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Accounting Procedures and Methods under the 1954 Internal Revenue Code

Philip G. Johnson
University of Nebraska College of Law

ACCOUNTING PROCEDURES AND METHODS UNDER THE 1954 INTERNAL REVENUE CODE

Difference between tax accounting rules and generally accepted accounting principles have been a source of irritation to accountants, lawyers, and business men generally. Although the regulations interpreting the Internal Revenue laws have long asserted that, "approved standard methods of accounting will generally be regarded as clearly reflecting the income",[1] court decisions and rulings have undermined the broad principles in the regulations.

1 U.S. Treas. Reg. 118, § 39.41-2(a) (1953).

The principle area where the rules of tax accounting differed from generally accepted accounting principles was found in the rules applicable to the timing of transactions. They were confined principally to questions of *when* income should be recognized and *when* expenses should be deductible. Thus under tax rules income was often held to accrue at the time cash was received free of restrictions,[2] although under accounting principles the time of receipt was not as relevant as the service period involved.[3]

Tax accounting rules did not allow deductions for costs or expenses until all the events had occurred which were necessary to find the amount and the fact of the taxpayer's liability for payment.[4] Generally accepted accounting principles require that costs and expenses be matched against revenues of the period to which they relate in order to determine net income. If the precise amount of any costs or expenses is not determinable, reasonable estimates must be used.[5]

A further major area of divergence occurred in the rules relative to accrual of property taxes. Accounting practice has been to accrue such taxes over the fiscal period of the taxing authority.[6] Tax accounting has required accrual on certain critical dates which differ in various jurisdictions.[7]

Methods for eliminating these divergences have been provided by the 1954 Internal Revenue Code. For the most part the new provisions are elective in order to prevent inequities during the transition period.

I. PERMISSIVE ACCOUNTING METHODS

The new law recognizes the use of the same permissive methods of accounting as under the prior law, the cash receipts and disbursements method and the accrual method.[8] In addition it specifically authorizes the use of hybrid accounting methods.[9]

2 Chateau Frontenac v. Commissioner, 147 F.2d 856 (6th Cir. 1945); Commissioner v. Lyon, 97 F.2d 70 (9th Cir. 1938); Renwick, Trustees v. United States, 87 F.2d 123 (7th Cir. 1937).

3 Kester, Advanced Accounting 387 (4th ed. 1946).

4 United States v. Anderson, 269 U.S. 422 (1926).

5 Kester, Advanced Accounting 380 (4th ed. 1946).

6 American Institute of Accounting Research Bulletin No. 43 Restatemen and Revision of Accounting Research Bulletins 81 (1953).

7 Helvering, v. Schimmel, 114 F.2d 554 (8th Cir. 1940); G.C.M. 22454 1940-2 Cum. Bul. 210; G.C.M. 21373, 1939-2 Cum. Bul. 82.

8 Int. Rev. Code of 1954, § 446(c).

9 Ibid.

The committee reports cite the example of a small retail store. The retailer may use the accrual basis with respect to items which affect gross income such as purchases, sales of goods, accounts payable, and accounts receivable. With respect to items of deductions such as rent, interest, clerk's salaries, insurance and similar items, the retailer may use the cash basis.[10]

It also gives specific recognition to the right of the taxpayer engaged in more than one trade or business to use a different method of accounting for each trade or business.[11] The committee reports also indicate that the taxpayer does not need to use the same method of accounting for his personal affairs as he does for his business transactions.[12]

The new code also makes it clear that a taxpayer who changes his general method of accounting without the consent of the Secretary cannot use the new method of accounting for the purpose of computing taxable income in the absence of express statutory permission.[13]

Under the old law the accounting period used by a taxpayer had to end on the last day of a calendar month.[14] Taxpayers in certain industries, notably the meat packing industry, close their annual accounting period on a particular day of the week rather than on the last day of the month. In some years these taxpayers would have accounting years of fifty-two weeks. In one year out of six, they would have an accounting year of fifty-three weeks. Under the prior law such businesses were forced to use a calendar year for tax reporting purposes.[15]

