaser are not the equivalent of cash.[17] Thus, the return-of-basis rule in the Administration proposal appears to be a reversal of a longstanding Treasury position.

Third, it appears that complex rules could be needed to avoid significant abuse potential that would exist if a return-of-basis rule were implemented. For example, transactions that would ordinarily involve a significant down payment (and resulting recognition of a proportionate amount of gain) could instead be structured with no down payment but with the amount that would have been the down payment due in a short period of time. If, prior to the payment of such amount, the obligation were pledged, recognition of the gain that would have resulted from the down payment might be avoided.[18]

Finally, the return-of-basis rule may be contrary to notions of proper income measurement of an ongoing business. Where property is sold and cash received on a regular basis in a profitable business, there appears to be little justification for deferring the recognition of income and payment of tax.

Treatment of subsequent payments

Under the Administration proposal, if an installment obligation has been pledged and payments on the obligation are made, no income is recognized on account of the payments until the gain attributable to the payments exceeds the gain recognized on account of the pledge of the obligation. Two issues are raised by this aspect of the proposal.

The first issue is whether the proposal's rule is appropriate without regard to whether the payments received are applied to the debt for which the obligations are pledged. The absence of such a distinction in the proposal is apparently justified either by the view that lenders generally will require payments on the pledged obligation to be applied to the indebtedness, or by the view that since money is fungible, inordinate administrative difficulties would occur in trying to trace the application of payments.

Nevertheless, if an installment obligation is pledged for a loan that is considerably less than the face amount of the obligation, a lender may not necessarily require all payments on the obligation

[17] *See, e.g., Nina J. Ennis,* 17 T.C. 465 (1951); *Harold W. Johnston,* 14 T.C. 560 (1950).

[18] The result in such a situation would depend in part upon the way subsequent payments on the installment obligation were treated. Possible rules are discussed below, "treatment of subsequent payments."

to be applied toward the loan. Where this is the case, under the Administration proposal, the holder of an obligation may be able to receive a large percentage of the cash value of the obligation without recognizing a commensurate portion of the gain.

For example, assume two taxpayers each make casual sales of property that had a basis of $50,000 and receive $100,000 installment obligations from the respective buyers. Each taxpayer borrows $40,000 pledging the obligation as collateral and then receives a $40,000 payment on the obligation; in one case, the taxpayer uses the $40,000 payment on the obligation to pay off the $40,000 borrowing while the other taxpayer retains the $40,000 payment without paying off any of the borrowing. Under the Administration proposal, both taxpayers would recognize gain of $20,000. The treatment of the taxpayer who has in effect received $80,000 while recognizing only $20,000 of gain may be considered inappropriately generous in the context of the proposal.

Accordingly, it may be appropriate for rules relating to subsequent payments to take into account the use of such payments. On the other hand, such an approach might raise difficult tracing problems, particularly where the timing of payments on the loan did not coincide with the timing of payment on the installment obligation, it may be possible to develop adequate rules that deal with this problem.

The second issue involves measuring the appropriate amount of gain attributable to subsequent payments on the obligation if a return-of-basis rule is adopted for pledges of certain installment obligations. Based on the analogy to the qualifying indebtedness rules, it may be appropriate to adjust upward the gross profit ratio applicable to subsequent payments, rather than to apply the gross profit ratio that would apply in absence of any qualifying indebtedness.

For example, using the above facts, where subsequent payments were retained and were treated as triggering additional gain without adjustment to the gross profit ratio, the taxpayer who sold property in the ordinary course of business under the Administration proposal would recognize only $20,000 of gain while a taxpayer who sold property subject to $40,000 of qualifying indebtedness would recognize approximately $33,000 of gain.[19]

General lien exception

Frequently, a business, some of whose assets may consist of installment receivables, enters into loan agreements that grant the lender a lien on all of the borrower's assets (including the installment obligations) whether or not the loan would be secured adequately by a lien on less than all of the borrower's assets. In such situations, particularly due to the potential overcollateralization,

[19] In the case of a sale subject to qualifying indebtedness of $40,000, a gross profit ratio of $50,000 (gross profit) divided by $60,000 (selling price minus qualifying indebtedness) would be applied to payments on the installment obligation. Accordingly, a $40,000 payment would result in recognition of approximately $33,000 of gain. In addition, if a tracing rule were adopted that resulted in no additional tax consequences being attributed to subsequent payments that are used to repay debt, an upward adjustment would be required in this situation in order to assure recognition of the entire gain.

the taxpayer may not be said necessarily to have borrowed against its installment obligations.

The Administration proposal would address this situation by providing an exception relating to general liens. Since a typical pledge of installment obligations using a finance subsidiary may literally fall within the exception, the proposal would limit the exception to cases where installment obligations do not comprise substantially all of the borrower's assets.

This exception could be abused, however, by modifying a typical pledge of installment obligations only slightly. For example, both installment obligations and a substantial amount of government securities could be placed in a financing subsidiary that would then issue debt secured by a general lien on all of its assets. Since substantially all of the borrower's assets would not then consist of installment obligations, the borrower arguably would qualify for the general lien exception. Accordingly, it may be desirable to consider specifying that any general lien exception would apply only where substantially all of the borrower's assets, not including passive investment assets other than installment obligations, do not consist of installment obligations.

Notwithstanding the desirability of accommodating the common transaction described above where the borrower may not have actually borrowed against installment obligations, it is possible, however, that a borrower substantially all of whose assets do not consist of installment obligations will nevertheless have effectively borrowed against such obligations where the amount borrowed exceeds the value of the borrower's non-installment obligation assets. In these situations, the general lien exception may be considered to be too broad.

In order to tailor relief more directly to situations where the borrower has not necessarily borrowed against installment obligations, the general lien exception could be modified. The modified exception could provide that the pledge pursuant to a general lien would not be subject to the proposed rules except to the extent that the amounts borrowed exceed the fair market value of borrower's non-installment obligation assets. Such a rule also would eliminate the need for a limitation on the exception where substantially all the borrower's assets are installment obligations. On the other hand, such a rule may raise administrative problems in determining the fair market value of the borrower's assets.

90-day debt exception

The exception in the Administration proposal for installment obligations that are pledged for indebtedness due within 90 days (provided that the indebtedness is not renewed or continued) would permit certain short-term borrowings using installment receivables as collateral without triggering gain on the receivables. This provision appears intended to allow taxpayers to continue to use the installment method to account for income relating to installment obligations that are pledged to satisfy short-term cash needs, but not installment obligations that are pledged for longer-term debt that appears to effect more of a "cashing out" of the obligation.

If an exception of this nature is believed to be desirable, consideration may be given to three issues. The first issue is whether the short-term non-cashing out situation is not already accommodated by the exception for pledges pursuant to a general lien, since the type of short-term borrowing contemplated may well take place pursuant to such an arrangement. The second issue is whether 90 days is the appropriate line to be drawn between borrowings that are or are not considered to be sufficiently short-term to reflect a borrowing that should not be treated as a cashing out of an installment obligation. The third issue is what sort of rules would be necessary to prevent certain disguised continuances of otherwise permissible short-term indebtedness, particularly in the context of transactions within an affiliated group.

Imposing an interest charge on deferral

A major justification for permitting the use of the installment method is the liquidity problems that might arise for a taxpayer who is required to pay an immediate tax after exchanging property for an installment obligation. A direct solution to such a liquidity problem, however, would be for the Treasury to permit the taxpayer to defer payment of the tax liability and, recognizing that the taxpayer has therefore received a loan, to charge interest (either at the rate normally charged for tax underpayments or at the rate of interest that the installment obligation bears) for the period that the tax liability remains unpaid.

Alternative effective date

Some taxpayers may argue that the portion of the Administration proposal that would treat obligations that were pledged prior to the general effective date as being pledged on January 1, 1991, is unfair since it alters the income tax treatment of transactions entered into before the general effective date of the provision. As an alternative, present law could be applied to all obligations pledged prior to the effective date of the provision.

C. Inventory Valuation

Present Law and Background

Background

The maintenance and valuation of inventories is an essential part of the measurement of income for many business enterprises. Where an enterprise purchases goods for resale, or purchases unfinished or raw materials for conversion into the products it will eventually sell, the matching principle requires that the cost of the purchase be recognized in the same period as the income from the eventual sale. Since purchase and sale may take place in different taxable periods, it is necessary to establish an inventory account for the cost of items which remain on hand at the end of a taxable period, but which are expected to be sold in a later period.

Once it is established that inventory accounts must be kept, it is necessary to adopt a methodology for their valuation. In the simplest situation, all elements of inventory are unique and can be assigned to a specific finished product or work in process. In that case, it is relatively easy to count up the costs associated with product sold and take that figure as the period's cost of goods sold expense, leaving the remainder of inventoriable costs incurred in the inventory account. This approach is comparable to capitalization of the costs of self-constructed property.

Inventory valuation becomes more complicated—and at the same time more important—where both the items of inventory and the products for sale to which they relate are not unique. Identical inventory items may have been purchased at different times and at different prices. The sales items to which they relate may also be identical items sold in different tax periods.

In these common situations, it is not obvious which inventory costs should be associated with which sales items. In addition, very large numbers of small value items may constitute inventories and sales, making it economically inefficient to try to allocate inventory costs specifically to each individual sale (perpetual inventory). Thus, it is necessary not only to be able to allocate inventory to sales, but also to be able to do so at the close of a given period (periodic inventory) in order to minimize the accounting burden.

Numerous approaches for valuing inventories have been suggested. These include allowing the taxpayer to allocate whichever inventory costs it chooses against its sales (the specific identification method); using an average cost of fungible inventory items; matching the earliest inventory items against the earliest sales (FIFO); matching the most recent inventory items against the earliest sales (LIFO); valuing items removed from inventory at their replacement cost; and using various indexed inventory techniques. Each of these approaches can be expected to yield a somewhat different valuation of ending inventory and, as a result, to affect the taxpayer's income and tax liability for the taxable year.

Valuation of ending inventories provides an essential component in the determination of the cost of sales for a given period. In general, cost of sales is computed as follows:

	Beginning inventory
Plus	Purchases
Plus	Other costs of sale
Less	Ending inventory
Equals	Cost of sales

The lower the valuation which can be assigned to ending inventory, the higher will be the cost of sales. Higher costs of sales result in lower reported income.

Present law

In general

Under present law, a taxpayer is required to maintain inventories whenever the production, purchase, or sale of merchandise is an income-producing factor in the taxpayer's trade or business (Treas. Reg. sec. 1.471-1). To be acceptable for tax purposes, the inventory system chosen must conform as nearly as possible to the best accounting practice in the trade or business and must clearly reflect income.

Because different methods may best suit different trades or businesses, no single uniform method is prescribed. In order to clearly reflect income, it is essential that the method chosen be used consistently from year to year. The regulations provide that "greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation so long as the method or basis used is in accord with [the regulations under sec. 471]." [20]

Taxpayers traditionally have been required to use the specific identification method where inventory items have not been commingled and can be identified with specific invoices. If goods taken into inventory have been commingled, the goods remaining in inventory at year-end are assumed to be those most recently purchased or produced (the FIFO method), unless an election is made to use the LIFO method under section 472.

The average cost method, although not approved by regulations, has been allowed as an alternative to the FIFO and LIFO methods in several court cases. Where the average cost method has been consistently employed, is a generally accepted accounting method, and is specifically approved of by the agency regulating the taxpayer, it may continue to be used.[21] The average cost method may not be used, however, to include purchases made during any year other than the current year in the value of ending inventory (the so-called "rolling average" method).[22]

No indexed inventory method is approved under present law, nor is the replacement cost method.

Computation under FIFO

The computation under the FIFO method is generally done by keeping a list of each addition to inventory by date of addition and price paid. At the close of the taxable period, a physical inventory is taken and the most recent additions assigned to the ending inventory pool. Since only the most recent additions are included in the inventory value, the earlier additions (the first in) are considered the earliest sold (the first out).

The FIFO computation method can be demonstrated by the following example for a calendar-year taxpayer:

Inventory Elements

Item A		Item B	
Beginning	100 units @ $1.00	Beginning	50 units @ $2.00
5/20	100 units @ $1.10	2/26	200 units @ $2.10
7/24	200 units @ $1.15	8/31	40 units @ $1.90
	Ending inventory: Item A=310 units; Item B=50 units.		

[20] Treas. Reg. sec. 1.471-2(e).

[21] *See Madison Gas and Electric,* 72 T.C. 521 (1979), *aff'd on other issues,* 633 F.2d 512 (7th Cir. 1980).

[22] Rev. Rul. 71-234, 1971-1, C.B. 148.

Ending Inventory Valuation

Item A		Item B		Total
200 @ $1.15 =	230	40 @ $1.90 =	76	
100 @ $1.10 =	110	10 @ $2.10 =	21	
10 @ $1.00 =	10			
	350		97	447

Under this FIFO example, cost of sales would be calculated as follows:

	Item A	Item B	Total
Beginning inventory	$100	$100	$200
+Purchases	340	496	836
−Ending inventory	(350)	(97)	(447)
=Cost of sales	90	499	589

The FIFO method can also be used for perpetual inventories by recording additions at cost and reducing the inventory account by the earliest purchase remaining in inventory. If done correctly, both the perpetual and periodic approaches should yield the same ending inventory valuation and cost of sales.

Computation under LIFO

The computation under the LIFO method also depends on the keeping of a list of inventory additions by date of addition and price paid. At the close of the taxable year, a physical inventory is taken and the earliest additions are assigned to the ending inventory pool, as opposed to the latest additions under the FIFO method. As a result of adding the earliest additions to ending inventory, the latest additions (the last in) are considered the earliest sold (the first out).

If LIFO principles were applied to the example above, ending inventory valuation would be computed as follows:

Item A		Item B		Total
100 @ $1.00 =	100.0	50 @ $2.00 =	100	
100 @ $1.10 =	110.0			
110 @ $1.15 =	126.5			
	336.5		100	436.5

Under this LIFO example, cost of sales would be calculated as follows:

	Item A	Item B	Total
Beginning inventory	$100	$100	$200
+Purchases	340	496	836
−Ending inventory	(336.5)	(100)	(436.5)
=Cost of sales	103.5	496	599.5

As the LIFO method requires the beginning inventory to be included in ending inventory to the extent possible, it is exclusively a periodic inventory system.

While the above discussion describes the general rules for the computation of LIFO inventories, several refinements are available. The most important of these are the dollar-value pooling refinements.

If a taxpayer has many different kinds of items in inventory, it is quite burdensome to maintain a separate inventory account for each, whether FIFO or LIFO is used. The dollar value LIFO approach meets this need by grouping a number of inventory accounts into a single pool and measuring them according to LIFO principles based not upon a count of units in the pool, but rather in terms of the dollar value in the pool. By measuring inventory in terms of dollars, individual items within the pool may be added or removed and new items substituted for old items without necessarily affecting the dollar value of the pool as a whole.

In practice, the dollar-value LIFO computation may provide a significantly different result from LIFO computations done for a number of accounts of specific items. In periods of rising prices, the items used to value ending LIFO accounts may be costed at amounts substantially below their current costs. Where ending inventory quantities are lower than beginning inventory quantities, a portion of these low-costed items will make up cost of goods sold for the period, resulting in a higher reported income for the period.

To the extent that the type of specific items an entity holds in inventory changes, this "recapture" of older inventory items may occur, despite the fact that total inventory continues to increase. This is avoided by using dollar-value pools, since different type items which are in fact replacing the decreasing inventory account may substitute for them when restated in dollar terms. Thus, the introduction of older, lower priced inventory items into cost of sales will occur only when the dollar value of the entire pool declines, and not just the amount of a single specific item.

A taxpayer is generally free to choose either the FIFO or LIFO method in the first taxable year in which inventories other than on the specific identification method are required to be kept. Where the LIFO method is elected, the election may be limited to one or more categories of raw material inventories,[23] to raw materials and work in process up to the first salable goods stage,[24] or to all inventories. After the original election, the method chosen cannot be changed without first receiving permission from the IRS.

If the taxpayer selects a LIFO method, that method must also be used for reporting to shareholders, partners, proprietors, beneficiaries, and creditors (sec. 472(c)). This so-called "LIFO conformity requirement" is more stringent than the general requirement that accounting methods be the same as those used to keep the taxpayer's books. That requirement, which applies to all inventory methods, has been held to be satisfied when sufficient records are kept to reconcile the taxpayer's books with the tax return.

In the case of LIFO conformity, no method other than LIFO may be used for the computation of income profit or loss for external reporting purposes for the full taxable year. A non-LIFO method may be used for interim reporting purposes (partial years),[25] for internal management purposes, for the purpose of reporting asset valuations, and several other areas specifically excepted by regulations.[26]

Under limited circumstances, a non-LIFO method may be reflected in supplementary or explanatory material. This includes footnotes to the primary income statement itself so long as all footnotes are grouped together and accompany the income statement in a single report.[27] Also included in the supplementary or explanatory exception are disclosures which are clearly identified as such. The use of a different LIFO method for external reporting purposes from the LIFO method selected for tax purposes does not constitute a violation of the conformity requirement.

Administration Proposal

The Administration proposal would allow taxpayers an election to use an indexed FIFO method of valuing inventory instead of the normal FIFO and various LIFO methods of inventory. The method of indexing FIFO inventories would be set forth in Treasury Regulations. In general, this method would allow beginning inventory to be restated by an inflation factor equal to a general price index for the year. To the extent that items in beginning inventory are taken into cost of sales during the year, the amount attributable to the inflation factor would increase cost of sales and decrease reported income.

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[23] Treas. Reg. sec. 1.472-1(c).

[24] If an intermediate stage in the manufacturing process yields a good which is recognized generally as a salable product, the LIFO election may be limited to inventories through that stage (Treas. Reg. sec. 1.472-1(i)).

[25] However, if the interim reports may be aggregated to yield income for the complete year reported on a FIFO basis, then the conformity requirement is violated (Rev. Rul. 78-49, 1978-1 C.B. 145).

[26] Treas. Reg. sec. 1.472-2(e).

[27] Treas. Reg. sec. 1.472-2(e)(3)(i).

The inflation adjustment would also apply to inventories under the specific identification method and property held for sale to customers in the ordinary course of business which is not presently considered to constitute inventory, such as real estate held for sale by a dealer in such property. No guidance is given as to what inflation index would be used to compute the adjustment.

