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Adoption of and Change in Accounting Methods

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All of us are well aware, I am sure, that what we may consider to be a sound, and sometimes even necessary, accounting method for book and financial statement purposes may not be acceptable for tax purposes. For example, setting up reserves would come under this heading. Also, while a faulty accounting method may be easily corrected for book purposes by disclosing in the audit report the effect of the change, such change may not be as easily made for tax purposes because of the necessity for obtaining I.R.S. approval or because some of the years affected may be closed by the statute of limitations. So, I am going to try in the next few minutes to dispel some of the fog surrounding certain areas of this subject.

It seems to me this discussion can be logically approached by examining the various aspects of tax accounting methods in the following order:

1. Accounting methods that may be initially adopted by the taxpayer without prior approval by the I.R.S.
2. Change in accounting method.
3. Correction of the accounting with respect to a particular item of income or deduction.
4. Continuation of the use of an accounting method by a successor corporation in certain reorganizations.
5. Latest developments.

ADOPTION OF ACCOUNTING METHOD

As a general rule a taxpayer can initially adopt for tax purposes the regular method of accounting used in keeping his books provided such method clearly reflects income. Thus, if the books are kept by the consistent application of generally accepted accounting principles usually employed for the particular trade or business, income will normally be considered to be clearly reflected and the method will not be challenged.

Since passage of the 1954 Code, in addition to the cash method

and the accrual method, a hybrid method may be used. An example of the last mentioned would be a small retail store using the accrual method for items that affect gross income and the cash method for operating expenses. Where it is necessary to use inventories, unless they are minor, the accrual method must be used for purchases and sales.

In addition to the three methods just mentioned a person who regularly sells property on the instalment plan may adopt the instalment method of accounting. Further, income from building, installation, or construction contracts covering a period in excess of one year may be reported on the completed-contract method.

If a taxpayer is engaged in more than one business, he may use a different method of accounting for each business. (I.R.C. Sec. 446(d)). However, a complete and separate set of books must be kept for each business, and there must be no arbitrary shifting of profits or losses between businesses.

It is important that the method of accounting be consistent from year to year so that income will be clearly reflected. This applies, according to the regulations, to both the over-all method and the method applicable to a particular item, unless the law permits special treatment for such items. The importance of consistency and conformance with the method used in the industry is well illustrated in the *Pacific Grape Products* case (9 Cir.; 1955. 219 F. 2d 862, 47 AFTR 214). In that case the taxpayer, a canner of fruits and fruit products, regularly billed its customers for all goods ordered by them, some of which remained unshipped at the close of each year. At the same time the taxpayer accrued the income on such unshipped goods it accrued the brokerage commissions and estimated expenses of labeling, packaging, and preparing the goods for shipment. This method was upheld by our own Ninth Circuit.

Except for an individual whose income is wholly from salary or wages, a taxpayer must keep records that clearly reflect his income. In the absence of records the Commissioner may use whatever method will, in his opinion, clearly reflect the income (e.g., average gross profit-% X sales method; net worth-expenditures method; excess cash-expenditures method; bank-deposit method). Also, if inventories are not involved, the cash method must be used where there are no records.

Accounting rules of the Interstate Commerce Commission and other regulatory bodies are not binding upon the Commissioner.

I should like to stress here the utmost importance of giving serious

consideration to the accounting methods adopted in the first return. Laxity at such time can create serious problems later. For example, valuation of inventory at cost in the first return will cause difficulty in a later year where cost cannot be used in the financial statements. Also, more taxable income would be created in later years on the cost basis if market falls below cost.

CHANGE IN ACCOUNTING METHOD

Frequently the CPA is not on hand to see that the accounting methods adopted by a new business are proper for both financial statement and tax purposes. Later, when the services of a CPA are required, he may find that the accounting methods in use are not proper for tax purposes or will not permit him to render an unqualified opinion on the financial statements. Thus a change may be advisable though not mandatory.

To change the method of accounting for tax purposes a letter application must be filed with the Commissioner in Washington, D. C., within ninety days after the beginning of the year of change. The I.R.S. holds that approval is required even though the method in use is improper. However, in Beacon Publishing Company (10 Cir.; 1955, 46 AFTR 1561) the court held that the taxpayer has the right to apply the correct accounting method to a particular item when the change will correct errors and clearly reflect taxable income, particularly where taxes are not being avoided. (In practice Revenue Agents will sometimes agree to a unilateral change by a taxpayer where the effect is minor and it is clear that no tax is being avoided.) A change can include both a change in the over-all method and in the treatment of a material item.