The new rule permits such taxpayers, both corporations and individuals, who regularly keep their books on this basis, to elect to report their income for tax purposes on the business basis.[16] These new provisions apply to taxable years ending after the date of enactment. This method is used so rarely that it does not seem necessary to go into the details here. It may be mentioned that in the event of changes in tax rate during or at the end of a year, provisions are made to determine what is done with the odd days in the year.[17] No provision seems to exist for the tax-

10 Sen. Rep. No. 1622, 83d Cong., 2d Sess. 300 (1954).
11 Int. Rev. Code of 1954, § 446(d).
12 Sen. Rep. No. 1622, 83d Cong., 2d Sess. 300 (1954).
13 Int. Rev. Code of 1954, § 446(e).
14 Int. Rev. Code of 1939, §§ 48(a), 48(b).
15 Parks-Chambers, Inc. v. Commissioner, 131 F.2d 65 (5th Cir. 1942).
16 Int. Rev. Code of 1954, § 441(f)(1).
17 Id. § 441(1)(2)(B).

payers who were informally following the fifty-two-fifty-three week method for tax purposes. Some businesses were using such a year; however, for tax return purposes they showed the end of the month as the end of the year. Perhaps the regulations will indicate the proper method for changing from an unofficial fifty-two-fifty-three week year to an official accounting period.

II. PREPAID INCOME

In the past one of the greatest differences between tax accounting and good accounting practice was the treatment accorded prepaid income. Under the old law payments received in advance for the use of property in future years or for services to be rendered were includable in income by the recipient in the year received.[18] This was true regardless of the method of accounting used by the taxpayer. The rule ignored the actual earning of the revenue and the period in which the related expenses were incurred. The new rule permits an election to defer the reporting of advance payments as income until the period in which, under the taxpayer's regular method of accounting, the income is earned. Limits have been placed upon the period of deferral, however, if the period within which the income is to be earned extends more than five years from the end of the taxable year in which it is received, or if the income is to be earned over an indefinite period.[19]

"Prepaid income" is defined as any amount includible in gross income which is received in connection with and is directly attributable to a liability which extends beyond the close of the year in which the amount is received.[20] It does not include any income treated as gain from the disposition of a capital asset.[21] The term "liability" means a liability to render services, furnish goods or other property or to allow the use of property.[22] It thus includes such items as prepaid rents, fees, club dues, subscriptions, and coupons among others.

The statute divides prepaid income into three classes: short period income, long period income, and indefinite period income.

[18] Brown v. Helvering, 291 U.S. 193 (1934); Chateau Frontenac v. Commissioner, 147 F.2d 856 (6th Cir. 1945); Commissioner v. Lyon, 97 F.2d 70 (9th Cir. 1938); Renwick, Trustees v. United States, 87 F.2d 123 (7th Cir. 1937); South Tacoma Motor Co.. 3 T.C. 411 (1944); E.B. Elliott Co., 45 B.T.A. 82 (1941); Automobile Underwriters, Inc., 19 B.T.A. 1160 (1930).

[19] Int. Rev. Code of 1954, § 452.

[20] Id. § 452(c)(1).

[21] Ibid.

[22] Id. § 452(c)(2).

"Short period" prepaid income is income which at the time received will be earned within five years after the year of receipt.[23] This income is to be allocated over the period when earned in accordance with the taxpayer's method of accounting.[24] The committee reports make it clear that the amount need not be spread equally, but it may all be allocated to one year,[25] if proper under the taxpayer's method of accounting. The statute also provides that if the liability with respect to the income to be accounted for should change, then any unreported portion could be reported under regulations to be prescribed.[26] Thus prepaid income which originally was to be earned over a three year period might be reported instead in the fourth, fifth, and sixth years if an act of God intervened to extend the liability beyond the term originally set out in the contract.[27]

"Long period" prepaid income is income which at the time received will not be earned within five years after the year of receipt.[28] The taxpayer may take this income into account in any manner if he obtains consent to do so from the Secretary or his delegate. In the absence of such consent the amounts must be taken into income ratably over the year of receipt and the five succeeding taxable years. The committee reports use the illustration of a taxpayer who received in the first year the last year's rent on a ten year lease.[29] If the Secretary gives his consent, then this amount could be deferred until the tenth year. If the Secretary's consent is not obtained, the amount may be spread ratably, one-sixth in the year of receipt and one-sixth in each of the next five years.

