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Accounting Methods—Adoption and Change

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WE OFTEN HAVE OCCASION to suggest the desirability of adopting or changing established accounting practices. This frequently happens in the initial examinations of financial statements of new clients but can also arise in our tax-planning work with present clients or when changes in conditions make such a recommendation advisable.

In many cases, the suggested changes would have the effect of substantial increases in taxable income if they were made for tax accounting as well as for financial accounting purposes. Before we suggest changes in accounting, or before we approve changes suggested by the client, it is important that we be cognizant of tax effects of the changes and of the ways in which tax increases might be avoided or held to a minimum.

The purposes of my discussion today are:

First, to discuss some of the tax implications of changes in accounting methods.

Second, to indicate what your clients should do to secure desirable changes and also what they can do to resist undesirable changes initiated by the Commissioner.

Third, to consider some specific tax-planning opportunities in adopting and changing accounting methods.

FIRST—WHAT IS A CHANGE IN ACCOUNTING METHOD?

As you are probably aware, much uncertainty concerning tax results has stemmed from an inability to produce a solution to the problem of determining just what an accounting method is.

Before going into the definitional problem perhaps we should set it in perspective by answering the question, "Why is it important that we determine whether the item we are dealing with has the dignity of being an accounting method?"

The tax consequences of any change in accounting procedure depend to a large extent on whether the change is deemed to be a change in accounting method or merely a correction of an erroneous accounting treatment. Most changes of accounting method require the prior approval of the Service and, therefore, give the Service rather broad authority over the type of changes to be allowed and the method by which such changes can be accomplished. The correction of an erroneous accounting treatment, on the other hand, can be made without prior approval.

Of even more importance is the fact that if there is a change in accounting method forced by the Commissioner, the taxpayer is protected under the 1954 Code from adjustment for items of a similar nature at the beginning of the first year. If there is a correction of an error, however, necessary adjustments to prevent omission or duplication of any item will in the long run generally be made, even though there may be considerable sweat, blood, and tears in the mechanical aspects of achieving the adjustment.

The Internal Revenue Code itself does not contain a definition of the term "method of accounting." The Regulations provide that the term "includes not only the over-all method of accounting of the taxpayer but also the accounting treatment of *any* item."

This narrow definition is an attempt on the part of the Service to control the area for movement by taxpayers. The definition does increase the Commissioner's power to prevent changes. At the same time, however, it reduces his power to force them.

Early in the game it was argued that this narrow definition in the Regulations is wrong and that there was an intent on the part of Congress to create a concept of materiality in dealing with accounting methods. Thus, the Senate report on the 1954 Code states that "a change in the method of accounting is a substantial change as distinguished from each change in the treatment of each item." Further, early Supreme Court decisions were cited as support for the proposition that the term "accounting method" relates to the treatment of a category of items and not to the disparate treatment of one item in a group.

The Service has been quite successful in the courts, however, in arguing for its narrow approach. For example, the American Can Company, a taxpayer on the accrual basis, nevertheless had in four states been deducting vacation pay and property taxes on the cash basis. There was no dispute about when the liabilities accrued.

In 1953 these liabilities were also deducted on the accrual basis. Permission was not requested to make this change.

The Tax Court held that the deductions were allowable on the accrual basis and that the taxpayer was correcting an error in its over-all method of accounting. The Tax Court stated that the Commissioner confused the issue by attempting to characterize the changes as changes in method of accounting. The Circuit Court, however, reversed the Tax Court and found that even this narrow change was equivalent to an accounting method.

That the Tax Court was properly chastened is indicated by its later decision in Dorr-Oliver, Incorporated, and Fruehauf Trailer Company.

In Dorr-Oliver the taxpayer previously had treated all vacation pay under various union agreements on the cash basis. Without seeking or receiving the permission of the Commissioner, Dorr-Oliver began to accrue vacation pay in 1954. Even though the total amount of vacation pay thus accrued (and therefore the amount of the double deduction) was only $25,000, the Commissioner was upheld by the Tax Court in his contention that a change of accounting method was included and that a change could not be made without the consent of the Commissioner. The Tax Court saw this as a so-called hybrid method, which under the 1954 Code is permitted.

