Chapter 4: Timing Rules

A. Methods of Accounting

Businesses will use a method of accounting to compute (for financial purposes) their annual profit or loss. Publicly-traded companies will have audited financial statements that follow Generally Accepted Accounting Principles ("GAAP" rules). Taxpayers are required (subject to exceptions discussed bellowed) to keep their book and records for tax purposes using the same method of accounting as they use for financial purposes. §4461(a). This applies to noncorporate taxpayers (including individuals) as well as to corporate taxpayers. A taxpayer may not change her method of accounting without the consent of the Commissioner of Internal Revenue. §446(e).

Within a method of accounting, there often are a variety of possible ways a particular item may be recorded. A taxpayer may change the way a particular item is reported without the consent of the Commissioner so long as the change does not amount to a change of accounting method. There is no clear line between an "item" and a "method." In many circumstances, the Commissioner has published in a Revenue Procedure automatic consent to certain specific changes including, for example, consent to change from an inappropriate method to an allowable method.

1. Statutory Methods of Accounting

The statute lists two basic methods of accounting, and there are several other industry-specific methods. In general, a taxpayer may choose any authorized method. However, if a taxpayer's method of accounting does not clearly reflect the taxpayer's income, the Commissioner may require the taxpayer to use a different method even if the prior method of the taxpayer was one of the generally permitted methods. §446(b). When the Commissioner asserts a challenge under §446(b) to a taxpayer's method of accounting, the burden is on the taxpayer to prove the taxpayer's method of account clearly reflects the taxpayer's income.

Subject to the rules in §§446(a) and 446(b) discussed above, a taxpayer may use any of the following methods of accounting: (a) the cash receipts and disbursements method of account, see Reg. §1.446-1(c)(1)(i), under which income is includible when actually or constructively received and deductions are claimed when actually paid; and (b) an accrual method, see Reg. §1.446-1(c)(1)(ii), under which "income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." The same "all events" test applies to the timing of deductions except one additional requirement is imposed:

economic performance (as defined in §461(h)) also must have occurred with respect to the payment obligation; and (c) any other method authorized in the Code or Regulations.[1]

Accrual accounting is considered the method of accounting most consistent with economic realty. Under accrual accounting, income is recognized when earned. For service income, it is earned when the services are performed; for goods, the purchase price is earned when the goods are delivered. To be sure, some modest allowance should be made for possibility of default, but because almost all payment obligations are satisfied, it is reasonable for accrual accounting to ignore any risk of nonpayment and to account for that event (if it occurs) separately.[2] Cash method accounting, on the other hand, generally ignores income generation in favor of payment receipts. As a result, it often can be easy for a taxpayer to manipulate the timing of income and deductions.

2. Accrual Accounting

United States v. General Dynamics Corp.

481 U.S. 23 (1987)

JUSTICE MARSHALL delivered the opinion of the Court.

The issue in this case is whether an accrual-basis taxpayer providing medical benefits to its employees may deduct at the close of the taxable year an estimate of its obligation to pay for medical care obtained by employees or their qualified dependents during the final quarter of the year, claims for which have not been reported to the employer.

I

. . . . General Dynamics uses the accrual method of accounting for federal tax purposes; its fiscal year is the same as the calendar year. From 1962 until October 1, 1972, General Dynamics purchased group medical insurance for its employees and their qualified dependents from two private insurance carriers. Beginning in October 1972, General Dynamics became a self-insurer with regard to its medical care plans. Instead of continuing to purchase insurance from outside carriers, it undertook to pay medical claims out of its own funds, while continuing to employ private carriers to administer the medical care plans.

To receive reimbursement of expenses for covered medical services, respondent's employees submit claims forms to employee benefits personnel, who verify that the treated persons were eligible under the applicable plan as of the time of treatment. Eligible claims are then forwarded to the plan's administrators. Claims processors review the claims and approve for payment those expenses that are covered under the plan.

[1] E.g., §455 (prepaid subscription income.

[2] See §166 (bad debt deduction).

Because the processing of claims takes time, and because employees do not always file their claims immediately, there is a delay between the provision of medical services and payment by General Dynamics. To account for this time lag, General Dynamics established reserve accounts to reflect its liability for medical care received, but still not paid for, as of December 31, 1972. It estimated the amount of those reserves with the assistance of its former insurance carriers.

Originally, General Dynamics did not deduct any portion of this reserve in computing its tax for 1972. In 1977, however, after the Internal Revenue Service (IRS) began an audit of its 1972 tax return, General Dynamics filed an amended return, claiming it was entitled to deduct its reserve as an accrued expense, and seeking a refund. The IRS disallowed the deduction, and General Dynamics sought relief in the Claims Court.

The Claims Court sustained the deduction, holding that it satisfied the "all events" test since "all events" which determined the fact of liability had taken place when the employees received covered services, and the amount of liability could be determined with reasonable accuracy. Thus, the court held that General Dynamics was entitled to a refund. The Court of Appeals for the Federal Circuit affirmed, largely on the basis of the Claims Court opinion.

The United States sought review of the question whether all the events necessary to fix liability had occurred. We reverse.

II

As we noted in *United States v. Hughes Properties, Inc., 476 U.S. 593, 600 (1986),* whether a business expense has been "incurred" so as to entitle an accrual-basis taxpayer to deduct it under §162(a) is governed by the "all events" test . . . . The test is now embodied in Treas. Reg. §1.461-1(a)(2), which provides that "under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy."

. . . . Section 461(h) does not apply in this case. . . .

It is fundamental to the "all events" test that, although expenses may be deductible before they have become due and payable, liability must first be firmly established. Nor may a taxpayer deduct an estimate of an anticipated expense, no matter how statistically certain, if it is based on events that have not occurred by the close of the taxable year. Brown v. Helvering, *291 U.S. 193, 201 (1934);* cf. American Automobile Assn. v. United States*, 367 U.S. 687, 693 (1961).*

We think that this case, like *Brown*, involves a mere estimate of liability based on events that had not occurred before the close of the taxable year, and therefore the proposed deduction does not pass the "all events" test. We disagree with the legal conclusion of the courts below that the last event necessary to fix the taxpayer's liability was the receipt of medical care by covered individuals. A person covered by a plan could only obtain payment for medical services by filling out and submitting a health-expense-benefits claim form. Employees were informed that submission of satisfactory proof of the charges claimed would be necessary to obtain payment

under the plans. General Dynamics was thus liable to pay for covered medical services only if properly documented claims forms were filed. Some covered individuals, through oversight, procrastination, confusion over the coverage provided, or fear of disclosure to the employer of the extent or nature of the services received, might not file claims for reimbursement to which they are plainly entitled. Such filing is not a mere technicality. It is crucial to the establishment of liability on the part of the taxpayer. Nor does the failure to file a claim represent the type of "extremely remote and speculative possibility" that we held in *Hughes, 476 U.S., at 601,* did not render an otherwise fixed liability contingent. Mere receipt of services for which, in some instances, claims will not be submitted does not, in our judgment, constitute the last link in the chain of events creating liability for purposes of the "all events" test.

The parties stipulated in this case that as of December 31, 1972, the taxpayer had not received all claims for medical treatment services rendered in 1972, and that some claims had been filed for services rendered in 1972 that had not been processed. The record does not reflect which portion of the claims against General Dynamics for medical care had been filed but not yet processed and which portion had not even been filed at the close of the 1972 tax year. The taxpayer has the burden of proving its entitlement to a deduction Here, respondent made no showing that, as of December 31, 1972, it knew of specific claims which had been filed but which it had not yet processed. Because the taxpayer failed to demonstrate that any of the deducted reserve represented claims for which its liability was firmly established as of the close of 1972, all the events necessary to establish liability were not shown to have occurred, and therefore no deduction was permissible.

This is not to say that the taxpayer was unable to forecast how many claims would be filed for medical care received during this period and estimate the liability that would arise from those claims. Based on actuarial data, General Dynamics may have been able to make a reasonable estimate of how many claims would be filed for the last quarter of 1972. But that alone does not justify a deduction. In *Brown*, supra, the taxpayer, a general agent for insurance companies, sought to take a deduction for a reserve representing estimated liability for premiums to be returned on the percentage of insurance policies it anticipated would be cancelled in future years. The agent may well have been capable of estimating with a reasonable degree of accuracy the ratio of cancellation refunds to premiums already paid and establishing its reserve accordingly. Despite the "strong probability that many of the policies written during the taxable year" would be cancelled the Court held that "no liability accrues during the taxable year on account of cancellations which it is expected may occur in future years, since the events necessary to create the liability do not occur during the taxable year." A reserve based on the proposition that a particular set of events is likely to occur in the future may be an appropriate conservative accounting measure, but does not warrant a tax deduction.

That these estimated claims were not intended to fall within the "all events" test is further demonstrated by the fact that the Internal Revenue Code specifically permits insurance companies to deduct additions to reserves for such "incurred but not reported" (IBNR) claims. See *26 U. S. C. § 832*(b)(5) (providing that an insurance

company may treat as losses incurred "all unpaid losses outstanding at the end of the taxable year"); § 832(c)(4) (permitting deduction of losses incurred as defined in § 832(b)(5)). If the "all events" test permitted the deduction of an estimated reserve representing claims that were actuarially likely but not yet reported, Congress would not have needed to maintain an explicit provision that insurance companies could deduct such reserves.

General Dynamics did not show that its liability as to any medical care claims was firmly established as of the close of the 1972 tax year, and is therefore entitled to no deduction. The judgment of the Court of Appeals is

Reversed.

JUSTICE O'CONNOR, with whom JUSTICE BLACKMUN and JUSTICE STEVENS join, dissenting.

Section 446(a) of the Internal Revenue Code of 1954 provides that taxable income "shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." The Code specifically recognizes the use of "an accrual method,"*§ 446*(c)(2), under which a taxpayer is permitted to deduct an expense in the year in which it is "incurred," regardless of when it is actually paid. § 162(a). Under the "all events" test, long applied by this Court and the Internal Revenue Service, an expense may be accrued and deducted when all the events that determine the fact of liability have occurred, and the amount of the liability can be determined with reasonable accuracy. Treas. Reg. § 1.461-1. Because the Court today applies a rigid version of the "all events" test that retreats from our most recent application of that test, and unnecessarily drives a greater wedge between tax and financial accounting methods, I respectfully dissent.

This case calls for the Court to revisit the issue addressed only last Term in United States v. Hughes Properties, Inc., 476 U.S. 593 (1986). At issue in *Hughes Properties* was whether a casino operator utilizing the accrual method of accounting could deduct amounts guaranteed for payment on "progressive" slot machines but not yet won by a playing patron. A progressive slot machine has a jackpot whose size increases as money is gambled on the machine. Under Nevada law, a casino operator is prohibited from reducing the amount of the progressive jackpot. We concluded, therefore, that all the events had occurred that determine the fact of the casino operator's liability despite the fact that the jackpot might not be won for as long as four years. We rejected the argument made by the United States that the casino operator's obligation to pay the jackpot arose only upon a winning patron's pull of the handle, even though it was conceivable that the jackpot might never be won:

"There is always a possibility, of course, that a casino may go out of business, or surrender or lose its license, or go into bankruptcy, with the result that the amounts shown on the jackpot indicators would never be won by playing patrons. But this potential nonpayment of an incurred liability exists for every business that uses an accrual method, and it does not prevent accrual. . . .

In my view, the circumstances of this case differ little from those in *Hughes Properties*. The taxpayer here is seeking to deduct the amounts reserved to pay for medical

services that are determined to have been provided to employees in the taxable year, whether or not the employees' claims for benefits have been received. The taxpayer's various medical benefits plans provided schedules for the medical and hospital benefits, and created a contractual obligation by the taxpayer to pay for the covered services upon presentation of a claim. The courts below found that the obligation to pay became fixed once the covered medical services were received by the employee. Once the medical services were rendered to an employee while the relevant benefit plan was in effect, General Dynamics could not avoid liability by terminating the plan prior to the filing of a claim. Neither could General Dynamics extinguish its liability by firing an employee before the employee filed a claim for benefits.