"Indefinite period" prepaid income includes income subject to a liability of indefinite duration.[30] This includes income received from car tokens, coupons, tickets, etc.[31] A taxpayer applying this section must determine from experience that portion of the prepaid income with respect to which the liability will cease by the end of the fifth year after receipt. The amount that will be earned before the end of the fifth year can be accounted for as earned in accordance with good accounting practice. The part

23 Id. § 452(a)(1).
24 Ibid.
25 Sen. Rep. No. 1622, 83d Cong., 2d Sess. 301 (1954).
26 Int. Rev. Code of 1954, 452(a)(1).
27 Sen. Rep. No. 1622, 83d Cong., 2d Sess. 301 (1954).
28 Int. Rev. Code of 1954, § 452(b).
29 Sen. Rep. No. 1622, 83d Cong., 2d Sess. 302 (1954).
30 Int. Rev. Code of 1954, § 452(a)(2).
31 Sen. Rep. No. 1622, 83d Cong., 2d Sess. 302 (1954).

to be earned after the fifth year is to be spread ratably over the six year period. The committee reports indicate that the amount of such prepaid income to be reported each year may vary as the experience of the taxpayer changes, but ordinarily no portion is to be deferred beyond the fifth year after the year of receipt.[32] The statute itself indicates, however, that if the consent of the Secretary or his delegate is obtained, then the income may be included in such proportions and for such years as are specified in such consent.[33]

If the taxpayer's liability with respect to prepaid income ends without actual performance, any unreported portion must be reported in the year liability ceases.[34] Thus if the taxpayer goes out of existence or dies, the amount deferred must be included in income for the taxable year in which such event took place. An exception to this rule is provided in certain cases involving successsor corporations.[35]

Only accrual basis taxpayers engaged in a trade or business may elect this statement of prepaid income.[36] Cash basis taxpayers must continue to report such income in the year of receipt. The election may be made without consent in the tax return for the first taxable year in which prepaid income is received beginning after December 31, 1953, and ending after August 16, 1954.[37] An election may be made at any time with the consent of the Secretary or his delegate.[38] A separate election is available with respect to each trade or business in which the taxpayer is engaged. But once an election is made for a particular trade or business, it applies to all types or classes or prepaid income with respect to that trade or business.[39]

An exception to this rule is provided for prepaid income that will be earned within twelve months from the date of receipt.[40] Such income may be reported in the year of receipt and not deferred.

The proposed temporary rules published on August 27, 1954 require that if the election to defer prepaid income can be made

32 Ibid.
33 Int. Rev. Code of 1954, § 452(a)(2).
34 Id. § 452(c),
35 Id. § 381(c)(7).
36 Id. § 452(d)(1).
37 Id. § 452(d)(3)(A).
38 Id. § 452(d)(3)(B).
39 Id. § 442(d)(2).
40 Ibid.

without consent it is to be made by a statement attached to the taxpayer's return for the first taxable year to which the election is applicable.[41] The statement is to include:

> (1) the method of accounting used by the taxpayer in the particular trade or business; (2) the nature of the prepaid income for example, "rent from real estate" or "rents and royalties;" (3) the period over which the liability exists under each class of contract; (4) the taxable years and the amounts of prepaid income to be included in gross income for each year; and (5) the method of allocation.

If any part of the prepaid income is connected with a liability of indefinite duration, that fact is to be noted under (3).

The proposed rules also state that when consent is necessary for the election, applications for consent will not be accepted before the date of promulgation of regulations. The regulations, however, will provide a reasonable period of time within which taxpayers will be permitted to apply for such consents in the case of taxable years subject to the Internal Revenue Code of 1954 which end after the enactment of the Code and before the promulgation of regulations.

III. RESERVES FOR ESTIMATED EXPENSES

Good accounting practice often requires the use of reserves for estimated expenses. Under the prior law the addition to such reserves was not allowed as a federal income tax deduction until all of the events occurred which fixed the fact and the amount of the taxpayer's liability.[42] If the amount of the expense had to be estimated, or the liability to pay it had not occurred, then no deduction was permissible.