In Fruehauf Trailer Company, the taxpayer had consistently valued used trailers at $1.00 a unit. At one point, many years previously, the Internal Revenue Service had attempted to increase this valuation. After many conferences, however, at both the local and national levels, a settlement was reached permitting the continuation of the $1.00 value. In 1954, the Commissioner again attempted to increase the values to fair market value. In the contention that this change represented a change in accounting method against which it was protected for its pre-1954 buildup the taxpayer was upheld.

The taxpayer then appealed this case on a different ground. Neither side contested the accounting method holding in the appellate action and the Commissioner acquiesced in the Tax Court decision.

One distinction that might be made is between an erroneous reporting technique and the erroneous application of an accounting method. This seems to be the conclusion reached by the Tax Court in a very recent case (Underhill, 45 TC Number 46) in which the taxpayer held some highly speculative promissory notes. He had been reporting a portion of each collection as income but later changed his mind when he realized that the proper method of reporting for this type of obligation is to recover basis first. The Tax Court held that this was not a change in accounting method, because no income was actually taxable until basis had been recovered. The Court viewed the question as one of determining the character of the payment rather than one of using the proper time method in reporting an item, the character of which is not in question. For items such as inventories and vacation-pay accruals, the question relates more to the year of reporting.

Another type of change that should not be construed as an accounting method results when the taxpayer changes its method of doing business. In a recent case (Decision, Inc. 47 TC No. 5), the taxpayer, an accrual-basis publisher of business directories, changed the date for billing its advertisers from November of one taxable year to January 1 of the next taxable year. This was after a revenue agent had required the taxpayer to report the income in the year the billing accurred. The Service tried to argue that the change in business practice was really a change in accounting method, which required permission. The Tax Court held for the taxpayer, pointing out that the Service approach "would have the effect of denying a business the right to determine the terms of sale of its product without clearing the matter with the Commissioner of Internal Revenue, clearly an odious propagation of the tentacles of the government anemone." That the Service can be expected to continue to resist this type of change is indicated by a recent ruling relating to changes in time of billing by public utilities. (Rev. Rul. 65-287, 1965-2 CB 150)

As you can see, there are different positions the taxpayer may take in various situations when he wants to accomplish a desirable change or prevent the Service from forcing an undesirable change. Nevertheless, for planning purposes, it seems to me that almost every accounting procedure should be regarded as a method, and in the remainder of my discussion I am going to assume generally that we are talking about methods.

Just this approach has been taken by the AICPA Committee on Federal Taxation in a recent letter to the Commissioner. The Committee suggested that in future no attempt be made to distinguish between an accounting method and the correction of an error in accounting treatment. Rather, the Committee suggests, we should distinguish between material and immaterial changes in method.

INITIAL ADOPTION OF METHODS

The basic general rule is that the taxpayer must compute his taxable income under the method of accounting used in his books. Thus, in his first year, a taxpayer is presented with an opportunity to determine the method of accounting that will best meet his needs. The only restriction is that, if the book method does not clearly reflect taxable income, then the Commissioner may make a change. However, the Commissioner does not have complete freedom of action. This is because the Regulations state that a method of accounting employing the consistent application of generally accepted accounting principles in a particular trade or business will ordinarily be regarded as clearly reflecting income. Thus, because a later change may be very difficult to obtain, it is obvious that great care must be taken in the first year to adopt the proper method, even though at that time amounts may seem insignificant.

In addition to analyzing each account carefully, there are in the first year some basic decisions that must be made. The first of these relates to selecting an over-all method of accounting. Three choices are available, namely, cash, accrual, or hybrid. The accrual method is required only if there are inventories and then perhaps only if the inventories are a significant amount. While theoretical accounting perfection might suggest that the accrual method is the proper one, many taxpayers, through use of the cash method where applicable, have realized substantial benefit from deferring tax.

Another basic first-year choice relates to the method of inventory valuation when there are inventories and the accrual method is used. Here again there are several choices, the principal one being between cost and the lower of cost or market. The cost method can be further broken down as between LIFO and FIFO, as we will discuss a little later on. If FIFO is to be used, then the lower of cost or market will generally produce the best results because of the ability to write inventory down to market value if it should go below cost.

Some organizational expenses are generally incurred in the year of organization. Unless an election to amortize under five years is made, you will find that no deduction is allowed until the year of dissolution of the corporation, at which time there may be very little benefit from them.

