

## Chapter 7

# Is It Time to Abandon Accrual Accounting for Tax Purposes?

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### Introduction

Every few years, an outcry arises over the fact that large companies report billions of dollars of income on their financial statements yet pay little or nothing in taxes. This outcry is typically followed by calls to (1) require greater disclosure of differences between financial, sometimes referred to as book, and tax accounting; (2) impose a tax on the difference between book and tax income; or (3) align book and tax accounting so that firms must report the same income figures to investors and the IRS. This chapter focuses on the debate over book–tax alignment.

Those opposed to alignment have identified a number of problems with aligning book and tax accounting. Some are practical, such as the impact such a move might have on Congress’s ability to use the tax laws for social policy objectives.<sup>1</sup> Others are more theoretical, focusing on the different roles these two accounting regimes serve. For instance in *Thor Power Tool Co. v. Commissioner*, the U.S. Supreme Court justified its refusal to require alignment by noting that financial accounting serves to provide information to investors, while tax accounting is aimed at raising revenue.<sup>2</sup> As a result of these different purposes, the former permits significant flexibility and even estimates, while the latter requires uniform treatment and precision, thus precluding alignment.

I argue here that a far more fundamental difference in purpose warrants keeping the two accounting systems separate. Accrual accounting, which lies at the heart of most financial accounting regimes, is routinely hailed as the most accurate way to measure income because it matches anticipated revenues and expenses regardless of when cash is actually received or spent. However, separating income inclusion or deductions from cash receipts or expenditures can seriously undermine an income tax. What distinguishes income taxes from consumption taxes is that income taxes reach both consumption and returns on capital, while consumption taxes reach only consumption. Accrual accounting’s disconnect between cash receipts and expenditures and the reporting of income or deductions permits taxpayers to take advantage of the time value of money and can turn a nominal income tax into a de facto consumption tax by functionally excluding returns on capital from taxation.

The need for a tax-specific income definition and accounting system can also be seen in the early history of the income tax, in which tax authorities struggled to differentiate tax accounting rules from the trust and financial accounting rules that had been imported into the tax laws. In particular, they had to develop a system for tracking previously taxed dollars to ensure that all income was

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<sup>1</sup> See Reuven S. Avi-Yonah, *The Case for Retaining the Corporate AMT*, 56 SMU L. REV. 333, 334 (2003) (defending the traditional corporate AMT against claims that it should be abolished).

<sup>2</sup> 439 U.S. 522, 540 (1979).

taxed and that it was taxed only once. Aligning book and tax accounting would potentially reopen long-settled matters.

In light of this history and the more recent insights into the impact accounting rules can have on an income tax, I argue that efforts to align financial and tax accounting are misguided. Indeed, in some cases the two regimes should deviate more than they already do. Specifically, Congress should consider returning to the original income tax rules, which required taxpayers to use the cash method of accounting, to avoid the problems posed by accrual accounting.<sup>3</sup> If requiring all taxpayers to use the cash method of accounting is a bridge too far, Congress and the courts should make clear that the IRS's authority to challenge a taxpayer's accounting method under Code § 446(b) extends to any situation where timing effects permit income to go untaxed.<sup>4</sup>

To be clear, I do not mean to suggest that financial and tax accounting should deviate in all regards. Both systems attempt to measure income, and there is much tax accounting can learn from financial accounting, especially when it comes to income definition and capitalization. Financial accounting eschews the social and economic policy provisions that distort the Code's income definition and create unnecessary complexity and higher rates. And, as Lily Kahng describes in Chapter 6, financial accounting experts are seriously considering rules to require capitalization of expenditures that create intellectual capital. However, where fundamental tax principles and goals conflict with financial accounting rules, tax accounting should forge its own path.

### The Book–Tax Disparity “Problem” and the Debate over Book–Tax Alignment

#### *The Problem*

Reports that wealthy Americans and American companies pay little or no income tax periodically bubble to the surface, creating significant impetus for reform. For instance, in 1969, Treasury Secretary Joseph Barr revealed that 155 individuals with annual incomes over \$200,000 (including 20 earning over \$1 million per year) paid no income taxes in 1967.<sup>5</sup> In response, Congress enacted the alternative minimum tax (AMT) to ensure that wealthy individuals pay some income tax.<sup>6</sup>

Fifteen years later, in 1984, Robert McIntyre issued a report for Citizens for Tax Justice, revealing that 128 out of the 250 large companies he studied, including General Electric (GE), Boeing, Dow Chemical, Lockheed, and W.R. Grace & Company, paid no federal income tax.<sup>7</sup> This report was seen as one of the important catalysts for the 1986 tax reform, which included a corporate AMT.<sup>8</sup>

3 Revenue Act of 1913, ch. 16, 38 Stat. 114, 167.

4 Code § 446(b) currently states that the IRS may challenge a taxpayer's accounting method where such method does not “clearly reflect income.”