The new Code provides that accrual basis taxpayers may deduct reasonable additions to reserves for estimated expenses.[43] The expenses must be related to income taxed during the year, except for adjustments of previously established reserves.[44] The committee reports include the following types of expenses for which reserves are permitted: cash discounts, repairs and replacements under warranty, sales returns and allowances, freight al-

[41] Temporary Rules Relating to Income Tax and Administration Matters Under Internal Revenue Code of 1954. 19 Fed. Reg. 5497 (1954).

[42] United States v. Anderson, 269 U.S. 422 (1626).

[43] Int. Rev. Code of 1954, § 462.

[44] Id. § 462(d)(1)(B).

lowances, quantity discounts, vacation pay, and certain liabilities for self-insured injury and damage claims.[45]

Expenses which may be estimated in the taxable year are those which would, but for this section, be required to be taken into account, either part or all, in a subsequent taxable year.[46] The expenses must be related to the income of the taxable year or prior years in which expenses were estimated.[47] The Secretary or his delegate must be satisfied that the expenses can be estimated with reasonable accuracy.[48] Expenses attributable to the income of future years cannot be taken into account in determining the addition to a reserve in the taxable year.[49]

Rules similar to those which have been applicable to reserves for bad debts are to be applied to these expense reserves. Thus it is specifically set forth that the addition to the reserve must be reasonable.[50] The committee reports state that a reserve is to be considered reasonable when it is based on reliable data or statistical experience of the taxpayer or of others in similar circumstances.[51] Reserves for general contingencies, for indefinite future losses, or for amounts which are in litigation or are contested do not fall into this category. Reserves with respect to prepaid income which has been deferred by the taxpayer are not permissible.[52] Also reserves may not be provided for estimated expenses incurred in connection with income taken into account in years prior to the first taxable year for which the new treatment is elected.[53]

Additions to such reserves are allowable only at the discretion of the Secretary or his delegate.[54] This is similar to the requirement with respect to reserves for bad debts. This limitation is apparently intended to prevent the deduction of extravagant claims. With respect to the similar provision relative to additions to bad debt reserves, the courts have held that the Secretary's discretion may not be exercised in an arbitrary or capricious manner.[55]

45 Sen. Rep. No. 1622, 83d Cong., 2d Sess. 306 (1954).
46 Int. Rev. Code of 1954 § 462(d)(1)(A).
47 Id. § 462(d)(1)(B).
48 Id. § 462(d)(1)(C).
49 Sen. Rep. No. 1622, 83d Cong., 2d Sess. 306 (1954).
50 Int. Rev. Code of 1954, § 462(a).
51 Sen. Rep. No. 1622, 83d Cong., 2d Sess. 63 (1954).
52 Int. Rev. Code of 1954 § 462(d)(2)(B).
53 Id. § 462(d)(2)(A).
54 Id. § 462(a).
55 Art Metal Construction Co. v. United States, 17 F. Supp. 854 (Ct. Cl. 1937); Walter H. Goodrich & Co., Inc., 40 B.T.A. 960 (1939).

If the reserves are found to be excessive at the end of any particular year, the excess amounts are to be reported as income in that year.[56]

The election to set up such reserves may be made without the Secretary's consent in the tax return for the first taxable year in which there are estimated expenses attributable to the trade or business beginning after December 31, 1953 and ending after enactment of the Code.[57] The election may be made at any time with the consent of the Secretary.[58] Once the election is made with respect to a particular trade or business, it applies to all estimated expenses of the business. The election cannot be made applicable to only one type of expense, but must be applicable to all estimated expenses. For example, if the taxpayer elects to use the provision in order to accrue vacation pay, he must also accrue cash discounts, audit fees, and similar expenses in the same manner. If the taxpayer has two or more trades or business, he need not treat them all alike, but may elect with respect to one and not the others.

The proposed rules for electing the use of reserves for estimated expenses indicate that if the election can be made without consent, it must be made not later than the time prescribed by law for filing the return for such year including extensions.[60] The election will be binding for all subsequent years and shall be made by a statement attached to the taxpayer's return for the first taxable year to which the election is applicable. The statement is to show:

> (1) the method of accounting used by the taxpayer in the particular trade or business; (2) the nature of the estimated expenses, for example, "warranties on appliances," or "guarantees on service contracts;" (3) the period over which the liability on each class of such contracts exists; and, (4) a schedule showing in detail how the amount of the estimated expenses was computed.

