

## 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”). Taxpayers are required (subject to exceptions discussed below) to keep their books and records for tax purposes using the same method of accounting as they use for financial purposes. §461(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.<sup>1</sup> 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.

In addition to an accounting method, each taxpayer must have an accounting period; that is, a taxable year. See §441(b). For individuals, the calendar year invariably is used as the taxable year.<sup>2</sup> For corporate taxpayers, some other year might better coincide with the operation of the business.<sup>3</sup> For example, a school might wish to use a taxable year starting each year on July 1 and ending the following June 30 if that is its academic year. Such a taxable year is called a “fiscal” year, see §441(c).

#### 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,

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<sup>1</sup> For example, gain recognized from payments received over time may be reported using the “installment method” described in §465. The installment method is discussed later.

<sup>2</sup> Because few infants keep a set of fiscal books and records, infants start with the calendar year as their taxable year. §441(g). Changing taxable year (such as from the calendar year to a fiscal year) requires the consent of the government. §442.

<sup>3</sup> Special rules apply to certain types of entities. See §706(b) (taxable year of partnership determined by reference to taxable year of its partners; §1378 (taxable year of S Corporation generally is the calendar year).

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; (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;"<sup>4</sup> and (c) any other method authorized in the Code or Regulations.<sup>5</sup>

Accrual accounting is considered the method of accounting most consistent with economic reality. Under accrual accounting, income is recognized when earned. For service income, it is earned when the services are performed; for goods that are sold, 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.<sup>6</sup> Cash method accounting, on the other hand, generally ignores income generation in favor of payment receipt. As a result, it often can be easy for a taxpayer to manipulate the timing of income and deductions. Many taxpayers are precluded from using the cash method of accounting including most C corporations<sup>7</sup> as well as partnerships that have a C corporation as a partner. §448(b). In addition, most businesses that deal in inventories must use special inventory accounting. §471(a).

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<sup>4</sup> 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. In addition, §451(b) provides that the "all events" test may not be treated as satisfied later than when the taxpayer takes the item of income into account for financial reporting purposes. Like §444(a), this provision is intended to ensure that a corporate taxpayer cannot report a large amount of income to its shareholders while reporting a smaller amount of income to the government.

<sup>5</sup> E.g., §455 (prepaid subscription income).

<sup>6</sup> See §166 (bad debt deduction).

<sup>7</sup> A "C corporation" is a corporate entity not subject to special rules of taxation. See §1361(b). Other kinds of corporations include S corporations, see §1361(a), C corporations that are taxed as Real Estate Investment Trusts (REITs), §856, and C Corporations that are taxed as Regulated Investment Companies (RICs), §851..

## 2. Accrual Accounting

### **United States v. Hughes Properties, Inc.**

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**476 U.S. 593 (1986)**

JUSTICE BLACKMUN delivered the opinion of the Court.

This case concerns the deductibility for federal income tax purposes, by a casino operator utilizing the accrual method of accounting, of amounts guaranteed for payment on "progressive" slot machines but not yet won by playing patrons.

I

A

There is no dispute as to the relevant facts; many of them are stipulated. Respondent Hughes Properties, Inc., is a Nevada corporation. It owns Harolds Club, a gambling casino, in Reno, Nev. It keeps its books and files its federal income tax returns under the accrual method of accounting. During the tax years in question (the fiscal years that ended June 30 in 1973 to 1977, inclusive), respondent owned and operated slot machines at its casino. Among these were a number of what are called "progressive" machines. A progressive machine, like a regular one, pays fixed amounts when certain symbol combinations appear on its reels. But a progressive machine has an additional "progressive" jackpot, which is won only when a different specified combination appears. The casino sets this jackpot initially at a minimal amount. The figure increases, according to a ratio determined by the casino, as money is gambled on the machine. The amount of the jackpot at any given time is registered on a "payoff indicator" on the face of the machine. That amount continues to increase as patrons play the machine until the jackpot is won or until a maximum, also determined by the casino, is reached.

The odds of winning a progressive jackpot obviously are a function of the number of reels on the machine, the number of positions on each reel, and the number of winning symbols. The odds are determined by the casino, provided only that there exists a possibility that the winning combination of symbols can appear.

The Nevada Gaming Commission closely regulates the casino industry in the State, including the operation of progressive slot machines. In September, 1972, the Commission promulgated § 5.110 of the Nevada Gaming Regulations. This section requires a gaming establishment to record at least once a day the jackpot amount registered on each progressive machine. § 5.110.5. Furthermore,

"[n]o payoff indicator shall be turned back to a lesser amount, unless the amount by which the indicator has been turned back is actually paid to a winning player, or unless the change in the indicator reading is necessitated through a machine malfunction, in which case an explanation must be entered on the daily report as required in subsection 5."

§ 5.110.2. The regulation is strictly enforced. Nevada, by statute, authorizes the Commission to impose severe administrative sanctions, including license revocation, upon any casino that wrongfully refuses to pay a winning customer a guaranteed jackpot. *See Nev. Rev. Stat. § 463.310 (1985).*

It is respondent's practice to remove the money deposited by customers in its progressive machines at least twice every week, and also on the last day of each month. The Commission does not regulate respondent's use of the funds thus collected, but, since 1977, it has required that a casino maintain a cash reserve sufficient to provide payment of the guaranteed amounts on all its progressive machines available to the public. Nev. Gaming Regs. § 5.110(3).

B

At the conclusion of each fiscal year, that is, at midnight on June 30, respondent entered the total of the progressive jackpot amounts shown on the payoff indicators as an accrued liability on its books. From that total, it subtracted the corresponding figure for the preceding year to produce the current tax year's increase in accrued liability. On its federal income tax return for each of its fiscal years 1973, 1974, 1975, and 1977, respondent asserted this net figure as a deduction under § 162(a) as an ordinary and necessary expense "paid or incurred during the taxable year in carrying on any trade or business." There is no dispute as to the amounts so determined, or that a progressive jackpot qualifies for deduction as a proper expense of running a gambling business.

On audit, the Commissioner of Internal Revenue disallowed the deduction. He did so on the ground that, under Treas. Reg. § 1.461-1(a)(2), an expense may not be deducted until

"all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy."

In his view, respondent's obligation to pay a particular progressive jackpot matures only upon a winning patron's pull of the handle in the future. According to the Commissioner, until that event occurs, respondent's liability to pay the jackpot is contingent, and therefore gives rise to no deductible expense. Indeed, until then, there is no one who can make a claim for payment. Accordingly, the Commissioner determined deficiencies in respondent's income taxes for the years in question in the total amount of \$433,441.88, attributable solely to the denial of these progressive jackpot deductions. Respondent paid the asserted deficiencies and filed timely claims for refund. When the claims were denied, respondent brought this suit for refunds in the Claims Court.