5 See J. ECON. COMM., 91ST CONG., ECONOMIC REPORT OF THE PRESIDENT: HEARINGS BEFORE THE JOINT ECONOMIC COMMITTEE, CONGRESS OF THE UNITED STATES 6 (Comm. Print 1969).

6 Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487.

7 See JEFFREY H. BIRNBAUM & ALAN S. MURRAY, SHOWDOWN AT GUCCI GULCH 12 (1987). Ironically, W.R. Grace & Company's chairman headed a federal commission that concluded that wasteful spending was a huge threat to America's solvency.

8 Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085. Corporations were required to include in income 50 percent of the difference between book and tax income for purposes of calculating the AMT. This provision was replaced in 1990 with one that required corporations to include 75 percent of the difference between adjusted current earnings and taxable income. Andrew B. Lyon, *Tax Topics: Alternative Minimum Tax*,

About 15 years later, the financial markets were rocked by a series of accounting scandals, in which a number of companies, including Enron, Worldcom, and Adelphia Communications, Inc., manipulated accounting rules to report inflated income, hide off-balance sheet debt, or smooth out income to show steady increases year over year. At the same time, these companies were able to report relatively low earnings to the IRS, thus avoiding the tax hit that would have otherwise accompanied their fraud. This crisis led to increased disclosure requirements both for tax and financial reporting purposes.<sup>9</sup>

More recently, the news has been dominated by reports that a number of companies, including GE (again) and Apple, have found ways to manipulate the international tax rules so as to pay little or no income tax anywhere.<sup>10</sup> The companies insist that they have followed all the rules and are doing nothing improper,<sup>11</sup> but the revelations have once again generated calls for reform. Assuming that this current outcry follows the pattern above and Congress is motivated to act, the question of what it should do arises.

### *The Debate over Book–Tax Alignment*

Scholars have proposed three main types of responses to the problem of book–tax disparity. The first two track the reforms already implemented, including taxing the difference between book and tax income, either independently<sup>12</sup> or through a revised AMT, and requiring even greater disclosure whenever book and tax diverge, whether through the tax or financial accounting systems<sup>13</sup> or through some new format.<sup>14</sup> The third, and most radical, suggestion is that Congress align book and tax accounting,<sup>15</sup> requiring companies to report the same income figures for both tax and book purposes, perhaps subject to express, congressionally approved deviations.<sup>16</sup> Although accounting typically refers to the *timing* of income inclusion and deductions, in this context, alignment would require income definition conformity. This could significantly curtail Congress’s ability to use the Code for social or economic policy purposes, assuming, as most do, that the tax rules would conform to those found in financial accounting.

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*Corporate*, TAX POL’Y CTR., <http://www.taxpolicycenter.org/taxtopics/encyclopedia/alternative-minimum-tax-corporate.cfm> (last visited July 25, 2014).

9 Taxpayers had been required since 1990 to report certain differences between book and tax income on a Schedule M-1. This was replaced by Schedule M-3 in 2004, which among other things required taxpayers to explain the differences between their financial and tax accounting. Rev. Proc. 2004-45, 2004-2 C.B. 140. On the accounting side, the Financial Accounting Standards Board (FASB) enacted provisions, such as Financial Interpretation Number (FIN) 48, which required companies to report uncertain tax positions.

10 See, e.g., Megan Greene, *Apple’s Tax Dodge Should Prompt Rethink in Ireland*, BLOOMBERGVIEW (May 26, 2013), <http://www.bloomberg.com/news/2013-05-26/apple-s-tax-dodge-should-prompt-rethink-in-ireland.html>.

11 See *Apple CEO Rejects “Tax Evasion” Charges*, ALJAZEERA (May 21, 2013), <http://www.aljazeera.com/business/2013/05/201352165831522483.html>.

12 See Daniel Shaviro, *The Optimal Relationship Between Taxable Income and Financial Accounting Income: An Analysis and a Proposal*, 97 GEO. L.J. 423 (2009).

13 See Anthony J. Luppino, *Stopping the Enron End-Runs and Other Trick Plays: The Book–Tax Accounting Conformity Defense*, 2003 COLUM. BUS. L. REV. 35 (2003).