An important exception to the rule is that a dealer in personal property can change from the accrual to the instalment method without approval. However, in such case, income previously accrued may be subjected partially to double taxation. It is important that computations of the tax effect be made before election to change is adopted. It seems clear that double taxation can be avoided by a genuine sale of the instalment obligations before making the Section 453 election.

In the event of a change, whether by the Commissioner or by the taxpayer, adjustments are necessary to prevent the omission of income and/or duplication of deductions. There was much controversy under the 1939 Code about whether adjustments were always required,

especially where the change was forced by the Commissioner. To alleviate this controversy Congress introduced the notorious section 481 into the 1954 Code. Instead of alleviation there were new uncertainties. Owing to the administrative problems and retroactive 1958 changes, it took the Treasury Department four and one-half years to issue its regulations. This, in turn, produced problems for practitioners. Be that as it may, I shall now discuss the rules set forth therein.

If the Commissioner makes the change, adjustments applicable to pre-1954 Code years (years ending prior to August 17, 1954) do not apply. Thus, in this situation, if the net adjustment results in an increase in taxable income in excess of $3,000 for the year of change, such net adjustment may be allocated:

a) entirely to the year of change;
b) equally to the year of change and the two preceding years (if old method was used in two preceding years); or
c) to consecutively preceding years for which the new method can be established, with remainder to year of change, whichever produces the lesser tax.

If these allocations affect net operating losses or capital losses, the years to which such losses are carried are included in the computation.

Where the taxpayer initiates the change, any portion of the net adjustment attributable to pre-1954 Code years must be taken into account. The portion of the net adjustment attributable to pre-1954 Code years is determined by computing the amount of net adjustment that would have been required as of the beginning of the first 1954 Code year. That is, up to this amount the net adjustment is deemed to be pre-1954. If such amount exceeds $3,000 it may be allocated over ten years beginning with the year of change. In certain circumstances this ten-year period automatically ends. For example, this occurs where the taxpayer dies or quits business. Separate tax computations must be made with respect to the portion of the adjustment that is pre-1954 and the portion applicable to 1954 Code years, in order to determine the effect of the different allocation methods. The regulations contain good illustrations.

In lieu of the ten-year period the taxpayer may elect the allocation methods previously discussed in connection with a change made by the Commissioner. The election is made by means of a statement attached to the return for the year of change or filed within ninety days after the date on which the Commissioner grants permission to change, if such date is later than the due date of the return.

In the case of a corporate taxpayer subject to a pre-1954 allocation that transfers its assets to another corporation in certain tax-free reorganizations, such pre-1954 allocation must be continued by the acquiring corporation.

Pre-1954 adjustments will not apply for years beginning after December 31, 1963.

No adjustments may be made in closed years except those that result from section 481 allocations.

Where the allocations mentioned above do not seem to produce an equitable result the taxpayer can seek an agreement with the Commissioner to use some other method of allocation. (Section 1.481-5 of the regulations indicates the content of the request and where it should be filed.)

If the net adjustment decreases income for the year of change the allocation rules do not apply. That is, only that year is affected.

CORRECTION OF ERROR IN CLOSED YEAR

Now and again we are fearful of taking some practical accounting step, or acquiescing to a Revenue Agent's adjustment, because the old closed-year bogey is staring us in the face. But a check of the mitigation of statute provisions may dispel our fears, provided the tax liability for the closed year has not been compromised and we are not seeking an unfair tax advantage. The Internal Revenue Service may also reopen closed years under similar circumstances.

What are the rules governing the reopening of closed years?

First, adjustment of a closed year may be made only under eight specified conditions. Six of these conditions require that either the taxpayer or the I.R.S. be maintaining an inconsistent position. If the adjustment results in additional tax for the closed year, the taxpayer must be maintaining the inconsistent position. If it results in a refund for such year the I.R.S. must be maintaining the inconsistent position. These six conditions are:

1. An item of income is determined to be includible in an open year which had already been included by the taxpayer or a related taxpayer in a closed year. (For example, an item of gross income was included in a closed year. Later the I.R.S. contends and is upheld that the item belongs in a later year.) (I.R.S. is inconsistent.)
2. A deduction or credit taken in a closed year by the taxpayer or

a related taxpayer is subsequently held to be allowable in a later year. (Taxpayer is inconsistent.)