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II

Section 162(a) of the Internal Revenue Code allows a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." Section 446(a) 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." . . . An accrual-method taxpayer is entitled to deduct an expense in the year in which it is "incurred," § 162(a), regardless of when it is actually paid.

For a number of years, the standard for determining when an expense is to be regarded as "incurred" for federal income tax purposes has been the "all events" test prescribed by the Regulations. See Treas. Reg. § 1.446-1(c)(1)(ii) (accruals in general); § 1.451-1(a) (accrual of income); and § 1.461-1(a)(2) (accrual of deductions). This test appears to have had its origin in a single phrase that appears in this Court's opinion in *United States v. Anderson*, 269 U. S. 422, 269 U. S. 441 (1926) ("[I]t is also true that, in advance of the assessment of a tax, all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it"). Since then, the Court has described the "all events" test "established" in *Anderson* as "the touchstone" for determining the year in which an item of deduction accrues," and as "a fundamental principle of tax accounting." *United States v. Consolidated Edison Co. of New York*, 366 U. S. 380, 366 U. S. 385 (1961) (citing cases).

Under the Regulations, the "all events" test has two elements, each of which must be satisfied before accrual of an expense is proper. First, all the events must have occurred which establish the fact of the liability. Second, the amount must be capable of being determined "with reasonable accuracy." Treas. Reg. § 1.446-1(c)(1)(ii). This case concerns only the first element, since the parties agree that the second is fully satisfied.

### III

The Court's cases have emphasized that "a liability does not accrue as long as it remains contingent." *Brown v. Helvering*, 291 U. S. 193, 291 U. S. 200 (1934); *accord*, *Dixie Pine Products Co. v. Commissioner*, 320 U. S. 516, 320 U. S. 519 (1944). Thus, to satisfy the all-events test, a liability must be "fixed and definite in amount," *Security Flour Mills Co. v. Commissioner*, 321 U. S. 281, 321 U. S. 287 (1944), must be "fixed and absolute," *Brown v. Helvering*, 291 U.S. at 291 U. S. 201, and must be "unconditional," *Lucas v. North Texas Lumber Co.*, 281 U. S. 11, 281 U. S. 13 (1930). And one may say that "the tax law requires that a deduction be deferred until all the events' have occurred that will make it fixed and certain." *Thor Power Tool Co. v. Commissioner*, 439 U. S. 522, 439 U. S. 543 (1979).

### A

The Government argues that respondent's liability for the progressive jackpots was not "fixed and certain," and was not "unconditional" or "absolute," by the end of the fiscal year, for there existed no person who could assert any claim to those funds. It takes the position, quoting *Nightingale v. United States*, 684 F.2d at 614, that the indispensable event "is the winning of the progressive jackpot by some fortunate gambler." It says that, because respondent's progressive jackpots had not been won at the close of the fiscal year, respondent had not yet incurred liability. Nevada law places no restriction on the odds set by the casino, as long as a possibility exists that the winning combination can appear. Thus, according to the Government, by setting

very high odds, respondent can defer indefinitely into the future the time when it actually will have to pay off the jackpot. The Government argues that, if a casino were to close its doors and go out of business, it would not owe the jackpots to anyone. Similarly, if it were to sell its business, or cease its gaming operations, or go into bankruptcy, or if patrons were to stop playing its slot machines, it would have no obligation.

B

We agree with the Claims Court . . . and disagree with the Government, for the following reasons:

1. The effect of the Nevada Gaming Commission's regulations was to fix respondent's liability. Section 5.110.2 forbade reducing the indicated payoff without paying the jackpot, except to correct a malfunction or to prevent exceeding the limit imposed. Respondent's liability, that is, its obligation to pay the indicated amount, was not contingent. That an extremely remote and speculative possibility existed that the jackpot might never be won did not change the fact that, as a matter of state law, respondent had a fixed liability for the jackpot which it could not escape. The effect of Nevada's law was equivalent to the situation where state law requires the amounts of the jackpot indicators to be set aside in escrow pending the ascertainment of the identity of the winners. The Government concedes that, in the latter case, the liability has accrued, even though the same possibility would still exist that the winning pull would never occur.

2. The Government misstates the need for identification of the winning player. That is, or should be, a matter of no relevance for the casino operator. The obligation is there, and whether it turns out that the winner is one patron or another makes no conceivable difference as to basic liability.

3. The Government's heavy reliance on *Brown v. Helvering*, 291 U. S. 193 (1934), in our view, is misplaced. That case concerned an agent's commissions on sales of insurance policies, and the agent's obligation to return a proportionate part of the commission in case a policy was canceled. The agent sought to deduct from gross income an amount added during the year to his reserve for repayment of commissions. This Court agreed with the Commissioner's disallowance of the claimed deduction because the actual event that would create the liability -- the cancellation of a particular policy in a later year -- "[did] not occur during the taxable year," *id.* at 291 U. S. 200, but rather occurred only in the later year in which the policy was in fact canceled. Here, however, the event creating liability, as the Claims Court recognized, was the last play of the machine before the end of the fiscal year, since that play fixed the jackpot amount irrevocably. That event occurred during the taxable year.

4. The Government's argument that the fact that respondent treats unpaid jackpots as liabilities for financial accounting purposes does not justify treating them as liabilities for tax purposes is unpersuasive. Proper financial accounting and acceptable tax accounting, to be sure, are not the same. Justice Brandeis announced this fact well over 50 years ago: "The prudent business man often sets up reserves to cover contingent liabilities. But they are not allowable as deductions." The Court has

long recognized "the vastly different objectives that financial and tax accounting have." *Thor Power Tool Co. v. Commissioner*, 439 U.S. at 542. The goal of financial accounting is to provide useful and pertinent information to management, shareholders, and creditors. On the other hand, the major responsibility of the Internal Revenue Service is to protect the public fisc. *Ibid*. Therefore, although § 446(c)(2) permits a taxpayer to use an accrual method for tax purposes if he uses that method to keep his books, § 446(b) specifically provides that, if the taxpayer's method of accounting "does not clearly reflect income," the Commissioner may impose a method that "does clearly reflect income." Thus, the "Commissioner has broad powers in determining whether accounting methods used by a taxpayer clearly reflect income." *Commissioner v. Hansen*, 360 U. S. 446, 360 U. S. 467 (1959). The Regulations carry this down specifically to "the accounting treatment of any item." *Treas. Reg. § 1.446-1(a)(1)*.