Applications for consent to use the reserve method, if necessary, will not be accepted until regulations are adopted. The regulations will give taxpayers a reasonable period of time to apply for such consents.

56 Int. Rev. Code of 1954 § 462(b).
57 Id. § 462(c)(3)(A).
58 Id. § 462(c)(3)(B).
59 Id. § 462(c)(2).
60 Supra note 41. at 5497, 5498.

In the year in which the reserve method is first established, taxpayers will apparently be permitted two deductions. They will receive a deduction for the actual expenses incurred, which were not deductible prior to the enactment of the 1954 code, and a deduction for expenses to be incurred in subsequent taxable years.

The addition to the reserve, nevertheless, cannot include provision for expenses attributable to income taxed in years prior to the election of the reserve method, but actually incurred subsequent to the election. Such expenses will be deductible as if the new section had not been enacted.[61]

Particular costs and expenses which are taken into account in determining the amount of an addition to a reserve are not to be considered as having been incurred prior to the time they actually take place. The addition to each reserve is allowable as a single item in one year. Therefore, a provision for service allowances or guarantees might include an allocable portion of truck depreciation. The actual depreciation on the truck and the adjustments of its basis will be taken care of as if no reserve had been used.[62]

IV. ACCRUAL OF REAL PROPERTY TAXES

Under prior law an accrual basis taxpayer was forced to accrue property taxes for the year on a date when the liability and the amount of the tax become fixed.[63] In order to select the proper date, it was often necessary to examine state statutes and actions of local officials. At times the courts, the commissioner, and the taxpayer relied on different dates. This critical date governed the accrual of taxes under the old method. Generally, the accrual basis taxpayer deducted the tax on the critical date. When he transferred the property, he could not deduct the tax if the transfer occurred before the critical date, regardless of any agreement he might have with the purchaser. Many Nebraska taxpayers were especially handicapped by this rule. Nebraska real estate taxes have been held to accrue on January 1 of the following year.[64] Consequently, a taxpayer on the calendar year basis was not entitled to accrue the tax for that calendar year.

The new rule will permit accrual basis taxpayers to elect to accrue real property taxes that are related to a period of time

[61] Int. Rev. Code of 1954, § 462(e).

[62] Sen. Rep. No. 1622, 83d Cong., 2d Sess. 306 (1954).

[63] Helvering v. Schimmel, 114 F.2d 554 (8th Cir. 1940); G.C.M. 22454, 1940-2 Cum. Bul. 210; G.C.M. 21373, 1939-2 Cum. Bul. 82.

[64] G.C.M. 22454, 1940-2 Cum. Bul. 210.

ratably over that period.[65] Rules are provided so during the transitional period the electing taxpayer cannot deduct any tax that was allowable under the 1939 code for a year beginning before January 1, 1954.[66] But during 1954 the taxpayer can deduct any real property tax related to a previous year, which under the old code would have been allowable as a deduction.[67] Nebraska taxpayers on a calendar year who are subject to the January 1st accrual date can elect the new method and deduct two years taxes in the year of change. If they change in 1954, they will be entitled to deduct the 1953 taxes which accrued on January 1, 1954, and the 1954 taxes which accrue ratably over the year 1954. If made not later than the time prescribed by law for filing the return[68] for the year in which the taxpayer incurs real property taxes, the election to accrue real property taxes ratably over the period can be made without consent for the first taxable year beginning after December 31, 1953, and ending after August 16, 1954.[69] The election may be made at any time with the consent of the Secretary or his delegate.[70]

The proposed temporary rules in respect to this election state that if the election does not require consent, the election shall be made by a statement attached to the taxpayer's return for the first taxable year to which the election is applicable.[71] The statement must show (1) the method of accounting used by the taxpayer and (2) the period of time to which the taxes are related.

Applications, if necessary, for consent to prorate real property taxes will not be accepted until after the regulations are promulgated. However, the regulations will give the taxpayer ample time to make the elections.