Another type of initial adoption relates to what I call "first-time" choices. This is an accounting method that may be chosen in the first year in which an item arises. These choices may have another distinction from the choices required in the year of organization in that they relate more to specific items on which variations from book treatment are generally permitted. That is, the Code provides for treating the item in a certain way regardless of the book accounting.

For example, a taxpayer may adopt the reserve method for bad debts in the first year in which he has a bad debt. This is not necessarily the first year in which there are receivables, although it is best to go on the reserve method as soon as possible.

Another example is *research and experimental expenditures.* They may not be incurred in the first year and no election for their treatment is required until they are incurred. Missing this election, however, can be very costly.

Also in this category are *depreciation methods* to the extent that a new method can be adopted for each year's additions or for separate additions within a year. Once a method is adopted for a particular account, however, whether that account be the entire year's additions or various portions of the year's additions, that method must be retained in the future.

Still another category of initial adoption of accounting method relates to methods that may be adopted, without permission, after the first year or after the first time an item occurs.

A good example of this is the LIFO inventory method. This method can be adopted anytime. I do not intend to discuss LIFO in any detail, but I should point out that this privilege has been of substantial benefit to many taxpayers—those who were willing to make a decision at some point in time that prices of their inventory would continue to go up. Whether or not that conclusion is valid today is a question that each businessman must answer for himself. Because of the requirement for the use of LIFO that no write-downs to market are permitted, the decision is not an easy one. LIFO certainly is worth the consideration of any taxpayer, however.

LIFO in Bargain Purchases

In one particular situation the adoption of LIFO can be of great importance, however, and I will discuss it. That is true when a large amount of inventory is obtained at a bargain. This frequently happens if a business is being sold out. If LIFO is adopted in the year of the bargain purchase, this low cost can be retained indefinitely in the inventory accounts and the higher replacement costs for current items can be used in determining taxable income.

Where this approach is adopted, the election of the method for valuing increases in inventory must be made in a way that will cause the bargain acquisition to be included in the election. If a new corporation is formed to acquire the inventory and operate the acquired business, a short first year may be beneficial.

Another example of a method that can be adopted at any time is the instalment method of accounting. This can be particularly important for a retailer who is required to finance his receivables. If the cash that would otherwise be paid out as taxes can be retained until collection, substantial operating benefits are achieved.

In planning for the use of the instalment method, it is particularly important that the instalment receivables at the beginning of the first year of change be handled properly. This care is necessary to avoid the possibility that the income from these receivables will be taxed twice—once in the year of sale on the old accrual basis and once in the year of collection on the instalment basis. Although the Internal Revenue Code includes a provision intended to mitigate the effect of this double-up, the provision is not completely effective. To avoid this, many taxpayers have adopted the practice of selling the receivable immediately before the end of the last year preceding adoption of the instalment method. Thus, there will be no receivable outstanding to which the double-up can apply. It must be clear to the Internal Revenue Service that there has in fact been a sale and not merely a financing arrangement. That is, the bank must become the real owner of the receivables. This solution can be and has been worked out in many cases, however, and a number of rulings approving sales have been issued.

CHANGING ACCOUNTING METHODS

Assuming that we believe we have an accounting method, or at least a procedure that we would like to change and are willing to have recognized as an accounting method, what are the rules?

First, when are we required to get permission for a change? The Code literally requires that permission be requested for *any* change in accounting method. In this instance, however, the Regulations give some recognition to the principle of substantiality, and provide that only a material change requires permission. For example, changes in standard cost system or refinements of overhead or accrual computations would not require permission, nor should changes in items included in inventory overhead to give effect to improved cost systems. Depreciation rates, of course, are not accounting methods and can be changed without permission on the basis of facts known at the end of the year for which depreciation is being computed.

The Regulations require that permission be obtained even for a change from an improper method. In other words, if you have been wrong, you must continue to be wrong unless you get permission to go straight. Unfortunately, court decisions support this regulation.

On the other hand, the Commissioner has been held to have impliedly given consent to a change, even though no formal request was made, where returns have been accepted on the changed basis if they contained information giving notice of the change. This may be a safe enough approach if your change increases income but may be of little value when it decreases income.