14 See Peter C. Canellos & Edward D. Kleinbard, *Disclosing Book–Tax Differences*, 96 TAX NOTES 999 (2002).

15 See Celia Whitaker, Note, *Bridging the Book–Tax Accounting Gap*, 115 YALE L.J. 680 (2005).

16 See George K. Yin, *Getting Serious About Corporate Tax Shelters: Taking A Lesson From History*, 54 SMU L. REV. 209 (2001).

It is hard to argue against increased disclosure, which would allow interested parties to identify issues with either the tax or accounting rules and propose changes when appropriate.<sup>17</sup> However, it is not clear how effective it would be. Some differences between book and tax are intended,<sup>18</sup> and book–tax disparity may not reflect sheltering activity.<sup>19</sup> Accordingly, significant gaps between book and tax income, and the outcry they engender, may persist. In addition, disclosure will not deter tax shelters that do not depend on book–tax disparity.<sup>20</sup>

Imposing a tax on book–tax disparity ensures that companies cannot avoid more tax than Congress intended<sup>21</sup> and preserves Congress’s control over the tax rules, including its ability to use the Code to promote social and economic policy.<sup>22</sup> However, this solution retains two sets of accounting rules, which continues the current complexity. Indeed, it adds to that complexity because taxpayers may not be able to predict the tax consequences of their transactions until they determine their tax and financial accounting income at the end of the tax year.<sup>23</sup>

For these reasons, among others, a number of would-be reformers are drawn to the apparently simple solution of aligning tax with financial accounting. Those calling for book–tax alignment cite a number of benefits, including (1) simplifying the accounting process by having one set of books; (2) eliminating the incentive to search for arbitrage opportunities;<sup>24</sup> (3) constraining both financial fraud and tax evasion by “setting ambition against ambition,” that is, by pitting the desire to report high earnings to regulators, investors, and lenders against the desire to minimize tax liabilities;<sup>25</sup> and (4) adopting a broader and more accurate measure of income, which should permit lower rates.<sup>26</sup>

Nevertheless, calls for tax to follow financial accounting have not been widely embraced, either from the tax or financial accounting side of the aisle. Concerns range from the practical to the theoretical. Some are concerned that Congress would have to give up its ability to implement social and economic policy through the tax laws.<sup>27</sup> Others are concerned that Congress will not

17 See Canellos & Kleinbard, *supra* note 14.

18 For example, the deferral of foreign earned income and the treatment of stock options.

19 See Linda M. Beale, *Book–Tax Conformity and the Corporate Tax Shelter Debate: Assessing the Proposed Section 475 Mark-to-Market Safe Harbor*, 24 VA. TAX REV. 301, 352 (2004).

20 See George K. Yin, *The Problem of Corporate Tax Shelters: Uncertain Dimensions, Unwise Approaches*, 55 TAX L. REV. 405 (2002) (discussing the Compaq and UPS cases).

21 See Avi-Yonah, *supra* note 1, at 334.

22 A tax on the difference between book and tax income will constrain Congress’s ability to use the Code to provide benefits to some degree, because it might recapture some of the benefits conferred. Nonetheless, Congress can take this into account when designing benefits and increase them to account for this possibility. *Id.*

23 See Terrence R. Chorvat & Michael S. Knoll, *The Case for Repealing the Corporate Alternative Minimum Tax*, 56 SMU L. REV. 305, 313 (2002) (arguing that the corporate AMT should be eliminated because it is inefficient).

24 See Luppino, *supra* note 13, at 184–85.

25 See Shaviro, *supra* note 12, at 446–47.

26 One study suggested that a switch from tax to book income would allow rates to drop from 35 percent to 28 percent. See Calvin H. Johnson, *GAAP Tax*, 83 TAX NOTES 425, 425 (1999) (citing Kenneth Wertz, *A Book Income Tax*, Proceedings of 91st Annual Conference on Taxation, 1998).

27 For instance, the exclusion of municipal bond interest from income under Code § 103, understood to be a subsidy to bond issuers, would have to be abandoned. Similarly, accelerated depreciation would no longer be allowed. This is one of the largest corporate tax expenditures, costing an estimated \$274 billion over a 10-year window. See Memorandum Regarding Revenue Estimates from Thomas A. Barthold, Joint Comm.

give up such power and instead will interfere with the financial accounting rules.<sup>28</sup> This could distort the information provided and transfer the rule-making process from accounting experts to a political body, a possibility accountants abhor.<sup>29</sup> Still others worry that aligning book and tax would decrease the amount of information available to investors.<sup>30</sup>