V. APPORTIONMENT OF REAL PROPERTY TAXES ON SALE

Although the election to accrue the taxes ratably is only available to accrual basis taxpayers, nevertheless both accrual basis and cash basis taxpayers must apportion the taxes in the event of a sale.[72] The portion of the taxes which is properly allocable to the period ending on the day before the sale is treated as a

65 Int. Rev. Code of 1954, § 461(c)(1).
66 Id. § 461(c)(2).
67 Ibid.
68 Including extensions thereof.
69 Int. Rev. Code of 1954, § 461(c)(3)(A).
70 Id. § 461 c)(3)(B).
71 Supra note 41.
72 Int. Rev. Code of 1954, § 164(d)(1).

tax imposed on the seller,[73] and the part allocable to the period beginning on the day of sale is allocable to the purchaser.[74] These rules apply irrespective of whether or not the parties themselves allocate the tax. If the parties have not allocated the tax, appropriate adjustments must be made to determine the gain or loss to the seller and the basis of the property to the buyer.[75]

Taxpayers using the cash receipts and disbursement method cannot ordinarily deduct any amount for taxes until paid.[76] A special rule provides that such a taxpayer is considered at the time of sale to have paid the portion of the tax treated as imposed on him if the other party to the sale is personally liable for the tax.[77] If neither party to the sale is personally liable for the tax, then the rule applies if the other party holds the property at the time the tax becomes a lien.[78]

Accrual basis taxpayers, who have not elected to accrue the tax ratably, are also subject to a special rule.[79] They continue to deduct the tax on the accrual date. Upon a sale of the property, they can deduct the allocable portion of the tax on that same accrual date if they own the property on that date. If they do not own the property on the accrual date, the allocable tax is deductible on the date of the sale.

If a cash basis or an accrual basis taxpayer, who has not elected the new method, has paid the tax for the year or accrued it on the accrual date, he will have a recovery on the date of sale of the portion allocable to the purchaser. The portion recovered is not treated as affecting the gain or loss on sale, but is fully taxable as ordinary income, subject to the provisions affecting recoveries of bad debts, prior taxes and delinquency amounts.[80]

It is unfortunate that the new rules, which apply to all sales of real property after December 31, 1953, apply only to sales of real property and do not affect transfers other than sales.[81]

VI. INSTALLMENT SALES

Under the old Code, the installment basis of reporting income in the case of sales of real property or the casual sales of personal

73 Id. § 164(d)(1)(A).
74 Id. § 164(d)(1)(B).
75 Id. § 1012.
76 Id. § 164(a).
77 Id. § 164(2)(A).
78 Ibid.
79 Id. § 164(2)(D).
80 H.R. Rep. No. 2543, 83d Cong., 2d Sess.28 (1954).
81 Int. Rev. Code of 1954, § 164(d)(2)(B).

property was limited to sales in which the payments in the year of sale did not exceed 30% of the selling price.[82] This was interpreted to mean that there had to be some payment received in the year of sale.[83]

The new Code permits use of the installment basis of reporting, either where there are no payments in the year of sale or where the payments do not exceed 30%.[84] The new rule applies to sales in taxable years beginning after December 31, 1953.[85]

Dispositions of installment obligations, by sale or otherwise, usually result in recognition of gain or loss measured by the difference between the selling price or fair market value of the obligation and its basis.[86] Dispositions other than by sale include gifts and distributions to stockholders, but certain intercorporate liquidations are eliminated.[87]

Unless the heirs gave a bond guaranteeing payment, the prior law required in the case of transmission at death that income on the installment obligation be reported in the final return of the decedent.[88] The need for the bond is now eliminated and the new statute requires that in all cases the heirs or others receiving payments report the income in the same manner as the decedent would have.[89]

VII. CHANGES IN ACCOUNTING METHODS

If a taxpayer desired to change his accounting methods, it was, and still is, necessary for him to obtain permission to make the change.[90] The commissioner as a requirement for his granting the permission would require the taxpayer to agree to make adjustments in the year of change in order to insure that no item, either of income or deductions, would be included twice or omitted entirely as a result of the change. These changes sometimes resulted in the bunching of income in one year.