3. An income item included in an open year is determined to be properly includible by the taxpayer or a related taxpayer in a prior closed year thereby reducing the tax for the open year. (Taxpayer is inconsistent.)
4. The accumulation or distribution of the income of an estate or trust in a closed year is subsequently held to be in error. In such case if a determination (to be discussed later) is obtained by the fiduciary, correcting the error as to the trust or estate at a time when the error year in regard to the beneficiary is closed, such year may be reopened as to the beneficiary. To the contrary, if a determination is obtained as to a beneficiary, the closed year of the estate or trust may be reopened. If only one beneficiary is affected the effect on the trust is limited to that one.
5. A deduction or credit is allowed or disallowed to one corporation in an open year which affects a related corporation whose year is closed at the time of the determination. The closed year of the related corporation may be adjusted. A related corporation is one that is a member of an affiliated group, that is, 80% common ownership exists. (For example, a subsidiary claims an interest deduction in 1959 for an amount paid to the parent and the latter treats it as interest income; later such payment is held to have been a dividend, so that the subsidiary loses its deduction. In such circumstances the parent may make correction in 1959 even though that year is closed at time of determination with respect to the subsidiary.)
6. A determination corrects the basis of property of certain specified taxpayers that was incorrect because there had occurred one of three enumerated errors in respect to a transaction in a closed year on which the basis depends, or the transaction was erroneously treated as affecting the basis. The types of errors are:
   a) an erroneous inclusion or omission from gross income;
   b) an erroneous recognition or nonrecognition of gain or loss;
   c) an erroneous deduction of a capitalizable item or capitalization of an expense item.

The taxpayer with respect to whom the error occurred must be either (1) the taxpayer in regard to whom the determination is

made, or (2) a taxpayer who acquired the property in the erroneously treated transaction and then transferred it to the taxpayer who obtains the determination in a tax-free transaction or as a gift. (For example, in 1950 taxpayer receives $1,000 from Corporation X, which he reports as a dividend; in 1952, X is completely liquidated; in 1955 a closing agreement is executed under which the $1,000 is a return of capital, thereby increasing gain on liquidation because of decrease in basis of stock. In such circumstances the taxpayer may get a refund for 1950.)

The two conditions that do not require an inconsistent position are:

1. An income item erroneously excluded in a closed year by the taxpayer, or by a related taxpayer, for the same or another taxable year, is determined to be excludable from income of another year. (For example, A, on the accrual basis, performed in 1949 services for which he received payments in 1949 and 1950; the payments in 1950 were not included in his return for either 1949 or 1950; in 1952 I.R.S. assessed additional tax for 1949 on basis that the 1950 payments were includable in that year. A contended that he had no accruable right to 1950 payments in 1949 and was upheld by the Tax Court in 1955 after statute had run on 1950. I.R.S. may reopen 1950 and assess a deficiency.)
2. A deduction or credit is disallowed in an open year which should have been taken in a closed year by the taxpayer or a related taxpayer. (For example, taxes deducted in the year paid are disallowed as being properly deductible in a prior closed year.)

Under 1, above, you may wonder what is to prevent the I.R.S. from including the 1950 payments in, say, 1955 (after 1950 is closed) and then reopening 1950 on the basis of a determination that such payments are not includible in 1955. This is prevented by a provision to the effect that the proper year of inclusion, which is now closed, must have been open when the I.R.S. sent the deficiency notice for the other year.

Likewise, under 2, above, the now closed year must have been open when the taxpayer took the deduction for a later year.

The existence of one of the conditions just discussed is not enough to reopen the closed year. There also must be a determination concerning the error item. A determination is any one of the following:

- A final court decision.
- A closing agreement.
- Final disposition of a refund claim by the I.R.S.
- Execution of an agreement between the taxpayer and the District Director (Form 2259 is used).

In a number of instances reference has been made to "related taxpayers." This term is explicitly defined for this purpose in I.R.C. section 1313(c). Also, whereas in general the relationship need exist only at the time of error, there are some circumstances under which it must exist both in the year of error and at the time the inconsistent position is first maintained. Thus, where related taxpayers are concerned this Code section and the pertinent regulation should be carefully studied.

The closed year may be adjusted only to the extent of correcting the error and amounts directly affected by such correction. For example, the contributions deduction, net operating losses, capital losses, etc., may be corrected.

The statute of limitations relating to the previously closed year is extended, for this limited purpose, to one year after the date of the determination. Interest runs from the year of error unless the closed year is being adjusted for a corrected net operating loss. In such case interest runs from the loss year.

Although what constitutes an "item" is not entirely clear, it has been ruled that inventories are an item of gross income.

It has also been ruled that the disallowance of *accruable* vacation pay in the year of payment may give rise to an adjustment in a prior closed year even though there is a resultant double deduction in such closed year. (Rev. Rul. 58-24). However, Rev. Rul. 59-285 provides that a taxpayer cannot change from a "paid" basis (even though incorrect) to an "accrued" basis without the Commissioner's consent.