It is true, of course, that it was theoretically possible that some employees might not file claim forms. In my view, however, this speculative possibility of nonpayment differs not at all from the speculation in *Hughes Properties* that a jackpot might never be paid by a casino. As we observed in *Hughes Properties*, the potential of nonpayment of a liability always exists, and it alone does not prevent accrual. The beneficiary of a liability always has the option of waiving payment, but a taxpayer is still unquestionably entitled to deduct the liability. An injured employee entitled absolutely to reimbursement for medical services under a workers' compensation statute, for example, may fail to utilize the medical services. The employer, however, has been held to be entitled to deduct the expected medical expenses because the workers' compensation law creates liability. Similarly, any business liability could ultimately be discharged in bankruptcy, or a check might never be cashed by its recipient. There can be no doubt, however, that these remote possibilities alone cannot defeat an accrual basis taxpayer's right to deduct the liability when incurred.

. . . .

The holding of the Court today unnecessarily burdens taxpayers by further expanding the difference between tax and business accounting methods without a compelling reason to do so. Obviously, tax accounting principles must often differ from those of business accounting. The goal of business accounting "is to provide useful and pertinent information to management, shareholders, and creditors," while "the responsibility of the Internal Revenue Service is to protect the public fisc." United States v. Hughes Properties, Inc., 476 U.S., at 603. Therefore, while prudent businesses will accrue expenses that are merely reasonably foreseeable, for tax purposes the liability must be fixed. But Congress has expressly permitted taxpayers to use the accrual method of accounting, and the "all events" test has been a practical adjustment of the competing interests in permitting accrual accounting and protecting the public fisc. Unfortunately, the Court today ignores the pragmatic roots of the "all events" test and instead applies it in an essentially mechanistic and wholly unrealistic manner. Because the liability in this case was fixed with no less certainty than the range of expenses both routinely accrued by accrual method taxpayers and approved as deductible for tax purposes by this Court and other courts in a variety of circumstances, I respectfully dissent.

Notes

1. The Hughes Properties *Case*. *General Dynamics* was decided shortly after *Hughes Properties*. In that case, the taxpayer owned progressive slot machines whose jackpots increased with every lost wager until some patron won. Under applicable state law, the amount showing on the fact of a progressive slot machine cannot be returned to the owner of the machine: in effect, it is credited to the account of an unknown gambler whose identity is discovered inly when the winning pull is made. The taxpayer sought to deduct the amounts displayed on its progressive slot machines at the stroke of midnight on the last day of its taxable year because the amounts then displayed were beyond its control and in all events would have to be paid out. The government argued that until each progressive jackpot was won, the funds stored in the slot machine belonged to the owner and so could not be deducted. The Court held for the taxpayer on the theory that despite not knowing when the jackpots would be paid nor to whom the jackpots would be paid, the amounts displayed on the progressive slot machines represented fixed rather than contingent obligations and so should be accrued. Note that the second part of the all events test, namely that the amount could be displayed with reasonable accuracy, was not in dispute because the amount was publicly displayed on each progressive slot machine.

2. The General Dynamics *Case.* If *General Dynamics* seems significantly different from *Hughes Properties*, it is because as of the close of the taxpayer's taxable year, it could not know with certainty the dollar amount of medical claims it would have to pay. To be sure, amounts accrued during the taxable year represented services by medial providers rendered during the taxable year, and the cost of such services should be easy for the taxpayer to establish once it learned of the services. But because those services were rendered by third parties, until the claims were submitted for payment, the taxpayer really had no way of knowing its exposure. Accordingly, many people anticipated that General Dynamics would turn on the hurdle that accrual cannot take place prior to the taxpayer's ability to determine the amount of the deduction with reasonable accuracy.

But that was not the basis for the Court's opinion because, much to the surprise of most Court watchers, the government conceded on brief that this part of the all events test had been satisfied. And so the only issue before the Court was whether all the events had occurred that fixed the taxpayer's obligation to make the medical reimbursement payments. Because the services had been provided in full prior to the end of the taxable year and the taxpayer had an unconditional obligation to pay for those services once its employees filed their claim forms, it seems accrual was appropriate.

So why did the taxpayer lose? Was it because a few employees might forget to file their claims? Accrual accounting generally does not wait for a creditor to submit an invoice before accrual of a claim is allowed. Why did General Dynamics lose? The Court wrote:

> General Dynamics was thus liable to pay for covered medical services only if properly documented claims forms were filed. Some covered individuals, through oversight, procrastination, confusion over the coverage provided, or fear of disclosure to the employer of the extent or

> nature of the services received, might not file claims for reimbursement to which they are plainly entitled. Such filing is not a mere technicality. It is crucial to the establishment of liability on the part of the taxpayer.

Is this really the basis for the Court's conclusion? Can we put the shoe on the other foot and argue that a taxpayer need not accrue income until it files all claim forms that represent conditions precedent to the right to be paid?

In a later part of the opinion, the Court said:

> It is fundamental to the "all events" test that, although expenses may be deductible before they have become due and payable, liability must first be firmly established. Nor may a taxpayer deduct an estimate of an anticipated expense, no matter how statistically certain, if it is based on events that have not occurred by the close of the taxable year.
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> . . . .
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> A reserve based on the proposition that a particular set of events is likely to occur in the future may be an appropriate conservative accounting measure, but does not warrant a tax deduction.

While General Dynamics ultimately would be able to determine how much it owed for health services provided in each prior year, at the close of each year it could only guess at that amount. Recall that the taxpayer neither received nor provided the services itself. Accordingly, it had no real way of knowing the extent of the health services that had been provided. Has the Court imported the "reasonable accuracy" portion of the all events test into the "all events" portion of the all events test?

3. Accrual of Prepaid Income. The Supreme Court decided three related cases involving accrual accounting of prepaid income: American Automobile Club of Michigan, 353 U.S. 180 (1957), American Automobile Ass'n v. United States, 367 U.S. 687 (1961), and Schlude v. Commissioner, 372 U.S. 128 (1963). In each case, the taxpayer received prepayment for services to be rendered in the future, and the taxpayer argued that it did not have to accrue the income until the services had been rendered. For example, in the first two cases the taxpayer received payment of dues representing one year of membership in the taxpayer's automobile club. Memberships were sold continuously throughout the year so that virtually all of the memberships would include part of the year in which the membership was sold and part of the succeeding year.

In the *Michigan* case, the taxpayer argued that it should recognize the membership income in both the current and succeeding year based upon the number of months in each year covered by the membership term. But the Supreme Court rejected that argument, saying that the membership income was for services to be rendered by the taxpayer including travel advice and towing services, and that "substantially all services are performed only upon a member's demand and the taxpayer's performance was not related to fixed dates." 353 U.S. 180, 189 n.20. In *Michigan*, the taxpayer made no

showing how often and during what times of the year it was called upon to perform its services.

In the *AAA* case, the taxpayer essentially repeated the arguments made in *Michigan* but included in the record expert testimony showing that its method of account was consistent with generally accepted accounting standards and it introduced evidence detailing the costs it incurred and as well as the time periods when those costs generally arose. And yet the Court again rejected the taxpayer's argument, this time saying that the taxpayer's method of accounting

> [D]efers receipt, as earned income, of dues to a taxable period in which no, some, or all of the services paid for by those dues may or may not be rendered. The Code exacts its revenue from the individual member's dues which, no one disputes, constitutes income. When their receipt as earned income is recognized ratable over two calendar years, without regard to corresponding fixed individual expense or performance justification, but consistently with overall experience, their accounting doubtless presents a rather accurate image of the total financial structure, but fails to respect the criteria of annual tax accounting and may be rejected by the Commissioner.

Note that while the taxpayer in these cases deducted the costs associated with its membership obligations in the year in which the services were performed, its method of accounting might have permitted it to defer some of the related income until the succeeding year.

In *Schlude*, the Court considered a dance studio operator who deferred recognition of income allocable to dance lessons that had been prepaid but not requested by the end of the taxable year. If a customer prepaid for a group of 40 lessons over a three-year period, the taxpayer recognized one-fortieth of the income per lesson, with any unrecognized income fully recognized upon expiration of the term of the contract. The record in the case indicated that it was common for many contracts to expire before all the lessons had been claimed and that the taxpayer often paid a commission to the instructor who sold a contract, and that commission was deducted immediately rather than allocated across the term of the contract. Once again, the Court held for the government and demanded immediate recognition of the income.[3]

4. The Requirement of Economic Performance. In a number of cases, accrual method taxpayer claimed deductions for amounts that would have to be paid only in the distant future. For example, Mooney Aircraft issued a "Mooney Bond" to the purchaser of each new aircraft entitling the holder to a payment of $1,000 when the airplane was decommissioned. This was Mooney's way of assuring prospective purchasers that the planes would last a long time because if the bond had to be paid quickly, its present value would be significant (the Mooney bonds were issued in the early 1960s). Mooney deducted $1,000 per bond as soon as the bond was issued on the theory that all the

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[3] Congress ultimately sided with the taxpayers. §455 (prepaid subscription income).

events had occurred that established Mooney's obligation (someday) to pay $1,000 and the amount could be determined with reasonable accuracy.

What is the conceptually proper way to account for a future obligation such as the Mooney bond? In the year of issue, the issuer should deduct only the present discounted value of the bond. And then each year after issuance, it should deduct the increase in the present value of the bond. As a result, the entire $1,000 would be deducted over the life of the bond.[4] The court held that while accrual was proper under the all events test because there was no dispute that the bonds would have to be paid but only as to when they would be paid, the court also concluded that allowing an immediate deduction for the face value of the bonds would not clearly reflect the taxpayer's income. Mooney Aircraft, Inc. v. United States, 420 F.2d 400 (5th Cir. 1970).

Congress ultimately spoke to this issue, enacted §461(h) in 1984. Under §461(h), a deduction incurred by an accrual taxpayer will not be treated as satisfying the all events test until "economic performance" has occurred. The statute divides the time when economic performance occurs into three categories.

If the deduction arises in connection with services or property provided to the taxpayer, economic performance occurs when the services are (or property is) provided to the taxpayer. §461(h)(2)(A). If the taxpayer will use but acquire the property, then economic performance occurs as the taxpayer uses the property. §461(h)(2)(A)(iii). If the deduction arises in connection with services or property provided by the taxpayer, then economic performance occurs when the services are (or the property is) provided by the taxpayer. §461(h)(2)(B). And for deductions arising out of tortious activity or a workers compensation claim, economic performance occurs as the taxpayer makes payments ion the claim. §461(h)(2)(C).

While there is not an "economic performance" test for accrual of income, there is something similar for taxpayers that prepare financial statements (as described in §451(b)(3)): in general, the all events test for reporting income is treated as occurring no later than when the income is includible for financial reporting purposes. §451(b)(1). Of course, to the extent specific accounting treatment is provided by statute, such treatment can preempt this rule, see §451(b)(2).

5. Should Deposits Be Accrued? In Commissioner v. Indianapolis Power & Light Co., 493 U.S. 203 (1990), the Supreme Court addressed the issue raised when an accrual taxpayer received deposits from its customers to ensure future payments. Under the terms applicable to Indianapolis Power & Light Co. customers, deposits would be refunded or applied against the customer's account if payments were made on time for a set number

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[4] Of course, if Mooney Aircraft had placed the present discounted value of the bond in a savings vehicle, it would be taxed each year as the savings grew, just offsetting the deduction described in the text. As a result, the net deduction to Mooney Aircraft would be only the present discounted value of the bond, just as if it paid that amount initially to the purchaser of the aircraft and the purchaser than invested those funds in a savings vehicle. That is, the true measure of the cost of the Mooney Bond to Mooney Aircraft is only the initial present discounted value of the bond. See Ford Motor Co. v. Commissioner, 71 F.3d 209 (6th Cir. 1995)

of years. If the account was closed while in good standing, the deposit would be refunded as well. The company would retain the deposit and use it against current charges only if the customer failed to fully pay its monthly obligations to the company. And in all events the company would credit interest to the customer's account based on the amount of the deposit while it was held by the company. The Supreme Court held that the deposit did not constitute income to the accrual taxpayer because the deposit would have to be returned to the customer if the customer demanded repayment. Thus, the deposit was distinguishable from an advance payment which the recipient would keep in all events and apply at some point to the customer's account.