The LIFO conformity requirement of present law would be repealed. Taxpayers would be allowed to change their method of accounting for inventories to either the indexed FIFO or LIFO methods during an appropriate transition period.

The proposal would be effective for taxable years beginning on or after January 1, 1987. Indexing would be allowed only with respect to inflation occurring after the effective date of the proposal.

Subsequent proposal.—On August 31, 1985, Treasury Secretary Baker indicated by letters to Committee on Ways and Means Chairman Rostenkowski and Committee on Finance Chairman Packwood that the Administration would offer to delete their proposal to provide indexed FIFO rules and delete the LIFO conformity rules in order to better achieve revenue neutrality of the overall Administration tax reform proposal.

Other Proposal

1984 Treasury report

The 1984 Treasury report is generally the same as the Administration proposal. The report specified that the consumer price index would be used to compute the inflation adjustment. The Treasury report would have been effective for tax years beginning on or after January 1, 1986, rather than 1987 as in the Administration proposal.

Analysis

Overview

Considerable controversy exists over which inventory accounting method is more appropriate.

Proponents of the FIFO method argue that an enterprise whose inventory turns over with some regularity should not value inventory as if it included items purchased many years ago, as may frequently be the case under LIFO. They argue that the proper way to measure what the enterprise has left to sell is by retaining the most recent additions in inventory. Use of earlier acquired items to value ending inventory understates net worth in times of rising prices and as a result understates the income which measures the change in net worth for a given period. It is also noted that since ending inventory under LIFO is controllable by the purchase of additional units at year-end, the LIFO approach is susceptible to manipulation after most of the results for the year are known to the taxpayer.

Proponents of the LIFO method contend that by including the most recent purchases in cost of sale, a better picture of real change in net worth is achieved. They point out that the enterprise will have to replace the inventory to continue in business and that by including the most recent additions to the inventory in cost of sales, the required cost of replacing the inventory is more closely projected.

The LIFO supporters also point out that, although there may be turnover in inventory, it is highly unlikely that there is a time when there are no units in the inventory at all. They view this perpetual layer of inventory as a required condition of doing business and best valued at the time the layer was established. LIFO accomplishes this, while FIFO would misstate it by assigning more recent prices experienced after the layer came into existence.

Replacement cost supporters agree with the first LIFO argument, but instead of using an approximation of cost of replacement by way of the most recent additions to inventory, they would simply use the replacement cost as cost of sales despite the fact that no items in inventory may have been acquired at that cost. Average cost supporters are satisfied by none of the above arguments and say that if we cannot tell which item from an intermingled group was sold, the only responsible approach is to use some form of average of all the costs in the inventory account.

The proposal of an indexed method, such as the indexed FIFO of the Administration proposal, presents not only the questions involved in the comparison of nonindexed methods, but also the issue whether some insulation should be provided from income which results solely from general increases in prices and does not represent a true measure of how much better off the enterprise is. Whether the proposal should be adopted depends on determinations of whether insulation from inflation driven income is desirable, how well the proposal accomplishes this, how well the noninflation concerns of inventory accounting are addressed, and whether adequate safeguards exist in the system to prevent its abuse.

Indexed FIFO

The basic approach of indexed FIFO is the same as FIFO under present law. A physical inventory is taken at the end of the year and the most recent additions assigned to ending inventory, leaving the earlier additions for use as cost of sales.

However, before any of this takes place, beginning inventory is adjusted by the index amount. If all of the beginning inventory is included in cost of sales, the inflation adjustment is entirely an increase to those costs. Where a portion of the beginning inventory remains in ending inventory, an equivalent portion of the inflation adjustment will be reflected there. The process can be demonstrated by taking the same example described in the present law section and assuming an inflation index of 15 percent. The calculation now becomes:

Inventory Elements

Item A		Item B	
Beginning 100 @ $1.00	=100	Beginning 50 @ $2.00	=100
Adjustment 100 × .15	15	Adjustment 100 × .15	=15
Adjustment beginning 100 @ $1.15.	=115	Adjustment beginning 50 @ $2.30.	=115
5/30: 100 @ $1.10	=110	2/26: 200 @ $2.10	=420
7/24: 200 @ $1.15	=230	8/31: 40 @ $1.90	=76

Ending Inventory Valuation

Item A		Item B	
200 @ $1.15	=230	40 @ $1.90	=76
100 @ $1.10	110	10 @ $2.10	−21
10 @ $1.15	=115		
Ending balance	=351.5		97
Nonindexed FIFO	=350		97
Difference	=1.5		0

Under this approach, cost of sales would be calculated as follows:

	Item A	Item B	Total
Beginning inventory	100	100	200
+Adjustment	15	15	30
+Purchases	340	496	836
−Ending inventory	(351.5)	(97)	(448.5)
=Cost of sales	103.5	514	617.5
Nonindexed FIFO	90	499	589
Difference	13.5	15	28.5

As can be seen by comparing the results with the results under regular FIFO (above), all of the beginning inventory of item B was taken into cost of sales. As a result, the entire adjustment amount of $15 increased that cost. For item A, on the other hand, 10 percent of beginning inventory remains in ending inventory. Thus, 10 percent of the inflation adjustment ($1.50) is reflected there, while the remaining 90 percent ($13.50) is taken into cost of sales.

The purpose behind indexed FIFO is to improve the measurement of income for tax purposes by permanently removing inflationary gains from the tax base. This assumes that such gains, to the extent that they reflect general inflationary experience, are not really income since the enterprise is no better off in the inflated environment for having recognized them. Since the enterprise is not better off, it is argued, there is no real income which should be subjected to tax.

The Administration proposal raises a number of potential problems. For example, items which are taken into cost of sales from beginning inventory are adjusted for a full year's inflation regardless of when they were added or removed from inventory while items taken into cost of sales from current year's purchases receive no adjustment. To this extent, the approach assigns inflation adjustments without regard to actual holding periods. As a result, it may be possible to manipulate inventory levels to insure the greatest adjustment.

Many of these problems could be solved by using a perpetual inventory where adjustment would be based upon the portion of a year during which a particular item of inventory is held. Perpetual inventory, however, is considerably more complex than a periodic system. In addition, the amount of any distortion is significantly less if the rate of inflation and the size of the inventory is relatively constant during a year.

In attempting to design a system which removes inflationary gains from the sale of inventory items, it is unclear whether a general index (such as the Consumer Price Index) or a separate index for each type of inventory should be used. Where price change adjustments are being made for financial reporting purposes, such adjustments may be made either on the basis of a general inflation index or on the basis of separate indexes for each item.

The underlying theory of using a separate index for each type of inventory is that income arises only if the gross receipts from the sale of goods exceeds the cost of replacing those goods in inventory. Persons in favor of using specific indexes argue that, if the cost of an inventory item which makes up the bulk of an enterprises' cost of sales by 20 percent, that enterprise has experienced an inflation rate of 20 percent regardless of what the general inflation rate is for the economy as a whole.

On the other hand, advocates of the use of a general index argue that permitting use of specific indexes would result in excluding real gains and losses from income, rather than just inflationary gains and losses. The use of specific indexes is incorrect since income is determined by comparing gross receipts derived from the sale of goods with the cost (historical or price-level adjusted) of those goods, not with the replacement cost of the sold item. The purpose of the adjustment is to account for the changing value of the dollar, not the changing relative values of a particular type of good. For example, if a taxpayer purchases inventory at the beginning of the year of $100 which is worth $120 at the end of the year that has no general inflation, that taxpayer has experienced a real increment in wealth of $20. Moreover, the use of a general index is consistent with other portions of the Administration proposal with respect to indexation.

Moreover, use of separate indexes for specific items is considerably more complex than a general index.

Use of specific indexes requires replacement cost to be determined for every element of inventory, rather than obtaining a single index and adjusting all prices by that amount. In the case of manufacturers where a single inventory item may be made up of a number of components such as raw material, direct labor, allocated overhead, etc., a replacement cost number would have to be obtained for every component before adjustment could be made. For a perpetual type system, these calculations could be required on every day in which an item is removed from inventory for sale.

In adjusting for inflation, whether by use of a general index or by specific replacement costing, distortion may occur where only one portion of the income statement is adjusted for inflation and not other portions to which they relate. An enterprise recognizes inflationary gains which should be excluded from income only to the extent that it carries the inventory affected by inflation with its own funds. To the extent that the inventory is carried with funds borrowed from others, the inflation gain in the inventory can be expected to be roughly offset by an inflation component in the deductible interest the enterprise pays to its creditor.[29] Unless the deduction for some portion of the interest expense incurred to carry inventory eligible for inflation adjustment is disallowed, understatement of income will result.

The 1984 Treasury report contained a proposal which would have denied a deduction for a portion of interest expense which was estimated to be attributable to inflation. If inflation adjustments for inventory are to be allowed, some method should be established for identifying the debt incurred to carry such inventory and either deny a portion of the interest deduction attributable to inflationary expectations, or else allow inflation adjustment only for so much inventory as is not carried with borrowed funds.

Considering the difficulties associated with the indexed FIFO method of the Administration proposal, the question should be asked whether it actually provides a better result than is presently achievable under the approximation of inflation adjustment provided by LIFO. The Administration appears to address this question by noting that firms currently using LIFO are unlikely to change to indexed FIFO. LIFO allows the measurement of price changes specific to inventory items which the general index approach of indexed FIFO lacks.

Where addition to inventory and sales are fairly constant throughout the year, LIFO may provide a fairly close approximation of the results which would be obtained under a perpetual replacement cost accounting system. How close an approximation will be obtained depends on the existence of price movements between the time the last available item was added to inventory and the next sale. LIFO also offers the advantages of the dollar-value pooling techniques, although this feature could be added to the indexed FIFO proposal by allowing quantities of several different types of items in beginning inventory to be compared with ending inventories to determine what portion of beginning inventory is eligible for indexing.

One advantage indexed FIFO has over LIFO in adjusting for inflation is that indexed FIFO will permanently forgive the inflation

[29] The offset will not be exact because the inflation component built into the interest will be an expectation of future inflation, while the inflation in the inventory is actually measured. Because many borrowers compete for funds the inflation component of the interest payment will be an expectation of future general inflation and not necessarily an expectation of the inflation which a particular entity may experience because of the actual make-up of its inventory.

amount, while LIFO only defers it until such time as the amount of inventory is reduced or the taxpayer liquidates that line of business. Because of the tax expense of including older items of inventory when this occurs under the LIFO method, otherwise sound business decisions to liquidate a line of business or reduce levels of inventory may not be made.

Repeal of LIFO conformity

Many taxpayers are currently not using the LIFO method because they are unwilling to report for financial purposes the lower income and inventory valuations that frequently accompany the use of that method. Repeal of the LIFO conformity requirement may be expected to induce many of those taxpayers to switch to LIFO for tax purposes. Whether this is a desirable result depends in large part on the perception of whether FIFO or LIFO gives the more accurate measurement of income.

Supporters of repeal argue that the financial and tax accounting systems measure different things, and the method used for one should not govern what method is used for the other. They also note that no other accounting method requires this level of conformity between tax and financial methods.

The continuation of the LIFO conformity requirement may also be inconsistent with the proposed introduction of the indexed FIFO system. Although the two systems use different techniques and have different theoretical bases, the effect of their use will be to some extent similar. For this reason, they may be considered as alternatives to the same end by some taxpayers. Because indexed FIFO is not an acceptable method of inventory valuation for financial accounting purposes, the same type of conformity required for use of LIFO is not possible. Thus, it may be more consistent to drop the LIFO conformity requirement to make the availability of LIFO and indexed FIFO similar.

Opponents of repeal argue that LIFO is not clearly the better system, and its use should not be encouraged where a taxpayer is unwilling to use it for all purposes. In particular, if a taxpayer is unwilling to report the potentially lower net income to its shareholders, it is difficult to argue that the taxpayer needs to use LIFO for tax purposes.

D. Accounting for Production Costs

Present Law and Background

Overview

Annual accounting requirement

Under the Federal income tax system, tax liability generally is determined and reported on the basis of one-year periods (taxable years). Since a taxpayer's economic transactions frequently spans more than one taxable year, a system of allocating economic events among taxable years, known as a method of accounting, must be employed to determine the amount of income that is taxable during any taxable year.

Accounting methods

A taxpayer generally may compute taxable income using the same accounting method it regularly employs in keeping its books, unless the method does not clearly reflect income (sec. 446(a)). Permissible methods include (1) the cash receipts and disbursements method, (2) an accrual method, (3) any other method specifically authorized by the Code or regulations (for example, the installment sale and completed contract methods), and (4) any combination of the foregoing methods permitted under the regulations (sec. 446(c)).

Under the cash receipts and disbursements method of accounting, items includible in gross income generally are reported in the taxable year actually or constructively received, and expenditures generally are deducted when actually made. Under the accrual method of accounting, income is reported and deductions are allowed in the taxable year in which all events establishing the taxpayer's right to receive the income, or obligation to pay the liability, have occurred, and the amount can be determined with reasonable accuracy.[30]

As used in the Code, the term "method of accounting" encompasses not only the taxpayer's overall method (e.g., cash or accrual), but also the accounting treatment of particular items such as research and experimental expenditures, depreciation, and net oprating losses.[31] A method of accounting that reflects the consistent application of generally accepted accounting principles in a particular trade or business ordinarily will be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.[32]

While taxpayers generally are permitted to select their own method of accounting, the IRS may reject any method that it determines does not clearly reflect income (sec. 446(b)). The U.S. Supreme Court has upheld the broad discretion of the IRS to determine whether a particular accounting method clearly reflects income, and to require a different method if the IRS determines it does not. Moreover, the fact that a method is consistent with generally accepted accounting practices does not make it presumptively proper for tax purposes.[33] Accordingly, the courts generally will not interfere with a decision of the IRS to disallow the use of a taxpayer's accounting method in a particular situation, unless the method is explicitly authorized or required by statute.

Inventories

In general

Taxpayers are required to maintain inventories for tax purposes whenever necessary clearly to determine their income (sec. 471). In general, all producers and sellers of tangible goods must keep track of the size and value of their inventories, using inventory methods prescribed by the IRS as conforming to the best accounting practice

[30] A liability is not treated as satisfying this all-events test until economic performance has occurred—for example, until the goods have been received by, or services performed for, the taxpayer (sec. 461(h)).
[31] Treas. Reg. sec. 1.446–1(a)(1).
[32] Treas. Reg. sec. 1.446–1(a)(2).
[33] *Thor Power Tool* v. *Comm'r*, 439 U.S. 522, 540 (1979).

in the particular trade or business and as clearly reflecting income.[34] Taxpayers required to maintain inventories generally must use the accrual method of accounting for purchases and sales in order properly to reflect income.[35]

Inventory accounting under the tax system performs essentially the same function or purpose for both tax and financial accounting purposes—i.e., the matching of the costs of producing or acquiring goods with the revenues realized from their sale. The producer or merchant is required to capitalize the costs of production or acquisition and offset them against the related income. To the extent costs are includible in inventory, they do not reduce taxable income for the year unless the inventory to which they are attributable is sold during that year.[36]

As with all matters involving accounting methods, the IRS has wide discretion in determining whether a particular inventory accounting method or practice clearly reflects income. Thus, the IRS may disallow a method or practice that in its judgment distorts the taxpayer's income, even if the method is consistent with the best accounting practice in the trade or business.[37]

The two basic elements of an inventory accounting method are (i) the method of valuing the goods in the inventory and (ii) the assumptions concerning the order in which goods are removed from the inventory. Under the regulations, inventories may be valued either at cost, or the lower of cost or market.[38] Regarding the order of removal, the general requirement is that the "first-in, first-out" (FIFO) method must be used; that method assumes that the first goods acquired or produced are the first sold. Alternatively, the taxpayer may elect to use the "last-in, first-out," or LIFO, convention, which assigns the cost of the most recently acquired or produced goods to the cost of goods sold (sec. 472).

Inventory costing—the full absorption method

A taxpayer engaged in the manufacturing business must make a third decision with respect to its inventories, namely, what costs are part of the cost of the products manufactured. Although the costs of materials and labor used directly in manufacturing the product are clearly included in the cost of the inventory, not all expenses paid or incurred during the year are treated as inventoriable product costs for either book or tax purposes. Certain costs are recognized as so-called "period" costs, deductible in the year in which they are paid or incurred.

The Treasury regulations require that, in determining the cost of inventory for tax purposes, all direct and indirect "production costs"—costs incident to and necessary for production or manufacturing operations or processes—must be taken into account in ac-

[34] Treas. Reg. sec. 1.471–1.

[35] Treas. Reg. sec. 1.446–1(c)(2)(i).

[36] To compute gross income for Federal income tax purposes, gross receipts from sales are reduced by the cost of goods sold. Cost of goods sold, in turn, is determined by adding opening inventory to purchases during the taxable year, and subtracting the closing inventory. Thus, any inventoried costs remaining in closing inventory at the end of the taxable year remain in a "capital" account until a subsequent year.

[37] *Thor Power Tool* v. *Comm'r, supra,* 439 U.S. at 532.

[38] Treas. Reg. sec. 1.471–2(c). In the case of inventories maintained under the "last-in, first-out" (LIFO) method, described above, only the cost method may be used.

cordance with the so-called "full absorption" method.[39] Under the full absorption method, all direct production costs must be included in computing inventory cost. Direct production costs include the costs of materials forming an integral part of the product or consumed in the manufacturing process, and the labor that is directly involved in fabrication of the product. Direct labor costs include not only wages and salaries or production workers and supervisors, but such items as vacation and holiday pay, payroll taxes and payments to supplemental unemployment benefit plans paid or incurred on behalf of employees engaged in direct labor.[40]

For purposes of determining which indirect costs are includible in inventory, Treasury regulations divide indirect costs into three categories and prescribe the treatment of each category. Costs in Category 1 must be included in inventory costs. Costs in Category 2 do not have to be included in inventory costs. Costs in Category 3 must be included in inventory costs only if they are included in inventory costs for purposes of the taxpayer's financial reports.