Others question whether the growth in book–tax disparity is actually a problem<sup>31</sup> or whether alignment will adequately address it.<sup>32</sup> Moreover, the financial accounting rules have their own problems,<sup>33</sup> which alignment would not solve. In addition, setting ambition against ambition may not actually curtail aggressive tax planning or financial reporting, especially for private companies, which have no incentive to report high earnings. Even public companies may not feel constrained because they might be able to find other ways to communicate value to investors,<sup>34</sup> allowing them to report low earnings to reduce tax burdens, without suffering any downside.<sup>35</sup> Managers may also be willing to pay higher taxes or report lower earnings if the detriment is outweighed by the benefit.<sup>36</sup>

In *Thor Power Tool Co. v. Commissioner*, the U.S. Supreme Court focused on the different purposes the two accounting regimes serve and the design features that flow from those differences in deciding that tax accounting need not follow financial accounting. Financial accounting is designed to provide management and investors with useful information, while the tax system is designed to collect revenue and ensure that similarly situated taxpayers bear similar burdens.<sup>37</sup> As

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on Taxation, to an unnamed recipient (Oct. 27, 2011), *available at* <http://democrats.waysandmeans.house.gov/sites/democrats.waysandmeans.house.gov/files/media/pdf/112/JCTRevenueestimatesFinal.pdf>.

28 See Shaviro *supra* note 12, at 465.

29 *Id.* As noted above, a possible solution to these problems would be to use book income for tax purposes but to allow Congress to craft explicit deviations. See Yin, *supra* note 16, at 224. However, assuming Congress were to retain the number of different preferences now in the Code, the gains from simplification would likely be lost.

30 See Michelle Hanlon et al., *Evidence for the Possible Information Loss of Conforming Book Income and Taxable Income*, 48 J.L. & ECON. 407 (2005) (arguing that tax information that differs from financial accounting information may provide insights to investors that would be lost if book and tax were aligned).

31 For instance, two of the key drivers of book–tax disparity are the different treatment of options and foreign earned income under financial and tax accounting rules, neither of which involves improper sheltering.

32 See Yin, *supra* note 20, at 419.

33 For example, the Enron, Worldcom, and Adelphia accounting scandals.

34 For instance, taxpayers are now permitted to use the last-in, first-out (LIFO) method of inventory accounting for tax purposes only if they use LIFO for financial accounting purposes. Many companies do so but also report their financial results using the first-in, first-out (FIFO) method through a variety of means, including footnotes in the financial balance sheets and through press releases.

35 Some empirical evidence suggests that managers care about the cosmetics of their accounting, even when there is no cash-flow consequence. Efficient market theory suggests that this should not be so because the market will ferret out and account for information from whatever source available. Scholars have posited that external constraints, such as loan covenants, account for this behavior, though pride may also come into play. See David I. Walker & Victor Fleischer, *Book/Tax Conformity and Equity Compensation*, 62 TAX L. REV. 399, 408–09 (2009); see also Shaviro, *supra* note 12, at 460 (noting that the accounting treatment of stock options appears to have affected behavior, despite having no impact on cash flow).

36 The short-lived version of the AMT that existed from 1986 until 1989, which keyed off of book–tax differences, has been referred to as a “bragging tax” that some companies were apparently willing to pay. See Johnson, *supra* note 26, at 426. Indeed, a recent study of companies forced to restate their earnings for financial accounting purposes revealed that they paid up to 11 cents on the dollar for their overstated earnings. See Shaviro, *supra* note 12, at 449.

37 439 U.S. 522, 543–44 (1979).



a result, financial accounting rules permit a wide range of options for reporting transactions as well as estimates and guesses. At its core, it is supposed to be conservative. In contrast, tax principles require consistent treatment and precision. Conservatively stating income is not an income tax value. The court noted that requiring tax accounting to follow financial accounting would cede significant power to companies to decide, within the limits their accountants set, how much tax they wanted to pay.<sup>38</sup> In other words, the flexibility inherent in financial accounting could be abused to the detriment of the public fisc.

As described below, both the early history of the income tax—in which tax authorities struggled to disentangle the tax accounting rules from financial and trust accounting terms and concepts—and the more recent insights into the effects timing can have on an income tax offer a much more compelling justification for keeping tax and financial accounting separate than that provided by the Supreme Court in *Thor Power Tool*. The goal of an income tax is not simply to measure income, but to ensure that all income is subject to tax. Alignment would undermine this important goal by permitting taxpayers to use accrual accounting to escape tax on returns on capital by virtue of the time value of money.