Granting all this -- that the Commissioner has broad discretion, that financial accounting does not control for tax purposes, and that the mere desirability of matching expenses with income will not necessarily sustain a taxpayer's deduction - - the Commissioner's disallowance of respondent's deductions was not justified in this case. As stated above, these jackpot liabilities were definitely fixed. A part of the machine's intake was to be paid out, that amount was known, and only the exact time of payment and the identity of the winner remained for the future. But the accrual method itself makes irrelevant the timing factor that controls when a taxpayer uses the cash receipts and disbursements method.

5. The Government suggests that respondent's ability to control the timing of payouts shows both the contingent nature of the claimed deductions and a potential for tax avoidance. It speaks of the time value of money, of respondent's ability to earn additional income upon the jackpot amounts it retains until a winner comes along, of respondent's "virtually unrestricted discretion in setting odds," and of its ability to transfer amounts from one machine to another with the accompanying capacity to defer indefinitely into the future the time at which it must make payment to its customers. All this, the Government says, unquestionably contains the "potential for tax avoidance." See *Thor Power Tool Co. v. Commissioner*, 439 U.S. at 439 U. S. 538. And the Government suggests that a casino operator could put extra machines on the floor on the last day of the tax year with whatever initial jackpots it specifies and with whatever odds it likes, and then, on the taxpayer's theory, could take a current deduction for the full amount, even though payment of the jackpots might not occur for many years.

None of the components that make up this parade of horrors, of course, took place here. Nothing in this record even intimates that respondent used its progressive machines for tax avoidance purposes. Its income from these machines was less than 1% of its gross revenue during the tax years in question. Respondent's revenue from progressive slot machines depends on inducing gamblers to play the machines, and, if it sets unreasonably high odds, customers will refuse to play, and will gamble elsewhere. Thus, respondent's economic self-interest will keep it from setting odds likely to defer payoffs too far into the future. Nor, with Nevada's strictly imposed

controls, was any abuse of the kind hypothesized by the Government likely to happen. In any event, the Commissioner's ability, under § 446(b) of the Code, to correct any such abuse is the complete practical answer to the Government's concern. If a casino manipulates its use of progressive slot machines to avoid taxes, the Commissioner has the power to find that its accounting does not accurately reflect its income, and to require it to use a more appropriate accounting method. Finally, since the casino of course must pay taxes on the income it earns from the use of as-yet-unwon jackpots, the Government vastly overestimates the time value of respondent's deductions.

6. 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. "The existence of an absolute liability is necessary; absolute certainty that it will be discharged by payment is not." *Helvering v. Russian Finance & Constr. Corp.*, 77 F.2d 324, 327 (CA2 1935). And if any of the events hypothesized by the Government should occur, the deducted amounts would qualify as recaptured income subject to tax. Treas. Reg. § 1.461-1(a)(2).

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The judgment of the Court of Appeals is affirmed.

It is so ordered.

[The dissenting opinion of JUSTICE STEVENS, joined by the CHIEF JUSTICE, is omitted.]

#### Notes

1. *The Hughes Properties Case*. At issue in the *Hughes Properties* case was the proper application of the "all events" test applicable to accrual taxpayers. Under the all events test as in effect when the case was decided, income (and deductions) are accrued when all the events have occurred that fix the right to receive the income (or pay the deductions) and the amount can be determined with reasonable accuracy.<sup>8</sup> The government made two arguments that the amounts displayed on the taxpayer's progressive slot machines had not yet accrued under this test because (1) no one had yet won the jackpots so the identity of the patron entitled to the jackpot had not yet been determined, and (2) certain unlikely events such as bankruptcy of the taxpayer could extinguish the taxpayer's obligation to pay out the jackpot to anyone.

The Court rejected the first argument because "[t]he obligation is there, and whether it turns out that the winner is one patron or another makes no conceivable difference as to basic liability." Given the definition of the all events test, this conclusion seems inescapable. The second argument – accrual is not appropriate if there is any contingency that could prevent payment, has been argued – and lost -- by taxpayers to avoid accrual

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<sup>8</sup> The requirement of "economic performance" has been added to the all events test as it applies to accrual of deductions. See §461(h), discussed below.



of income. In *Georgia School-Book Depository v. Commissioner*, 1 T.C. 463 (1943), the taxpayer was a broker of schoolbooks that was entitled to be paid only when and if the State of Georgia paid the book publisher for the textbooks brokered by the taxpayer. Under state law then in effect, the Georgia's full faith and credit did not back its obligation to pay for the textbooks brokered by the taxpayer. Instead, payment could only be made from a fund generated by a tax imposed on the sale of beer. Accordingly, if the fund ran dry, Georgia would not have to pay for the textbooks. This fund had never been exhausted, and there was no real suggestion that it would happen in the future. The Tax Court held that taxpayer had to accrued its income once the textbooks were delivered because "there was no reasonable expectation that the sums owed by the state to petitioner's publishers and, consequently, the commissions to petitioner itself, would not ultimately be paid."

2. *The General Dynamics Case.* In *United States v. General Dynamics Corp.*, 481 U.S. 239 (1987), the taxpayer offered health care to its employees. Rather than purchasing insurance for its employees, the taxpayer self-insured, paying claims after they were submitted by employees and verified by a plan administrator. The taxpayer wanted to estimate at the end of its taxable year the amount of claims that would be submitted for medical services received by the employees before the end of the taxable year. If *General Dynamics* seems significantly different from *Hughes Properties*, it is because as of the close of General Dynamic's taxable year, the taxpayer 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 medical 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 seemee accrual was appropriate.

And yet the taxpayer in *General Dynamics* lost, apparently 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. Indeed, in *Hughes Properties*, it was possible (at least legally possible) that a jackpot winner would fail to collect her winnings. Why then 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.

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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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. Perhaps the Court imported the "reasonable accuracy" requirement into the "all events" portion of the 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 or the right to provide the services expired. 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 accounting 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 ratably 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.

The taxpayer in these cases deducted the costs associated with its membership obligations in the year in which the services it provided actually were performed, yet 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 contracts to expire before all the lessons had been claimed, 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 under the “clear reflection of income” standard of §446(b).<sup>9</sup>

If these three cases stand for the proposition that accrual of income cannot be deferred based on statistical analysis, could that explain the outcome in *General Dynamics*? Note that this issue did not arise in *Hughes Properties*.

**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

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<sup>9</sup> Congress ultimately sided with the taxpayers. §455 (prepaid subscription income).

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 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.<sup>10</sup> But courts have been unwilling to inject present value concepts into the Internal Revenue Code except where clearly mandated by Congress. In the Mooney bond case, 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 at some point, 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). As a result, no immediate deduction was allowed.