CONTINUATION OF ACCOUNTING METHODS BY ACQUIRING CORPORATION

In today's business world accountants are continually faced with corporate liquidations, acquisitions, and mergers; accountants must know their effect on accounting methods.

Under the 1954 Code where a corporation liquidates its subsidiary or transfers assets in a tax-free merger, consolidation, or reorganization, the acquirer of the assets must continue the transferor's over-all accounting method and inventory-valuation method if the acquirer's method is the same as that of the transferor. If not the same, the

method set forth in the regulations must be used. In addition there are a number of special items—one such is accelerated depreciation—for which the accounting method must be continued. Further, for years beginning after 1957 an acquirer life insurance company must continue the accounting methods of its transferor.

The continuation rules do not apply to the liquidation of a subsidiary where a stepped-up basis for the subsidiary's assets results.

It has been ruled that the continuation rules do not apply in the case of a divisive reorganization under I.R.C. section 355, governing spin-offs and split-offs.

To date there are no regulations on these provisions. Therefore, if a question arises that is not clearly answered by the Code and Committee reports, the only alternative may be to request a ruling.

LATEST DEVELOPMENTS

In *Consolidated Dry Goods Company* (180 Fed. Supp. 878, 5 AFTR 2nd 920) the Massachusetts District Court held that the instalment method could be applied to revolving-type credit sales. Rev. Rul. 60-293 states that I.R.S. will not follow this case. However, an I.R.S. study is now under way to ascertain whether workable standards can be formulated for determining what part of revolving credit sales might qualify as instalment sales.

Sec. 6 of P.L. 86-779 (signed by the President on September 14, 1960) added new Code section 180 which provides that farmers may elect to expense fertilizer, lime, ground limestone, marl, or other materials used in treating land used in farming. The provision applies to years beginning after December 31, 1959.

Sec. 6 of P.L. 86-781 added new Code section 461 (d) which provides that for years beginning after December 31, 1960 an accrual-basis taxpayer cannot take a double deduction for any tax resulting from a change by State or local taxing authorities in the "tax day." Rev. Rul. 60-133 bars double deduction of property taxes for 1958, 1959, and 1960. Also see TIR-214.

Rev. Rul. 60-243 holds that a change from the "deposit required" method to the "sales and repurchase" method of accounting for returnable containers requires consent of Commissioner. Consent will not be granted unless taxpayer can show a genuine change in its position.

Rev. Rul. 60-60 provides that if election has been made to include animals purchased for draft, breeding, or dairy purposes in inventory

under the unit-livestock-price method, such election cannot be changed without consent.

Rev. Rul. 60-191 provides that cost of hens and baby chicks purchased for egg-laying or for raising and sale may be deducted in years of payment by cash-basis taxpayer. Practice must be consistent.

The Tax Court has decided that a taxpayer can correct its prior wrong-handling of a single item to bring it into line with the correct over-all accounting method without I.R.S. consent. The case related to the proper time of accrual of group insurance dividends. In 1954 taxpayer accrued dividends that were authorized, computed and paid in that year but related to 1953 premiums. In prior years such dividends had been accrued in same year that premiums were deducted. (*O Liquidating Corp.*, Par. 60029 P-H Memo TC).

On July 12, 1960 TD 6480 was issued covering final regulations on sections 381(a), 381(b), and 381(c)(1).

Three important accounting method cases are now pending before the U. S. Supreme Court. They are:

1. *Consolidated Edison Co.*, 5 AFTR 2d 1504, in which it is held that contested taxes are deductible only in the year of accrual regardless of year of payment.
2. *American Automobile Association,* 181 F. Supp. 255.
3. *New Jersey Automobile Club,* 181 F. Supp. 259.

The second and third cases deal with the deferral of income from prepaid membership dues.

In *Milwaukee & Suburban Transport Corporation,* paragraph 60-5209 Prentice-Hall 1960, the Seventh Circuit Court of Appeals held on October 24, 1960 that a deduction was allowable for an addition to a reserve for potential and unsettled property damage and personal injury claims. The decision was based on the premise that the volume of claims was sufficiently large to enable the liability and amount of reserve to be fixed with reasonable certainty.

CONCLUSION

Accounting is our business. So it seems only logical that in justice to his clients every accountant should be particularly conversant with income tax provisions as they relate to accounting matters. He should know what accounting methods to use for a new business, under what conditions they can be changed, under what circumstances a closed year can be reopened, and when accounting methods must be con-

tinued by a successor corporation. It is also important that he keep abreast of the latest developments in those areas. Thus, to those who have not taken the time to familiarize themselves with these subjects, I urge that they do so.