Category 1 costs.—Category 1 costs include:

(1) repair expenses,

(2) maintenance,

(3) utilities, such as heat, power, and light,

(4) rent,

(5) indirect labor and production supervisory wages, including basic compensation, overtime pay, vacation and holiday pay, shift differential, payroll taxes, and contributions to a supplemental unemployment benefit plan,

(6) indirect materials and supplies,

(7) tools and equipment not capitalized, and

(8) costs of quality control and inspection to the extent such costs are incident to and necessary for production or manufacturing operations or processes.[41]

Category 2 costs.—Category 2 costs, which are not required to be included in inventory costs for tax purposes regardless of their treatment for financial purposes, include:

(1) marketing expenses,

(2) advertising expenses,

(3) selling expenses,

(4) other distribution expenses,

(5) interest,

(6) research and experimental expenses, including engineering and product development expenses,

(7) losses under section 165,

(8) percentage depletion in excess of cost depletion,

(9) depreciation and amortization reported for Federal income tax purposes in excess of depreciation reported for financial statement purposes,

(10) income taxes attributable to income received on the sale of inventory,

(11) pension contributions to the extent they represent past services costs,

[39] Treas. Reg. sec. 1.471-11.
[40] Treas. Reg. sec. 1.471-11(b)(2).
[41] Treas. Reg. sec. 1.471-11(c)(2)(i).

(12) general and administrative expenses incident to and necessary for the taxpayer's activities as a whole rather than to production or manufacturing operations or processes, and

(13) salaries paid to officers attributable to the performance of services which are incident to and necessary for the taxpayer's activities as a whole rather than to production or manufacturing operations.[42]

Category 3 costs.—Category 3 costs, whose treatment follows the taxpayer's financial accounting treatment, include:

(1) taxes otherwise allowable as a deduction under section 164 (other than State and local and foreign income taxes) attributable to assets incident to and necessary for production or manufacturing operations,

(2) depreciation reported on financial statements and cost depletion on assets incident to and necessary for production or manufacturing operations or processes,

(3) pensions and profit-sharing contributions representing current service costs otherwise allowable as a deduction under section 404, and other employee benefits incurred on behalf of labor incident to and necessary for production or manufacturing operations or processes,

(4) costs attributable to rework labor, scrap, spoilage, and strikes that are incident to and necessary for production or manufacturing operations or processes,

(5) factory administrative expenses (not including any cost of selling or any return of capital),

(6) salaries paid to officers attributable to services performed incident to and necessary for production or manufacturing operations or processes, and

(7) insurance costs incident to and necessary for production or manufacturing operations or processes (e.g. insurance an production machinery and equipment).[43]

If a taxpayer uses nonconforming methods of accounting for tax and financial reporting purposes, taxes, depreciation, production-related officers' salaries, and insurance costs and must be taken into account in inventory. Employee benefit costs and costs attributable to strikes, rework labor, scrap, and spoilage are treated as Category 2 costs and need not be included in inventory costs.[44]

Indirect production costs required to be treated as inventory costs must be allocated to goods in a taxpayer's ending inventory using a method of allocation that fairly apportions such costs among the goods produced. The regulations authorize use of either the standard cost method or the manufacturing burden rate method. In general, the standard cost method assigns a predetermined rate (e.g., $X per direct labor hour) for each element of product cost, including direct materials and labor and fixed and variable overhead.[45] The manufacturing burden rate method is similar to the standard cost method but assigns predetermined rates only to overhead costs.[46]

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[42] Treas. Reg. sec. 1.471-11(c)(ii).
[43] Treas. Reg. sec. 1.471-11(c)(2)(iii).
[44] Treas. Reg. sec. 1.471-11(c)(3)
[45] Treas. Reg. sec. 1.471-11(d)(3)(i).
[46] Treas. Reg. 1.471-11(d)(2).

Accounting for long-term contracts

Overview

Special accounting rules may apply to taxpayers providing goods under certain contracts spanning two or more taxable years.

A taxpayer with income and expenses from "long-term contracts" may report under the traditional cash or accrual methods which are, subject to the restrictions previously mentioned,[47] generally available to all taxpayers. At the taxpayer's election, however, income and expenses attributable to long-term contracts may be accounted for on one of two alternative methods—the percentage of completion method or the completed contract method.

A long-term contract for this purpose is a building, installation, construction, or manufacturing contract that is not completed within the taxable year in which it was entered. A manufacturing contract qualifies, however, only if it involves the manufacture of either unique items of a type not normally carried in the finished goods inventory of the taxpayer, or items normally requiring more than 12 months to complete.[48]

Cash method

As previously discussed, under the cash method, income is reported in the year in which actually or constructively received, and deductions are taken in the year in which actually paid. Accordingly, a taxpayer that uses the cash method to account for income and expenses attributable to long-term contracts includes payments in income when received, whether before or after completion of the contract, and takes deductions for expenses when actually paid.

Accrual method

Inclusion of amounts in gross receipts or gross income

Under the accrual method, income generally is reported when the all-events test is met; that is, when all events have occurred fixing the right to receive the income and the amount can be determined with reasonable accuracy. In the case of a contractor, the all-events test is normally satisfied when the income is billable under the terms of the contract.

It is common for businesses performing under long-term contracts to receive progress payments over the life of the contract. If these payments represent payment for products already delivered or services already performed by the taxpayer, they generally must be included in income in the year of receipt. If the payments are for products to be delivered or services to be performed in a future taxable year—that is, they constitute prepaid income—special rules may permit deferral of recognition until a later year.

Under proposed regulations, if an accrual-basis contractor uses a method of accounting whereby costs are accumulated until the subject matter of the contract is shipped, delivered, or accepted, and income is accrued at such time, recognition of "advance payments"

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[47] For example, the cash method normally may not be used by a taxpayer required to maintain inventories.

[48] Treas. Reg. sec. 1.451-3.

may be deferred until the taxable year of shipment, delivery, or acceptance.[49] Although advance payments are defined as amounts received with respect to a sale of inventory that will occur in a future taxable year, or with respect to a long-term building, installation, construction, or manufacturing contract, this special rule applies only to advance payments received under long-term contracts.

The proposed regulations also provide that other advance payments must be included in the year of receipt unless a financial statement conformity requirement is satisfied. Specifically, if the taxpayer's tax accounting method would include advance payments in income no later than the time they are includible for purposes of all its financial reports, that method will be deemed acceptable. If the taxpayer's financial statement method results in an earlier inclusion of advance payments, however, the taxpayer must include the payments in income in the taxable year in which they are reportable for financial purposes.[50]

Nevertheless, the proposed regulations limit deferral of recognition in the case of "substantial" advance payments with respect to a contract for the sale of goods includible in inventory where the taxpayer has goods on hand to satisfy such contract. In these circumstances, any advance payments must be included in gross income no later than the second taxable year following the taxable year in which it received substantial advance payments.[51]

A taxpayer that receives prepayments for services may also defer recognition of income in certain limited circumstances. Under Rev. Proc. 71-21, 1971-2 C.B. 549, an amount received as an advance payment by an accrual-basis taxpayer may be deferred for one taxable year if (i) the contract requires all services to be performed by the end of the taxable year immediately following the taxable year in which the advance payments are received, and (ii) the taxpayer defers at least that amount for financial reporting purposes. Many contractors are unable to rely on Rev. Proc. 71-21 because of its restrictive conditions. Although there is considerable judicial authority, including decisions by the Supreme Court, that prepaid services income must be recognized by an accrual-basis taxpayer in the year of receipt,[52] some cases suggest that this is not an absolute rule, and that such income may be deferred under a method of accounting that the taxpayer demonstrates clearly reflects income and results in a matching of income and expenses.[53]

Deduction of expenses

If an accrual-method contractor is not required to maintain inventories (e.g., a contractor that does not take title to its work

[49] Prop. Treas. Reg. sec. 1.451-5(b)(3). If the subject matter of the contract consists of more than one item, accounting must be on an item-by-item basis.

[50] Prop. Treas. Reg. sec. 1.451-5(b)(1).

[51] Treas. Reg. sec. 1.451-5(c)(1). The regulations characterize advance payments as substantial if they equal or exceed the total estimated cost of producing the goods. Treas. Reg. sec. 1.451-5(c)(3).

[52] *See Automobile Club of Michigan* v. *Comm'r,* 353 U.S. 180 (1957); *American Automobile Association* v. *U.S.,* 367 U.S. 687 (1961); and *Schlude* v. *Comm'r,* 372 U.S. 128 (1963).

[53] *See,* e.g., *Boise Cascade Corp.* v. *U.S.,* 530 F.2d 1367 (Ct.Cl. 1976), cert., denied, 429 U.S. 867 (1976); *Automated Marketing Systems, Inc.* v. *U.S.,* 74-2 USTC para. 9711 (N.D. Ill. 1974), *aff'd in unpublished opinion* (7th Cir. 1975).

product), all costs incurred in performing the contract are deductible in the year incurred, without regard to when billings reflecting such costs are issued to the customer.[54] Where an accrual-method contractor does maintain inventories, however, all costs that are necessary and incident to construction or production must be accumulated and inventoried until the product is shipped, delivered, or accepted, or title to the item passes to the customer, depending on the taxpayer's method of accounting.[55]

Proposed Treasury regulations provide that an accrual-method contractor using an inventory method of accounting must use special costing rules with respect to extended period long-term contracts, rather than the full absorption costing rules.[56] These special costing rules, which require that a number of additional indirect costs be inventoried, also apply to extended period contracts accounted for under the completed contract or percentage of completion method. These rules are discussed more fully below.

Under the generally applicable inventory rules, a contractor may value its inventory at cost or the lower of cost or market, and may identify its flow of costs under either the FIFO or LIFO method.[57]

Percentage of completion method

Under the percentage of completion method, which is used only for long-term contracts, income is recognized according to the percentage of the contract that is completed during each taxable year. The determination of the portion of the contract completed during the taxable year may be made by either (i) comparing the costs incurred during the year to the total estimated costs to be incurred under the contract, or (ii) comparing the work performed during the year with the estimated total work to be performed.[58] All costs attributable to the long-term contract are deductible in the year in which they are incurred, although a contractor must maintain inventories for materials and supplies.

Completed contract method

Overview

Under the completed contract method, the entire gross contract price of a long-term contract is included in income in the taxable year in which the contract is finally completed and accepted. All costs properly allocable to a long-term contract are deducted in the year of completion.

Historical background

Reporting under the completed contract method has been authorized by the Treasury Regulations since 1918.[59] In a 1970 revenue

[54] Treas. Reg. sec. 1.461–1(a)(2).
[55] *See* Prop. Treas. Reg. sec. 1.446–1(c).
[56] *See* Prop. Treas. Reg. sec. 1.451–3(d)(6), effective for taxable years beginning after December 31, 1982. The Treasury Department has invited comments on whether this requirement should be modified in the case of taxpayers using an accrual-inventory method of accounting for extended period long-term contracts where some threshold amount of income is recognized in taxable years before completion.
[57] *See* Treas. Reg. secs. 1.471–2 (c) and (d).
[58] Treas. Reg. sec. 1.451–3(c)(2).
[59] Art. 121, sec. 33 (1918), which also sanctioned use of the percentage of completion method.

ruling, the IRS explained the rationale behind the allowance of completed contract reporting as follows:

> One of the reasons why permission to report on a completed contract basis is given . . . is the fact that there are changes in the price of articles to be used, losses and increased costs due to strikes, weather, etc., penalties for delay and unexpected difficulties in laying foundations which make it impossible for any construction contractor, no matter how carefully he may estimate, to tell with any certainty whether he has derived a gain or sustained a loss until a particular contract is completed.[60]

The Treasury Department undertook a review of the completed contract method in the early 1970's. Initially, it proposed to impose a financial conformity precondition to use of the completed contract method as part of a broader effort to achieve greater conformity between tax and financing accounting. In 1971, proposed regulations were issued providing that a taxpayer could use the completed contract method of accounting for tax purposes only if it used such method for financial reporting purposes.[61] Financial accounting standards at that time (which remain in force today) discouraged the use of the completed contract method, regarding the percentage of completion method preferable except in cases when "lack of dependable estimates or inherent hazards cause forecasts to be doubtful."[62] Thus, in many cases, the financial conformity requirement would have caused income (or loss) on a long-term contract to be recognized in taxable years prior to completion of the contract.

In the face of strong opposition from the construction industry, which contended that imposing a financial conformity requirement was tantamount to prohibiting the completed contract method, the Treasury Department issued new proposed regulations in 1972. The new regulations, which were adopted as final in 1976, abandoned the financial conformity requirement. These regulations provided the applicability of the method to manufacturing contracts, and provided more elaborate rules for the treatment of contract costs.

These costing rules essentially paralleled the full absorption rules described above, except that most Category 3 costs had to be inventoried under the completed contract method, although fringe benefit costs and the costs of strikes, rework labor, scrap, and spoilage could be deducted as period costs. Thus, the costs that were deductible currently included the following: marketing and selling expenses (including the cost of developing bids); advertising expenses; distribution expenses; interest; general and administrative expenses attributable to the performance of services that benefited the contractor's activities as a whole (e.g., payroll, legal, and accounting expenses); research and experimental expenses under sec-

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[60] Rev. Rul. 70-67, 1970-1 C.B. 117.

[61] Prop. Treas. Reg. sec. 1.451-3(e)(1) (March 24, 1971). This was similar to a proposal, ultimately adopted in final regulations, that an accrual basis manufacturer be allowed to defer prepayments for goods for tax purposes only if it did so for financial reporting purposes. *See* Treas. Reg. sec. 1.451-5(b)(1)(ii).

[62] Accounting Research Bulletin No. 45, "Long-Term Construction-Type Contracts" (October, 1955).

tion 174; losses under section 165; percentage depletion in excess of cost depletion; depreciation and amortization on idle equipment and facilities; the excess of depreciation or amortization reported for tax purposes over that reported on financial statements; income taxes attributable to income received from long-term contracts; pension and profit-sharing contributions and other employee benefits (whether representing past or current service costs); costs attributable to strikes, rework labor, scrap, and spoilage, and salaries of officers that benefited the contractor's activities as a whole.

1982 Treasury proposals

In 1982, the Treasury Department issued alternative legislative and regulatory proposals relating to accounting for long-term contracts. In issuing its proposals, the Treasury Department expressed concern that the completed contract method was being used to avoid taxes. Contractors were able to defer recognition of income from long-term contracts, in some cases for as long as 20 years, while taking deductions for certain indirect costs currently.

Because of inflation and the increasing size of new contracts, the period costs often exceeded the income recognized from old contracts in any given taxable year. Thus, many contractors were reporting large tax losses while realizing and reporting to shareholders substantial economic profits. Similar results occurred where manufacturers used the accrual method and accounted for income and costs on long-term contracts at the time of shipment or acceptance. Under the accrual shipment and accrual acceptance methods of accounting, income could be deferred while certain costs were currently deductible. Moreover, under the inventory regulations, the taxpayer could elect the LIFO method, which generally resulted in further tax deferral.

The Treasury Department's 1982 legislative proposal would have prohibited the use of the completed contract method and required all taxpayers to elect to use either the percentage of completion or a new method, the "progress payment" method, to account for long-term contracts. Under the progress payment method, most costs incurred by the contractor would have been allocated to long-term contracts and deferred until the contractor had a right to receive payment under the contract. When the right to payment accrued, the taxpayer would have been allowed to deduct the total of the current and the previously unclaimed costs allocated to the contract, up to the amount of the accrued income. To the extent accrued payments exceeded costs, the contractor would have recognized income.

In its regulatory proposal, the Treasury Department proposed to amend the completed contract regulations to restrict further the indirect costs qualifying as period costs, and to tighten the rules relating to severability, aggregation, and completion of long-term contracts. In addition, taxpayers using the accrual shipment or accrual acceptance method of accounting for multi-unit contracts would be required to accrue income at the time of shipment or acceptance of the various units rather than when the final unit produced under the contract was shipped or accepted. Finally, the inventory regulations would be amended to require taxpayers entitled to use an inventory method for long-term contracts to use the cost accounting rules applicable to taxpayers using the completed contract method.

TEFRA amendments

The Treasury Department again met with vigorous opposition from the various industries that relied heavily on the completed contract method for tax purposes. Congress responded by adopting provisions in the Tax Equity and Fiscal Responsibility Act, P.L. 97–248 (TEFRA), containing specific instructions to Treasury regarding the amendment of its regulations relating to long-term contracts. The proposals for repeal of the completed contract method and implementation of the progress payment method of accounting for long-term contracts were not adopted.

Section 229 of TEFRA directed Treasury to modify its regulations relating to when a contract is completed and when agreements should be severed or aggregated, and relating to the use of the accrual method of accounting for long-term contracts. The Act also required Treasury to modify its regulations relating to the allocation of costs to long-term contracts. In the case of "extended period" long-term contracts—those that are not expected to be completed within 24 months—certain costs previously treated as period costs were to be allocated to the contracts to the extent they either directly benefit or were incurred by reason of such contracts. These costs included:

(1) bidding expenses on contracts awarded to the taxpayer;

(2) distribution expenses, such as shipping costs;

(3) general and administrative expenses properly allocable to long-term contracts under regulations to be prescribed by the Treasury Department;

(4) research and development expenses that either are directly attributable to particular long-term contracts existing when the expenses are incurred, or are incurred under an agreement to perform research and development;

(5) depreciation, capital cost recovery, and amortization for equipment and facilities currently being used in the performance of extended period long-term contracts, in excess of amounts reported for financial accounting purposes;

(6) pension and profit-sharing contributions representing current service costs, and other employee benefits;

(7) rework labor, scrap, and spoilage; and

(8) percentage depletion in excess of cost depletion.

An exception to these rules was provided for contracts for the construction of real property if the contract is expected to be completed within three years and the contractor's average annual gross receipts for the three taxable years preceding the year of the contract do not exceed $25 million. The regulations as adopted in 1976 continue to apply to these contracts, and all long-term contracts expected to be completed within two years.

The legislative history expresses Congress' intention that the portion of the taxpayer's general and administrative expenses that directly benefits extended period long-term contracts must be allocated to such contracts, even though the same type of costs also benefit other activities of the taxpayer. However, general and administrative expenses that are incurred in the operation of the taxpayer's general management or policy guidance functions (for example, salaries of financial officers) were intended to be currently deductible.[63]

The Treasury Department issued proposed regulations in 1983 which reflected the TEFRA modifications and clarifications. Under the proposed regulations, the principal distinctions between the treatment of long-term contracts and the treatment of extended period long-term contracts involve the deductibility of depreciation (in the case of assets used in the performance of particular long-term contracts, only book depreciation must be capitalized in the former, whereas all such depreciation must be capitalized in the latter); the deductibility of current pension costs (deductible for the former but not the latter); and general and administrative expenses (deductible for the former if beneficial to the taxpayer's activities as a whole, but in most instances allocable in part for the latter).[64]

In addition, rework labor, scrap, and spoilage costs are subject to capitalization in the case of extended period long-term contracts, but not for other long-term contracts.