How to Request a Change in Method

The basic procedure for obtaining a change in accounting method is to make application to the Commissioner on Internal Revenue Service Form 3115. This form must be filed within the first 90 days of the year for which the requested change is to become effective. A statement of business reasons is required. If the Commissioner approves, he will issue a so-called terms letter setting forth the conditions under which a change will be granted. Generally this requires that the books be conformed to the new method and that adjustments required to effect the change are taken into account over a ten-year period. If the taxpayer agrees, he signs the terms letter and returns it, at which time the formal permission to change is granted.

A special procedure for obtaining changes in the reserve method for bad debts was instituted some time ago. Under this procedure, application is made directly to the District Director.

Changes in Accounting Practice

Of course, this procedure for obtaining accounting method changes can be inconvenient. First, it requires that the application be filed in the first 90 days of the year. It is not always known at that time whether a change is desirable. Thus, advance planning is required. In addition, it requires in some cases that the question of whether the change is or is not an accounting method be faced.

With these difficulties in mind, particularly the timing factor, it seems to me that a procedure introduced by the Internal Revenue Service early in 1964 is worthy of your serious consideration. This is Revenue Procedure 64-16. It is intended to provide a means of obtaining certainty for taxpayers who would like to make a change but who are reluctant to file a request for permission because they are unable to determine its tax effect in advance. Under Revenue Procedure 64-16, it is not necessary to determine whether there is an accounting method. Rather, the taxpayer merely requests permission to change a described accounting practice with respect to particular items of income or expense.

The procedure has wide application. About the only things that cannot be covered are a change in the over-all method of accounting (for example, from cash to accrual), a change to the reserve method for bad debts, a change from the LIFO to FIFO inventory methods, livestock-inventory method changes, and depreciation-method changes.

A major advantage of the procedure is that an application can be filed at any time before filing the return for the year in which the change is to be effective. In addition, it is also possible to make the change effective for the preceding year if an examination by the Service is being conducted and an issue has been raised concerning the item.

The only real conditions to application of the procedure are that the proposed method be acceptable and that the taxpayer agree to put the method on his books and to spread adjustments over a ten-year period. The spreading of the adjustment works both ways; that is, both increases and decreases in income are spread. The taxpayer in effect absorbs the impact of the change on the instalment plan.

This procedure has been helpful in eliminating discrepancies between tax accounting practices used by taxpayers and those that might be regarded as preferable by the taxpayers themselves. It has been our experience that every application filed under this procedure has been granted by the Service without its attempting to raise the issue of whether the change should have been made in a prior year or whether the impact of the change should be over less than a ten-year period. As long as each change requested is to an acceptable accounting practice, it has been granted with no questions asked.

For example, in the area of changes resulting in additional deductions, we have obtained permission to change from deducting real estate taxes as paid to deducting them when accrued.

In another case, the Service permitted elimination of selling and administrative expenses from inventories of work in process and finished goods. This change was made retroactive to the beginning of the previous year.

We have also obtained permission for a taxpayer in the title insurance business to change from the method of deducting claims for losses on title insurance policies when paid to the practice of deducting the claims as they accrue.

Examples of changes that have increased income but have had their impact spread over a ten-year period include a change to the practice of including consigned goods in inventories from that of deducting their cost as an expense. Another change resulted in including elements of factory labor and overhead in inventories when they had been previously excluded and there was little or no pre-1954 protection.

Another rather common change, and what could be an important one, permits savings and loan association to adopt the practice of reporting "points" over the life of the loan rather than in the year in which the loan is made.

As you can see, this approach has been working very well. From time to time, someone will suggest that it should be withdrawn because perhaps it technically does not accord with the Regulations. After ten years of no action on changes, something that works and is fair should not be eliminated on a technicality.

Adjustments

We have been talking for some time about adjustments that are required when a change is made. Perhaps we should spend a little time discussing exactly how the adjustments are accomplished.

The basic principle is that each year's income is to be determined by proper application of rules to the facts for that year. However, the Code includes provisions intended to prevent duplication or omission as a result of the application of the basic principle. For example, if a change is made from the cash to the accrual method, the collection of receivables during the first year of the accrual method normally would not be reported as income because they have accrued in a prior period. Thus, if no adjustment is made, the income from these sales—that is, those made in the preceding year but collected in the accrual year—will never be reported.