Questions

1. T, an accrual basis taxpayer, is a movie producer. Under union rules, every production of a feature film must employ the services of 5 post-production film editors for a minimum of 2 weeks per editor. The minimum wage for a post-production film editor is $1,000 per week. When may T deduct the $10,000 minimum cost of post-production film editing?

2. N operates nuclear power plants. Under federal law, N is required to incur the $10,000,000 cost of decommissioning the power plant after it serves its useful life of 15-20 years. When may N deduct the decommissioning cost, assuming it signs a contract for commissioning with a third party when the plant is first operated?

3. When would the Mooney Aircraft Company be entitled to deduct the liability represented by its Mooney bond, assuming the §461(h) applied to the liability?

4. Can a taxpayer accelerate its deduction by prepaying deductible liabilities prior to the time the obligation accrues? See Reg. §1.461-4(d)(7) example 1(ii)).

5. If you are advising a landlord, would you recommend that the residential lease provide that a tenant prepay first and last month's rent as a condition to taking position or that a tenant prepay only the first month's rent and provide a security deposit equal to one month's rent that will be refunded if all rent obligations are made in a timely fashion and no damage is made to the rented unit?

3. The Cash Receipts and Disbursements Method

Amend v. Commissioner

13 T.C. 178 (1949)

Findings of Fact

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From 1942 to 1946, inclusive, petitioner, a wheat farmer, annually contracted to sell a portion of his wheat in one year for delivery and payment in January of the subsequent year. . . .

At the time the contract was made in each of the five transactions, the purchaser either had the grains in storage or received them prior to January 1, pursuant to a contemporaneous agreement as to shipping date. Under the terms of the contract made in each of the five transactions, petitioner was to receive his money for the wheat in January of the year following the contract of sale. The contracts of sale in each year were oral. These contracts were bona fide arm's-length transactions between the seller and the buyer.

Petitioner did not attempt to obtain payment, nor was it represented to him or his attorney in fact that he could obtain payment, prior to January of the following year under the contract made in each of the five transactions. The parties traded upon a "flat price" in each of the above five transactions, without any agreement for payment of storage.

The price of wheat for January delivery was determined by agreement between the parties. A price is not posted for January delivery in the grain business as the grain exchanges do not provide January as a delivery month on future contracts.

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Opinion

BLACK, JUDGE:

We have two taxable years before us for decision, 1944 and 1946. The year 1945 is not before us because the Commissioner has determined an overassessment as to each petitioner for that year.

In each of the taxable years there is one common issue and that is whether the doctrine of constructive receipt should be applied to certain payments which petitioner received from the sale of his wheat. There is no controversy as to the amounts which petitioner received or as to the time when he actually received them. Petitioners, being on the cash basis, returned these amounts as part of their gross income in the years when petitioner actually received them. As heretofore explained, the Commissioner has refused to accept petitioner's treatment of the payments and has applied the doctrine of constructive receipt and determined that such amounts were income of the prior years. . . .

In discussing the situation which we have in the instant case, we turn our attention first to the contract of sale which petitioner made of his 1944 wheat crop to Burrus. The testimony was that 1944 was a bumper wheat crop year and that petitioner produced and harvested about 30,000 bushels, some of which was lying out on the ground and some of which was stored on the farm. Petitioner, through his attorney in fact, Paul Higgs, sold this wheat to Burrus for January 1945 delivery at $1.57 per bushel. It was the understanding that petitioner would ship his wheat to Burrus at once and that Burrus would pay him for it in January of the following year. The contract was carried out. Some time during the month of August 1944, after August 2, petitioner shipped the 30,000 bushels to Burrus. Burrus received it, put it in its elevator, and paid petitioner for it by check dated January 17, 1945.

Respondent's contention seems to be based primarily on the fact that petitioner could have sold Burrus the wheat at the same price for immediate cash payment in August 1944 and that although he did not do so, he should be treated in the same manner as if he had and the doctrine of constructive receipt should be applied to the payments received. We do not think the doctrine of constructive receipt goes that far. Porter Holmes, who was the manager of the Burrus Panhandle Elevator in Amarillo at the time of the 1944 transaction, testified at the hearing. He testified that it was the usual custom of Burrus to pay cash for wheat soon after it was delivered and that the transaction between Burrus and petitioner for January 1945 delivery and settlement was unusual and that he telephoned the manager at Dallas, Texas, for authority to make the deal that way and secured such authority and the deal was made. He testified that when Burrus' check for $40,164.08 was mailed to petitioner January 17, 1945, it was done in pursuance of the contract. So far as we can see from the evidence, petitioner had no legal right to demand and receive his money from the sale of his 1944 wheat until in January 1945. Both petitioner and Burrus understood that to be the contract. . . .

The Commissioner . . . is contending is that petitioner had the unqualified right to receive his money for the wheat in 1944; that all he had to do to receive his money was to ask for it; and that, therefore, the doctrine of constructive receipt applies . . . .

For reasons already stated, we do not think the Commissioner's determination to this effect can be sustained. If petitioner had begun this method of selling his wheat in 1944, when he had a bumper crop, there might be reason to doubt the *bona fides* of the contract, but what we have said about the 1944 transaction between Burrus and petitioner is based upon the finding that the contract between Burrus and petitioner was bona fide in all respects . . . .,

Petitioner, in each of the years before us, returned as a part of his gross income the checks which he actually received in payment for his wheat. This being so, we think he complied with the income tax laws governing a taxpayer who keeps his accounts and makes his returns on the cash basis.

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Decisions will be entered under Rule 50.

Pulsifer v. Commissioner

64 T.C. 245 (1975)

HALL, JUDGE:

Respondent determined a deficiency of $2,449.41 against each of the three petitioners for 1969. The sole issue for decision is whether petitioners, who were minors in 1969, must include in gross income in 1969 their winnings from the 1969 Irish Hospital Sweepstakes which were deposited with the Irish court.

Findings of Facts

All of the facts have been stipulated and are so found.

The petitioners, Stephen W. Pulsifer, Susan M. Pulsifer, and Thomas O. Pulsifer, are brothers and sister who lived in Medford, Mass., when they filed their petitions. They filed their 1969 Federal income tax returns, using a cash receipts and disbursements accounting method, with the Internal Revenue Service Center, Andover, Mass. They are the minor children of Gordon F. Pulsifer and Theodora T. Pulsifer of Medford, Mass., who together are petitioners' counsel herein.

Mr. Pulsifer acquired an Irish Hospital Sweepstakes ticket in his name and the names of his three minor children. On March 21, 1969, he and petitioners received a telegram from the Hospital Trust advising them that their ticket would be represented by Saratoga Skiddy, a horse which would run on their behalf in the Lincolnshire Handicap. Saratoga Skiddy placed second, winning $48,000.

When he applied for the winnings, Mr. Pulsifer was advised that three-fourths of the amount would not be released to him because the ticket stub reflected three minor coowners. He was further advised that, pursuant to Irish law, the withheld portion together with interest earned to date would be deposited with the Bank of Ireland at interest to the account of the Accountant of the Courts of Justice for the benefit of each of the petitioners. The money would not be released until petitioners reached 21 or until application on their behalf was made by an appropriate party to the Irish court for release of the funds. Mr. Pulsifer was sent his share of the prize.

The amounts paid over and credited to each of the petitioners were principal of $11,925 plus interest of $250.03, or $12,175.03. Mr. Pulsifer, as petitioners' next friend and legal guardian, has since filed for release of those funds, and he has an absolute right to obtain them.

Opinion

Both parties agree the prize money is income to the petitioners. The only question is in what year must it be included in income. Petitioners contend that they should not be required to recognize the Irish Hospital Sweepstakes winnings held for them by the Irish court in 1969. They reason that neither the constructive-receipt nor the economic-benefit doctrines apply, and that all they had in 1969 was a nonassignable chose in action. Respondent argues that the economic-benefit doctrine applies, thereby dictating recognition of the prize money in 1969. . . . We agree with respondent.

Under the economic-benefit theory, an individual on the cash receipts and disbursements method of accounting is currently taxable on the economic and financial benefit derived from the absolute right to income in the form of a fund which has been irrevocably set aside for him in trust and is beyond the reach of the payor's debtors. *E. T. Sproull,* 16 T.C. 244 (1951), affd. per curiam 194 F. 2d 541 (6th Cir. 1952). Petitioners had an absolute, nonforfeitable right to their winnings on deposit with the Irish court. The money had been irrevocably set aside for their sole benefit. All that was needed to receive the money was for their legal representative to apply for the funds, which he forthwith did. See *Orlando v. Earl of Fingall,* Irish Reports 281 (1940). We agree with respondent that this case falls within the legal analysis set out in *E. T. Sproull, supra.*

In the *Sproull* case the employer-corporation unilaterally and irrevocably transferred $10,500 into a trust in 1945 for taxpayer's sole benefit in consideration for prior services. In 1946 and 1947, pursuant to the trust document, the corpus was paid in its entirety to taxpayer. In the event of his death the funds were to have been paid to his administrator, executor, or heirs. The Court held that the entire $10,500 was taxable in 1945 because Sproull derived an economic benefit from it in 1945. The employer had made an irrevocable transfer to the trust, relinquishing all control. Sproull was given an absolute right to the funds which were to be applied for his sole benefit. The funds were beyond the reach of the employer's creditors. Sproull's right to those funds was not contingent, and the trust agreement did not contain any restrictions on his right to assign or otherwise dispose of that interest.

The record does not show whether the right to the funds held by the Bank of Ireland was assignable. Petitioner claims they were not, but cites no authority for his position. However, the result is the same whether or not the right to the funds is assignable. See *Renton K. Brodie,* 1 T.C. 275 (1942) (deferred annuity contract held currently taxable even though nonassignable and without surrender value).

In order to reflect our conclusion,

Decisions will be entered for the respondent.

Notes

1. *The Economic Benefit Doctrine*. In *Pulsiver*, there was no actual receipt and the court was willing to assume there was no constructive receipt. Nevertheless, the court required recognition of the income under the "economic benefit doctrine." That doctrine provides that a cash-basis taxpayer must recognize income if it is paid to a third party on behalf of the taxpayer and is beyond the reach of the transferor's creditors.

The virtue of cash accounting is its simplicity: when a payor transfers funds to a payee, it generally is easy to determine (a) the time the payment occurs, (b) the amount of the payment, and (c) that the transfer will not be called off. Does the economic benefit doctrine offer these benefits? Cash accounting also offers the administrative benefit that taxation arises when the taxpayer receives funds (and so can pay the resulting tax liability). The economic benefit doctrine plainly does not offer this advantage.

Questions

1. T, using the cash receipts and disbursement method of accounting, agrees to dig a swimming pool for R, with T to be paid $20,000 in one year. When does T recognize the income?

2. T, using the cash receipts and disbursement method of accounting, agrees to dig a swimming pool for R, and R pays T $20,000 immediately. T does not cash or negotiate the check for one year. When does T recognize the income?

3. T, using the cash receipts and disbursement method of accounting, agrees to dig R a swimming pool in exchange for 1 one-year certificate of deposit worth $22,000 at

maturity. The CD is immediately given to T and T can sell it, but no one can cash it in until maturity. When does T recognize the income and what is the amount?

4. T, using the cash receipts and disbursement method of accounting, agrees to dig R a swimming pool in exchange for $20,000 placed in an interest-bearing account. T cannot sell the account or borrow against it, and the account matures in one year. When does T recognize the income?

5. In questions 1 – 4, when would T recognize the income if T were an accrual taxpayer?

Notes

1. *Paying deductible expenses with borrowed funds.* Can a cash-method taxpayer deduct when paid an expenditure described in §162 if the payments is made with borrowed funds? Yes. Note that given the creditor a note is not treated as "payment" for cash-method taxpayers. Thus, the debtor can borrow from anyone *other than* the creditor and get an immediate deduction.