The proposed regulations, which have not yet been adopted as final, take an expansive view of general and administrative expenses that directly benefit extended period long-term contracts. The types of functions for which no allocation of costs is required are limited, including overall management and policy guidance (e.g., services by the board of directors and the chief executive, financial, legal, and accounting officers if no substantial part of their services relate to a particular contract), general financial planning and management, financial accounting, tax services, public relations, and internal audit.[65]

Self-constructed assets

Under present law, the cost of acquiring, constructing, or improving buildings, machinery, equipment, or other "capital" assets having a useful life substantially beyond the end of the taxable year is not currently deductible (sec. 263).[66] Rather, such capital expenditures become part of the basis of the acquired, constructed, or improved property.

Depending on the nature of the property, these costs may be recoverable over the useful life of the property through depreciation or amortization deductions (if the property is used in the taxpayer's business or for the production of income and is otherwise subject to an allowance for depreciation or amortization); otherwise, such costs are recoverable when the property is sold or otherwise disposed. At the time of sale or disposition, any unrecovered basis of the asset is offset against the amount realized in computing gain or loss on the sale.

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[63] S. Rept. No. 97-530, 97th Cong., 2d Sess. (1982), at 547.

[64] The proposed regulations do not distinguish between long-term and extended period long-term contracts insofar as research and experimental costs are concerned.

[65] *See* Prop. Treas. Reg. sec. 1.451-3(d)(9)(vi). Thus, a portion of many overhead expenses which benefit both overall managment and policy functions must be allocated under a burden rate or other reasonable method.

[66] *See also* Treas. Reg. secs. I.263(a)-2(a); 1.263-1(b); 1.446-1(a)(4)(ii); 1.461-1(a)(2).

In *Idaho Power Co.* v. *Comm'r,* [67] the U.S. Supreme Court explained the purpose of section 263 as being

> to reflect the basic principle that a capital expenditure may not be deducted from current income. It serves to prevent a taxpayer from utilizing currently a deduction properly attributable, through amortization, to later tax years when the capital asset becomes income producing.

The Court emphasized the importance of matching income with expense by amortizing costs incurred in the building of capital assets over their useful lives, and the policy of maintaining parity between the taxpayer that builds its own capital asset and the taxpayer that purchases a similar asset from an independent contractor or dealer. The Court held that depreciation on equipment used to construct capital improvements had to be capitalized as part of the cost of the improvements.

Case law has generally adopted a rule of reason approach in applying section 263, tacitly acknowledging the impracticality of requiring that every cost with some conceivable future benefit be capitalized. In *Comm'r* v. *Lincoln Savings & Loan Ass'n,* [68] the U.S. Supreme Court stated that capitalization was required under section 263 only if the expenditure serves "to create or enhance . . . what is essentially a separate and distinct additional asset. . . ." The Court held that "the presence of an ensuing benefit that may have some future aspect is not controlling," noting that "many expenses concededly have prospective effect beyond the taxable year."

It is well-established that a taxpayer that constructs a building or other capital asset for its own use [69] must capitalize all direct construction costs such as direct materials and labor. Moreover, it is clear under *Idaho Power Co.* that depreciation on the taxpayer's equipment may not be deducted currently but must be capitalized into the basis of the self-constructed property.

There is less certainty, however, as to the proper tax treatment of many indirect expenses incurred in connection with self-construction of property. It has been held on the authority of section 446(b), which requires use of an accounting method that clearly reflects income, and *Idaho Power Co.* that vacation pay, payroll taxes, health and welfare benefits, and general overhead costs and executive salaries attributable to self-construction must be capitalized rather than deducted currently.[70] But there is other contrary authority suggesting that such indirect costs need be capitalized only to the extent they are incremental or variable overhead costs,

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[67] 418 U.S. 1, 16 (1974).

[68] 403 U.S. 345, 354 (1971).

[69] The applicability of the full absorption rules to constructors of nonfungible property (e.g., homes) to be held for sale rather than for the use of the constructor is unclear. The regulations provide that all "manufacturers" must apply the rules. Treas. Reg. sec. 1.471-11.

[70] *See, e.g., Adolph Coors Co.* v. *Comm'r,* 519 F.2d 1280 (10th Cir. 1975), *cert. denied,* 423 U.S. 1087 (1976) (IRS justified in requiring capitalization of overhead costs of construction); *Louisville & Nashville R.R. Co.* v. *Comm'r,* 641 F.2d 735, (6th Cir. 1981), *aff'g, rev'g, and remanding* 66 T.C. 962 (1976) (upholding Tax Court's determination that vacation pay and health and welfare benefits were subject to capitalization, but reversing as to payroll taxes); *Variety Construction Co.* v. *Comm'r,* T.C. Memo 1962-257 (1962) (overhead costs held subject to capitalization).

that is, are in excess of fixed overhead or vary significantly with the level of self-construction.[71]

The use of "incremental" costing for indirect costs (in lieu of full absorption costing) is expressly forbidden for inventory under the Treasury regulations, but no such prohibition exists for self-constructed property. Indeed, in some instances, the IRS has permitted the deductibility of certain indirect costs incurred during self-construction. In *Idaho Power Co.,* the IRS conceded that the taxpayer could deduct payroll taxes incurred with respect to employees engaged in construction of the property.

Special accounting rules for farming and ranching

The Code and Treasury regulations provide a number of special benefits to taxpayers engaged in the business of farming or raising livestock, including an election to use the cash method of accounting, the right to use special inventory methods if an accrual method is adopted, and the right to deduct certain costs that would otherwise have to be capitalized.

Election to use cash method of accounting

Although as producers of goods for sale, farmers and ranchers otherwise would be required to maintain inventories and use the accrual method, they historically have been exempted from these requirements. Instead, they have been allowed to elect a "simplified cash method" based on the premise that establishing and deferring the precise costs of raising crops and animals may be too difficult for farmers and ranchers.[72]

Farmers and ranchers who adopt the cash method may generally deduct the costs of producing crops and raising livestock in the year of payment. Expenditures for buildings, machinery, and other capital assets are, subject, however, to the normal capitalization requirements of section 263. In addition, the IRS takes the position that amounts paid for supplies such as feed and fertilizer that will not be consumed until a later taxable year may not be deductible currently if current deduction would cause a material distortion of income, or if the prepayment does not have a business purpose.[73]

Special rules apply to passive farmers operating through "farming syndicates." Payments by farming syndicates for feed, seed, fertilizer, or other similar farm supplies may be deducted no earlier than the taxable year in which they are consumed (sec. 464).[74] The cost of poultry purchased for use in a business, or for use in a business and for sale, must be capitalized and deducted over 12 months.

A farming syndicate is defined as a partnership, S corporation, or other noncorporate enterprise engaged in the business of farming, more than 35 percent of the losses of which are allocable to limited partners or other similar types of passive investors. These

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[71] *Fort Howard Paper Co.* v. *Comm'r,* 49 T.C. 275 (1967) (incremental method and full absorption method equally permissible). *See also* I.T. 2196, IV–2 C.B. 112 (1925); *Paducah Water Co.* v. *Comm'r,* 33 F.2d 559 (D.C. Cir. 1929).

[72] *See U.S.* v. *Catto,* 384 U.S. 102, 111 n. 15 (1966).

[73] *See* Rev. Rul. 79–229, 1979–2 C.B. 210.

[74] These rules apply whether the syndicate uses the cash or the accrual method of accounting. Supplies described in sec. 464 may also constitute preproductive period expenses subject to sec. 447 or sec. 278 (see discussion below), in which case they would have to be capitalized.

restrictions also apply to any "tax shelter," defined as an enterprise the principal purpose of which is the avoidance or evasion of Federal income tax (secs. 461(i)(4) and 6661(b)(2)(C)(ii)).

Certain other passive farmers using the cash method are subject to the further restriction, generally applicable to accrual taxpayers, that no deduction may be claimed for an item until "economic performance" has occurred (sec. 461(i)).[75] In the case of the purchase of goods or services, economic performance occurs when the goods or services are received.

The cash method is not available to corporations or partnerships with one or more corporate partners that are engaged in farming or ranching. Such taxpayers are required to report on an accrual basis and to capitalize "preproductive period expenses." Preproductive period expenses are expenses incurred prior to the disposition of the first marketable crop or yield in the case of farm property having a useful life in excess of one year or expenses incurred prior to disposition in the case of other property (sec. 447). Exceptions to these rules are provided for certain family-owned corporations and for corporations whose gross receipts for all prior taxable years after 1975 do not exceed $1 million. The rules do not apply to taxpayers engaged in the production of timber.

Special inventory methods for accrual-method farmers

In general.—Although a farmer electing to use the accrual method must use inventories in computing income, special rules are provided for the computation of gross income. The regulations do not require a computation of cost of goods sold, but instead provide for (1) an inclusion of the farmer's ending inventory in gross income and (2) a deduction of opening inventory and purchases during the year. This achieves essentially the same result as a deduction for cost of goods sold.[76]

Special rules are also provided for valuing inventory. Rather than valuing inventory under the conventional cost or lower of cost or market methods, farmers may value their inventories of livestock or other farm products using the "farm-price" method. In addition, livestock may be valued under a third method, the "unit-livestock-price" method. (Livestock acquired by the taxpayer for draft, breeding, dairy, or sporting purposes may also be treated as a capital asset subject to depreciation rather than inventory, provided such practice is consistently followed.)[77] Under either the farm-price method or the unit-livestock-price method, all expenditures that would otherwise have to be inventoried may be deducted when incurred (subject to any applicable restrictions, such as the capitalization requirements of sec. 447).

Farm-price method.—Under the farm-price method, inventories are valued at their market value minus any direct costs of disposition.[78] If the farm-price method is elected, it generally must be

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[75] Taxpayers subject to this restriction include (1) any enterprise (other than a C corporation) whose securities or interests must be registered under Federal or State securities laws prior to sale, (2) a syndicate as defined in sec. 1256(e)(3)(B), and (3) a tax shelter as defined in sec. 6661(b)(2)(C)(ii) (i.e., the principal purpose of which is tax avoidance).

[76] Treas. Reg. sec. 1.61–4(b).

[77] Treas. Reg. secs. 1.61–4(b) and 1.162–12(a). Certain livestock may be eligible for the investment tax credit (*see* sec. 48(a)(6)).

[78] Treas. Reg. sec. 1.471–6(d).

used for all of the taxpayer's inventories. However, livestock, whether purchased or raised, may be valued under the unit-livestock-price method or may be capitalized and depreciated.[79]

Unit-livestock-price method.—Under the unit-price-livestock method, the taxpayer must group livestock according to kind and age and apply a standard unit price for each animal within each class. The value of each animal is then increased annually by a standard amount reflecting the cost of raising an animal in that class.[80] If the taxpayer elects the unit-price-livestock method, all livestock raised by the taxpayer must be valued under this method; thus, none may be treated as capital assets subject to depreciation.[81]

Special capitalization requirement for certain preproductive costs

Amounts paid or incurred in planting, cultivating, maintaining, or developing citrus or almond groves before the end of the fourth taxable year after planting must be capitalized (sec. 278(a)). The developmental costs of growing other crops (including nuts other than almonds) may be treated as currently deductible expenses by taxpayers that are not corporations subject to section 447 or farming syndicates subject to 464 or to section 278(b) (described below).[82]

If the taxpayer is a "farming syndicate" (defined in the same manner as for the prepaid feed, fertilizer, etc. expense limitation of sec. 464), planting and maintenance costs incurred with respect to any grove, orchard, or vineyard must be capitalized if incurred prior to the first taxable year in which there is a crop or yield in commercial quantities (sec. 278(b)).

Accounting for timber production

Under present law, the direct costs of acquiring or creating standing timber must be capitalized and recovered through depletion allowances if the timber is harvested or in determining the amount of any gain or loss if the timber is sold. The cost of creating timber includes amounts paid for seed or seedlings, for site preparation, for planting (including the cost of tools, labor, and depreciation on machinery and equipment), and for early stand establishment.[83] Costs incurred for management and protection after stand establishment (generally one or two years after planting) are generally deductible currently. Expenses in this category would include labor and materials for fire, disease, and insect control and for removal of unwanted trees and brush. Costs incurred for reforestation after 1979 may be eligible for seven-year amortization to the extent they do not exceed $10,000 per year (sec. 194).

Under present law, carrying charges such as property taxes, interest, costs of administration, and costs of protecting timber may

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[79] Treas. Reg. sec. 1.471-6(d); Rev. Rul. 77-326, 1977-2 C.B. 184.
[80] Treas. Reg. sec. 1.471-6(e).
[81] Treas. Reg. sec. 1.471-6(f) and (g).
[82] Rev. Rul. 83-28, 1983-1 C.B. 47.
[83] *See* Treas. Reg. sec. 1.611-3(a); Rev. Rul. 75-467, 1975-2 C.B. 93.

be either deducted currently or added to the taxpayer's basis in the timber, whether the property is productive or unproductive.[84]

Capitalization of construction period interest and taxes

Interest and taxes incurred by a taxpayer during construction or improvement of real property (other than low-income housing) to be used in its trade or business or held in an activity engaged in for profit generally must be capitalized and amortized over 10 years (sec. 189). The construction period commences with the date on which construction of the building or other improvement begins and ends on the date it is ready to be placed in service or held for sale.[85]

The legislative history of amendments to this provision indicates Congress' intention that the Treasury Department regulations allocating interest to expenditures for real property during construction generally be done in the same manner as it is allocated under financial accounting standards. Congress expected that these regulations will adopt rules similar to those contained in Financial Accounting Standards Board Statement Number 34. Under those rules, the amount of interest to be capitalized is the portion of the total interest expense incurred during the construction period that could have been avoided if funds had not been expended for construction. Interest expense that could have been avoided includes interest costs incurred by reason of additional borrowings to finance construction, and interest costs incurred by reason of borrowings that otherwise could have been repaid with funds expended for construction.[86]

No regulations relating to this provision have been proposed or adopted to date.

Administration Proposal

Capitalization of production costs other than interest

In general

The Administration proposal would apply the capitalization requirements applicable to extended period long-term contracts to all activities involving the production or manufacture of real or personal property, including goods to be held in inventory or for sale to customers in the ordinary course of business, property built or manufactured to the specifications of a particular customer, and assets (or improvements to assets) constructed by a taxpayer for use in its own trade or business or in an activity engaged in for profit. Thus, only those costs specifically designated as period costs in section 229 of TEFRA (e.g., marketing, selling, and advertising expenses, expenses incurred in unsuccessful bids, general and administrative expenses not allocable to particular production activities, research and experimental expenses not allocable to particular production activities, past-service pension contributions, and costs attributable to strikes) would be currently deductible.

[84] *See* Treas. Reg. sec. 1.266-1; Rev. Rul. 75-467, 1975-2 C.B. 93.
[85] H. Rep. No. 97-760, 97th Cong., 2d Sess. (1982) at 485.
[86] *Id.*

In addition, interest (which under present law may be deductible currently even if allocable to extended period long-term contracts) would in some circumstances be subject to capitalization. All costs subject to capitalization under these rules would be indexed under other provisions proposed by the Administration.

Special rules would apply in the case of long-term contracts structured on a cost-plus basis, and certain long-term contracts with the Federal Government. Special rules also would be provided for farmers and those who raise livestock. Producers of timber, however, would be subject to the general capitalization requirements, including those relating to interest.

Special rule for cost-plus and certain Federal Government contracts

Under the proposal, general and administrative expenses incurred in connection with a "cost-plus" type long-term contract would be subject to capitalization to the extent such expenses were reimbursed under the contract. A cost-plus contract is one under which the contractor is paid an amount representing its costs in performing the contract, plus an additional amount (e.g., a percentage of approved costs or a fixed fee). This same rule would apply in the case of long-term contracts with the Federal government under which the contractor is required by statute or regulation to submit certified cost data in connection with the award of the contract.

Special rule for farmers and ranchers

The rules of section 278(b), requiring farming syndicates to capitalize the costs of planting and maintaining groves, orchards, and vineyards incurred prior to the year of commercial production, would be revised and extended to all taxpayers, and to all crops and livestock having a "preproductive period" of two years or more.

The costs subject to capitalization would be the same as those subject to the general rule; namely, the costs that must be allocated to extended period long-term contracts under present law. These rules would not apply, however, to animals held for slaughter. As an alternative to inventorying preproductive costs under this provision, a taxpayer would be allowed to use simplified valuation methods similar to the farm-price or unit-livestock-price method of inventory valuation.

The preproductive period of plants would begin when the plant or seed was first planted or acquired by the taxpayer, and would end with the time the plant became productive or was sold. The preproductive period of animals would begin at the time of acquisition, breeding, or embryo implantation, and would end when the animal became ready to perform its intended function (e.g., to produce marketable quantities of milk).

Taxpayers currently subject to section 447 (requiring certain corporations and partnership engaged in farming to use the accrual method and capitalize preproduction costs) would continue to be subject to that provision. In addition, under a separate proposal, farmers with average annual gross receipts over a three-year period of more than $5 million would be required to use the accrual method of acounting for tax purposes.[87]

Production period interest

The proposal would require capitalization of interest on debt incurred or continued to finance the construction or production of property in Class 5 or Class 6 of the proposed Capital Cost Recovery System (in general, buildings and other real property that is 15-year or 18-year property under present law, plus certain other long-lived assets), if the property will be used by the taxpayer in its trade or business or an activity for profit. Interest incurred in connection with other property, including plants and animals, requiring two or more years to reach a productive stage, would also be subject to the interest capitalization requirement.

Interest capitalized under this provision would be added to the basis of the property and recovered through cost recovery allowances or at the time of sale or other disposition.[88] The requirement would not apply, however, to property to be used by the taxpayer for personal purposes.

The production period would begin when construction or production is commenced, and end when the property is ready to be placed in service or held for sale. If property is produced under a long-term contract, the production period would end when the contract is completed.