A different situation occurred if the commissioner required a change from one basis to another because the taxpayer had been using an incorrect basis. In these cases various courts decisions

[82] Int. Rev. Code of 1939, § 44(b).
[83] U.S. Treas. Reg. 118, § 39.44(b) (1953).
[84] Int. Rev. Code of 1954, § 453(b)(2)(A).
[85] Ibid.
[86] Id. § 453(d)(1).
[87] Id. § 453(d)(4).
[88] Int. Rev. Code of 1939, § 44(d).
[89] Int. Rev. Code of 1954, § 453(d)(3).
[90] Id. § 442.

have denied the commissioner the right to require adjustments to prevent omission of income, but limited the adjustments to those necessary to correctly determine the income for the particular year.[91] In such cases the amount of sales represented by opening accounts receivable might go untaxed, and the purchase represented by the opening inventory might be deducted a second time in the year of change.

Under the new Code it will not make any difference whether the change is voluntary or involuntary.[92] In either case adjustments are to be made in the year of change in order to prevent items from being duplicated or omitted.[93] However, an exception is made with respect to adjustments based on items that were, or should have been, under the proper method of accounting, taken into account in a year to which this new provision does not apply.[94] Thus the rule with respect to Treasury forced changes prior to 1954 is applicable to all changes in 1954, whether voluntary or not. Taxpayers probably cannot take too great advantage of this however, as the Treasury still has control over whether or not it will grant approval to make a change. It would seem quite possible that the Treasury would withhold approval if the tax savings were material.

With respect to changes in 1955 or later, it is necessary to make transitional adjustments in respect of years subject to the new Code, but it is not necessary to make such adjustments in respect of years beginning before January 1, 1954.[95] This rule again applies whether the change is initiated by the taxpayer or by the Treasury.[96] The report of the Finance Committee indicates that the amount of inventory on hand at the end of the taxable year beginning in 1953 can be excluded from the inventory adjustment regardless of the identity of the items in the inventory.[97] For instance, the example refers to a calendar year corporation having an inventory of $2,500 at the beginning of the year of change and $6,000 at the end of the year. If $1,000 of the $2,500 inventory had been deducted in years prior to 1954,

91 Commissioner v. Dwyer, 203 F.2d 522 (2nd Cir. 1953); Welp v. United States, 201 F.2d 128 (8th Cir. 1953); Commissioner v. Frame, 195 F. 2d 166 (3d Cir. 1952); Commissioner v. Mnookin Estate, 184 F.2d 89 (8th Cir. 1950).

92 Int. Rev. Code of 1954, § 481(a)(1).

93 Id. § 481(a)(2).

94 Ibid.

95 Sen. Rep. No. 1622, 83d Cong., 2d Sess. 308 (1954).

96 Ibid.; Int. Rev. Code of 1954, § 481(a)(1).

97 Sen. Rep. No. 1622, 83d Cong., 2d Sess. 308, 309 (1954).

then the only adjustment to be made in the year of change would be the remaining $1,500 of the inventory. If the same principle is to be applied to other items requiring adjustment, then only the increase since the end of the taxable year beginning in 1953 needs to be taken into consideration.

Relief is provided for the bunching of income in one year if the adjustments result in an increase in taxable income of more than $3,000.[98] In order to provide this relief two limitations on the maximum amount of tax attributable to the increase are provided.

The first limitation is available only if the taxpayer had used the old accounting method for two years prior to the year of change.[99] In that case the tax attributable to the increase in taxable income resulting from the change cannot exceed the aggregate of income and excess profit taxes that would result if one-third of the increase were included in the year of change and one-third in each of the two preceding taxable years.[100]

The second method is available only if the taxpayer can establish what his taxable income for one or more consecutive years prior to the year of change[101] would have been if the new accounting method had been used in such years.[102] Where this can be done, the tax attributable to the increase in taxable income resulting from the adjustments cannot exceed the net increase in taxes that would result if the adjustments were allocable to the taxable years to which they applied under the new method of accounting and the balance, if any, to the taxable year of change.[103] A balance to be allocated to the year of change will occur only where the taxpayer cannot determine the taxable income under the new accounting method of some year beginning after December 31, 1953.