Congress ultimately spoke to this issue, enacting §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 defines the time when economic performance occurs using 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 not 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 worker's compensation claim, economic performance occurs as the taxpayer makes payments on 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

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<sup>10</sup> 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 then 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)

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 receives 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 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.

#### *Questions*

Q-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?

Q-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 decommissioning with a third party when the plant is first operated?

Q-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?

Q-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)).

Q-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 possession 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**

Under the regulations, a cash method taxpayer includes income when it is actually or constructively received and deducts items when they are actually paid. Reg. §1.446-1(c)(i). What is "constructive" receipt? It occurs when funds have been credited to the taxpayer's account, set apart for him, or otherwise made available so that he may draw

upon it at any time, or so that he could have drawn upon it if notice of intention had been given. Reg. §1.451-2(a). "However, income is not constructively received if the taxpayer's control of the receipt is subject to substantial limitations or restrictions." *Id.* For examples of constructive receipt, see Reg. §1.451-2(b).

**Amend v. Commissioner**

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**13 T.C. 178 (1949)**

**Findings of Fact**

....

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.

....

**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. Sometime 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.

. . . .

*Decisions will be entered under Rule 50.*

**Pulsifer v. Commissioner**

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**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.*

#### *Note*

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*

Q-6. 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?

Q-7. 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?

Q-8. 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?

Q-9. 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?

Q-10. In questions 4 – 7, 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 payment is made with borrowed funds? Yes. E.g., *Franklin v. Commissioner*, 683 F.2d 125 (5th Cir. 1982). Note that giving the creditor the taxpayer's own 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 cash-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 issuing bank that issued the MasterCard 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. Under general cash method accounting principles, this election should 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. §471(a). 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).

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**Commercial Security Bank v. Commissioner**

**77 T.C. 145 (1981)**

OPINION

TANNENWALD, CHIEF JUDGE:

Respondent determined deficiencies in the Federal income taxes of Orem State Bank (Orem) of \$2,793.20 and \$86,510.06 for the taxable years ending December 31, 1973, and June 14, 1974. Petitioner has accepted liability for all deficiencies adjudged against Orem as transferee of Orem's assets and liabilities. Because of concessions by petitioner, the issues remaining concern the proper tax treatment of accrued but unpaid deductible expenses and accrued but unreceived items of ordinary income in the short taxable year of Orem's complete liquidation.

...

Orem was a Utah corporation with its principal place of business in Orem, Utah. Orem filed its Federal income tax returns on a calendar year basis using the cash receipts and disbursements method of accounting. Orem's last taxable year ended on June 14, 1974, because it ceased to exist as of that date. See secs. 443(a)(2), 441(b)(3).

Orem's complete liquidation met the requirements of [former §337, since repealed. That provision allowed a liquidating corporation to sell its assets without the recognition of gain if completed within 12 months of adopting the plan of liquidation.] Within a 12-month period after adopting its plan of liquidation, Orem sold its assets to petitioner in consideration of the payment of \$1,175,000 in cash and the assumption by petitioner of all of Orem's existing obligations and liabilities (including any Federal or State income taxes of Orem due by reason of the transaction). Petitioner determined the price it was willing to pay for Orem's assets on the basis of estimating all of Orem's items of income and expense as if Orem were on the accrual basis at the time of closing of the sale. Among the "accruable" items were:

(a) *Accrued interest receivables*

U.S. Government securities	\$5,173.35
U.S. Government agency securities	10,227.23
Commercial loans	31,936.07
Trust receipts	3,544.61
Real estate loans	17,457.27
Total	<u>68,338.53</u>

(b) *Accrued business liabilities*

Interest expense—all deposits	\$120,786.75
Wage expense—fringe benefits	4,570.00
Insurance expense—group plan	135.60
Repairs/maintenance expense	34.00
Accountant's fee	800.00
Computer processing expense	<u>3,718.25</u>
Total	<u>130,044.60</u>

Orem's final tax return included the "accrued interest receivables" in income and deducted the "accrued business liabilities." Respondent accepted Orem's inclusion in income of the items of "accrued interest receivables" but disallowed the deduction of the "accrued business liabilities." Those liabilities appear to represent items of a character which would have been deductible by Orem when paid under sections 162 and 163, and respondent has not contended otherwise.

Petitioner's primary position accepts the inclusion of the "accrued interest receivables" in Orem's income but disputes the denial of the deduction of the "accrued business liabilities." It contends that its assumption of those liabilities should be treated as the receipt of an equivalent amount of cash to Orem and the payment of those liabilities by Orem, with the result that the deductions therefor were properly taken by Orem in its final return. Alternatively, petitioner argues that Orem was at least entitled to offset a portion of the liabilities representing accrued interest payable against the "accrued interest receivables." Respondent asserts (1) that, under all circumstances, the inclusion of "accrued interest receivables" in Orem's income was proper, (2) that, by claiming a deduction for the "accrued business liabilities," Orem changed its method of accounting without obtaining respondent's prior consent (see sec. 446(e)), and (3) that Orem is under no circumstances entitled to deduct any of those liabilities, because it remained a cash basis taxpayer and did not pay them. For reasons which are hereinafter set forth, we agree with petitioner's primary position that the "accrued business liabilities" are deductible in full.

At the outset, we note that there can be no question but that the "accrued interest receivables" were properly includable in Orem's income for its last taxable year, and petitioner does not contend otherwise. It is also beyond question (and petitioner does not argue otherwise) that the amount of the "accrued business liabilities" would, but for the impact of section 337, have been taken into account in computing Orem's gain or loss from the sale. *Crane v. Commissioner*, 331 U.S. 1 (1947). But it does not necessarily follow that those liabilities are deductible. That, as we see it, is a separate issue.

Orem seeks to deduct only those liabilities which had accrued on the date of sale. It is clear that had Orem simply sold all its assets and retained its liabilities, the deductions now being contested would have been deductible only as the liabilities were actually paid. It is equally clear, however, that if Orem had retained those liabilities, the amount of cash it would have received would have been correspondingly increased. Indeed, this is the foundation of petitioner's argument that, by accepting less cash for its assets in exchange for the assumption of its liabilities, Orem effectively paid the accrued liabilities at the time of the sale. We agree.

We recognize that Orem, itself, did not actually satisfy the accrued liabilities by direct payment to, or unrestricted crediting of the accounts of, the ultimate obligees. But in substance, by accepting less cash than it otherwise would have received, it made an actual payment to petitioner which was sufficient to justify the deductions. . . . We emphasize that we are not holding that Orem was making a constructive payment of the liabilities in question — an approach which sometimes presents considerable difficulty where a cash basis taxpayer is involved, particularly with respect to the relationship (or, more properly, the absence of a relationship) between constructive receipt and constructive payment. Consequently, respondent's arguments based upon sections 1.446-1(c)(1)(i) and 1.461-1(a)(1), Income Tax Regs., limiting deductions to those "actually made" are beside the point.