The definition of construction period interest would be similar to the definition under section 189 of present law. Thus, it would include any interest expenses of the taxpayer that would have been avoided if production or construction expenditures had been used to repay unrelated indebtedness of the taxpayer.[89]

Debt that can be specifically traced to production or construction expenditures first would be allocated to construction. If production or construction expenditures exceed the amount of this debt, interest on other debt of the taxpayer would, to the extent of this excess, be treated as production or construction period interest. For this purpose, the assumed interest rate would be an average of the rates on the taxpayer's outstanding debt (excluding debt specifically tracable to production or construction). The Administration proposal states that appropriate related party rules would be provided.

Special rules would apply if production or construction is for a particular customer who makes progress payments or advance payments for property to be used in a business or activity for profit, or held for sale. The customer would be treated as self-constructing the property to the extent of such payments. Thus, payments to the contractor would be subject to capitalization by the customer if the property is long-lived property or requires a production or construction period of two years or longer. The contractor would capitalize interest only with respect to the excess of its accumulated contract costs over the accumulated payments during the year.

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[87] *See* discussion in part II.A., above.

[88] This basis would be indexed under a separate Administration proposal. See discussion in Joint Committee on Taxation, *Tax Reform Proposals: Taxation of Capital Income* (JCS-35-85), August 8, 1985, Part III.B.,

[89] Production or construction expenditures would include the cumulative production costs required to be capitalized.

Effective date

The proposed rules generally would be effective for costs and interest paid or incurred after 1985. Long-term contracts entered into before 1986, and self-constructed assets with respect to which substantial construction was begun before 1986, would be exempt from the new rules. In addition, production costs, including interest, incurred in the production of timber would be subject to a 10-year phase-in rule. Under this rule, only 10 percent of such costs would have to be capitalized in 1986, 20 percent in 1987, and so on.

The new rules would apply to inventories for the taxpayer's first taxable year beginning on or after January 1, 1986. Taxpayers would be allowed to spread the adjustment resulting from the change in inventory accounting over a period of no more than six years, in accordance with the rules applicable to a change in method of accounting initiated by the taxpayer and approved by the IRS.

Other Proposals

S. 409 and H.R. 800 (Bradley-Gephardt)

Accounting for long-term contracts

The Bradley-Gephardt bill would impose an interest charge or credit on the gain or loss deferred by a taxpayer using the completed contract method of accounting for long-term contracts. Any interest charge could be paid at the time the contract is completed, or currently at a reduced rate. A de minimis exception of $10,000 would apply.

The bill would also repeal the exception from the extended period long-term contract capitalization rules for certain construction contracts completed within three years.

Accounting for farming

The Bradley-Gephardt bill would extend the accrual method to all farming syndicates, and all other taxpayers having gross receipts of more than $1 million in the current or any prior taxable year. Taxpayers under this rule would not be allowed to deduct certain expenditures deductible under present law, such as soil and water conservation expenditures (sec. 175), fertilizer and other soil conditioning expenditures (sec. 180), and land-clearing expenditures.

The bill would be effective for taxable years beginning after 1986.

H.R. 2214 (Stark)

H.R. 2214 would direct the Treasury Department to modify its income tax regulations to prohibit use of the completed contract method of accounting for long-term contracts with the Federal government. Taxpayers performing under such contracts would be required to include in gross income in any taxable year the greater of (1) the aggregate amount received under the contract in the form of advances or progress payments, or (ii) the amount determined under the percentage of completion method, reduced by amounts includible in gross income with respect to the contract in prior taxable years.

S. 1281 (Roth)

S. 1281 would deny use of the completed contract method for any long-term contract to which the Department of Defense is a party. A contractor would be required to include in gross income with respect to any such contract the greater of (1) the aggregate amount received under the contract in the form of advances or progress payments, or (2) the amount determined under the percentage of completion method, reduced by amounts includible in gross income with respect to the contract in prior taxable years. Exceptions would be provided for construction contracts to be completed within three years and taxpayers having average annual gross receipts (over the prior three years) of $25 million or less.

S. 909 (Quayle)

S. 909 would require the Treasury Department to issue regulations relating to the completed contract method of accounting under which (1) the proper share of the net income or loss from a long-term contract reported on such method is allocated to each year of the contract and (2) interest is charged or credited to take into account the deferral of any income or loss.

Analysis

In general

The Administration proposal recommends the adoption of a comprehensive set of accounting rules under which substantially all direct and indirect costs of producing all types of assets would be capitalized into the basis of the asset. The intent of the Administration proposal is to reduce the mismatching of income and related expenses, which occurs when costs relating to a product sold in a subsequent taxable year or to property placed in service by the taxpayer in a subsequent taxable year are deducted currently; to eliminate the distortions in business and investment decisions caused by the disparate treatment of self-constructed assets and contractor-built assets under present law; and to reduce inequities to taxpayers in lower marginal brackets, who are in effect "crowded out" of certain multiperiod activities by upper-bracket investors seeking tax deferral.

The fundamental issues raised by the Administration's proposal are whether the proposal results in a better measurement of a taxpayer's income and, if so, whether the Administration's proposal is a reasonable and workable one. Subsidiary issues include which types of product-related costs may, consistent with the objective of accurately measuring "income," be deductible currently, and which types of costs should be deferred; whether and to what extent financial accounting standards regarding the deductibility of particular costs should influence the treatment of such costs for tax purposes; and whether and to what extent capitalization rules should override special tax incentives provided under the Code (e.g., the deductibility of research and experimental costs under sec. 174).

The "mismatching" identified in the Administration's proposal is attributable to the annual accounting requirement of the tax system. If a taxpayer currently deducts an expense attributable to an activity or transaction, but defers recognition of the income produced by the activity or transaction until some future taxable year, the taxpayer's income is distorted. The longer the period between the deduction and the recognition of related income, the greater the distortion in the taxpayer's income.

Several provisions of the Code directly address this mismatching problem, including section 263 (requiring capitalization of capital expenditures), section 471 (requiring use of inventories), section 189 (requiring capitalization of construction period interest), and section 195 (requiring capitalization of preopening expenditures). Moreover, section 446 (requiring that the taxpayer's method of accounting "clearly reflect income") grants the IRS broad powers to prevent premature deductions for particular items, unless a deduction is specifically authorized under the Code.

The Administration proposal is premised upon the concept that a taxpayer's income is more accurately measured if all of the costs it incurs in producing the asset are matched against the income derived from the sale of that asset. Some have questioned whether the benefits of imposing comprehensive capitalization requirements to achieve more accurate reflection of income are outweighed by the administrative and compliance burdens on the taxpayer. Obviously, the longer the period between the time the costs are incurred and the time the income from the asset is recognized, the greater the potential for distortion of income.[90] Indeed, the principal impetus for the development of comprehensive capitalization rules under the completed contract regulations was the fact that income was being deferred until contract completion, which was, in many cases, long after the related costs were deducted. It may be appropriate to consider whether these same stringent rules should be applied in circumstances where the period between deduction and recognition is not significant.

It also may be appropriate to consider whether indirect costs, whose size is not material, should be exempted from the capitalization requirement.[91]

Accounting for inventories

As explained above, under the full absorption rules of present law, taxpayers maintaining inventories are required to capitalize all direct costs and a number of indirect costs. Under the proposal, these taxpayers would have to capitalize certain additional costs, including pension contributions and other employee benefits representing current service costs, the excess of tax depreciation over financial statement depreciation, rework labor, scrap, and spoilage, certain research and product development costs, and direct and indirect costs incurred in connection with administrative, service, and support functions.

Critics of the proposal argue that it ignores the long-established distinction between period and product costs, and thus fails to match properly revenues and expenses. These critics argue that

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[90] The special two-year rules applicable to production of agricultural products and to interest implicitly recognize the importance of the time factor.

[91] As previously noted, case law has traditionally applied a "rule of reason" in interpreting section 263, declining to require capitalization of all costs that could conceivably have a benefit beyond the current taxable year.

many of the costs the proposal would require to be inventoried are "period" costs that do not relate to the production of a particular item and do not substantially benefit future periods. Rather, they represent costs of doing business for the period incurred, and should continue to be currently deductible against revenues from that period in order to properly match income and expenses. The IRS has long recognized that the current deduction of these items is consistent with the clear reflection of income, they argue, and therefore, there is no reason to change that position.

Opponents of the proposal also contend that the proposal would eliminate the flexibility provided under the full absorption regulations with respect to many indirect costs (i.e., those in Category 3). This flexibility, they argue, is essential because of the divergent accounting treatment of such costs in the various trades and industries. Furthermore, opponents argue that the proposal would result in undue complexity and impose unreasonable administrative burdens on taxpayers. Allocating many of these costs to specific products or projects, they argue, will be difficult and time-consuming.

Finally, the critics contend, the proposal undermines the basic goal of inventory accounting in the tax system and undercuts several incentives Congress has put in the Code to encourage capital investment. The objective of maintaining inventories is to allow a determination of economic income on the sale of an item, which is achieved only if real, economic costs are included in cost of goods sold. The proposal would require the inclusion of the excess of tax depreciation over book depreciation in inventory. Moreover, the critics argue that the proposal would diminish the impact of accelerated depreciation, the deduction for research and experimental expenses, and other specific statutory incentives for investment by requiring them to be included in inventory rather than deducted currently.

It is reasonable to assume that the proposal would add some additional complexity to the inventory accounting process. Many taxpayers would be required for the first time to develop procedures and formulae for making allocations of new types of overhead costs to inventory. It is unclear, however, whether this additional burden on taxpayers would be as substantial as claimed. It is possible that many taxpayers, even smaller businesses, could modify their inventory systems to take into account some portion of these costs without undue difficulty. Indeed, some taxpayers already make allocations of general and administrative costs to inventory.

Moreover, some of the additional costs, such as current pension payments [92] and employee benefits attributable to direct labor, could be inventoried fairly easily.

While it is true that there is no consensus within the financial accounting community that indirect costs such as general and administrative expense and employee benefits should be allocated to inventory, this should not necessarily influence the determination of whether such allocations are necessary to clearly reflect taxable income. It is widely acknowledged that tax and financial accounting have different objectives. Financial accounting standards en-

[92] Payments to a defined contribution plan should pose no allocation problems, although payments to a defined benefit plan could.

courage conservatism in financial statements, which is achieved by treating costs that are not clearly and directly identifiable with a product as period costs and thereby reducing earnings for the year. This conservatism may not be consistent with the objective of tax accounting, which in general is to determine accretions to wealth realized by the taxpayer during the taxable period and therefore to measure the taxpayer's income.

Because the objectives of the tax and financial systems are not, and need not, be the same for tax and financial purposes, arguably there is no necessity to retain the full absorption regulations in their present form in order to allow "flexibility." Inclusion of those costs would appear to be appropriate if their inclusion would more accurately reflect income, regardless of the treatment for financial purposes. If a particular business or industry, or the financial accounting profession in general, decides for reasons of conservatism that these costs be treated as period expenses for financial statement purposes, it may do so without regard to the tax treatment of these items. There are numerous instances under current law where the computation of tax and book income diverge and adjustments are required in computing taxable income.

Some argue that the financial conformity requirement of the present system creates a natural tension that is sufficient to prevent abuse. A taxpayer may deduct a Category 3 cost for tax purposes only at the price of deducting it for book purposes and reducing its financial statement income. Although in some (perhaps many) cases, the financial conformity requirement may serve as a deterrent to deduction of some of the Category 3 costs, one may question whether it is appropriate to allow financial reporting standards (which, because of their conservatism, may be indifferent to current expensing), or a taxpayer's sensitivity to public perceptions about its financial health, to influence the amount of taxes paid.

Accounting for long-term contracts

The Administration's proposal would extend the more stringent costing rules now applicable only to extended period long-term contracts [93] to other long-term contracts. Accordingly, construction contracts lasting three years or less and contracts entered into by contractors whose gross receipts do not exceed $25 million, and other contracts that are less than two years (but more than one year) in duration, would be brought under the rules, whether or not the completed contract method is elected.

Since long-term contracts by their very nature involve a greater potential for mismatching of income and expense, it may be appropriate to impose more stringent capitalization requirements where such contracts are involved. Indeed, present law does impose cost capitalization requirements for extended period long-term contracts (whether or not extended period). As in the case of inventories, the question is whether the complexity and administrative burdens created by such rules outweigh the possible benefits of more accurate reflection of income.

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[93] That is, contracts not expected to be completed within two years after commencement, other than certain construction contracts.

The administrative burden argument would not appear to apply with respect to general and administrative expenses under cost-plus contracts or Government contracts providing for reimbursement of such expenses [94] since the parties have specifically acknowledged their relationship to a particular contract.

The Administration proposal would not repeal the completed contract method of accounting. Accordingly, taxpayers would still be permitted to defer recognition of income until completion of the contract. Congress may wish to consider the proposals under which the benefits of deferral of income under some or all long-term contracts would be eliminated.

Accounting for farming and timber

The effect of the proposal is to require certain farmers, ranchers, and producers of timber who are now allowed to expense their production costs for Federal income tax purposes to account for those costs in inventories, at least for some portion of their business. Some family-owned and family-operated farms that raise livestock or (noncitrus) fruit trees, vineyards, or other crops requiring two years or longer to reach the productive stage would be most affected. Some "passive" farmers and ranchers who have avoided the capitalization requirements of sections 278 and 447 would also be affected, as would all producers of timber.

The principal criticism raised by opponents of the proposal is that it is unreasonable to require persons actively engaged in farming or ranching to maintain the types of records that would be necessary to inventory preproduction costs. The proposal would allow an election for farmers and ranchers to employ methods similar to the alternative inventory valuation methods currently available to farmers, the farm-price method or the unit-livestock-price method. Although use of these methods may simplify accounting for crops and livestock, it does not entirely eliminate the administrative burden. Moreover, use of these alternative methods could result in a higher tax than if the more complex conventional inventory methods are used.

Producers of timber argue that it is unreasonable as well as unrealistic to require them to keep detailed inventories of costs for the entire preproduction life of each tree, which in some cases can be 50 years or longer.

Production period interest

The requirement under the Administration proposal that interest be capitalized with respect to long-lived assets or assets with a two-year or longer production period has been criticized on the ground that interest always has been treated as a period cost under the Code. Critics also criticize the proposal on the grounds that, under the proposed allocation rules, interest paid on debt of the taxpayer that is wholly unrelated to the construction or production would be allocated in part to construction or production expenditures.

[94] Federal law generally requires submission of certified cost data in connection with Government contracts involving more than $100,000.

On the other hand, section 189 has required partial capitalization of interest as a product cost in the case of real property since 1976. It may be appropriate to extend this requirement to other types of property constructed or produced for a customer under long-term contracts or for self-use.[95] It is unclear, however, whether the interest allocation rules to be specified in regulations under section 189 (not yet issued) will be workable for all taxpayers potentially subject to the rule.

E. Special Treatment of Certain Items

1. Reserves for Bad Debts

Present Law and Background

In general

Present law allows taxpayers a deduction from income for those debts arising from a trade or business which become wholly or partially worthless during the taxable year (sec. 166(a)). The amount of the deduction may be determined under either the specific charge-off or the reserve method. The deduction is not available, however, to a cash-method taxpayer who has not taken into income the amount of the debt.

Noncorporate taxpayers with wholly worthless debts arising from activities which do not constitute a trade or business must treat their losses as short-term capital losses, using the specific charge-off method (sec. 166(d)). Dealers in property are allowed to establish a reserve for liabilities which may arise out of liability as a guarantor, endorser, or indemnitor on debt which arose as a result of the dealer's sale of property (sec. 166(f)). If a debt evidenced by a security which is a capital asset in the taxpayer's hands becomes wholly worthless, it generally is treated as sold for no value on the last day of the taxable year in which worthlessness occurs, resulting in the recognition of a long- or short-term capital loss, as the case may be (sec. 165(g)).

Specific charge-off method

The specific charge-off method recognizes an expense for bad debts only as the debts actually became either wholly or partially worthless. At such time as a receivable is determined to be uncollectible in whole or in part, the receivable is reduced by the amount equal to that portion determined to be uncollectible, and an expense is recognized in an equal amount. If an amount previously charged off as uncollectible is later recovered, the recovery is treated as a separate income item at the time of collection.

Wholly worthless amounts are charged off as a bad debt deduction for tax purposes in the year in which they become worthless. Partially worthless amounts not only must have become partially

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[95] The Administration proposal would apparently liberalize sec. 189 where construction will be completed within two years, provided the property will be held for sale rather than used by the taxpayer. Apparently, this liberalization assumed that income from the property would be reported by the taxpayer within two years. This will generally not be the case where property is sold in an installment sale. Congress may wish to consider whether construction-period interest should be capitalized in the case of property sold on the installment method.

worthless for tax purposes, but must also be charged off on the taxpayer's books in the amount of such partial worthlessness before a bad debt deduction is allowed for tax purposes.

Reserve method

Under the reserve method, a reserve account is set up as an allowance against the eventuality that some of the receivables may eventually prove to be uncollectible. The actual deduction for bad debts for any year is the amount which is necessary to bring the beginning bad debt reserve, adjusted for actual bad debt experience and recoveries during the year, to the allowed ending balance computed under one of the approved methods.[96] Thus, amounts specifically charged off or recovered are not items of expense or income, but are components of the computation of the deductible addition to the reserve.

The results obtained under the reserve method will differ from results obtained under the specific charge-off method if ending reserve balances change from year to year. Where the beginning and ending reserve balances are the same, both methods yield the same deduction amount. Any increase in the ending reserve balance as compared to the beginning balance will yield a higher deduction under the reserve method, while any decrease will yield a lower deduction. For an ongoing entity, the sum of deductions claimed for all years under the reserve method will exceed the sum of deductions claimed under the specific charge-off method as long as there is a positive bad debt reserve balance at year end.

Determination of addition to reserve

The annual addition to the reserve account is required to be reasonable in amount, determined in light of the facts existing at the close of the taxable year of the proposed addition. Reasonableness primarily depends on the total amount of debts outstanding at the close of the taxable year and the total amount of the existing reserves.[97]

The most widely used formula for determining the appropriate bad debt reserve for tax purposes is based on the decision in *Black Motor Company* v. *Comm'r.*[98] This formula uses a six-year moving average, determined by dividing the sum of bad debts actually charged off (net of actual recoveries) for the most recent six years (including the current year) by the sum of the debts owed the taxpayer at the end of each year over the same six-year period. This average is multiplied by the amount of debts outstanding at the close of the current year to produce the reserve balance at the close of the current year.