Can a tax-method taxpayer deduct an expenditure at Office Depot if paid with a MasterCard? Yes. What if payment is made by an Office Depot credit card? No. Why the difference? Because when the taxpayer uses a MasterCard, Office Depot is paid immediately by the issuing bank and the taxpayer becomes a debtor of the issuing bank. Thus, the taxpayer has paid immediately with borrowed funds. Note: a cash-method taxpayer is entitled to claim a deduction paid by check when the check is mailed to the payee (assuming the check is paid in due course). Rev. Proc. 92-71, 1972-2 C.B. 437.

2. *Taxation of lottery winnings*. The purchaser of a lottery ticket is given the choice, if the ticket wins, of receiving payment as a lump-sum or as an annuity. This election must be irrevocably made prior to the date of the lottery. Why? Because if the owner of the winning ticket has the ability to receive the lump-sum and then elects annuity payments, the owner of the winning ticket will have constrictive receipt of the lump sum and so will be taxed immediately. To avoid that result, the choice must be made before the ticket wins and the choice must be irrevocable. Note that §451(h) now permits the election to be made after winning.

3. *Limitations on use of cash accounting.* Under some circumstances, a taxpayer is precluded from using cash accounting. Under §448, most corporations, partnerships having a corporate partner, and tax shelters (defined in §448(d)(3)) must use accrual accounting. §448(a). In addition, sellers of inventory must use accrual accounting. Note, though, that if a taxpayer is engaged in two or more trades or businesses, she may use different methods of accounting for each business. §446(d).

4. Clear Reflection of Income

Thor Power Tool Co. v. Commissioner

439 U.S. 522 (1979)

MR. JUSTICE BLACKMUN delivered the opinion of the Court.

. . . .

I

The Inventory Issue

A

Taxpayer is a Delaware corporation with principal place of business in Illinois. It manufactures hand-held power tools, parts and accessories, and rubber products. At its various plants and service branches, Thor maintains inventories of raw materials, work-in-process, finished parts and accessories, and completed tools. At all times relevant, Thor has used, both for financial accounting and for income tax purposes, the "lower of cost or market" method of valuing inventories.

Thor's tools typically contain from 50 to 200 parts, each of which taxpayer stocks to meet demand for replacements. Because of the difficulty, at the time of manufacture, of predicting the future demand for various parts, taxpayer produced liberal quantities of each part to avoid subsequent production runs. Additional runs entail costly retooling and result in delays in filling orders.

In 1960, Thor instituted a procedure for writing down the inventory value of replacement parts and accessories for tool models it no longer produced. It created an inventory contra-account and credited that account with 10% of each part's cost for each year since production of the parent model had ceased. The effect of the procedure was to amortize the cost of these parts over a 10-year period. For the first nine months of 1964, this produced a write-down of $22,090.

In late 1964, new management took control and promptly concluded that Thor's inventory in general was overvalued. After "a physical inventory taken at all locations" of the tool and rubber divisions, management wrote off approximately $2.75 million of obsolete parts, damaged or defective tools, demonstration or sales samples, and similar items. The Commissioner allowed this writeoff because Thor scrapped most of the articles shortly after their removal from the 1964 closing inventory. Management also wrote down $245,000 of parts stocked for three unsuccessful products. The Commissioner allowed this write-down, too, since Thor sold these items at reduced prices shortly after the close of 1964.

This left some 44,000 assorted items, the status of which is the inventory issue here. Management concluded that many of these articles, mostly spare parts, were "excess" inventory, that is, that they were held in excess of any reasonably foreseeable future

demand. It was decided that this inventory should be written down to its "net realizable value," which, in most cases, was scrap value.

Two methods were used to ascertain the quantity of excess inventory. Where accurate data were available, Thor forecast future demand for each item on the basis of actual 1964 usage, that is, actual sales for tools and service parts, and actual usage for raw materials, work-in-process, and production parts. Management assumed that future demand for each item would be the same as it was in 1964. Thor then applied the following aging schedule: the quantity of each item corresponding to less than one year's estimated demand was kept at cost; the quantity of each item in excess of two years' estimated demand was written off entirely; and the quantity of each item corresponding to from one to two years' estimated demand was written down by 50% or 75%.Thor presented no statistical evidence to rationalize these percentages or this time frame. In the Tax Court, Thor's president justified the formula by citing general business experience, and opined that it was "somewhat in between" possible alternative solutions.[5] This first method yielded a total write-down of $744,030.

At two plants where 1964 data were inadequate to permit forecasts of future demand, Thor used its second method for valuing inventories. At these plants, the company employed flat percentage write-downs of 5%, 10%, and 50% for various types of inventory. Thor presented no sales or other data to support these percentages. Its president observed that "this is not a precise way of doing it," but said that the company "felt some adjustment of this nature was in order, and these figures represented our best estimate of what was required to reduce the inventory to net realizable value." This second method yielded a total write-down of $160,832.

Although Thor wrote down all its "excess" inventory at once, it did not immediately scrap the articles or sell them at reduced prices, as it had done with the $3 million of obsolete and damaged inventory, the write-down of which the Commissioner permitted. Rather, Thor retained the "excess" items physically in inventory and continued to sell them at original prices. The company found that, owing to the peculiar nature of the articles involved, price reductions were of no avail in moving this "excess" inventory. As time went on however, Thor gradually disposed of some of these items as scrap; the record is unclear as to when these dispositions took place.

Thor's total write-down of "excess" inventory in 1964 therefore was:

Ten-year amortization of parts for discontinued tools	$22,090
First method (aging formula based on 1964 usage)	744,030
Second method (flat percentage write-downs)	160,832
Total	$926,952

Thor credited this sum to its inventory contra-account, thereby decreasing closing inventory, increasing cost of goods sold, and decreasing taxable income for the year by that amount. The company contended that, by writing down excess inventory to scrap value, and by thus carrying all inventory at "net realizable value," it had reduced its inventory to "market" in accord with its "lower of cost or market" method of accounting. On audit, the Commissioner disallowed the write-down in its entirety, asserting that it did not serve clearly to reflect Thor's 1964 income for tax purposes.

The Tax Court, in upholding the Commissioner's determination, found as a fact that Thor's write-down of excess inventory did conform to "generally accepted accounting principles"; indeed, the court was "thoroughly convinced . . . that such was the case." The court found that if Thor had failed to write down its inventory on some reasonable basis, its accountants would have been unable to give its financial statements the desired certification. *Id.,* at 161-162. The court held, however, that conformance with "generally accepted accounting principles" is not enough; § 446 (b), and § 471 as well, of the 1954 Code, 26 U. S. C. §§ 446 (b) and 471, prescribe, as an independent requirement, that inventory accounting methods must "clearly reflect income." The Tax Court rejected Thor's argument that its write-down of "excess" inventory was authorized by Treasury Regulations and held that the Commissioner had not abused his discretion in determining that the write-down failed to reflect 1964 income clearly.

B

Inventory accounting is governed by §§ 446 and 471 of the Code, 26 U. S. C. §§ 446 and 471. Section 446 (a) states the general rule for methods of accounting: "Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." Section 446 (b) provides, however, that if the method used by the taxpayer "does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the [Commissioner], does clearly reflect income." Regulations promulgated under § 446, and in effect for the taxable year 1964, state that "no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income." Treas. Reg. § 1.446-1 (a) (2).

Section 471 prescribes the general rule for inventories. It states:

> "Whenever in the opinion of the [Commissioner] the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventory shall be taken by such taxpayer on such basis as the [Commissioner] may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."

As the Regulations point out, § 471 obviously establishes two distinct tests to which an inventory must conform. First, it must conform "as nearly as may be" to the "best accounting practice," a phrase that is synonymous with "generally accepted accounting principles." Second, it "must clearly reflect the income." Treas. Reg. § 1.471-2 (a) (2).

It is obvious that on their face, §§ 446 and 471, with their accompanying Regulations, vest the Commissioner with wide discretion in determining whether a particular method of inventory accounting should be disallowed as not clearly reflective of income. This Court's cases confirm the breadth of this discretion. In construing § 446 and its predecessors, the Court has held that "[t]he Commissioner has broad powers in determining whether accounting methods used by a taxpayer clearly reflect income." Since the Commissioner has "[m]uch latitude for discretion," his interpretation of the statute's clear-reflection standard "should not be interfered with unless clearly unlawful." . . . .

As has been noted, the Tax Court found as a fact in this case that Thor's write-down of "excess" inventory conformed to "generally accepted accounting principles" and was "within the term, `best accounting practice,' as that term is used in section 471 of the Code and the regulations promulgated under that section." Since the Commissioner has not challenged this finding, there is no dispute that Thor satisfied the first part of § 471's two-pronged test. The only question, then, is whether the Commissioner abused his discretion in determining that the write-down did not satisfy the test's second prong in that it failed to reflect Thor's 1964 income clearly. Although the Commissioner's discretion is not unbridled and may not be arbitrary, we sustain his exercise of discretion here, for in this case the write-down was plainly inconsistent with the governing Regulations which the taxpayer, on its part, has not challenged.

It has been noted above that Thor at all pertinent times used the "lower of cost or market" method of inventory accounting. The rules governing this method are set out in Treas. Reg. § 1.471-4, 26 CFR § 1.471-4 (1964). That Regulation defines "market" to mean, ordinarily, "the current bid price prevailing at the date of the inventory for the particular merchandise in the volume in which usually purchased by the taxpayer." § 1.471-4 (a). The courts have uniformly interpreted "bid price" to mean replacement cost, that is, the price the taxpayer would have to pay on the open market to purchase or reproduce the inventory items.[12] Where no open market exists, the Regulations require the taxpayer to ascertain "bid price" by using "such evidence of a fair market price at the date or dates nearest the inventory as may be available, such as specific purchases or sales by the taxpayer or others in reasonable volume and made in good faith, or compensation paid for cancellation of contracts for purchase commitments." § 1.471-4 (b).

. . . .

For these reasons, we agree with the Tax Court and with the Seventh Circuit that the Commissioner acted within his discretion in deciding that Thor's write-down of "excess" inventory failed to reflect income clearly. In the light of the well-known potential for tax avoidance that is inherent in inventory accounting, the Commissioner in his discretion may insist on a high evidentiary standard before allowing write-downs of inventory to "market." Because Thor provided no objective evidence of the reduced market value of its "excess" inventory, its write-down was plainly inconsistent with the Regulations, and the Commissioner properly disallowed it.

C

The taxpayer's major argument against this conclusion is based on the Tax Court's clear finding that the write-down conformed to "generally accepted accounting principles." Thor points to language in Treas. Reg. § 1.446-1 (a) (2) to the effect that "[a] method of accounting which reflects the consistent application of generally accepted accounting principles . . . *will ordinarily be regarded* as clearly reflecting income" (emphasis added). Section 1.471-2 (b) of the Regulations likewise stated that an inventory taken in conformity with best accounting practice "can, *as a general rule,* be regarded as clearly reflecting . . . income" (emphasis added). These provisions, Thor contends, created a *presumption* that an inventory practice conformable to "generally accepted accounting principles" is valid for income tax purposes. Once a taxpayer has established this conformity, the argument runs, the burden shifts to the Commissioner affirmatively to demonstrate that the taxpayer's method does *not* reflect income clearly. . . .

If the Code and Regulations did embody the presumption petitioner postulates, it would be of little use to the taxpayer in this case. As we have noted, Thor's write-down of "excess" inventory was inconsistent with the Regulations; any general presumption obviously must yield in the face of such particular inconsistency. We believe, however, that no such presumption is present. Its existence is insupportable in light of the statute, the Court's past decisions, and the differing objectives of tax and financial accounting.

First, as has been stated above, the Code and Regulations establish two distinct tests to which an inventory must conform. The Code and Regulations, moreover, leave little doubt as to which test is paramount. While § 471 of the Code requires only that an accounting practice conform "as nearly as may be" to best accounting practice, § 1.446-1 (a) (2) of the Regulations states categorically that "*no* method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income" (emphasis added). Most importantly, the Code and Regulations give the Commissioner broad discretion to set aside the taxpayer's method if, "in [his] opinion," it does not reflect income clearly. This language is completely at odds with the notion of a "presumption" in the taxpayer's favor. The Regulations embody no presumption; they say merely that, in most cases, generally accepted accounting practices will pass muster for tax purposes. And in most cases they will. But if the Commissioner, in the exercise of his discretion, determines that they do not, he may prescribe a different practice without having to rebut any presumption running against the Treasury.