If the adjustments allocated to particular years under either method affect a net operating loss deduction or a capital loss carry-over, the effect on the year to which such loss is carried is taken into account if this year precedes the year of change.[104]

Instead of including the transitional adjustments in income

[98] Int. Rev. Code of 1954, § 481(b).
[99] Id. § 481(b)(1)(A).
[100] Id. § 481(b)(1).
[101] But beginning after December 31, 1953.
[102] Int. Rev. Code of 1954, § 481(b)(2)(B).
[103] Id. § 481(b)(2).
[104] Id. § 481(b)(3).

in the year of change, an option is provided to permit the taxpayer to take the adjustments into account in any period which is agreed upon by the taxpayer and the Secretary.[105]

Dealers in personal property who change from the accrual basis to the installment basis of reporting income cannot use this general provision.[106] In fact the new Code grants them only partial relief from the double inclusion of income required under prior law. Under the old Code the gross profit on installment sales made prior to the change and collected after the date of change was taxed twice -- on the accrual basis in the year of sale, and on the installment basis when collected.[107]

The new law continues this double inclusion of income. In the case of changes in method for taxable years beginning after December 31, 1953, the law provides an adjustment which according to the committee reports eliminates the double taxation.[108] However, the word "eliminates" is used erroneously. This adjustment is in the form of a reduction in tax for the year in which the gross profit is includable the second time.[109] The reduction is the amount of the tax attributable to the profit in the prior years[110] but not in excess of the tax attributable to the profit in the year in which it is includable the second time.[111] However, the law provides a special method of determining the amount of tax attributable to the profit in both years.[112] The amount of tax attributable to the gross profit is that percentage of the tax for the year which the gross profit bears to the total gross income. This introduction of the extraneous factor of gross income in the computation greatly reduces the amount of relief afforded. For example a corporation has a total gross income of $200,000, expenses of $175,000, and income tax of $7,500. Included in income is $10,000 of installment income previously reported in the year of accrual. The limitation on relief would be 10/200 of the tax or $375. The actual tax due to the inclusion of the $10,000 is $3,000. The relief granted in this example is barely over 10% of the tax. There does not seem to be any clue in the committee reports as to why this item was treated so inequitably as compared to the treatment afforded other adjust-

105 Id. § 481(c).
106 Id. § 481(d).
107 Int. Rev. Code of 1939, § 44(c).
108 Sen. Rep. No. 1622, 83d Cong., 2d Sess. 303 (1954).
109 Int. Rev. Code of 1954, § 453(c)(1)(B).
110 Id. § 453(c)(2)(A).
111 Id. § 453(c)(2)(B).
112 Id. § 453(c)(3).

ments resulting from changes in accounting methods.[113] Apparently this is not the year for an installment dealer to change his method of accounting.

VIII. REPAYMENT OF AMOUNTS HELD UNDER CLAIM OF RIGHT

Under prior law if a taxpayer was obliged to refund amounts which he had received in a prior period and included in income because it appeared that he had an unrestricted right to such amounts, then he could take a deduction in the year of restitution.[114] In many instances, the deduction allowable in the later year did not adequately compensate the taxpayer for the tax paid in the earlier year.[115]

If the amount so restored exceeds $3,000, the new statute permits the taxpayer to recompute the tax for the prior year by excluding from income the amount repaid.[116] The reduction in tax for the prior year may then be subtracted from the current year's tax, omitting any deduction for the restitution. Because the new method is elective, the taxpayer can use the method that saves the most tax.[117] If the reduction in tax for the prior year is larger than the tax computed for the current year, the difference will be refunded in the same manner as if there was an overpayment for such taxable year.[118]

The new rule does not apply to an item which was included in gross income by reason of the sale or other disposition of inventory or property held primarily for sale to customers.[119] However, the benefits of this new section will not be denied to refunds made by a regulated public utility, if such refunds were directed to be made by a regulatory body.[120]

IX. EMBEZZLEMENT LOSSES

Losses from theft or embezzlement have ordinarily been deductible at the time sustained.[121] Because there has been considerable uncertainty and litigation about this rule, the new statutes provide that such losses will always be deductible only in the year in which the taxpayer discovers the loss.[122]

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113 Id. § 481.
114 United States v. Lewis, 340 U. S. 590 (1951).
115 Sen. Rep. No. 1622, 83d Cong., 2d Sess. 118 (1954).
116 Int. Rev. Code of 1954, § 1341(a).
117 Ibid.
118 Int. Rev. Code of 1954, § 1341(b)(1).
119 Id. § 1341(b)(2).
120 Ibid.
121 U. S. Treas. Reg. 118, § 39.43-2 (1953).
122 Int. Rev. Code of 1954, § 165(f).
* Certified Public Accountant.