The result is a figure based on past experience which approximates the bad debt charge-offs expected to occur in a single taxable year. The addition to the reserve for the current year is determined as in all other reserve systems by adjusting the beginning

[96] The actual formula is beginning reserve minus actual worthless debts experienced during the year plus actual recoveries during the year plus deductible addition to reserve equals ending reserve. The formula is solved for the deductible addition after all the other amounts are determined.
[97] Treas. Reg. sec. 1.166–4.
[98] 41 B.T.A. 300 (1940), *aff'd* 125 F.2d 977 (6th Cir. 1941).

balance in the reserve for actual charge-offs and recoveries and solving for the amount necessary to restore the adjusted reserve figure to the proper year-end amount.

The use of the *Black Motor* method can be demonstrated by the following computation for year 7:

Year	Debts	Total chargeoffs	Recoveries	Net chargeoffs
1	4,000	250	0	250
2	5,000	0	0	0
3	4,500	400	100	300
4	5,500	700	0	700
5	6,000	300	50	250
6	5,500	200	0	200
7	7,000	400	100	300
Sum 1–6	30,500	1,850	150	1,700
Sum 2–7	33,500	2,000	250	1,750

Reserve Balance end of Year 6=[(1700/30500)×5500]=$306.56
Reserve Balance end of Year 7=[(1750/33500)×7000]=$365.67

Computation of addition to reserve for Year 7:

Prior Year-end Balance	$306.56
Less Year 7 Charge-offs	(400.00)
Plus Year 7 Recoveries	100.00
Plus Addition to Reserve	359.11
Equals Current Year-end Balance	365.67

Current year deduction equals addition to reserve=$359.11.

The *Black Motor* formula does not provide the exclusive method for determining the deductible addition to reserve. The result obtained under the formula must still be determined to be reasonable under the circumstances of the year of computation. The Treasury Department has indicated that as a general rule the *Black Motor* formula will be applied in determining what is a reasonable addition to the reserve for bad debts. If a taxpayer considers that it is entitled to a larger addition to reserves than past experience indicates is necessary, however, it may claim such larger addition provided that the need can be substantiated. Likewise, if the IRS finds that an amount less than the addition under the *Black Motor* formula is reasonable in light of facts existing at the close of the taxable year, such lesser addition to reserves may be required.[99]

Extraordinary losses and recoveries

The reserve method of recording bad debt expense is designed for the estimation of normal losses arising in the ordinary course of a taxpayer's trade or business. An extraordinary loss—one which is rare and unpredictable in nature and not arising out of day-to-day operations—will cause distortions if it is included in an experience

[99] Rev. Rul. 76–362, 1976–2 C.B. 45.

based reserve calculation such as the *Black Motor* formula. For this reason, such extraordinary events are required to be accounted for by the specific charge-off method under present law, despite the simultaneous use by a taxpayer of the reserve method for debts arising from the ordinary course of trade or business.[100]

Determination of worthlessness

Both the specific charge-off and the reserve method require a determination of the period in which the debt becomes totally or partially worthless.

Worthlessness is a question of fact, to be determined by considering all pertinent evidence, including the value of any collateral securing the obligation and the financial condition of the debtor.[101] A debt is not worthless merely because its collection is in doubt. So long as there is a reasonable expectation that it eventually may be paid, the debt is not to be considered worthless.

Wholly worthless bad debts may be charged off for tax purposes only in the year they become worthless, and not in some later year when the fact of worthlessness is confirmed. The period in which the debt is actually charged off the taxpayer's books is not determinative. Partially worthless bad debts must also be charged off on the taxpayer's books in order to be charged off for tax purposes and hence may yield a charge-off for tax purposes in a year after the debt becomes partially worthless. However, a tax charge-off for a partially worthless bad debt may not be taken after the year in which the debt becomes wholly worthless.

Among factors which may be considered in determining worthlessness are bankruptcy of the debtor, termination of the debtor's business, the debtor's death or disappearance, receivership of the debtor, and a decline in the value of collateral available to satisfy the debt. None of these factors is in and of itself determinative, however, and a finding of worthlessness must be predicted on an objective test of all facts and circumstances.[102] Thus, the entering of a debtor into bankruptcy does not by itself establish worthlessness. However, if the surrounding facts and circumstances indicate only a de minimis chance of recovery, a debt may be treated as worthless at that time.[103]

A debt is not worthless merely because it cannot be collected currently if there is a reasonable expectation that it may become collectible in the future. A business debtor may be able to satisfy its obligations out of future activities, despite the fact that it is technically insolvent at the present time. An individual, although currently insolvent, may generate future income that could pay off the debt. Where these expectations are reasonable, the debt is not worthless.

A creditor must normally take all reasonable steps necessary to collect a debt, including legal action if appropriate, before it will be

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[100] Rev. Rul. 74-409, 1974-2 C.B. 61.

[101] Treas. Reg. sec. 1.166-2(a).

[102] See *Denver and Rio Grande Western Railroad Co.* v. *Comm'r*, 279 F. 2d 368 (10th Cir. 1960), aff'g, 32 T.C. 43 (1959).

[103] Rev. Rul. 71-577, 1971-2, C.B. 129 (charge-off of a wholly worthless bad debt allowed where the receiver in bankruptcy notified creditors that, following liquidation, at most one or two cents on the dollar would be available).

held to be worthless. However, where the surrounding circumstances indicate that a debt is worthless and uncollectible and the legal action would in all probability not result in satisfaction, a showing of such facts will suffice, and legal action need not actually be brought.[104] The fact that the debtor refuses to pay or the creditor makes a business decision not to pursue the debtor does not support a charge-off of the debt for tax purposes. The running of the statute of limitations is not conclusive in establishing that a debt has become worthless, unless it is clear that the debtor would avail himself of that defense.[105]

Bad debt reserves for guarantees, etc.

Present law requires that an actual debt be owed the taxpayer in order to support the creation of a reserve for bad debt losses. For this reason, no deduction generally is allowed for potential losses of taxpayers who guarantee, endorse, or provide indemnity agreements with respect to debts owed to others.

An exception to this general rule is made for dealers in property. To the extent that these types of potential obligations arise from the sale of real or tangible personal property, dealers may establish a reserve account and deduct additions necessary to maintain it in the same manner as a reserve account for business debts owed directly to the taxpayer. This type of reserve normally arises where a guarantee or other indemnification agreement is given to induce a lender to arrange financing for a dealer's property or where a dealer's receivables are factored with rights of recourse.

Administration Proposal

The Administration proposal would repeal the use of the reserve method in computing the deduction for bad debts, effective for taxable years beginning on or after January 1, 1986. The balance in the bad debt reserve account at that time (if any) would be included in income ratably over a 10-year period.

The treatment of wholly worthless bad debts would be conformed to the treatment for partially worthless bad debts, effective for taxable years beginning on or after January 1, 1986. Thus, no debt would be deductible as wholly or partially worthless for tax purposes until it is charged off.

Other Proposal

1984 Treasury Report

The 1984 Treasury report would repeal the reserve method for bad debts with the same effective date and ratable inclusion of reserves as in the Administration proposal. Under the report, wholly bad debts would be deductible in the year of worthlessness regardless of whether written off for book purposes.

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[104] Treas. Reg. sec. 1.166-2(b).
[105] *Suman* v. *Comm'r,* 26 TCM 420 (1967).

Analysis

Overview

Taxpayers generally are not allowed to deduct a future liability or expense until all events giving rise to the liability or expense occurs. However, the Code permits taxpayers (in the discretion of the IRS) to deduct a reasonable addition to a bad debt reserve prior to the time when a business debt created or acquired by the taxpayer becomes partially or wholly worthless. A similar rule applies to dealers in property who guarantee the repayment of debt obligations arising from the taxpayer's sale, in the ordinary course of business, of real and tangible personal property (including related services).

Absent these special provisions for bad debt reserves, taxpayers would not be allowed to deduct a loan loss until the loan or obligation is determined to be wholly or partially worthless. For example, a bad debt deduction generally may not be claimed with respect to obligations arising from the sale of services (such as the accounts receivable of a law firm) until the time when the obligation is determined to be worthless in whole or in part.

The main issue is whether the reserve method of accounting for loan losses more accurately measures the economic income of creditors than the specific charge off method that would be required under the Administration proposal. A related issue is whether the specific charge-off method results in a proper matching of income and expense for accrual-method taxpayers. A third issue is the tax treatment of accumulated bad debt reserves on existing loans under the Administration proposal.

Income measurement

To measure income correctly, a bad debt deduction should be accrued at the time that the economic loss occurs. For example, suppose that a firm sells 100 widgets (to different customers) on December 31, 1984 for $10 each payable on March 31, 1985. The firm records an increase in accounts receivable of $1,000 (100 times $10) at the time of sale. If the firm's default rate on receivables is one percent, then $990 (i.e., $10 from 99 customers) is collected on March 31, 1985. Thus, $10 of economic loss occurs sometimes during the first three months of 1985.

Under present law, a calendar year, accrual-method taxpayer that elects to use the reserve method likely would deduct $10 in 1984 based on an anticipated default rate of one percent (i.e., one percent times $1000 of year-end receivables). Under the Administration proposal, the reserve method is eliminated; consequently, the bad debt deduction would be deferred until the receivable becomes partially or wholly worthless. As noted in the Administration proposal, the reserve method effectively allows a deduction for losses accrued in the current year plus a deduction for anticipated losses attributable to the increase in the amount of receivables held at year-end.

If bad debts are charged off promptly when they economically accrue, the rules in the Administration proposal would result in a properly timed bad debt deduction. However, a taxpayer may not promptly charge off bad receivables at the time when, from an economic perspective, they become wholly or partially worthless.[106] Under such circumstances, the Administration proposal may result in a deduction being taken in a period later than when the loss economically accrued.

The Administration proposal takes the position that because no market transaction occurs to fix the amount or time of economic loss, the tax system must rely on the estimated decline in the value of receivables at year-end based on all facts and circumstances. In particular, the proposal would require that a bad receivable be charged off the taxpayer's books under generally accepted accounting practice (GAAP) as necessary, but not sufficient, evidence of economic loss.

Matching of income and loss

The Administration proposal has been criticized on the ground that an accrual-method taxpayers would in effect be forced to use the cash method for losses. It is argued that this results in a mismatch of income and deductions. In the example above, a cash-method taxpayer would include $1,000 in taxable income in 1984, but would not be allowed to deduct the loss associated with this income under the proposal until 1985.

In response, it could be argued that accrual-method taxpayers have the option under present law (and under the proposal) to state separately the interest charge implicit in a deferred payment sale, and to recognize the interest income when it accrues rather than at the time of sale. In the example above, suppose the cash value of widgets is $9.70. The firm charges customers $0.30 for the privilege of deferring payment for three months. In extending credit to customers, the firm is similar to a bank: it must price the $9.70 loan based on its cost of funds and the risk of default. In this example, the firm charges $10 per widget which represents the cash value of a widget ($9.70)), plus the cost of extending credit of $9.70 for three months ($0.20), plus a $0.10 charge to cover the one-percent anticipated default risk on all 100 widget receivables.

If interest is separately stated, an accrual-method taxpayer would record a receivable of $970 (100 times $9.70) at the time of sale, and include $970 rather than $1000 in income. Three months later, the taxpayer collects $990 from 99 customers of which $960.30 is attributable to principal (99 times $9.70). The remaining $29.70 is attributable to interest (99 times $0.30), and is included in income at this time.

If the firm charges off the bad receivable, then under the Administration proposal, a bad debt deduction generally would be allowed for $9.70 (the uncollectible amount previously included in income). Consequently, net taxable income at the date of collection is $20 (i.e., $29.70 of interest income less a $9.70 bad debt deduction).

Thus, the bad debt deduction under the specific charge-off method exactly offsets the portion of interest income attributable to the risk of default. The remaining interest income ($20) exactly

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[106] Although the market value of a receivable may decline over time as the probability of collection declines, under present law, a receivable generally may be charged off (in whole or in part) only when the probability of collection is close to zero. Even in situations where charge-off is permissible, taxpayers might not charge off bad debts promptly because of the adverse effect on reported income.

matches the cost of extending credit ($0.20 per widget times 100 widgets). The firm's taxable income is exactly the same as if it had sold the 100 widgets for $970 cash, invested the proceeds, and earned $20 of interest income after three months. Thus, provided that interest charges are separately stated, the Administration proposal creates a level playing field between cash and deferred payment sales made by accrual method taxpayers.

If interest is not separately stated in a deferred payment sale, then the proposal causes a mismatch of income and deduction for accrual-method taxpayers that do not (or cannot) elect the installment method of reporting. In this case, the entire $1000 sale price (consisting of $970 of principal and $30 of interest that is not separately stated) is included at the time of sale, but the $10 loan loss would not be deductible for at least three months. This results in a mismatching of income arising from the extension of credit in a deferred payment sale and the loss arising from the credit transaction. If the seller does not separately state interest, then it can be argued that the reserve method in present law more accurately measures income and expense.

However, it can be argued that the separate stating of interest more accurately reflects the extension of credit that is implicit in a deferred payment sale. Even though the specific charge-off method of deducting bad debts does not match income and expense where the creditor fails to separately state interest charges, it is argued that problem lies not with the specific charge-off method but with the reporting of income. While it is acknowledged that the separate stating of interest would be burdensome for some, the Administration proposal would relieve taxpayers of the burden of computing bad debt reserves for tax purposes.

Transitional rule

To prevent taxpayers from deducting losses on receivables first as a deduction to a reserve for bad debts under current law and then as a deduction for specific bad debts under the proposed rules (and thus obtaining a double deduction), the Administration proposal would require that existing bad debt reserves be recaptured ratable over a 10-year period beginning with the first taxable year starting after 1985.

This transitional rule is substantially more generous than simply requiring taxpayers to charge bad debts on existing loans to their existing reserves. Data for 1980 indicates that, on average, accounts receivable turn over in nine weeks in manufacturing, six weeks in the service sector, five weeks in wholesale trade, and three weeks in retail trade.[107] Consequently, requiring present-law treatment for outstanding loans as of the effective date of the proposal would effectively recapture these reserves in a few weeks for many taxpayers.

The Administration proposal includes a provision to tax taxpayers who claimed accelerated depreciation deductions at present law tax rates and, under the proposal, would be taxed on income from

[107] Department of the Treasury, *1980 Corporation Income Tax Returns* (May 1983), Table 2. The turnover period is measured as the ratio of year-end accounts receivable to annual business receipts, times 52 weeks per year.

this property at proposed lower tax rates. It could be argued that since bad debt deductions reduced tax liability by 46 cents per dollar (at the 46-percent corporate rate), these deductions should be recaptured at 46 cents rather than 33 cents per dollar (at the proposed 33-percent corporate rate). In principle, the windfall gain from the proposed rate reduction could be taxed by increasing the amount of bad debt reserves included ratably in income under the proposal by 39.4 percent (the difference between the current 46-percent tax rate and the proposed 33-percent tax rate, as a percent of the proposed tax rate).

2. Mining and Solid Waste Reclamation Costs

Present Law and Background

Under present law, taxpayers may elect a special reserve method for deducting qualified mine and waste disposal reclamation and closing costs prior to economic performance (sec. 468). Taxpayers who do not elect this method are subject to the general rules of the Code (sec. 461) which do not permit accrual-basis taxpayers to deduct future expenses prior to the time when economic performance occurs.

Electing taxpayers may deduct the estimated current cost of reclaiming land that is disturbed during the current taxable year at mines and waste disposal sites. Electing taxpayers may also deduct the estimated current cost of certain site closing costs allocable to ore removed (wastes deposited) during the taxable year, based on the units-of-production (units-of-capacity) method of account.

All amounts deducted for site reclamation costs are deemed deposited, in the year deducted, in a site-specific reclamation sinking fund. Similarly, all amounts deducted for site closing costs are deemed deposited in a site closing sinking fund in the year deposited. The site reclamation and closing sinking funds are deemed to earn interest at a rate based on the short-term applicable Federal rate provided in section 1274.

Amounts expended for qualified reclamation and site closing activities, allocable to land disturbed and ore produced (or site capacity utilized in the case of a waste disposal facility) subsequent to the date of election, are deemed withdrawn from the applicable sinking fund in the year paid. The excess of such amounts paid for reclamation and closing costs over the year-end sinking fund balance (after deemed deposits and interest and before deemed withdrawals in the current taxable year) is deductible in the year paid. Therefore, amounts paid for site reclamation are not deductible except for the excess over the site sinking fund balance.

The balances of the site reclamation and site closing sinking funds are subject to limitations. Amounts in the site reclamation and closing sinking funds in excess of these limits, at the end of each taxable year (after deemed deposits, interest, and other withdrawals), are deemed withdrawn and are included in that year's gross income.

The balance of the site reclamation sinking fund, at the end of each taxable year, is limited to the current cost of reclaiming land that has been disturbed subsequent to the date of election, but not previously reclaimed. Similarly, the balance of the site closing sinking fund, at the end of each taxable year, is limited to the current cost of closing the portion of the site which has been utilized (based on a cumulative units-of-production or units-of-capacity method), subsequent to the date of election.

The election to deduct reclamation and closing costs under this provision must be made for a site in its entirety. Where an election is made and responsibility for site reclamation is divided between taxpayers with an interest in the site, each taxpayer may claim deductions for its share of the liability. For each site, the election may be revoked by the taxpayer; however, the balance of the site reclamation and closing funds must be included in gross income in that tax year, and the election may not be reinstated.

If a mine or waste disposal site is sold or otherwise disposed of prior to completion of site reclamation and closing, the seller recognizes the outstanding balances of the sinking funds in gross income. If any portion of the site is disposed of, then this portion of the site's sinking funds is subject to recapture. Recapture of sinking fund balances is also required at the end of the tax year in which a waste disposal site is listed in the National Contingency Plan.

Administration Proposal

The special reserve method for mine and waste disposal reclamation and closing costs would be repealed. Thus, such costs generally would be deductible only as the sites were closed or the land reclaimed (i.e., when economic performance occurs).

The proposal would be effective on or after January 1, 1986. The Administration proposal does not indicate whether elections as of December 31, 1985 would be revoked, and reserve amounts taken into income over a period of time. Another option would be to revoke the election only for the portion of the site not allocable to reclamation and closing cost sinking funds in effect as of December 31, 1985.