Respondent's reliance on *Arcade Restaurant, Inc. v. Commissioner*, a Memorandum Opinion of this Court dated August 13, 1948, is misplaced. In that case, we held that the assumption of a corporation's liabilities by its shareholders as part of the corporation's complete liquidation was not a "payment" sufficient to support a deduction of those liabilities on the corporation's final income tax return. Aside from any question as to the "antiqueness" of the case, the fact is that there was no sale or other exchange of value; rather, the shareholders took whatever assets and liabilities the corporation had. In the instant case, however, the amount of cash which Orem received for its assets was diminished by the amount of its liabilities, and it is that diminution which permits a finding of actual payment distinguishing the instant case from *Arcade* and similar cases.

Respondent argues that to allow Orem the deduction claimed herein will permit a situation akin to a double deduction, because the amount of the liabilities deemed paid by their assumption increases the basis of the assets acquired by petitioner, with a resulting potential tax benefit to petitioner upon the ultimate disposition of those assets, i.e., decreased gain or loss. There is no question but that an increase in basis occurs. *Crane v. Commissioner*, *supra*. Nevertheless, we think that respondent's argument misses the mark.

Because the purchase price which petitioner paid was equal to the value of Orem's assets less the value of its liabilities, allowing petitioner to increase its basis by the amount of the liabilities assumed simply brings its basis back to the full value of the assets, value paid in part to Orem and in part to the obligees of the accrued liabilities in dispute. See *Crane v. Commissioner*, *supra* at 13-14. Petitioner's basis is precisely what it would have been had Orem retained its accounts payable and paid them itself, and in such case, the deductions would clearly have materialized. Thus, petitioner's

basis in the purchased assets is perfectly consistent with allowing Orem the disputed deductions.<sup>11</sup>

Respondent contends that allowing Orem to deduct the accrued liabilities in this case will have the effect of permitting Orem to change its method of accounting without respondent's prior approval. Yet, as we have made clear above, that is not the case; by receiving less for its assets, Orem discharged its liabilities and can be considered as having effectively paid them. Moreover, by requiring Orem to include "accrued interest receivables" in income, respondent has in effect put Orem on an accrual basis as to those items, and we think his reliance on a highly technical reading of his regulations to say that similar treatment should not be accorded to the "accrued business liabilities" is questionable. This observation is, we think, particularly applicable in the instant situation, where the items in question are, as far as this record reveals, not only of a character otherwise qualifying for deduction under sections 162 and 163, but also appear to have been intimately related to the items of "accrued interest receivables."

....

*Decision will be entered under Rule 155.*

#### *Note*

1. *The Commercial Security Bank case.* The *Commercial Security Bank* case can be hard to understand. The facts are these: one bank (the "Selling Bank") sold all of its assets, subject to all of its liabilities, to a second bank (the "Purchasing Bank"). Under a corporate tax provision then in effect but long since repealed, no gain or loss was recognized by the Selling Bank on this sale. The assets of the Selling Bank included loans the Selling Bank had made to borrowers as well as accrued but unreceived interest on some of those loans. The liabilities of the Selling Bank included deposits made by customers of the Selling Bank as well as accrued but unpaid interest on some of those deposits. The government asserted that the Selling Bank had to report the accrued but unreceived interest on the loans as interest income, and the Selling Bank did not dispute this. At issue was whether the Selling Bank could deduct the accrued but unpaid interest it owed on the deposits. The Selling Bank used the cash receipts and disbursements method of accounting so that interest income would be taxable only when actually or constructively received and interest owed would be deductible only when actually paid.

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<sup>11</sup> Had Orem retained its liabilities and then satisfied them itself, it is possible that some of the deductions would not have ripened until Orem's next taxable year (we are assuming that Orem would not have dissolved until after it had paid its debts) because only then would some of the accrued liabilities have become due. Thus, our holding allows some acceleration of deductions. However, because we are faced with liabilities which have already accrued (i.e., would already be deductible in full had Orem been on the accrual basis), the amount of the acceleration is minimal and no more than the usual by-product of accrual accounting. See sec. 1.446-1(c)(1)(ii), Income Tax Regs. Liabilities of a transferor which do not accrue until after the transfer are, of course, deductible by the transferee when paid or accrued.

First note that recognizing interest income and deducting interest owed is not inconsistent with the statute that then provided no “gain or loss” would be recognized on the sale because interest income is not “gain” and an interest deduction is not a “loss.” Do not forget that there are many kinds of income such as compensation, income from the cancellation of indebtedness, interest received, and dividends that are not “gain” because gain only arises from the disposition of property (when amount realized exceeds adjusted basis). Similarly, not all deductions are loss deductions. For example, the ordinary and necessary costs incurred in carrying on a trade or business are deductible but are not “losses.”

If the Selling Bank had not sold its assets to the Purchasing Bank, then the Selling Bank eventually would have included the interest received and would have deducted the included the accrued interest to be received and would have deducted the accrued interest to be paid prior to the sale. The courts have long understood that a taxpayer’s method of accounting should affect the timing of income and deduction recognition but should not affect whether something is income or a deduction nor to whom. In *Commercial Security Bank*, if the accrued income and deduction had not been accounted for at the time of sale, it could never be taxed to or deducted by the Selling Bank because what gave rise to the nonrecognition rule on the sale was that the Selling Bank had to immediately distribute the sale proceeds to its shareholders and then dissolve (called a “corporate liquidation” by the Code). To ensure that cash accounting could not be used to avoid interest income recognition, the accrued interest to be received had to be included in income by the Selling Bank at the time of interest paid. Indeed, if the Selling Bank had been an accrual taxpayer, it would have transfer. That was already a well-established rule.

The novel question was whether the Selling Bank could deduct the accrued by unpaid interest it owed to its depositors. We know that the Selling Bank did not actually pay that interest: it would be paid by the Purchasing Bank when payment came due (at the end of the month, or the end of the quarter, or whenever interest was paid to depositors). But note that because the Purchasing Bank would have to make those interest payments, presumably the sale price agreed to by the parties was reduced by the payments the Purchasing Bank would have to make in the future. Thus, while the Selling Bank did not actually pay the accrued interest to its depositors, it had less funds to distribute to its shareholders when it liquidated immediately following the sale just as if it had paid that interest. The court was willing to treat this reduction in sale proceeds as the equivalent of payment of the accrued interest obligations.