Second, the presumption petitioner postulates finds no support in this Court's prior decisions. It was early noted that the general rule specifying use of the taxpayer's method of accounting "is expressly limited to cases where the Commissioner believes that the accounts clearly reflect the net income." More recently, it was held in *American Automobile Assn.* v. *United States* that a taxpayer must recognize prepaid income when received, even though this would mismatch expenses and revenues in contravention of "generally accepted commercial accounting principles." "[T]o say that in performing the function of business accounting the method employed by the Association `is in accord with generally accepted commercial accounting principles

and practices,'" the Court concluded, "is not to hold that for income tax purposes it so clearly reflects income as to be binding on the Treasury." "[W]e are mindful that the characterization of a transaction for financial accounting purposes, on the one hand, and for tax purposes, on the other, need not necessarily be the same." Indeed, the Court's cases demonstrate that divergence between tax and financial accounting is especially common when a taxpayer seeks a current deduction for estimated future expenses or losses. The rationale of these cases amply encompasses Thor's aim. By its president's concession, the company's write-down of "excess" inventory was founded on the belief that many of the articles inevitably would become useless due to breakage, technological change, fluctuations in market demand, and the like. Thor, in other words, sought a current "deduction" for an estimated future loss. Under the decided cases, a taxpayer so circumstanced finds no shelter beneath an accountancy presumption.

Third, the presumption petitioner postulates is insupportable in light of the vastly different objectives that financial and tax accounting have. The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested; the major responsibility of the accountant is to protect these parties from being misled. The primary goal of the income tax system, in contrast, is the equitable collection of revenue; the major responsibility of the Internal Revenue Service is to protect the public fisc. Consistently with its goals and responsibilities, financial accounting has as its foundation the principle of conservatism, with its corollary that "possible errors in measurement [should] be in the direction of understatement rather than overstatement of net income and net assets." In view of the Treasury's markedly different goals and responsibilities, understatement of income is not destined to be its guiding light. Given this diversity, even contrariety, of objectives, any presumptive equivalency between tax and financial accounting would be unacceptable.

This difference in objectives is mirrored in numerous differences of treatment. Where the tax law requires that a deduction be deferred until "all the events" have occurred that will make it fixed and certain, accounting principles typically require that a liability be accrued as soon as it can reasonably be estimated. Conversely, where the tax law requires that income be recognized currently under "claim of right," "ability to pay," and "control" rationales, accounting principles may defer accrual until a later year so that revenues and expenses may be better matched. Financial accounting, in short, is hospitable to estimates, probabilities, and reasonable certainties; the tax law, with its mandate to preserve the revenue, can give no quarter to uncertainty. This is as it should be. Reasonable estimates may be useful, even essential, in giving shareholders and creditors an accurate picture of a firm's overall financial health; but the accountant's conservatism cannot bind the Commissioner in his efforts to collect taxes. . . .

Finally, a presumptive equivalency between tax and financial accounting would create insurmountable difficulties of tax administration. Accountants long have recognized that "generally accepted accounting principles" are far from being a canonical set of rules that will ensure identical accounting treatment of identical transactions. "Generally accepted accounting principles," rather, tolerate a range of "reasonable" treatments, leaving the choice among alternatives to management. Such,

indeed, is precisely the case here. Variances of this sort may be tolerable in financial reporting, but they are questionable in a tax system designed to ensure as far as possible that similarly situated taxpayers pay the same tax. If management's election among "acceptable" options were dispositive for tax purposes, a firm, indeed, could decide unilaterally—within limits dictated only by its accountants—the tax it wished to pay. Such unilateral decisions would not just make the Code inequitable; they would make it unenforceable.

D

Thor complains that a decision adverse to it poses a dilemma. According to the taxpayer, it would be virtually impossible for it to offer objective evidence of its "excess" inventory's lower value, since the goods cannot be sold at reduced prices; even if they could be sold, says Thor, their reduced-price sale would just "pull the rug out" from under the identical "non-excess" inventory Thor is trying to sell simultaneously. The only way Thor could establish the inventory's value by a "closed transaction" would be to scrap the articles at once. Yet immediate scrapping would be undesirable, for demand for the parts ultimately might prove greater than anticipated. The taxpayer thus sees itself presented with "an unattractive Hobson's choice: either the unsalable inventory must be carried for years at its cost instead of net realizable value, thereby overstating taxable income by such overvaluation until it is scrapped, or the excess inventory must be scrapped prematurely to the detriment of the manufacturer and its customers."

If this is indeed the dilemma that confronts Thor, it is in reality the same choice that every taxpayer who has a paper loss must face. It can realize its loss now and garner its tax benefit, or it can defer realization, and its deduction, hoping for better luck later. Thor, quite simply, has suffered no present loss. It deliberately manufactured its "excess" spare parts because it judged that the marginal cost of unsalable inventory would be lower than the cost of retooling machinery should demand surpass expectations. This was a rational business judgment and, not unpredictably, Thor now has inventory it believes it cannot sell. Thor, of course, is not so confident of its prediction as to be willing to scrap the "excess" parts now; it wants to keep them on hand, just in case. This, too, is a rational judgment, but there is no reason why the Treasury should subsidize Thor's hedging of its bets. There is also no reason why Thor should be entitled, for tax purposes, to have its cake and to eat it too.

II

The judgment of the Court of Appeals is affirmed.

5. Contested Amounts

Applying the usual accrual accounting rules to contested amounts is problematic: if payment remains in dispute, can the all events test ever be satisfied. In North American Oil Consolidated v. Burnett, 286 U.S. 417 (1932), an accrual method taxpayer operated a well although the government also claimed ownership of the property. In 1916, receipts

from operation of the well were paid to a receiver pending the outcome of litigation between the taxpayer and the government. In 1917, the trial court held for the taxpayer and the receiver disbursed the funds to the taxpayer. But litigation continued and was not finally resolved (still in the taxpayer's favor) until 1922.

At issue was inclusion of the profits generated in 1916 and paid to the receiver in that year. The government argued in favor of accrual in 1916 because that is when the taxpayer first claimed the legal right to the funds. But the Supreme Court held that the proper year of inclusion was 1917 when the funds were paid to the taxpayer, writing:

> [T]he company was not required in 1916 to report as income an amount which it might never receive. See Burnet v. Logan. Compare Lucas v. American Co., 280 U.S. 445, 452; Burnet v. Sanford & Brooks Co. There was no constructive receipts of the profits by the company in that year, because at no time during the year was there a right in the company to demand that the receiver pay over the money. Throughout 1916 it was uncertain who would be declared entitled to the profits. It was not until 1917, when the District Court entered a final decree vacating the receivership and dismissing the bill, that the company became entitled to receive the money.
>
> . . . .
>
> If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.

As a result of this language, *North American Oil Consolidated* gave rise to the "claim of right" doctrine under which an accrual taxpayer cannot defer recognition of income because of a disputed claim once the funds are received by the taxpayer under the taxpayer's claim of right and no legal restrictions are imposed on the taxpayer's use of the funds.

A similar issue arises if the taxpayer pays a deductible obligation but disputes that the payment is owed. For example, suppose an accrual taxpayer pays $100,000 in property taxes to a state but disputes the state's valuation. Assuming the payment is otherwise deductible, see §164(a)(1), a deduction in the amount of $100,000 is proper in the year the payment is made even if the taxpayer believes only, say, $80,000 is owed and a claim for reduction is filed. §461(f). Of course, if the taxpayer receives a refund of some or all of the taxes paid and deducted, the taxpayer must report the income under the tax benefit rule.

B. Open Transactions, Installment Sales, Deferral and Deferred Sales

1. Open Transactions

Burnet v. Logan

283 U.S. 404 (1931)

MR. JUSTICE MCREYNOLDS delivered the opinion of the Court.

These causes present the same questions. One opinion, stating the essential circumstances disclosed in No. 521, will suffice for both.

Prior to March, 1913, and until March 11, 1916, respondent, Mrs. Logan, owned 250 of the 4,000 capital shares issued by the Andrews & Hitchcock Iron Company. It held 12 per cent. of the stock of the Mahoning Ore & Steel Company, an operating concern. In 1895 the latter corporation procured a lease for 97 years upon the 'Mahoning' mine and since then has regularly taken therefrom large, but varying, quantities of iron . . . . The lease contract did not require production of either maximum or minimum tonnage or any definite payments. Through an agreement of stockholders (steel manufacturers), the Mahoning Company is obligated to apportion extracted ore among them according to their holdings. On March 11, 1916, the owners of all the shares in Andrews & Hitchcock Company sold them to Youngstown Sheet & Tube Company, which thus acquired, among other things, 12 per cent. of the Mahoning Company's stock and the right to receive the same percentage of ore thereafter taken from the leased mine.

For the shares so acquired, the Youngstown Company paid the holders $ 2,200,000 in money, and agreed to pay annually thereafter for distribution among them 60 cents for each ton of ore apportioned to it. Of this cash Mrs. Logan received 250/4000 ($137,500); and she became entitled to the same fraction of any annual payment thereafter made by the purchaser under the terms of sale.

Mrs. Logan's mother had long owned 1,100 shares of the Andrews & Hitchcock Company. She died in 1917, leaving to the daughter one-half of her interest in payments thereafter made by the Youngstown Company. This bequest was appraised for federal estate tax purposes at $277,164.50.

During 1917, 1918, 1919, and 1920 the Youngstown Company paid large sums under the agreement. Out of these respondent received on account of her 250 shares $9,900 in 1917; $11,250 in 1918; $8,995.50 in 1919; $5,444.30 in 1920--$35,589.80. By reason of the interest from her mother's estate, she received $19,790.10 in 1919, and $11,977.49 in 1920

Reports of income for 1918, 1919, and 1920 were made by Mrs. Logan upon the basis of cash receipts and disbursements. They included no part of what she had obtained from annual payments by the Youngstown Company. She maintains that until the total amount actually received by her from the sale of her shares equals their value on March 1, 1913, no taxable income will arise from the transaction. Also that, until

she actually receives by reason of the right bequeathed to her a sum equal to appraised value, there will be no taxable income therefrom.

. . . .

The Commissioner ruled that the obligation of the Youngstown Company to pay 60 cents per ton has a fair market value of $1,942,111.46 on March 11, 1916; that this value should be treated as so much cash, and the sale of the stock regarded as a closed transaction with no profit in 1916. He also used this valuation as the basis for apportioning subsequent annual receipts between income and return of capital. His calculations, based upon estimates and assumptions, are too intricate for brief statement. He made deficiency assessments according to the view just stated, and the Board of Tax Appeals approved the result. The Circuit Court of Appeals held that, in the circumstances, it was impossible to determine with fair certainty the market value of the agreement by the Youngstown Company to pay 60 cents per ton. Also that respondent was entitled to the return of her capital-the value of 250 shares on March 1, 1913, and the assessed value of the interest derived from her mother-before she could be charged with any taxable income. As this had not in fact been returned, there was no taxable income.

We agree with the result reached by the Circuit Court of Appeals.

. . . As annual payments on account of extracted ore come in, they can be readily apportioned first as return of capital and later as profit. The liability for income tax ultimately can be fairly determined without resort to mere estimates, assumptions, and speculation. When the profit, if any, is actually realized, the taxpayer will be required to respond. The consideration for the sale was $2,200,000 in cash and he promise of future money payments wholly contingent upon facts and circumstances not possible to foretell with anything like fair certainty. The promise was in no proper sense equivalent to cash. It had no ascertainable fair market value. The transaction was not a closed one. Respondent might never recoup her capital investment from payments only conditionally promised. Prior to 1921, all receipts from the sale of her shares amounted to less than their value on March 1, 1913. She properly demanded the return of her capital investment before assessment of any taxable profit based on conjecture.

. . . .

The judgments below are affirmed.

Note

1. *The Government's Response*. Unhappy with the result in *Burnet v. Logan*, the Commissioner promulgated a regulation, now Reg. §1.1001-1(a), that limits that case to very narrow circumstances: "Only in rare and extraordinary circumstances will property be considered to have no fair market value." Why does the government have such a strong bias against the open transaction approach?