Analysis

The special deduction method available for mines and waste disposal facilities departs from the general principle that accrual-method taxpayers may not deduct future liabilities until economic performance occurs. Firms outside of the mining and waste disposal industries cannot take advantage of these special rules.

One argument for this preferential tax treatment is to encourage the establishment of adequate reserves to pay for the costs of restoring the land disturbed by mining and waste disposal facilities. However, unlike the special reserve method that may be used to fund nuclear power plant decommissioning costs (sec. 468A), the mine and waste disposal sinking funds are unfunded (paper) reserves. Also, State and local governments generally require that strip mining companies demonstrate financial capability to pay reclamation expenses. Thus, it is argued that the tax incentive is not effective and may not be necessary given the current regulatory requirements.

An argument for providing preferential treatment to the strip mining industry is to encourage coal production to help reduce the risks of an energy shortage. Nevertheless, the United States is a net exporter of coal and is not vulnerable to foreign supply interruptions. To the extent that strip mining is more environmentally damaging than other types of mining, it could be argued that tax policy should instead discourage strip mines.

An argument for providing preferential tax treatment to the waste disposal industry is to encourage the development of waste disposal capacity in order to provide for the proper disposal of hazardous wastes. However, the 1984 amendments to the Solid Waste Disposal Act discourage land disposal of hazardous waste in favor of alternative treatment and disposal technologies. Thus, it could be argued, tax incentives for land-based waste disposal facilities may be inconsistent with current hazardous waste management policy.

3. Accrued Vacation Pay

Present Law

Under present law, an accrual-method taxpayer generally is permitted a deduction in the taxable year in which all the events have occurred that determine the fact of a liability and the amount thereof can be determined with reasonable accuracy. In determining whether an amount has been incurred with respect to any item during the taxable year, all events that establish liability for such amount are not be treated as having occurred any earlier than the time economic performance occurs. With respect to a liability that arises as a result of another person's providing services to the taxpayer (such as the liability to provide vacation pay in exchange for services by an employee), economic performance generally occurs when such other person provides the services.

In order to ensure the proper matching of income and deductions, in the case of deferred benefits (such as vacation pay earned in the current taxable year, but paid in a subsequent year) for employees, an employer generally is entitled to claim a deduction in the taxable year of the employer in which ends the taxable year of the employee in which the benefit is includible in gross income.[108] Consequently, in the case of vacation pay, present law provides that an employer is not entitled to deduct vacation pay earned in a taxable year, but rather the deduction is postponed until the taxable year of the employer in which ends the earlier of the taxable year of the employee for which the vacation pay (1) vests (if the vacation pay plan is funded by the employer) or (2) is paid.

An exception to this rule applies to amounts that are paid within 2½ months after the close of the taxable year of the employer in which the vacation pay is earned. Such amounts are not subject to the deduction-timing rules applicable to deferred benefits, but are subject to the general rules under which an employer is entitled to a deduction when economic performance occurs (i.e., when the serv-

[108] Special deduction-timing rules apply to benefits provided under a qualified pension, profit-sharing, or stock bonus plan.

ices of the employee for which vacation pay is earned are performed).

Under a special rule of present law, an employer may make an election under section 463 to deduct an amount representing a reasonable addition to a reserve account for vacation pay (contingent or vested) earned by employees in the current year and expected to be paid by the close of that year or within 12 months thereafter. For example, in the case of a taxpayer who makes this determination at the end of a taxable year, the reasonable addition for the year is the amount necessary so that the balance in the account at the beginning of the next taxable year is the amount reasonably expected to be paid in that year. Thus, if the balance in the account, before any addition, is greater than this amount, no additional deduction is allowed. Certain rules also allow a deduction for reductions in certain suspense accounts.

Possible Proposal

The special provision (sec. 463) under present law relating to accrued vacation pay could be repealed. Under the usual rules for benefits earned but not paid during the current taxable year, an employer's deduction for vacation pay would be deferred until an employee includes the vacation pay in gross income.

Analysis

The general rules under present law provide that an employer is not entitled to deduct amounts for benefits earned by an employee until the employee includes the benefits in gross income. These rules are designed to ensure that employers do not deduct amounts that have not been included in an employee's income.

Some have argued that the special provision (sec. 463) of the present law, under which an employer is entitled to deduct reasonable additions to an account for earned vacation pay expected to be paid within 12 months following the close of the taxable year, is inconsistent with the general principle that no deduction should be provided for a deferred benefit until the employee includes the benefit in income. They also suggest that the present-law treatment is inequitable, because the rules for accrued vacation pay are more favorable than the rules that apply to other deferred benefits. Consequently, an employer may have an incentive to provide employees with accrued vacation pay in lieu of certain deferred compensation, because the employer may be entitled to deduct the amount of the vacation pay currently even though employees would not be taxed on the vacation pay until it is received.

Further, those who support a proposal to repeal section 463 argue that the deferred benefit deduction rules, by permitting an employer to deduct amounts paid within 2½ months after the close of the taxable year, provide sufficient flexibility to employers to take account of year-end accruals and normal payroll practices.

On the other hand, some believe that the special treatment of accrued vacation pay is appropriate and should not be repealed. They argue that section 463 provides a de minimis benefit to employers, which does not justify the administrative inconvenience and hardship that repeal of the provision would create.

4. Returns of Magazines, Books, and Records

Background

Overstocking of inventory

Publishers and distributors of magazines, paperbacks and records often sell more copies of their merchandise to wholesalers and retailers than it is anticipated will be resold to consumers. The cost of this "overstocking" of inventory is frequently borne by the publisher through an agreement to repurchase any unsold copies from vendors. These unsold items are commonly referred to as "returns".

Several reasons have been suggested for the use of the overstocking approach. The use of overstocking generally depends on the fact that after set-up and other fixed costs have been incurred, the marginal cost of producing additional copies of a title is generally quite low.

Overstocking may be used as part of a mass-marketing technique which relies on the use of conspicuous displays of merchandise and the ability of retailers to satisfy promptly an unpredictable amount of consumer demand. This technique is particularly suited to those publishers in the paperback and record area who rely on a relatively small number of "hot sellers" to produce the bulk of their profits.

When a publication is marketed, the publisher may have only a rough estimate as to the item's potential to become the desired "hot seller". Use of the mass-marketing technique fills the stores with the title, creating at least the impression that it ought to be a best seller, and positions the retailer to deliver the product immediately if strong demand for the title does occur. The ability to deliver products immediately is important in the popular paperback and records market, where the period of time a title remains a "hot seller" may be relatively short.

The overstocking and return system allows the publisher to try for "hot seller" status with a number of titles, incurring only the low marginal cost of the extended press run on the ones which do not succeed, and reaping the high returns on the few titles that do. Because the vendor knows that unsold items can be resold to the publisher via the return system, the retailer is willing to participate in the approach on a larger number of titles than if the retailer itself were at risk for the sale of the potentially excessive inventory.

The low marginal cost of producing additional copies combined with the overstocking and return system also allows the publishing industry a much wider distribution of that portion of its product which is not being mass marketed. A special-interest periodical may be purchased by a portion of its readership only sporadically, or be an impulse purchase when seen at a newstand. Not infrequently, the entire supply may be returned from some retailers; yet, on other occasions an individual vendor may sell all the copies received. It is suggested that many vendors would refuse to carry such product without the return guarantee.

Returns of unsold items

The return guarantee is also essential in assuring the willingness of vendors to stock a sufficient number of magazines for which there is a more steady demand. Without returns, the vendor would be obliged to estimate more closely expected sales and to forego sales in strong selling months to avoid having out-of-date, unsold copies in slow selling months. As to a publishers' permanent catalog, the overstocking and return system may induce vendors to provide a broader range of titles than would otherwise by the case.

The rate of returns under the overstocking and return system may be quite high. In 1975, the American Institute of Certified Public Accountants estimated that rate of returns could be as high as 30 percent for records, 60 percent for paperback books, and 65 percent for magazines.[109] There also may exist a lag between the time a title is properly determined to be unsellable by a vendor and the time of actual return. Since the vendor bears the burdens of ownership, such as risk of loss associated with keeping the title in inventory until the time of return, it may be presumed that the vendor ordinarily will not allow this lag time to become too great.

However, this may not always be the case. To the extent that the return process requires the handling of physical goods and the filing of physical reports, some passage of time in the return process may be unavoidable. Also, in the case of a weak publisher dealing with a strong vendor, full payment may not be due on sales until the return process is completed. In this case, there may be little initiative for the vendor to complete the return process in a timely manner.

Consignment alternative

The overstocking and return system is not the only method which can be used to achieve these desired business effects. Rather than selling the product to the vendor and agreeing to buy it back should it not resell, the publisher could place the product with the vendor on consignment. Under the consignment system, legal ownership would remain with the publisher until eventual sale. The vendor would be compensated by retaining a portion of sales price, which could, but need not be, equal to the markup profit the vendor currently obtains by selling its own inventory.

Several reasons exist for publishers to prefer the current system over a consignment system. In the return system, the obligations of ownership pass to the vendor. Also, it has been suggested that control over the veracity of return reports might be decreased if the product were placed on consignment rather than sold with a right of return.

Present Law

In general

Under present law, an accrual-basis taxpayer generally is required to recognize gross income on the sale of goods at the time of

[109] AICPA Accounting Standards Division, *Statement of Position 75-1: Revenue Recognition When Right of Return Exists* (1975).

sale, whether or not the product is subject to being returned in case it is not resold to consumers. Repurchased returns constitute an adjustment to income in the year of their return.

For a cash-basis taxpayer, income is recognized when it is received, and a reduction for repurchased returns occurs when the returns are paid for. Since manufacturers are required to maintain inventories on the accrual method of accounting, use of the cash method in the publishing of paperbacks and records is thought to be rare, although it may occur in the magazine industry since some publishers may not keep inventory but ship all copies directly from the printer to distributors.

Exclusion election

For accrual-basis taxpayers, an election is available to exclude from gross income for a taxable year the income which is attributable to the qualified sales of magazines, paperbacks, or records which are returned to the taxpayer before the close of the merchandise return period (sec. 458).[110] The merchandise return period is the first two months and fifteen days after the close of the taxable year for magazines, and the first four months and fifteen days after the close of the taxable year for paperbacks and records. To be eligible for the election, the taxpayer must have a legal obligation to adjust the sales price in case the item is not resold, and the sales price in fact must have been adjusted before the close of the merchandise return period.

The amount to be excluded from income is the lesser of the acknowledged legal obligation with regard to the returned item or the adjustment amount agreed to before the close of the merchandise return period. Adjustment of the sales price may be evidenced by actual refund, credit to the vendor's account, or the issuance of a credit memorandum or other document stating the credited amount.

The computation of income under the merchandise-return election constitutes a method of accounting. An election to adopt the method must be made in accordance with Treasury Department regulations; once made, the election is binding on the taxpayer unless consent is obtained from the IRS to revoke it. The election applies separately to each trade or business in which the relevant items are sold. If two or more categories of items are sold in connection with the same trade or business, each category is treated as a separate trade or business.

Special rules for year of election

Absent transitional rules, the year in which the merchandise return method is adopted will yield a reduction of income in the amount of returns for the full tax year plus the qualified return period. For magazines, this would allow the returns for a 14½ month period to offset the sales income for a 12-month period. To avoid this result, the reduction in taxable income resulting from

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[110] For this purpose, magazine means any periodical other than a newspaper; paperback means any book with a flexible outer cover if the pages are permanently affixed to the cover; and record means any disc, tape, or similar object on which musical, spoken, or other sounds are recorded, not including blank media for home recording.

the adoption of the merchandise return method for magazine sales must be spread pro rata over a five-year period consisting of the year of election plus the succeeding four years.

For paperbacks and records, the potential distortion in the year of adoption is even greater since 16½ months of return will be offsetting 12 months of sales. Rather than spread the reduction in taxable income over some period of years, taxpayers adopting the method for these items must establish a suspense account. Separate suspense accounts must be maintained with regard to each trade or business (or category treated as a separate trade or business) with respect to which an election is made.

For the first year in which an election to use the merchandise-return method is effective, an opening balance in the suspense account is established by comparing the amounts which would have been excluded from income due to returns within the 4½ month merchandise return period in the most recent three years (including the year for which the election is effective) as if an election had been in effect, and recording the largest dollar amount of the three. If the amount recorded as the opening balance in the expense account exceeds the amount attributable to the most recent year (the year of election), the difference is recorded as a taxable income item in the year of election.

For each year in which the election to use the merchandise return system is in effect, the opening balance in the suspense account is compared to the amount which is excluded from gross income as a result of returns during the 4½ month merchandise return period for the current year (the section 458 amount). If the opening balance in the suspense account exceeds the current year's section 458 amount, the suspense account is reduced by such difference and an equal amount is excluded from gross income for the year. If the section 458 amount for the current year is greater than the opening balance in the expense account, the excess is added to the suspense account up to the amount necessary to restore the initial opening balance in the account. Any amount so added is treated as an increase to gross income in the year of its addition. The effect of the suspense account is to prevent any timing benefit from being obtained from the amount of the deferral attributable to the initial opening account balance.

Administration Proposal

The Administration proposal would repeal the availability of the election to exclude from income the return of magazines, paperbacks, and records during the merchandise return period, effective for tax years beginning on or after January 1, 1986. The balance in any suspense account for paperback and records returns, as well as any amounts attributable to the year of election for magazines which has not yet been deducted, would be deductible in the first taxable year in which the proposal is effective.

Other Proposal

1984 Treasury Report

The 1984 Treasury report would provide the same treatment as the Administration proposal.

Analysis

Overview

An accrual-basis taxpayer is allowed a deduction or reduction of gross income only in the year in which the liability giving rise to the deduction or reduction is incurred. A liability is not incurred until all the events have occurred which determine the fact of the liability and its amount can be determined with reasonable accuracy. A liability which arises out of property being provided to a taxpayer, such as the liability which arises from a returned magazine, paperback, or record, generally is not considered to be incurred prior to the actual provision of the item to the taxpayer. Except for the special provision of section 458, taxpayers would not be allowed a reduction of income for returns which occur after the close of the taxpayer year.

The principal issue is whether the section 458 rules provide a better measurement of income for any given period than would the application of the general rules of accrual tax accounting. If the special provision does not provide a better measurement of income, are there other significant reasons why it should be allowed? An additional issue is whether the allowance of such a deviation from general rules of accrual tax accounting should be allowed for a limited group of taxpayers when it is unavailable to others.

Income measurement

The Federal income tax system requires taxpayers to measure and pay tax on their income for a given period of time, i.e., the taxable year. Accordingly, a determination must be made as to which items of income and expense will be assigned to a given year. In the case of returns of magazines, paperbacks, and records, two competing principles must be considered in determining the proper tax year to which income and expense should be assigned—the matching principle and the transaction principle.

The matching principle holds that items of expense and adjustments to gross income should, to the extent possible, be recognized in the same period as the income to which they relate. Ideally, an adjustment to income from the return of merchandise pursuant to a qualified sale would be recognized in the same period as the sales income for the item returned was recognized. Supporters of present law argue that by allowing returns occurring during the merchandise return period to adjust income in the prior taxable year, the bulk of returns attributable to sales in the prior year are matched to the same tax year that income was recognized. This is not an absolute match, since items sold in the previous taxable year may not be returned until after the close of the merchandise return period and will offset income in a later year.

The transaction (or realization) principle holds that no item of income, adjustment to income, or expense should be recognized prior to the time at which the transaction giving rise to the item is completed. A major corollary to this principle is the idea that contingent items—i.e., items dependent on the occurrence or nonoccurrence of future events—should not be recorded until the future event either occurs or it becomes reasonably certain the event will not occur.

The Administration proposal uses this principle as its focus. Income should be recognized in the year that the event establishing the right to that income occurs, i.e., the year of sale; adjustment to income should be recognized in the year in which the event giving rise to the liability to pay for the return occurs, i.e., the year of return. Present law does not achieve this effect because it allows the adjustment for returns to be taken in a year prior to the year in which the return actually occurs.

As a result, a deferral of tax exists in the amount of the returns during the merchandise return period in comparison to the tax which would have been due had the returns been required to be reported in the taxable year of the transactions giving rise to them. To the extent such tax is deferred, it will be paid in dollars worth less at a future date than those dollars are worth today, due to the effect of the time value of money. To the extent the deferral amount grows each year, an amount of tax liability may be created which never will be paid under present law.

The adjustment for returns occurring during the merchandise return period in the prior taxable year, when viewed from the prior year-end, is the allowance of an adjustment for a contingent item. One of the primary reasons for not allowing contingent items to be recorded for tax purposes is that it is unknown whether the contingency will occur. Recording a contingent item prior to the contingency's occurrence causes taxable income to be determined by estimates of future events rather than actual transactions. This may not be a significant problem under present law, since the only contingent items allowed to be recorded are ones where the contingency is known to have occurred within the merchandise return period.

The question of which system provides the best measurement of income depends on the relative emphasis to be given to the matching and transaction principles. If the matching principle is considered to be of primary importance, then a special allowance for returns occurring after the taxable year may be justified.

Other considerations

For financial accounting purposes, sellers of merchandise subject to a right of return are required to maintain a contingency reserve account in the amount of future returns which can be reasonably estimated. Additions to the reserve account are recorded as an adjustment to income in the year of sale. If the amount of future returns cannot be reasonably estimated, income on the sale of such merchandise is not recorded until the return period has substantially expired or the amount of future returns can be reasonably estimated. Actual returns occurring between the end of the year and the date of financial statements may be considered in determining the adequacy of the reserve balance at year end, but are not determinative of its amount.[111]

The present tax treatment of returns during the merchandise return period may yield an amount similar to the reserve amount established for financial purposes, but does not conform with the financial accounting approach. An addition to reserve reducing current income will be required for financial purposes for the estimated returns on all sales and not just for those sales which may experience return during a set period after year end. While the return system under present law comes closer to the results obtained for financial accounting purposes than would the Administration proposal, it still requires a discrete calculation for tax purposes.