When the Purchasing Bank receives the accrued interest from its borrowers, it does not have income from that receipt. Can you see why? And when it pays the accrued interest to its depositors, it cannot claim an interest deduction. “Interest” for tax purposes is money paid for the use of someone else’s money (i.e., it is what is paid to rent someone else’s money). Can you see why the Purchasing Bank cannot treat the accrued interest it will pay as “interest” under this definition? What did the Purchasing Bank get that requires it to pay those accrued interest payments? How should it treat those payments? (Hint: the transaction could have been structured by having the Selling Bank retain its accrued interest obligations and then paying them off prior to liquidation out of the sale proceeds. If it had been done that way, how would the sale price have changed? Note

that now there would have been actual payment of the deductible interest by the Selling Bank.)

*Question*

Q-11. Is the effect of *Commercial Security Bank* to create a doctrine of constructive payment for cash method taxpayers? The Supreme Court's decision in *Massachusetts Mutual Life Co. v. United States*, 288 U.S. 269 (1933), generally is considered authority for the proposition that there is no doctrine of "constructive payment." How did Judge Tannenwald meet that objection?

*Problem*

P-1. Seller, a cash method taxpayer, has the following balance sheet:

<u>Asset</u>	<u>Value</u>	<u>Adjusted Basis</u>
Equipment	\$750,000	\$200,000
Goodwill	\$300,000	\$ 0
Receivables	\$ 50,000	\$ 0
<u>Liability</u>	<u>Amount</u>	
Bank Loan	\$400,000	
Payables	\$100,000	

How much should a buyer be willing to pay for all the assets of Seller (subject to all the liabilities of Seller)? How should Seller be taxed on the sale (ignore the distinction between ordinary income and capital gain)?

**4. Clear Reflection of Income**

**Thor Power Tool Co. v. Commissioner**

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**439 U.S. 522 (1979)**

MR. JUSTICE BLACKMUN delivered the opinion of the Court.

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**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.<sup>151</sup> 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)	<u>160,832</u>
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.<sup>121</sup> 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. Burnet*, 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 receipt 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 a lesser amount, 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.

## **6. Inventory Accounting**

Gain and loss from the sale of inventory is computed in the aggregate rather than on an asset-by-asset basis. This means that amounts received for inventory are included in gross income and the cost of goods sold is deducted from gross income. Further, a taxpayer’s cost of goods sold is not computed by identifying the actual adjusted basis in the inventory items sold during the year but rather is computed using one or another convention. This approach is based on the recognition that it can be difficult or even impossible for a seller of fungible items to determine the amount paid for specific items.

The two most important conventions used in inventory accounting are the First In, First Out (FIFO) convention and the Last In, First Out convention. Using FIFO, a taxpayer selling fungible goods assumes that assets sold during the year were those purchased earliest. Conversely, using LIFO, a taxpayer selling fungible goods assumes the assets sold during the year were those purchased most recently. See §472(b). In a world in which prices generally rise over time, LIFO generates a bigger deduction in the early years than does FIFO.

### *Problem*

P-2. T purchases 1,000 widgets for \$100 apiece (\$100,000 total) in opening inventory in 2021. During that year, T purchases an additional 1,000 widgets for \$110 each and sells 1,000 widgets for \$150 each. In 2022, T again sells 1,000 widgets, now for \$160 per unit, and purchases 1,000 new widgets for \$120 each. In 2023, T sells 1,000 widgets for \$170 each and purchases 1,000 new widgets for \$130 each. In 2024, T sells 1,000 widgets for \$180 each but does not purchase any new inventory. Compute T’s taxable income for each year 2021 through 2024 using both LIFO and FIFO. Does this help explain why allowance of LIFO is considered a tax subsidy to inventory sellers?



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

**1. Open Transactions**

**Burnet v. Logan**

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**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 taxpayer's contract rights were 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 is 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 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 no 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.<sup>12</sup>

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.

### Notes

1. *Extension of §453 when the contract price is indeterminate.* Suppose T sells a mine 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 ratably over the contract period

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<sup>12</sup> For the definition of "gross profit," see Reg. §15A.453-1(b)(2)(v). For the definition of "total contract price," see Reg. §15A.453-1(b)(2)(iii).

(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 so that, for example, if 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).<sup>13</sup>

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 as 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 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, see §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 an interest charge will be imposed on all installment obligations arising in that year.<sup>14</sup> Surprisingly, installment

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<sup>13</sup> Note also that §453 does not defer recognition of gain that is treated as depreciation recapture under §453(i). Depreciation recapture will be covered in the Chapter on capital gains and losses.

<sup>14</sup> §453A(b)(2).

obligations arising in different taxable years are not combined to reach the \$5,000,000 threshold.<sup>15</sup>

5. *Annuities.* An annuity is an investment by a taxpayer in which one or more premiums are paid (generally to an insurance company) in exchange for the right to annual payments that last for a fixed number of years or until the taxpayer's death. Section 72 addresses the taxation of annuities, and it operates in the same manner as the installment sale rule in §453. Section 72(b) defines the "exclusion ratio," and this ratio is used to determine how much of each annuity payment is includible in income.

A taxpayer's basis in an annuity (called the taxpayer's "investment in the contract") generally equals the amount the taxpayer has paid in premiums. §72(c)(1)(A). The exclusion ratio is the ratio of the taxpayer's "investment in the contract" to the estimated amount the taxpayer is expected to receive. §72(b)(1). To determine the amount a taxpayer is estimated to receive, we multiply the annual annuity payment times the taxpayer's life expectancy as determined under regulations promulgated under §72. Thus, the exclusion ratio is nothing but the taxpayer's basis in the annuity contract divided by the total amount the taxpayer is estimated to receive. As the taxpayer receives annuity payments, the proportion of the payment equal to the exclusion amount is not taxed while the remainder (think of the remainder as the inclusion ratio, and compare §453(c)) is taxed. §72(a)(1).

Some taxpayers outlive their life expectancy while others die prematurely. If a taxpayer is fortunate enough to receive annuity payments beyond the expected number, the taxpayer's basis in the annuity contract has been fully recovered and so the exclusion ratio drops to zero. §72(b)(2). On the other hand, if a taxpayer dies prior to receipt of all the expected annuity payments, some of the taxpayer's basis in the contract remains unrecovered, and such a taxpayer is entitled to a deduction equal to that unrecovered portion of basis on her final income tax return (filed, of course, by the deceased taxpayer's executor). §72(b)(3).