2. *Estate Tax vs. Income Tax.* The value of the taxpayer's contract rights was valued when she died as required by the estate tax. Why was the value used for the estate tax not also used for the income tax?

2. Installment Sales

If a taxpayer sells property over time, it often can be difficult to determine the taxpayer's gain because valuation of the future payments may be uncertain. The statute has included a provision to address such transaction for many years, and the current version in in §453. The installment method as defined in §453 is applicable to taxpayers without regard to their method of accounting, and while no election needs to be made to use the installment method of accounting with respect to an installment sale, a taxpayer is free to elect out. §453(d). Note that the installment method applies to installment sales that produce gain but not to such sales that produce loss. §453(a).

An "installment sale" is a disposition of property where at least one payment is to be received in a future year. §453(b)(1). Note that there is not a requirement that the sale include two or more payments: a disposition in which the single sale price will be received in a future year is an "installment sale" captured by §453. Certain dispositions are excluded from §453: dealer dispositions, §453(b)(2)(A), and dispositions of inventory (not including real estate inventory), §453(b)(2)(B).

The "installment method" is defined in §453(c). It requires the taxpayer to recognize a proportion of gain from each payment received based on the total gain that will be recognized under the contract as compared to the total amount that will be received (ignoring interest, taxed separately). To understand the language of §453(c), treat "gross profit" as realized gain and "total contract price" as amount realized, in each case using the total contract price and not the amount received in a particular year.[5]

For example, suppose T owns property with adjusted basis of $55,000 and fair market value of $100,000. T sells the property for a down payment of $20,000 and four additional payments of $20,000 ($100,000 total) plus appropriate interest on the unpaid balance each year. Because the total contract price is $100,000 (interest is ignored) and T's adjusted basis is $55,000, T can exclude 55% of each payment as a recovery of basis and must include 45% of each payment as gain. Thus, as to the $20,000 down payment as well as to each subsequent payment, T will exclude $11,000 and include $9,000. Note that if the buyer should pay more or less than the agreed upon amount of $20,000 in any particular year, T excludes 55% of whatever is received and includes 45% of what is received.

[5] For the definition of "gross profit," see Reg. §15A.453-1(b)(2)(v). For the definition of "total contract price," see Reg. §15.453-1(b)(2)(iii).

Notes

1. *Extension of §453 when the contract price is indeterminate.* Suppose T sells a mine in exchange to someone who agrees to use her best efforts to operate the mine and who will pay T one-third of the gross proceeds from operation of the mine for the first five years of operation. Assuming T's adjusted basis in the mine equals $50,000, how should T be taxed? Because the amount of the payments cannot be determined in advance, but the duration of the payment stream is known, T recovers her adjusted basis ratable over the contract period (that is, over five year, or $10,000 per year). §453(j); Reg. §15A.453-1(c)(3)(i). However, no loss can be recognized until the end of the payment period that if, for example, the payment in one year is less than $10,000, no loss is recognized but the unused basis carries forward to the following year. Reg. §15A.453-1(c)(3)(ii) (example 1).

2. *Anti-abuse Rules in §453.* Section 453 contains two important anti-abuse rules. First, if appreciated property is sold to a related party who then resells the property within two years, the second sale triggers gain from the first sale. §453(e). Second, sales of depreciable property to a controlled entity are excluded from installment sale rule to ensure that property cannot be depreciated twice by related parties without the recognition of income. §453(g). Finally, note that §453 does not defer recognition of gain that is treated as depreciation recapture under §§453(i).

3. *Disposition of an installment obligation.* A taxpayer who has sold property using an installment sale may decide to sell the installment note (usually called the installment obligation) rather than collect it over time. If so, the disposition of the installment obligation is covered by §453B (called "section 453 cap-B"). The rules of this provision ensure that any of the seller's adjusted basis in the asset that has not yet been used against installment proceeds will be used against the proceeds from disposition of the installment obligation.

Suppose S owns Blackacre with an adjusted basis of $55,000. S agrees to sell Blackacre for $100,000 to B, with $20,000 paid in cash immediately and $20,000 paid each succeeding year for four years (plus fair market interest on the unpaid balance). After the down payment and the first installment is made, S sells the installment obligation for $50,000. Under §453B, S must recognize gain from that sale of $17,000, computed at follows.

Under §453B(a)(1), S recognizes gain equal to the excess of S's amount realized of $50,000 in excess of S's "basis of the obligation." That basis is determined under §453B(b), S's basis of the obligation equals the excess of the face value of the obligation – that is, $60,000 – over the amount that would be includible if the obligation were paid in full. We know that under §453, S treats 55% of each $20,000 payment as a nontaxable return of capital and 45% as gain. Accordingly, if the installment obligation has been paid in full – that is, if S had received the full face value of $60,000 – then S would include 45% of that amount, or $27,000 and would exclude $33,000. Accordingly, S's basis in the obligation equals $33,000, making S's gain from the sale of the installment obligation equal to $50,000 less $33,000, or $17,000.

4. *Deferred Interest Charge.* Large taxpayers must pay an interest charge on taxes deferred by §453, §453A, where "large" in this context is defined in an unusual way that is dependent on the gross value of installment obligations held by the taxpayer. If in any year the taxpayer sells property on the installment method and receives installment obligations having face value of more than $5,000,000, then the interest charge will be imposed on all installment obligations arising in that year.[6] Surprisingly, installment obligations arising in different taxable years are not combined to reach the $5,000,000 threshold.[7]

3. Deferral

a. Using Options to Defer Gain

A taxpayer who owns an appreciated asset can convert that appreciation into cash by borrowing against the asset. While income from investment of the loan proceeds will have to service the debt before ending up in the taxpayer's pocket, borrowing against an appreciated asset allows the taxpayer to defer taxation on the unrealized appreciation.

However, if the taxpayer wishes to shift the benefits and burdens of ownership of the asset to someone else, borrowing against the asset will not suffice. Selling an option to purchase the asset at a fixed price (called a "call" option) will transfer most of the benefits of ownership to the option holder while paying someone for a put option (that is, an option to sell the property for a fixed price) will transfer most of the risk of diminution in value of the property to the seller of the put option. Selling a call option while buying a put option is called a "collar," and the narrow the spread between the strike prices of the put and the call, the narrower is the collar and the more closely the collar resembles a sale.

i. *Strike Price*

"Strike Price" is the price at which the option can be exercised. If T has the right to purchase 100 shares of X Corp. stock at $10 per share, the strike price is $10 per share.

ii. *In the Money*

An option to purchase an asset is "in the money" if the strike price is below the current market price of the asset (called the "spot price"). A put option is in the money when the strike price is above the spot price.

iii. *Deep in the Money*

A call option is "deep in the money" if the strike price is considerably below the spot price. Deep in the money has no quantitative meaning.

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[6] §453A(b)(2).
[7] §453A(b)(2)(B) ("arose during").

iv. *Underwater*

A call option is "underwater" if the strike price is above the spot price. In general, there is no reason to exercise an option when it is underwater. A synonym for "underwater" is "out of the money."

v. *Long Position*

A "long" position in an asset means the taxpayer will profit if the asset arises in value. Owning an asset and owning a call option on an asset are each a long position.

vi. *Short Position*

A "short" position in an asset means the taxpayer will profit if the asset declines in value. Owning a put option is a short position.

vii. Option Price

The "option price" is the price paid to acquire the option from the option writer.

viii. Underlying

The "underlying" or "underlying property" is the asset against which the option is written. That is, it is the asset that will be bought and sold if the option is exercised.

b. Taxation of Options

When an option is written in exchange for a cash payment, both the option writer and the option purchaser treat the sale as an open transaction.[8] Consider for example the writer of a call option. Whether the option is written against a unique asset such as a parcel of real estate or against fungible property such as shares of publicly-traded stock, the results are the same. The sale proceeds are not treated as income when received. If the option is allowed to lapse, the option writer has income equal to the option price. And because the underlying property was not transferred, that income is not gain and so cannot qualify as capital again. However, if the call option is exercised, then the option price is added to the strike price and that aggregate is treated as the option writer's amount realized from sale of the underlying property, and gain or loss will be recognized by the option seller based on a comparison of this amount realized and the seller's adjusted basis in the underlying property.

For the option holder, the analysis runs parallel. If the option is allowed to lapse, the option holder recognizes it entitled to claim a loss deduction equal to the option price, while if the option is exercised, the sum of the strike price and the option price are treated as the option holder's basis in the underlying property.

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[8] The tax treatment of options is described in Rev. Rul. 78-182, 1978-1 C.B. 265. Rules governing the character of income and deduction arising from option transactions are provided in §§1234 and 1234A.

Question

1. Given the rules described above, how should a put option be taxed to both the option holder and to the option writer if the option is allowed to lapse or is exercised?

c. *Collars*

Suppose the taxpayer owns Blackacre with current value of $100. If the taxpayer sells a call option with a strike price of $100 and simultaneously purchases a put option with the same strike price of $100, the two transactions are the equivalent to an immediate sale of the property for $100 because no matter what the value of the property, one of the two options will be exercised (unless the property is worth exactly $100 during the option period). That is, if the property is worth less than $100, the taxpayer will exercise the put option while if the property is worth more than $100, the buyer of the call option will exercise it. Thus, the taxpayer is economically indifferent to changes in the value of Blackacre and so should be taxed as if the taxpayer sold the property for $100.

Suppose the put option has a strike price of $85 while the call option has a strike price of $110. Now, the taxpayer will enjoy the first $10 of appreciation in the property and will suffer for the first $15 of decline in value. Thus, this collar is unlikely to be treated as an immediate sale because the taxpayer retains a significant economic interest in the value of the property. Note that the owner of the property would like to increase both strike prices (to maximize possibility of gain while minimizing possibility of loss).

Congress has passed a "constructive sale" provision that taxes as an immediate sale the acquisition of a hedging provision which eliminates “substantially” all the risk from an “appreciated securities position.” As a result, if a collar is too tight, it will be treated as an immediate sale.[9]

d. *Deferring Compensation*

i. *Basic Principles*

“Deferred compensation” refers to an agreement between a service provider and the service beneficiary (usually employee and employer) to compensation the service provider in a year subsequent to the year in which services are provided. Assuming the service provider uses the cash method of accounting, this allows the service provider to defer recognition of income, as illustrated by the *Amend* case *supra.* That is, an employee is not immediately taxable on an employer’s mere promise to pay compensation in the future. Rev. Rul. 60-31, 1960-1 C.B. 174. Of course, it also defers receipt of the compensation, and that may present difficulties for the service provider. In particular, the

[9] See §1259.

service provider may have an unexpected need for additional cash flow that cannot easily be satisfied by borrowing or may fear that the service beneficiary will become insolvent prior to the payment obligation becoming due.

To offer deferral to an employee while minimizing the risks inherent in the deferral of receipt, an employer may create some form of a "Rabbi Trust." This technique has the employer transfer to a trust funds sufficient to satisfy the future compensation promise. The beneficiary cannot be the employee because the of economic benefit doctrine as discussed in the *Pulsifer* case *supra.* Instead, the employer is made the beneficiary of the trust, and by the terms of the trust payments will be made to the beneficiary (that is, to the employer) only as payments are due on the deferred compensation agreement. Thus, the employer's "mere promise to pay" is now secured by the corpus of the trust, and while that corpus can be at risk to the employer's creditors, spendthrift trust rules can make it difficult for a creditor to levy on the trust other than as payments from the corpus become due. Note that because of the requirement of economic performance in §461(h), the employer cannot deduct the deferred compensation until it is paid even if the employer is an accrual taxpayer.[10] Of course, for a religious institution or other charitable organization, deferral of a deduction is meaningless.