The computation of taxable income would be simpler under the Administration proposal than under the return method of present law. The present-law approach requires the value of returns be determined at an interim date (the end of the merchandise return period), and for paperbacks and records requires the maintenance of a separate suspense account. Also, to the extent that returns within the merchandise return period are eligible to adjust income in the prior year only if they relate to sales of the prior period, the time of sales and returns of specific titles must be recorded and the records compared to determine which returns should be eligible for adjustment in the prior period. It should be noted, however, that the return method of present law is an elective method and need not be used by those taxpayers desiring to avoid its complexity.

Some taxpayers currently using the merchandise return method have argued that such relief is essential to the proper computation of their taxable income. They point out that a major mass marketing effort (of the type described above) at year-end which fails could lead to substantially distorted net income figures if total sales are included in one year and total returns in the next. Since returns would have to be received by year-end to currently benefit the taxpayer, vendors may have to be encouraged to return books when there is still a reasonable chance that they can be resold to the general public. To the extent that present law facilitates the dissemination of a wide range of titles through the return guarantee, social benefits may also result from present law.

The consideration of events occurring after year-end in computing taxable income is not generally available to taxpayers. As a matter of tax policy, it is not clear a special tax accounting treatment should be allowed to publishers through the merchandise return method. Many manufacturers may offer resale guarantees in order to promote the distribution of their product, yet only in the case of magazines, paperbacks, and records is the special merchandise return period allowed. As to the argument that eliminating the merchandise return period would force them to encourage returns when a real possibility of sale still exists, present law has the same effect. The merchandise return period, while an extension of time for returns of merchandise sold in a prior year, is also an absolute cut-off date for the purpose of determining what returns may be applied against prior year income. Thus, the same pres-

[111] *Accounting Standards, Current Text,* Financial Accounting Standards Board (1984), sec. 75.107-109.

sures should exist to encourage returns at the end of the merchandise return period as would exist at tax year end under the Administration proposal.

Assuming that social benefits are associated with the availability of a wider range of magazine, paperback, and record titles, the issue arises whether providing a tax benefit by way of deferral is the most efficient way in which to achieve this social benefit. There may even be some question as to how great an effect present law has on the availability of a wide range of titles at least in the paperback and record area. Other than recent issues, retail inventories of paperbacks and records are presumably based on expectations of consistent demand. Thus, the incidence of returns may be substantially lower than is the case for titles subject to current promotion through mass marketing techniques.

5. Qualified Discount Coupons

Background

In general

Many manufacturers promote their products to the general consuming public by the use of "cents-off" or discount coupons. These coupons provide a specific monetary incentive to the consumer to purchase a product and may induce a retailer to provide shelf space for the product in anticipation of coupon-generated demand. Discount coupons are used both to help introduce new products and to preserve or increase the market share of products previously introduced.

A discount coupon is generally issued by direct mail to the consumer, by having it printed in a newspaper or magazine, or by attaching or inserting it in the same or another product of the manufacturer. In most cases, the consumer presents the coupon to the retailer at the time of sale in order to receive the discount. The retailer then forwards the coupon to the manufacturer in exchange for the amount of the discount allowed the consumer plus a handling fee. In many cases, the retailer does not present the coupon directly to each manufacturer; instead, the retailer forwards all its coupons to a clearinghouse which handles the redemption in exchange for a portion of the handling fee to be received from the manufacturer.

Certain types of coupons do not involve the retailer but rather require the consumer to forward the coupon and proof of purchase directly to the manufacturer for a rebate of part of the purchase price of one or more items.

Legislative history

Issuers of premium coupons with sales (rebate certificates, trading stamps, etc.) have traditionally been allowed to reduce the current year's sales income by an amount equal to the cost to the taxpayer of merchandise, cash, and other property used for redemption of the premium coupons during the taxable year, plus the net addition to a reserve account necessary to reflect anticipated redemption of currently issued coupons in future years.[112] However, several IRS rulings disallowed use of such a reserve account for discount coupons which were distributed to consumers through the mail or through newspaper and magazine advertisements (Rev. Rul. 73-415, 1973-2 C.B. 154) or were issued in or on the package of a product (Rev. Rul. 78-212, 1978-1 C.B. 140). In each case, the reasoning given was that the sale to which the liability for the coupon related was the sale of the product to the consumer for which the previously issued coupon was tendered. Implicit in the refusal to allow the establishment of a reserve account was the position that no obligation to redeem the coupon existed until evidence of the later sale was given to the issuer of the discount coupon by presentment of the coupon for payment.

In the Revenue Act of 1978, Congress established a limited deduction of expenses related to discount coupons estimated to have been turned in by consumers by the close of issuer's taxable year, but which have not been received by the issuer at that time.

Present Law

Under present law, accrual issuers of qualified discount coupons may elect to deduct the cost of redeeming qualified discount coupons outstanding at the close of the taxable year and received by the taxpayer within the six-month period following the close of the taxable year (sec. 466).[113] A qualified discount coupon is one which (1) is issued by the taxpayer, (2) is redeemable by the taxpayer, and (3) allows a discount on the purchase price of merchandise or other tangible personal property. The coupon must not be redeemable directly by the issuer (a direct consumer rebate) and may not by itself or in conjunction with any other coupons bring about a price reduction of more than $5 with respect to any item.

The election must be made with respect to each trade or business of the taxpayer and constitutes a method of accounting. Thus, revocation of an election may be made only with permission of the IRS. A suspense account is established and used in the year of election in the same manner as for returns of paperback books and records (see part II, E, 4, above).

Administration Proposal

The Administration proposal would repeal the special rules allowing the redemption of qualified discount coupons received after year-end, effective for taxable years beginning on or after January 1, 1986. Any balance in a suspense account would be deductible in the first tax year for which the proposal is effective.

Other Proposal

1984 Treasury Report

The 1984 Treasury report would provide the same treatment as the Administration proposal.

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[112] Treas. Reg. sec. 1.451-4.

[113] The six-month period is the maximum allowed. A taxpayer may elect a shorter period.

Analysis

Whether issuers of qualified discount coupons should be granted the type of treatment they enjoy under present law depends on whether such a treatment more clearly reflects taxable income than would a method limiting the deduction for returns to those received by year-end.

The matching principle—the concept that income and related expenses should be recognized in the same period—may support allowance of a deduction in the prior year for coupons received after the close of the year. As the coupons must be physically handled, there will always exist some time lag between the time they are turned in by the customer and the time they are presented to the issuer for redemption. To the extent that the sales income to which the coupon redemption expenses relates is income from sales to distributors and vendors of products at or prior to the time of the issuance of the coupon, the expense of redeeming the coupon may be said to be properly matched against the prior period's income.

Present law, however, fails to ensure that the desired matching always occurs.

In some cases the sales income to which the coupon expense relates may not have been recognized in the prior year. If this is the case and the operation of the statutory six-month period rule allows the deduction for cost of redemption to be taken in the prior year, while the income is recognized in the current year, a mismatching of income and expense results. The only requirement for deduction in the prior year under present law is that the coupons have been issued and outstanding by the close of the prior year and received within the statutory period. If a coupon is issued with a long period or with no expiration date, the income to which the coupon relates may not be from sales prior to issuance, but rather from future sales. To the extent that a coupon is used in the purchase of a product of the coupon issuer which was sold by the issuer after the close of the year, and the coupon is received within the six-month period, a mismatching of income and expense may occur under present law.

There may be some question as to whether six months is the appropriate period for allowing redemption expenses to be applied against the prior year. In the case of a discount coupon, the retailer has foregone cash on accepting the coupon and will not get cash or credit back until the coupon is presented to the issuer for redemption. In light of this, it may be reasonable to assume that there will not be a long lag time between the use and presentment of the coupon. If it is considered desirable to continue some special post-taxable year period for coupon returns, consideration could be given to reducing the six-month statutory period in order to minimize the potential for mismatching of income and expense which can result. Alternatively, the use of the post-taxable year period could be limited to those coupons used by consumers prior to year-end.

The allowance of a redemption period after the close of the taxable year violates the transaction or realization principle of tax accounting. Income and expense generally are recognized only when all events have occurred which fix the right to or obligation to pay funds with respect to the item. Were it not for the special rule, the all-events test would not be considered satisfied until the coupon is presented for redemption. The fact that income may have been recognized in the prior period is not determinative, since a right to the full amount of that income existed until the coupon was presented in a later year.

6. Contributions in Aid of Construction

Present Law

Under present law, a corporate regulated public utility which provides electric energy, gas (through a local distribution system or transportation by pipeline), water, or sewage disposal services may treat contributions in aid of construction which it receives as contributions to capital (sec. 118(b)). Thus, such contributions are not includible in gross income by the utility, and the amounts received (or any property constructed or acquired with such amounts) may not be included in the utility's rate base for rate-making purposes.

An excludable contribution may be in the form of property used in the utility's trade or business or in the form of money or other property. To the extent money or other property is contributed, an amount equal to the amount of such contribution must be expended by the utility on trade or business property the acquisition of which was the purpose motivating the contribution. The expenditure must be made before the end of the second taxable year after the year in which such contribution of money or other property was received by the utility. The adjusted basis of any property contributed or purchased with the proceeds of any excludable contribution in aid of construction is zero.

Background

General

Certain utility companies have traditionally obtained capital needed for the construction of facilities by requiring those customers to be directly served to contribute toward the cost of the facilities. This approach reduces the amount of capital which the utility otherwise would have to raise or furnish to expand its operations. It also gives an incentive to the utility to extend service to areas which otherwise might not be served, either because the utility lacks internal capital for expansion or because expansion to that area would not be profitable if the utility's own capital resources had to be used. To the extent that a regulated utility may be required to expand service to those areas demanding it, requiring contributions by customers directly served by the expansion protects the customers of the entire utility system from having to absorb the cost of expansion through higher rates.

Legislative and judicial history

Code section 61 provides that gross income includes all income, from whatever source derived, unless otherwise provided by law. Section 118 provides that gross income does not include any contribution to the capital of the taxpayer. The issue of whether contributions in aid of construction made to a utility by its potential customers constitute contributions to the utility's capital, excludable from gross income, arose in *Liberty Light & Power Co.,* 4 B.T.A. 155 (1926); acq. VI–1 C.B. 4 (1927).

This case involved a regulated electric utility company which was required to extend service to all applicants within its territory. As service could not be extended to rural communities on a paying basis, the utility was not required to do so unless the prospective customers either contributed a sufficient amount to construct the necessary facilities or constructed the facilities and contributed them to the utility; if so, the utility was obligated to receive and maintain the facilities and to provide service at regulated rates. Analogizing to the case in which a sovereign government's subsidy to encourage a utility's activity had been held not to constitute gross income,[114] the court held that the receipt of utility lines from future customers constituted a contribution to the capital of the utility, and not gross income as a prepayment of services.

The *Liberty Light & Power* approach does not appear to have been seriously challenged until *Teleservice Co. of Wyoming Valley,* 27 T.C. 722 (1957), *aff'd,* 254 F.2d 105 (3rd Cir. 1958), *cert. denied,* 357 U.S. 919 (1958). In that case, the Tax Court held that customer contributions to a community television antenna system for construction of facilities constituted income to the companies. *Teleservice* would appear distinguishable from the earlier case since the taxpayer in *Teleservice* was not a regulated public utility subject to a continuing duty to provide service to its customers. However, the *Teleservice* decision was not based on factual differences from *Liberty Light & Power,* but rather on the ground that the customer contributions were payments for services rendered or to be rendered, and not contributions to capital.

In affirming, the Third Circuit stated that the taxpayer's reliance on the *Cuba Railroad Company* case was "misplaced" and "as to *Liberty Light and Power* . . . and cases which followed the rule [it] enunciated we can only say we are not in accord." [115] The IRS responded to the *Teleservice* case in Rev. Rul. 58–555, 1958–2 C.B. 25, stating that it had litigated the case because it considered it distinguishable from *Liberty Light & Power,* and that its acquiescence to the latter case was not to be withdrawn for contributions in aid of construction of regulated public utilities.

In Rev. Rul. 75–557, 1975–2 C.B. 33, the IRS withdrew its acquiescence in *Liberty & Power,* effective for transactions entered into on or after February 1, 1976. This followed the Supreme Court's decision in *United States* v. *Chicago, Burlington & Quincy Railroad Co.,* 412 U.S. 401 (1973), which held that government payments received for improvements at grade-crossings and intersections were not contributions to capital since they represented payments for specific, quantifiable services, and the decision in *Hayutin* v. *Comm'r.,* 31 CCH Tax Ct. Mem. 509 (1972), *aff'd,* 508 F.2d 462 (10th Cir. 1974), which held that the public utility distinction of Rev. Rul. 58–55 was not supported by the *Teleservice* case and should not form a basis for distinction.

[114] *Cuba Railroad Co.* v. *Edwards,* 298 Fed. 664 (S.D. N.Y. 1924) , *aff'd,* 268 U.S. 628 (1925).
[115] 254 F.2d at 112.

Congress responded to this change in approach in the Tax Reform Act of 1976, establishing present law with regard to water and sewage disposal utilities. In the Revenue Act of 1978, the rules of present law were expanded to cover contributions in aid of construction to regulated public gas and electric utilities.

Possible Proposal

It has been suggested that present law may provide an inappropriate tax subsidy through the treatment of payments in aid of construction as nontaxable contributions to capital. Accordingly, Congress may wish to consider repealing section 118(b) and requiring income to be recognized at the time the payment in aid of construction is received.

Analysis

General

The principal issue is whether contributions in aid of construction should be viewed as contributions to the capital of a corporation or as payments in anticipation of services to be rendered. If viewed as payments in anticipation of services, such amounts should be treated as items of income to the recipient. If such treatment is proper, the appropriate time and amount for recognition of income must be determined. Even if such amounts are properly classified as payments in anticipation of services, substantial nontax reasons may be viewed as supporting special treatment of these items.

Nature of contributions in aid of construction

In order properly to be viewed as a contribution to capital, an amount paid a corporation must be motivated either by donative intent, or a belief that the contributor will somehow be advantaged by the enlargement of the capital of the company. Contributions to capital do not include amounts expended in recompense for the provision of a specific service. In such a case, the corporation has received income for the services, and not a contribution to capital.

Some argue that the transfer of property by a prospective customer to a utility in order to induce the utility to provide services is better viewed as a prepayment for services than a contribution of capital. The customer desires services and is willing to pay the utility the necessary price to get them. If this involves providing facilities or funds to construct facilities, such amounts constitute part of the cost paid to obtain the services.

Of course, the customer is benefited by the utility's increase in capital, since the utility then has the funds to provide services to the customer. This can be said, however, of any payment for goods and services. If a provider can obtain enough funds in return for its goods or services, it will provide the goods or services, whether the funds it receives are called a contribution to capital or sales price. In the case of a contribution in aid of construction, there is a direct nexus between the payment and the receipt of services. It is not the overall capital of the utility that concerns the customer, but rather a specific asset which relates to the services the customer will receive.

If the contribution in aid of construction is best viewed as a prepayment for services, the appropriate time and amount of inclusion in the utility's income must be decided. Under present tax accounting principles, this would be at the time of receipt by the utility, unless the payment is in the nature of a refundable deposit. If the amount is not refundable, the utility's financial position has been increased at the time the money or property is received. Although the utility does incur a liability to perform a service in the future, it generally will receive separate compensation in the amount of normal, regulated charges at that time. The transaction resulting in the current increase in financial position through the receipt of property or moneys to construct property is a closed transaction.

Some contend that requiring current inclusion in the utility's income results in a mismatching of income and expense. As a condition of receiving the contribution in aid of construction, the utility will incur expenses to maintain the facilities and to provide the service. Adherence to the matching principle would match the income arising from the contribution in aid of construction against the costs of maintenance of the facilities and provision of services, to the extent that those costs are not attributable to income from the periodic charge for the service itself. This raises the problem of determining over what period the income from the contribution in aid of construction should be spread. Present law has the effect of spreading the income over the statutory depreciation period that would be assigned the constructed facilities and recognizing the income at the same rate and by the same method as that depreciation. It is not clear that this is the best period over which the income could be spread.

The present tax accounting rules require that amounts received as income be valued at their fair market value. For property, this is the amount for which the property would change hands between a willing buyer and a willing seller (generally, the retail price). For money, it is the face amount received.

It is argued that the application of the general rule may overstate the actual benefit to the utility of receiving the contribution in aid of construction. If money is received as a contribution in aid of construction, it cannot be used for any purpose the utility wishes, but rather must be spent on specific facilities to serve specific customers. Also, it is argued that facilities, whether received directly or built with contributed monies, may not have the same value to the utility as their cost. The facilities normally will be tied into the general system of the utility and cannot be removed and resold, even if the obligation to the contributing customers could somehow be abrogated. The customers may be willing to expend amounts to get service in excess of any value which accrues to the utility from having those facilities in place. That is one of the reasons that the contribution in aid of construction had to be made by the customer in the first place. Accordingly, it is contended that requiring the utility to recognize income at full fair market value would overstate the amount by which it has been benefited in obtaining the facilities, and therefore overstate its income.

On the other hand, it is reasonable to presume that there is at least some value to the utility in receiving the contribution. The contribution permits the utility to sell its product to the contributor on which the utility makes a profit. Thus, the present-law approach of assigning no value for Federal income tax purposes to the contribution understates income.

Other considerations

Supporters of the present-law approach to contributions in aid of construction argue that, regardless of theoretical considerations, the approach is necessary for substantial nontax reasons. It is suggested that current inclusion in income of the value of the contribution in aid of construction could impair the operating capital of the utility, since an increase in rates to cover the additional tax expense may not be granted until after the taxes would have to be paid. While this may be a valid concern, it would seem to relate more to a failure in the setting of regulated rates.

It is also argued that the special rules of present law promote a social good by making it easier for regulated utilities to expand and to meet the public's demand for new and increased services. While this may be desirable, it is not clear why the tax laws should provide favorable rules which effectively subsidize that activity. One of the economic reasons for requiring contribution in aid of construction is that it prevents the cost of expansion from being charged to all customers, by assigning that cost to the customers directly benefiting from the expansion. In light of this, it might appear inconsistent with this goal to spread a portion of that cost to taxpayers generally through a special tax provision.

Finally, it is argued that if public utilities are required to pay tax currently on contributions in aid of construction, they may resist accepting such contributions, preventing needed expansion of facilities from occurring. This should be the case only where the actual benefit to the utility in receiving the contribution in aid of construction is less than the additional tax liability resulting from inclusion in income. As such, this is really a question of how the contribution to income should be valued, and not whether a special nonrecognition rule is required.

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