A prior rule in §72 allowed a taxpayer to continue to use the exclusion ratio indefinitely even after all basis had been recovered. That same rule denied any deduction to a taxpayer who died prematurely. Assuming the life expectancy tables in the regulations are actuarially accurate, this alternate rule has no impact on the Treasury but has the effect of forcing those annuity holders who die early to subsidize those who die late. Can you think of any social policy further by such a subsidization policy?

Note that what is taxed under §72 is in effect interest on the taxpayer's investment. Interest generally is taxed as it accrues, even to a cash-basis taxpayer. The effect of the annuity rule is to give a taxpayer deferral of that implicit build-up of interest. Is such deferral appropriate? Note that a taxpayer could construct her own annuity simply by depositing money into a savings account and then withdrawing from the account in equal annual installments. But in such circumstances the annual interest would be taxable without any deferral. Why should the economically similar transaction be taxed

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<sup>15</sup> §453A(b)(2)(B) ("arose during").

differently just because the taxpayer invests through an insurance company rather than through a bank?

6. *Owning an Installment Obligation at Death: IRD.* Suppose a taxpayer owns an installment obligation at death, and that obligation is devised to some beneficiary of the estate. What is the beneficiary's basis in the installment obligation?

Recall the general rule that devised property takes a fair market value basis (i.e., a "step-up" basis) in the hands of the estate or devisee. §1014(a). If this rule applied, it would eliminate from the tax base any gain that would have been recognized by the decedent if she had survived and received the installment payments directly. But this rule does not apply because of §1014(c): the step-up in basis is denied to any property that constitutes "income in respect of a decedent" as defined in §691. Instead, the installment obligation takes a carry-over basis so that any gain is preserved in the hands of the new owner. §691(a)(4).

The definition of "income in respect of a decedent" (usually called "IRD") is any amount that would have been taxable to the decedent prior to the decedent's death if recognition was deferred because of an accounting treatment. See §691(a)(1); Reg. §1.691(a)-1(b). In the case of income from the sale of property where the sale was made by the decedent prior to death, all the gain would have been recognized immediately had §453 (the installment method of accounting) not been in the Code. Thus, income from such sale was deferred because of installment reporting and so is IRD, and such IRD will be taxed to whomever receives it. §691(a)(1)(A)-(C). In effect, the devisee of IRD steps into the shoes of the decedent for purposes of income recognition.

The most common type of IRD is a payment from a qualified pension plan including 401(k) plans and traditional IRAs. Most distributions from such plans are fully taxable to the plan beneficiary (e.g., to the employee for whom contributions to the plan constitute deferred compensation). If the plan beneficiary dies, there is no step-up in basis so that whoever receives distributions from the plan will report the same income that would have been reported by the decedent had she survived to receive the distribution.

Note that IRD generally does *not* include unrealized appreciation from stocks, real estate, and other appreciated assets held by a decedent at death because such unrealized appreciation was not deferred by reason of an accounting treatment: the realization doctrine is not an accounting method nor an item of an accounting method.

### **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.

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 narrower the spread between the strike prices of the put and the call – that is, the narrower the collar -- the more closely the collar resembles a sale.

*b. Option Jargon*

*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.

*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 rises 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.

*c. 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.<sup>16</sup> 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. Consider for example the writer of a call option. 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 gain. 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 is 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.

*Problem*

P-3. 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?

*d. 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 (and the same expiration date), the two transactions are the equivalent to an immediate sale of the property for \$100 because no matter what the value of the property becomes, 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 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

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<sup>16</sup> 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.



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.<sup>17</sup>

e. *Deferring Compensation*

i. *Basic Principles*

"Deferred compensation" refers to an agreement between a service provider and the service beneficiary (usually employee and employer) to compensate 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, the employee also defers receipt of the compensation, and that may present cash-flow difficulties for the service provider. In particular, the service provider may have an unexpected need for additional cash 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 sufficient funds to satisfy the future compensation promise. The beneficiary of the trust cannot be the employee because of the 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.<sup>18</sup> 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 employee 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,

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<sup>17</sup> See §1259.

<sup>18</sup> See also §404(a)(5).

and other theories.<sup>19</sup> This seems to be a structure that gives the employee as much control over the deferred compensation as 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 employee need not report income until distributions from the plan are received (generally when she retires). The assets of the plan are held by a pension trust that is tax-exempt so that the contributions can 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 the employee and so will not qualify for capital gain taxation without regard to the assets held by the pension trust.

(A) Employer-Sponsored Plans

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. That is, the terms of the plan provide for specific dollar amounts that will be payable upon retirement, with such amounts generally dependent on the employee's age, final or highest salary, and years of service as of the date of retirement. 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 employee bears all the risks that the pension assets will underperform, it is increasingly common to permit the employee to have substantial say in how the pension assets are invested. Note that a defined contribution plan cannot be underfunded because the employee is entitled to no more (and no less) than her share of 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 \$6,000 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.

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<sup>19</sup> These other theories included the rules covering the taxation of trusts as well as the rules of §83.

### (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). Note also that issuance of ISOs is significantly constrained by the dollar limitation in §422(d).

#### 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 such an 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 immediately taxable under §83(a), then the taxpayer will be taxed 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)(3), 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, 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).

#### (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 required holding period to 3 years.<sup>20</sup>

*Question*

Q-12. 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 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**

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**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**

....

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

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<sup>20</sup> Section 1061.

purchaser back to Steinway. The petitioner's attorney, however, requested that the single contract be split into two separate contracts.

....

#### 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.

....

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.

. . . .

#### *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 Acts 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 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 remainder beneficiary. From that result it is but a short step to provide that the remainder beneficiary 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.

*Problem*

P-4. 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.)

**C. Answers to 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?**

As the post-production editing is done. §461(h)(2)(A)(i).

**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 decommissioning with a third party when the plant is first operated?**

As the decommissioning occurs. §461(h)(2)(A)(i).

**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?**

When the bond is paid. §461(h)(2)(B).

**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)).**

No.

**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 possession 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?**

Provide that the payment will be refunded if all rental payments are timely made and the unit is left free of damage. That is, do not specify that it is an advance payment but instead specify that it is a refundable deposit, thereby falling within the rule of *Indianapolis Power & Light Co.*

**6. 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?**

When paid. *Amend.*

**7. 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?**

As soon as the check is received under the doctrine of constructive receipt.

**8. 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?**

Because the CD is marketable, it is treated as a cash equivalent; that is, it is treated as property. Accordingly, T includes the fair market value of the CD immediately.

**9. 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?**

T has income immediately under the economic benefit theory as described in *Pulsifer*.

**10. In questions 4 – 7, when would T recognize the income if T were an accrual taxpayer?**

When the work is completed.