It may be helpful if we put this in terms of an example. Let us assume that we wish to change from the cash to the accrual method. At the beginning of the year of change, there were accounts receivable representing sales, made but not collected, of $15,000, inventories of $6,000, and accounts payable of $8,000. By netting these amounts we find that we would have had $13,000 more income on the accrual basis than on the cash basis—that is, the total of items that will increase income, $15,000 sales and $6,000 inventory, or $21,000, less the items that decrease income—the payables of $8,000. This net amount of $13,000 is the adjustment that needs to be made to convert to the accrual basis.

The Code includes a provision indicating that adjustments resulting in increases in income are to be picked up and tax paid immediately, although the tax may be computed as if it had been allocated over a prior period. However, the Service has in fact been permitting the adjustment to be spread over ten years. Thus, the $13,000 adjustment in our example would be taken into income at the rate of $1,300 a year, starting with the year of change.

This provision applies also to so-called negative adjustments, that is, those that decrease taxable income. Although the Code indicates that these may be taken into account immediately, the Service requires that they also be spread over a ten-year period. For example, assume a change to pick up vacation pay on the accrual basis, and that the amount that would have been accrued at the beginning of the year of change is $20,000. This will result in additional deductions of $2,000 a year for ten years.

Now let us return to our basic example of the change from cash to accrual. Assume that the taxpayer had been in existence at the beginning of 1954 and had had net amounts of $6,000 at that time. If the Commissioner had initiated the change, the $6,000 would not be required to be picked up in income. In other words, it would escape taxation forever.

Initiating the Change

Thus, as you can see, if we are dealing with a change that would increase income, which is the kind usually initiated by the Commissioner, and there is a pre-1954 balance, it is important to know who caused the change to be made.

Where the taxpayer requests a change in accounting method, then he has, of course, initiated such a change. It is also clear there where a taxpayer makes a change in tax accounting treatment without requesting permission, he has initiated it.

More difficult questions arise when the taxpayer changes an accounting treatment on his books or in his published statements, or both, without changing for tax purposes. Section 446(e) would clearly seem to cover the situation. It specifically requires that, before a change made on the books can be reflected in a tax return, the consent of the Commissioner must be obtained. Nevertheless, there are reports of Service attempts to invoke the general Code requirement that the tax returns be filed on a basis consistent with that on which the books are maintained. Thus, it might contend that the taxpayer's action in changing his books was the action that initiated the change for tax purposes. However, it appears that the Service's position is weak.

CHANGES SUGGESTED BY AN INTERNAL REVENUE AGENT

One of the most difficult situations to deal with arises when a change is suggested by a revenue agent. To require a change there should be a formal written record of Internal Revenue Service action. This evidence may be important in establishing that the change was in fact initiated by the Service. The importance of this is pointed up by comparing three court decisions in this area—namely, the Lindner and Welch cases on the one hand, and the Falk case on the other.

The facts in the Lindner case were that, prior to 1955, the taxpayer's partnership was on the cash basis for book and tax purposes. The revenue agent examining the 1954 return had told the taxpayer that the law required the use of the acrual basis and that it was necessary that the partnership change it. The agent suspended his audit pending filing of the 1955 return. Beginning with the calendar year 1955, the partnership changed its method of accounting to the accrual method for both book and tax purposes. The receivables at the beginning of 1955 were not included in income on the return.

The taxpayers testified that they believed they were required to make the change and would not have made it had the necessity not been stated by the agent.

The court held that the change was initiated by the Service, and therefore, no adjustment of receivables at the beginning of 1954 was required. These receivables thus were brought home tax-free.

In reaching its decision, the court relied heavily on the Committee Reports under the 1958 Technical Amendments Act, and particularly, the following statement: "A change in the taxpayer's method of accounting required by a Revenue Agent upon examination of the taxpayer's return will not be considered as initiated by the taxpayer . . . ." The suspension of the audit apparently also influenced the court.