In Minor v. United States, 772 F.2d 1472 (9th Cir. 1985), the plan was advanced one step further: the beneficiary was made trustee of the Rabbi trust so that she could control investment of the deferred compensation prior to the time it was paid out. The court rejected challenges by the government based on constructive receipt, economic benefit, and other theories.[11] This seems to be a structure that gives the service provider as much control over the deferred compensation as is possible without triggering recognition of the compensation income prior to receipt.

ii. *Qualified Plans*

In general, the tax benefit of a "qualified" pension plan is that the contributor (employer or employee) can deduct contributions to the plan when made even though the employees need not report the income until they receive distributions from the plan (when they retire). The assets of the plan are held be a pension trust that is tax-exempt so that the contribution of the employer will increase tax-free until distributions are made. Thus, qualified plans offer two benefits: (1) an immediate deduction to the employer despite no constructive receipt by the employee and (2) tax-free growth (called tax-free inside build-up). Pension plans that qualify for this treatment are subject to detailed rules ensuring that the plans do not overly benefit highly compensated individuals (the anti-discrimination rules) and will in fact pay what is promised (the vesting rules). When the funds are paid to the employee, they are treated as compensation to

[10] See also §404(a)(5).
[11] These other theories included the rules covering the taxation of trusts as well as the rules of §83.

the employee and so will not qualify for capital gain taxation without regard to the assets held by the pension trust.

(A) Employer-Sponsored Plan*s*

A "defined benefit plan" within the meaning of §401(*l*)(3) requires the employer to make contributions sufficient to provide the express benefits promised to the employees. Note that if the employer predicts a higher rate of return in the plan's assets than in fact is achieved, the plan will be underfunded.

A "defined contribution plan" within the meaning of §401(l)(2) requires the employer to make specific contributions into the pension trust and then the employees will receive benefits based on the actual returns of the pension investments. Because the employees bear all the risks that the pension assets will underperform, it is increasingly common to permit the employees to have substantial say in how the pension assets are invested. Note that a defined contribution plan cannot be underfunded because the employees are entitled to no more (and no less) than the value of the pension trust.

(B) Employee Funded Plans

If a taxpayer who has compensation income is not able to participate in an employer-sponsored pension plan, the employee is permitted to contribute up to $2,000 per year to an "individual retirement account (an "IRA") or to a Roth-IRA. Contributions to an IRA are deductible when made and taxable as compensation when received at retirement. Contributions to a Roth-IRA are nondeductible when made but subsequent distributions from the Roth-IRA are tax-free to the recipient. Both IRAs and Roth-IRAs grow tax-free.

(C) Incentive Stock Options

Under §422, a corporation can issue stock options to employees in connection with their work. The employees are not taxed on receipt of the options. The employees are not taxed when they convert those options into shares of stock. The employees are only taxed when they sell the stock, and at that time the gain (amount realized over what the employee paid for the stock, if anything) is taxable as capital gain. This is very favorable to the employee, but *the employer never gets a deduction for this form of compensation*. Note the "anti-spring-loading" restriction in §422(a)(1) (no disposition within 1 year of receiving the stock) as well as the restriction that the strike price not be below the value of the stock on the date of issue, §422(b)(4).

iii. *Nonqualified Plans*

Nonqualified plans are pension plans that do not qualify for preferential tax treatment. Often, an employer will permit employees to purchase equity in the company to better align the employee's economic interests with that of the company. If the price offered to employee is below current fair market value but the shareholder's ownership is substantially restricted, it was unclear how and when the employee should be taxed. Section 83 was added to the Code to comprehensively deal with the transfer of property transferred as compensation when the employee’s ownership of the property may be subject to restrictions.

(A) Section 83

Under §83(a), a taxpayer who receives "property" in connection with the performance of services is taxed upon receipt of the property (on the value of the property received less the amount paid for the property) unless the taxpayer's ownership of the property is subject to a substantial risk of forfeiture and the taxpayer cannot sell the property without the restrictions continuing to apply to the buyer. If the property is subject to a substantial risk of forfeiture that continues to burden the property if transferred, we say the taxpayer's ownership is not "vested." Once the risk of forfeiture is removed, we say the taxpayer's ownership has vested. Note that most compensation is not subject to a risk of forfeiture and so, under §83(a), the service provider is taxed immediately.

If the property is not currently taxable under §83(a), then the taxpayer will be taxable when the taxpayer's ownership has vested. When taxation occurs under §83(a), it is treated as compensation and not as capital gain. If a taxpayer prefers immediate taxation despite lack of vesting, the taxpayer can file an election under §83(b) within 30 days of receipt of the property. Such an election will cause the taxpayer to be taxed on the value of the property (ignoring any valuation discounts arising from possible forfeiture) over the amount (if any) that the taxpayer paid for the property. If the property is forfeited subsequent to a §83(b) election, the taxpayer can deduct the amount paid for the property but not the amount includible as a result of the election. §83(b)(1) (final flush language).

Section 83(h) imposes a matching rule on the payor. Whether the service provider recognizes income under §83(a) when the property vests or under §83(b) when the property is received, the payor is entitled to claim a deduction equal to the inclusion by the service provider and at the same as the compensation is includible to the service provider.

Under §83(e)(4), most stock *options* are not treated as property for purposes of §83. As a result, a taxpayer is not generally taxable on the receipt of a stock option, see *Burnet v. Logan* above, nor can a §83(b) election be filed. However, once the option is exercised, the stock will be property for purposes of §83(a)-(b), so the taxpayer will be taxed once ownership of the stock vests.

Section 83 was modified by the TCJA of 2017 to give start-up companies the ability to offer restricted stock to employees such that the employees have up to five years to pay the tax after vesting. See §83(i).

Cramer v. Commissioner

64 F.3d 1406 (9th Cir. 1995)

BRUNETTI, CIRCUIT JUDGE

In 1972, Richard Cramer founded IMED Corp., a company that designed, manufactured and sold electronic medical instruments. Cramer served as president and chief executive officer of IMED from its inception until 1982. During that time, Warren Boynton served as vice-president, and Kevin Monaghan, an attorney, served

as outside general counsel. All three also served at various times on the board of directors of IMED.

From 1978 to 1981, the stock of IMED was neither publicly traded on an established exchange, nor registered with the Securities and Exchange Commission. During that time, that stock was held by approximately 150 to 250 shareholders. In 1978, IMED issued to Cramer an option to purchase 50,000 shares of IMED stock at $50 per share. The terms of the option provided certain vesting restrictions: Cramer could only exercise the option in 20% increments in each of the next five years, and only so long as he remained employed by IMED. The terms also provided certain transfer restrictions: Cramer could only transfer the option to persons approved by the board as "qualified offerees," and any transferee would take the option subject to the vesting restrictions.

In 1979, IMED issued to Cramer an option to purchase 4390 shares of IMED stock at $8 per share, to Boynton an option to purchase 30,000 shares of IMED stock at $13 per share, and to Monaghan an option to purchase 4500 shares at $13 per share. All of these options provided for a five year vesting schedule and were subject to the same vesting and transfer restrictions as Cramer's 1978 option.

. . . .

IMED issued all of these options in recognition of the services Cramer, Boynton and Monaghan provided to the company. The delayed vesting schedules and restrictions were intended to induce their continued employment with IMED. Appellants never exercised any part of the options.

In 1978, Dan Hendrickson, the corporate comptroller and treasurer of IMED, consulted with an accountant at Arthur Young & Co. regarding the tax treatment of these options. The accountant did not actually review the IMED options. Nonetheless, he informed Hendrickson that as a general matter, I.R.C. § 83(b) elections could be filed to include the value of so-called "nonstatutory options" (options not subject to I.R.C. § 422), such as the IMED options, in ordinary income at the time of grant, even if they were not publicly traded, and that the options would then receive capital gains treatment upon later disposition.

. . . .

In an attempt to ensure capital gain treatment upon future disposition of the options, appellants filed § 83(b) elections with the IRS for Cramer's 1978 option, Boynton's 1979 option and Monaghan's 1979 option. The elections stated that the fair market value of the options at the date of grant was zero. No such elections were filed either for Cramer's 1979 option or for the 1981 option issued to the trust. Appellants reported no taxable income in the year of grant from the receipt of any of the options.

. . . .

In 1982, Warner-Lambert Corp. purchased all of the stock of IMED for approximately $163 per share. As part of the agreement, the officers and directors of IMED resigned.

Warner-Lambert also agreed to buy all outstanding vested and nonvested options on IMED stock. Warner-Lambert paid appellants approximately $163 less the exercise price for each option. Cramer received $25,945,506 for all of his options; Boynton received $7,714,800 for his options; and Monaghan received $2,273,895 for his.

. . . .

The IRS audited appellants' 1982 returns. It determined that the sale of the options produced ordinary income in 1982, not capital gain, and calculated deficiencies accordingly. It also assessed penalties against appellants for intentional disregard of tax rules and regulations . . . .

DISCUSSION

. . . .

Appellants argue that under § 83(e)(3), the 1978 and 1979 IMED options had a "readily ascertainable fair market value" at the time of transfer, and that therefore § 83 applied to the transfer of those options. They filed § 83(b) elections with the IRS to include the value of the 1978 Cramer option and the 1979 Boynton and Monaghan options in ordinary income in the year of transfer. While they no longer maintain that those options had zero value upon grant, they argue that, pursuant to § 83(b), the value of those options (determined without regard to any restrictions) was taxable as ordinary income in the year of transfer, and that any subsequent appreciation in value was taxable as capital gain upon sale in 1982.

The Commissioner argues that those options did not have a "readily ascertainable fair market value" at the time of transfer, and that therefore, under § 83(e)(3), § 83 did not apply at the time of transfer. According to this analysis, the transfer of the options was a nontaxable event, § 83 applied only when appellants sold the options in 1982, see Treas. Reg. § 1.83-7(a), and the proceeds were taxable entirely as ordinary income.

Thus, the issue presented by this case is whether, at the time of the original transfer, the options had a "readily ascertainable fair market value," within the meaning of I.R.C. § 83(e)(3). Treasury has issued a regulation defining this standard. That regulation provides that an option that is not traded on an established market, such as the IMED options,

> does not have a readily ascertainable fair market value when granted unless the taxpayer can show that *all* of the following conditions exist:
>
> (i) The option is transferable by the optionee;
>
> (ii) The option is exercisable immediately in full by the optionee;
>
> (iii) The option or the property subject to the option is not subject to any restriction or condition which has a significant effect upon the fair market value on the option; and

(iv) The fair market value of the option privilege is readily ascertainable in accordance with paragraph (b)(3) of this section.

Treas. Reg. § 1.83-7(b)(2) (emphasis added).

The 1978 and 1979 IMED options clearly did not meet all four of these conditions at the time of transfer, and therefore did not have a "readily ascertainable fair market value" according to this regulation. Because the options could not be exercised unless the original recipient remained employed at IMED, the options were subject to "substantial risk of forfeiture." See I.R.C. § 83(c)(1). The terms of the options also required that if they were transferred, the transferee must take the options subject to this risk. Thus, the options were not "transferable" within the meaning of the statute. See I.R.C. § 83(c)(2). Moreover, the five year vesting schedule rendered them not "exercisable immediately in full" upon grant. Finally, appellants do not seriously challenge the Tax Court's factual finding that the transfer and vesting restrictions had a "significant effect upon the fair market value on the option[s]."We need not address whether the fourth condition was satisfied, because, even though appellants presented evidence below that the value of each IMED "option privilege" was ascertainable, these options so clearly failed the first three conditions. Therefore, according to Reg. § 1.83-7(b)(2), the value of the options was not readily ascertainable at the time of transfer, § 83 did not apply to that transfer, and the gain from the 1982 sale of those options was ordinary income, not capital gain.

Rather than contest this analysis, appellants argue that Reg. § 1.83-7(b)(2) is simply an invalid interpretation of I.R.C. § 83. They point out that § 83(a) and (b) both require that all lapsing restrictions, such as those listed in Reg. § 1.83-7(b)(2)(i-iii), be disregarded when valuing an option for purposes of calculating the tax. They argue that such restrictions should also be disregarded when determining whether an option has a "readily ascertainable fair market value" within the meaning of § 83(e)(3). Since, rather than disregarding those restrictions, Reg. § 1.83-7(b)(2) mandates that such restrictions prevent an option from satisfying the § 83(e)(3) test, appellants argue it is invalid.

. . . .

In sum, because the 1978 and 1979 options clearly did not have a "readily ascertainable fair market value" upon transfer according to Reg. § 1.83-7, § 83 did not apply until the sale of those options in 1982, see I.R.C. § 83(e)(3); Reg. § 1.83-7(a), and that sale therefore produced only ordinary income. We affirm the Tax Court's decision upholding the deficiency with respect to these options.