**11. Is the effect of *Commercial Security Bank* to create a doctrine of constructive payment for cash method taxpayers? The Supreme Court's decision in *Massachusetts Mutual Life Co. v. United States*, 288 U.S. 269 (1933), generally is considered authority for the proposition that there is no doctrine of "constructive payment." How did Judge Tannenwald meet that objection?**

Judge Tannenwald concluded that receiving reduced sale proceeds on account of the accrued deposit interest is equivalent to receiving full sale proceeds and then paying the accrued deposit interest directly. Economically, that is correct, but recall that cash method accounting does not really emphasize economics.

**Q-12. 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 investors, and T is compensated with 20% of the net income generated by the partnership's investments. How should T be taxed?**

Under §83(a)(1), property received by a taxpayer in connection with services provided to or for someone else is taxable when ownership of the property vests. And when it becomes taxable, the amount of the inclusion is the fair market value as of the date of inclusion. *Id.*

If the service partner's share of partnership profits is conditioned on the performance of future services by the service partner, then ownership of the partnership interest has not vested and so the service partner should not be taxed on the value of the partnership interest. Reg. §1.83-3(c)(2). Indeed, until ownership of the partnership interest vests, the service partner is not treated as owning the partnership interest and so might not even be treated as a partner. In such circumstances, the service partner should not be taxed on partnership income as it is earned. Rather, the service partner's share of profits should

be taxed to the recognized partners (that is, to partners who contributed cash or property for their partnership interests). When distributions from the partnership are made to the service partner, the service partner should only then be taxed. Presumably the distributions should be treated as made by the partnership and, through it, by the recognized partners. As a result, if payment of compensation to the service partner generates a deduction as an ordinary and necessary business or investment expense, that deduction should be shared by the recognized partners.

**D. Answers to Problems**

1. Seller, a cash method taxpayer, has the following balance sheet:

<u>Asset</u>	<u>Value</u>	<u>Adjusted Basis</u>
Equipment	\$750,000	\$200,000
Goodwill	\$300,000	\$ 0
Receivables	\$ 50,000	\$ 0
<u>Liability</u>	<u>Amount</u>	
Bank Loan	\$400,000	
Payables	\$100,000	

How much should a buyer be willing to pay for all the assets of Seller (subject to all the liabilities of Seller)? How should Seller be taxed on the sale (ignore the distinction between ordinary income and capital gain)?

The assets of the Seller are worth \$1,100,000. Because the Buyer will have to pay \$500,00 to third parties to keep the assets, the Buyer should be willing to pay \$600,000 for the assets encumbered by the liabilities. If the Buyer pays \$600,000, then the Seller's amount realized equals \$1,100,000 so that the Seller's gain equals \$900,000 and the Seller should be entitled to a deduction of \$100,000 for the payables (assuming they have accrued and are deductible when paid), or \$800,000 net income.

2. T purchases 1,000 widgets for \$100 apiece (\$100,000 total) in opening inventory in 2021. During that year, T purchases an additional 1,000 widgets for \$110 each and sells 1,000 widgets for \$150 each. In 2022, T again sells 1,000 widgets, now for \$160 per unit, and purchases 1,000 new widgets for \$120 each. In 2023, T sells 1,000 widgets for \$170 each and purchases 1,000 new widgets for \$130 each. In 2024, T sells 1,000 widgets for \$180 each but does not purchase any new inventory. Compute T's taxable income for each year 2021 through 2024 using both LIFO and FIFO. Does this help explain why allowance of LIFO is considered a tax subsidy to inventory sellers?

Regardless of T's method of accounting, T's gross income in 2021 is \$150,000, in 2022 it is \$160,000, in 2023 it is \$170,000, and in 2024 it is \$180,000. Using LIFO, T's cost of goods sold in 2021 equals \$110,000, \$120,000 in 2022, \$130,000, and \$100,000 in year 4. Using FIFO, T's cost of good sold is \$100,000 in 2021, \$110,000 in 2022, \$120,000 in 2023, and \$130,000. In tabular form:

Year	Gross Income	LIFO COG	LIFO Income	FIFO COG	FIFO Income
2021	\$150,000	\$110,000	\$40,000	\$100,000	\$50,000
2022	\$160,000	\$120,000	\$40,000	\$110,000	\$50,000
2023	\$170,000	\$130,000	\$40,000	\$120,000	\$50,000
2024	\$180,000	\$100,000	\$80,000	\$130,000	\$50,000

**3. 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?**

Consistent with the tax treatment of call options, the creation and sale (usually called the “writing”) of a put option should not be a taxable event. If the option expires unexercised, the option holder should be entitled to a deduction for the cost of the option and the seller (i.e., the “writer”) should have income in the same amount. If the option is exercised (so that the holder sells the underlying to the writer at the option price), the amount realized to the option holder should equal the option price (received) less the cost of the option (paid). For the writer’s basis in the underlying should equal the same amount.

**4. 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 of the seller’s adjusted basis and that you account for it properly, thinking back to the Inaja Land case.)**

Under the government’s theory of the case, the seller sold the entire property for \$1,000,000 and the leased the property back to the seller for 2.5 years in exchange for \$250,000 in pre-paid rent. Thus, the seller should recognize a gain on the sale of \$400,000 and a deduction of \$250,000 for the rent. Should the rent be includible immediately or as it accrues? Assuming the seller is an accrual taxpayer, the conceptual answer is it should be accrued over the term of the lease. But the government usually argues for inclusion no later than when payment is received. Because rental payments in a commercial context generally are deductible to the payor as well as includible to the recipient, there often is little revenue at stake in the timing of the payments. Congress in §467 (a section we are not covering) generally allows the parties to allocate the timing of rental obligations however they desire. See §467(b)(1)(A).

Under the taxpayer’s theory of the case, the seller has sold a remainder in the property for \$750,000. The taxpayer’s gain on that sale should equal the excess of the \$750,000 amount realized over the taxpayer’s adjusted basis *in the remainder*. We know that the building is worth \$1,000,000 and that the remainder is worth \$750,000, so the taxpayer is selling three-fourths of the property. If we allocate three-quarters of the basis to the remainder, then gain from the sale equals \$750,000 less \$450,000, or \$300,000. In addition, the seller has \$150,00 of adjusted basis remaining in the term interest. Should that amount be recovered over the term of the lease (i.e., over 2.5 years) or only at the end of the lease. While the conceptually correct answer seems to be over the term of the lease (at least for an accrual taxpayer), the government has taken the position that taxpayer cannot create depreciable property by selling a remainder in property they own. Thus, the government will argue for a deduction of \$150,000 once the remainder terminates.