In the Welch case a partnership having inventory had been reporting on the cash basis. Pretty much at the insistance of a Revenue Agent, who came in with the announced intention of putting them on the accrual basis, the taxpayers executed Form 870, agreeing to a deficiency but without giving effect to inventories at the beginning of 1954. In addition, the partnership changed later years' returns to show beginning inventories consistent with the amount agreed to. The taxpayer later contended that the beginning 1954 inventories should have been recognized and that the signing of the Form 870 should not be used against it. The Tax Court held against the taxpayer and said that he had initiated the change. The Government argued that an agent did not have power to initiate a change. The circuit court, however, reversed, largely on the basis of the agent's actions in insisting on the change. Nevertheless, it was a close call and the signing of the Form 870 very nearly became a disaster.

In the Falk case, the revenue agent investigating a partnership return of income for 1952 told the partnership's CPA and one of the partners that the proper method of keeping the records and filing the return for 1954 was the accrual basis. The agent refused to make a change for 1952 because of the adverse results under the 1939 Code. Neither did he insist that the 1954 return be prepared on the accrual basis. The 1954 return was, however, in fact filed on the accrual basis, with a notation that it was done in accordance with the instructions of a revenue agent.

The Tax Court held that the change in accounting method had been initiated by the taxpayer. It concluded that the revenue agent merely suggested, as distinguished from instructed, the change. The fact that the Revenue Agent was unwilling to change the prior year and had indicated in his report only a possibility of forcing a change under section 481 also appears to have been important.

LIABILITY OF TAXPAYER TO RESIST FORCED CHANGES

We have been considering the problem of determining who initiated a change. Just as it is important to understand the implications of changes initiated by our clients, it is also important for us to be able to help our clients resist undesirable changes that the Service may attempt to initiate. Although the Commissioner has great power and discretion in the area, the taxpayer is not without weapons of his own, and their existence should be recognized.

Generally speaking, the Commissioner has the authority to require a change in accounting method only if the present method does not reflect income clearly or if the present method is not in conformity with the method used in the books and records (sections 446 (a) and (b)). There are a number of obstacles in the Service's path that may make it unwilling to attempt to force the change and that may make it unsuccessful if it does make such an attempt.

The most important practical limitation is the tax-free status of the adjustments relating to pre-1954 Code years. Perhaps the best illustration of this is in the area of undervalued inventories. The Service's extremely narrow definition of the term "method of accounting" works to its disadvantage in this situation, since section 481 makes the pre-1954 portion tax-free, thereby making the Commissioner unwilling to take a step that would result in relief he would prefer not to grant.

Another obstacle to the Commissioner's power to force changes is that the use of an accounting method on a consistent basis frequently has been held to be more important than conformity of tax accounting with book accounting. The importance of consistency is recognized at several places in the Regulations, including the regulation relating to the general rules for determination of inventory values. This consistency will overcome a lack of theoretical correctness.

Another important factor is the Service's past acceptance of a method. If an accounting method is challenged we should make a strong effort to investigate prior revenue agents' examinations to determine whether there is a basis for claiming that the agent was aware of the method in use and did not challenge it. Tacit approval can have the effect of formal approval. For example, witness the case of the Geometric Stamping Company in which the use of the direct costing method was upheld, at least in part, on the basis of tacit approval by the Commissioner of the use of the method in the past.

Conformity with industry practice presents another serious obstacle to the Service in its attempts to change accounting methods forceably.

The general provision of the Code requiring conformity of tax accounting with book accounting frequently is not a strong weapon in the hands of the Commissioner because such conformity may be inconsistent with the more important tests of consistency, prior acceptance, and clear reflection of income.

For a period of some years, it appeared that the circuit courts at least were tending to accept application of good accounting principles in deciding tax accounting cases. However, the significance of these decisions has been greatly reduced by the more recent Supreme Court decisions in the automobile club cases and the Schlude case.

The Schlude case would seem to be particularly important. It dealt with the accounting for lesson contracts by a dance studio. The Eighth Circuit held that the studio was clearly reflecting its income from dance instruction when it deferred that income until it had actually been earned. However, the Supreme Court remanded for further consideration. The final result was that income was held to be realized when the studio received a note, even though there was an obligation to give lessons and incur expenses in the future. The receipt of something of value is more than the Supreme Court can accept without charging someone with income. The argument that good accounting requires deferral of the income or recognizing the future expenses unfortunately has turned out to be a very weak defense. The Schlude decision has implications covering a vast range of items and will become of great importance as time goes on unless some legislative recognition of sound accounting is achieved.