. . . .

AFFIRMED.

Notes

1. *Was there anything the taxpayers could have done?* From the opinion in Cramer, we see that issuing stock options to the taxpayers precluded them from making an election under §83(b) until the options were exercised. Why did they not exercise the options

immediately? Why were they issued stock options rather than restricted stock, i.e., stock that would be forfeited if they left the company?

(B) Section 409A

In response to a well-publicized non-qualified pension plan that gave rights to the beneficiaries allowing them to avoid any bankruptcy risk of the plan's provider by accelerating payment of their benefits, Congress enacted §409A. Section 409A can be thought of as an expansion of the constructive receipt doctrine for certain nonqualified deferred compensation plans. If a plan gives its beneficiaries the right to accelerate their benefits, it fails the test in §409A(a)(3) and so the draconian rules in §409A(a)(1) are imposed. Those rules demand that the compensation be taxed immediately to the beneficiaries (even if they have not accelerated the benefits), §409A(a)(1)(A), and an additional tax of 20% of the includible amount is imposed, §409A(a)(1)(B).

Certain acceleration events, enumerated in §409A(1)(2), are allowed without triggering taxation under §409A(a). These are events generally beyond the control of the service provider or events with a legitimate business nexus.

iv. *The Partnership Carried Interest Controversy*

A partnership is not a taxable entity; its items of income and deduction are passed through to and includible by the partners. Accordingly, a partner has income from partnership activities only when and if the partnership engages in profitable conduct. In addition, the character of the income to the partners is determined at the partnership level so that, for example, if the partnership has gain from the sale of a capital asset, the income includible by the partners is capital gain.

Under existing administrative guidance, the contribution of services to a partnership in exchange for a partnership interest is not a taxable event. The service provider will be treated as a partner and will be subject to the usual rules applicable to partners. As a result, there is no immediate income despite receiving property (in the form of a partnership interest) as compensation for services rendered, and if the partnership's business consists of selling capital assets, the income eventually reported by the service partner will be capital gain.

As part of the TCJA of 2017, Congress limited the capital gain preference from carried interests by increasing the holding period to 3 years.[12]

Question

1. Suppose an individual provides services to a partnership in exchange for an interest in the partnership's future profits. If that is treated as a taxable exchange, how should the amount of the service provider's compensation income be determined? For example, suppose T agrees to manage investment assets of $100,000,000 for a group of cash

[12] Section 1061.

investors, and T is compensated with 20% of the net income generated by the partnership's investments. How should T be taxed?

4. Deferred Sales

Alstores Realty Corp. v. Commissioner

46 T.C. 363 (1966)

Hoyt, Judge.

Respondent determined a deficiency in income tax against petitioner in the amount of $120,429.60 for petitioner's taxable year ended January 31, 1958. Respondent's disallowance of a portion of petitioner's claimed deduction for accrued taxes has not been challenged. Hence, the only issues remaining for decision are: (1) Whether petitioner realized $253,090.75 of rent income as a result of a transaction in which it purchased a warehouse property for $750,000 cash plus a simultaneous agreement to permit the seller to retain occupancy of a portion of the building rent free for 2 1/2 years, and (2) if petitioner did realize rent income as determined by respondent, is it entitled to increase its cost basis in the property by the amount so realized, and accordingly increase its annual depreciation of the building?

FINDINGS OF FACT

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Steinway's original asking price for the subject premises was $1,250,000; this was later lowered to $1 million. However, because Steinway at the time of these negotiations was not yet prepared to remove its manufacturing operations from the subject building, it would not at that time have agreed to a sale unless an arrangement could be made permitting it to retain possession of a portion of the building until its new plant would be ready for occupancy. Eventually, in 1956, the parties agreed to a transaction under which petitioner (Alstores) would pay $750,000 cash for title to the building and Steinway would retain occupancy of a portion of the building for 2 1/2 years from the date of conveyance, without further payment of rent.

After this arrangement had been agreed upon, Steinway's attorney prepared a single written document to effectuate the contract. This document provided for sale of the subject premises with a contemporaneous lease of portions of the premises by the purchaser back to Steinway. The petitioner's attorney, however, requested that the single contract be split into two separate contracts.

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ULTIMATE FINDINGS OF FACT

The fair market value as of February 1, 1957, of Steinway's rights of occupancy under the space-occupancy agreement was $253,090.75. The fair market value of the subject premises on February 1, 1957, was $1,003,090.75, and petitioner's cost basis in the property was $1,003,090.75, the total purchase price paid when the cash

consideration of $750,000 is added to the fair market value of the leaseback to Steinway. Petitioner received rental income of $253,090.75 on February 1, 1957, when the transaction was closed and the subject property was deeded to it by Steinway & Sons.

OPINION

It is respondent's contention that petitioner realized taxable rent income as a result of the transaction described in our findings. Petitioner contends simply that Steinway's occupancy was expressly made rent free and that petitioner never received any rent payments from Steinway for occupancy of the subject premises in the taxable year in question or any other year.

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There are two approaches to analyzing the transaction here involved. One approach is to say that there was a purchase by petitioner of the entire fee interest in the subject premises and at the same time a lease of a portion of the premises back to the seller for a 2 1/2-year term. This is the approach taken by the respondent herein.

Petitioner contends that even if the space-occupancy agreement should be regarded as a lease, there was, nonetheless, no income produced to the "lessor" since the "lease" was rent free. While it may be true that no rent was due or to be paid after Steinway's occupancy was to begin as petitioner's tenant, the agreement of the parties recognizes that it was because prepayment had been made by Steinway. . . .

The alternative analysis of the situation looks to the substance of the transaction. Petitioner here argues that, although in form there may have been a sale and leaseback, in substance there was a conveyance of a future interest with Steinway reserving to itself, or carving out, a term of 2 1/2 years in a portion of the property. Hence, Steinway in substance retained its right to occupancy not as a lessee of petitioner, but as a legal owner of a reserved term for years. . . .

Although at first blush petitioner's argument is an appealing one, we conclude that it must be rejected. . . . Steinway did not in form or substance reserve an estate for years.

An analogous situation was presented in McCulley Ashlock, 18 T.C. 405 (1952). There the building in question was subject to a lease to a third party at the time it was purchased by the taxpayer. The contract of sale provided that the buyer would pay $40,000 cash but the seller was to retain "possession" of the premises and all the rights to the rental income from the lessee until the expiration of the primary term of the existing lease (about 28 months from date of the sale contract). The Commissioner determined that the rent received by the seller subsequent to conveyance of title to the taxpayer purchaser was really taxable income to the taxpayer purchaser. We rejected the Commissioner's approach in that case, holding that the seller had reserved an ownership interest in the property (an estate for years) and that the rents received were income to the seller for occupancy of what was still his property -- not income to the purchaser, who did not then have a present legal ownership interest but only a future interest. The essence of our reasoning in the *Ashlock* case was as follows (pp. 411-412).

> Here, the trustees [the sellers of the property] not only retained the rents legally but they also retained control and benefits of ownership. Under the contract of sale on April 18, 1945, the trustees specifically agreed to pay property taxes, insurance premiums, and "all normal maintenance items and expenses," so that the property would be delivered to . . . [the buyer] in the present condition except for normal wear and tear. Furthermore, the June 11, 1945, agreement stated that in the event that the property was damaged or destroyed, and loss of income during the period of repair or reconstruction would be the trustees' loss. It further provided that insurance proceeds would be devoted to restore and repair the property, except in the event of total destruction petitioner would have the option of rebuilding the premises or compensating the trustees for unpaid rent. Thus the trustee bore the risks of ownership of the rents and managed the property. Larger expenses or a cessation of rents were risks incurred by the trustees. . . .

The same factors which we looked to in Ashlock in deciding in favor of the purchaser, analyzed in the factual posture of the instant case, dictate the opposite result here. Petitioner, the buyer, assumed control of the premises and the benefits of ownership. Petitioner, the buyer, specifically agreed to pay for and supply to Steinway, the seller, heat, electricity, and water. The space-occupancy agreement stated that in the event the property was damaged or destroyed and Steinway's occupancy was thereby destroyed or impaired the burden of loss would be upon petitioner (with petitioner agreeing to pay Steinway 6 1/4 cents per square foot per month for space so affected). It is clear in the instant case that the buyer bore the risks and burdens of ownership during the term of the space-occupancy agreement. . . .

Furthermore, the rights of Steinway, the seller, as occupant were not those of a holder of a legal estate for years but were specifically limited to those of a lessee. The standard terms and conditions of a New York Real Estate Board form lease were imposed. For example, Steinway could not alter or improve the building nor sublet or assign its interest without the consent of petitioner.

Of key significance in this case is the fact that petitioner was required to pay to Steinway 6 1/4 cents per square foot per month for space which Steinway was entitled to occupy but which it may have been unable to occupy by reason of an act of God or the fault of petitioner, or which it may have elected to vacate during the last one-half year of the space occupancy agreement. This arrangement is entirely inconsistent with the theory that Steinway had a reserved estate for years; why would petitioner, the alleged remainderman, be required to make payments to Steinway, the alleged owner of an estate for years, as a result of nonoccupancy by the latter? What we really have here is a provision for reimbursement of prepaid rent in the event the tenant is denied (or, during the last one-half year of the term, elects abandonment of) its right of unfettered occupancy, the prepaid rent being in the form of the value of the property received by petitioner in excess of the $750,000 cash paid therefor.

Petitioner emphasizes the fact that it received no cash rental payments at any time; it merely purchased real estate for cash. This is partly true, but one need not receive cash to have received income. . . .

Possibly the result in the instant case would be different if the parties had in fact intended to carve out a reserved term for years in Steinway and had structured their transaction in that form. We do not agree with petitioner, however, that to hold that there was a sale of the fee and a simultaneous leaseback here is to exalt form over substance. The so-called space-occupancy agreement placed the two parties' rights, obligations, and risks as they would be allocated in a typical lease arrangement. Hence, the arrangement was a lease in substance as well as in form.

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Notes

1. *The Arguments.* The taxpayer agreed to purchase a warehouse with current fair market value of $1,000,000. The terms of the agreement provided for an immediate payment of $750,000, and the seller retained possession for 2½ years. The government argued that the transaction should be treated as if the taxpayer paid $1,000,000 for the warehouse and then the seller immediately transferred $250,000 as prepaid rent for a 2½ year term. As a result, the government argued that the taxpayer should have a $1,000,000 basis in the building and $250,000 of rental income.

The taxpayer argued that the taxpayer only purchased a remainder in the building for its fair market value of $750,000. From this, the taxpayer argued that it took a $750,000 basis in the building and has no income as a result of the transaction. Thus, the fight centers on whether the taxpayer must recognize $250,000 of rental income (with an equivalent increase in asset basis).

2. *The Outcome*. The court held for the government. Why? The court found that "risk of ownership" had been fully transferred to the taxpayer: the taxpayer was obligated to provide heat, electricity and water to the tenant, and the taxpayer (rather than the tenant) bore the risk of damage caused by Act of God. Could a good tax lawyer have structured the transaction to produce a different result? Were the indicia of ownership on which the court focused significant enough to carry this much weight? If the government's and the taxpayer's characterizations are so close, should not they produce the same outcomes?

3. *The relevance of* Irwin v. Gavit. Note that if *Irwin v. Gavit* had been come out the other way, this case would not arise. Recall that the Supreme Court in *Gavit* held that the donee of an income interest had no basis to amortize, thereby giving the entire basis to the donee of the remainder. If the Court had given basis to the donee of the income interest, there would be less basis for the remainderbeneficiary. From that result it is but a short step to provide that the remainderbeneficiary recognizes income each year as the remainder becomes closer to possession. Here, that would mean that the taxpayer would recognize income of $250,000 over 2½ years even under the taxpayer's theory of the case.

Question

1. Assume the seller's adjusted basis in the warehouse was $600,000. What are the tax consequences to the seller under the government's and the taxpayer's characterizations? (Hint: make certain you fully account for all the seller's adjusted basis and that you account for it properly, thinking back to the *Inaja Land* case.)