### **Income Tax Fundamentals and the Development of a Tax-Specific Income Definition and Accounting Regime**

Before adopting the modern income tax in 1913, the U.S. government depended largely on import duties and excise taxes, both classic consumption taxes, to raise revenue. Policy makers at the time understood that this regime was regressive and permitted significant accumulations of wealth to go untaxed. Accordingly, they pushed for an income tax to fix this problem, which would impose a tax on both consumption and returns on capital.<sup>39</sup> By reaching the significant wealth that was generated but not currently consumed, the income tax would ensure that the tax burden was apportioned based on ability to pay.

Early authorities struggled with the question of just what constituted income for tax purposes,<sup>40</sup> eventually adopting a broad definition that encompassed most accessions to wealth.<sup>41</sup> In the process, they developed a tax-specific income definition and accounting system to ensure that all income was included in the tax base and was subject to tax only once. More recently, scholars have come to understand that the timing inherent in an accounting system can convert a nominal income tax into a de facto consumption tax. Both this early history and modern insights are directly relevant to the question of whether tax and financial accounting should be aligned.

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38 The Court's arguments regarding variation among taxpayers is not as clear-cut as the Court suggests. Similarly situated taxpayers currently use a variety of accounting methods, which affects their tax liability.

39 See ERIC M. JENSEN, *THE TAXING POWER: A REFERENCE GUIDE TO THE UNITED STATES CONSTITUTION* 17 (2005); see also Ajay K. Mehrotra, *Forging Fiscal Reform: Constitutional Change, Public Policy, and the Creation of Administrative Capacity in Wisconsin 1880–1920*, 20 J. POL'Y HIST. 94 (2008) (describing efforts in Wisconsin to implement an income tax to address the regressive effect of property taxes, which did not reach the significant intangible wealth being created); Ajay K. Mehrotra, "More Mighty than the Waves of the Sea": *Toilers, Tariffs, and the Income Tax Movement, 1880–1913*, 45 LAB. HIST. 165 (2007) (describing the perceived problems of the tariff system and labor's support of an income tax).

40 *Eisner v. Macomber*, 252 U.S. 189 (1920).

41 *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426 (1955).

### *Early Efforts to Disentangle Financial, Trust, and Tax Accounting*

Early tax authorities borrowed heavily from other accounting systems, including trust and financial accounting. While many of the concepts and rules worked well in the tax arena, some did not. In particular, the trust and financial accounting notion of capital and the distinction between capital and income did not work well in the tax system. Accordingly, the early authorities developed a tax-specific income definition and accounting rules.

#### *Capital Gains*

One of the first issues to arise under the income tax was whether capital gains, which were clearly distinguished from income under the trust accounting regime, could be considered income for tax purposes. Trust law differentiates between the corpus or capital (i.e., amounts put into a trust) and the income produced by the capital. The distinction matters because trusts often permit access to the income to lifetime beneficiaries, while reserving the capital for remaindermen.

The question of whether capital gains (i.e., gains on the sale of capital assets) should be considered income for tax purposes first arose in England. As Calvin Johnson has explained, the British excluded capital gains from their first income tax in 1799.<sup>42</sup> The British income tax (like the American income tax) was based on the notion that those with a greater ability to pay should pay more to support government. However, at that time most real property in Britain was either entailed or held in trust.<sup>43</sup> Current owners were only entitled to the income generated by the land, usually in the form of agricultural produce or rents. Any gains that accrued to the trust property (i.e., the capital) were not available for current consumption and therefore did not increase a life beneficiary's ability to pay. Accordingly, they were not considered income for tax purposes.

The possibility of taxing capital gains in Britain was raised during major tax reform efforts in 1920 and 1955, but the idea was rejected both times. The British finally decided to tax capital gains in 1965, when it became apparent that such gains *were* available for current consumption thus increasing the recipient's ability to pay. Excluding capital gains from income under such circumstances created significant fairness issues because taxpayers with considerable capital gains were able to live largely income-tax free, while low-paid wage earners were subject to the tax. The decision to include capital gains in income rectified this inequity and brought the tax base closer to the underlying ability-to-pay justification for an income tax.

In the United States, this question was decided in *Merchants' Loan & Trust Co. v. Smietanka*,<sup>44</sup> in which the plaintiff argued that gain on the sale of trust property (i.e., stock in a company) was not taxable under the recently enacted income tax because it was not treated as income under the terms of the trust. The U.S. Supreme Court quickly disposed of this argument, holding that trust accounting rules distinguishing capital gains from income did not control in the income tax setting and that such gains were indeed subject to the income tax. The Court pointed out that the tax laws clearly contemplated a tax on gains from the sale of property,<sup>45</sup> and it would be problematic if private parties could remove such gains from the tax base by simply placing property in trust and restricting the use of capital gains.

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42 Calvin H. Johnson, *Taxing the Consumption of Capital Gains*, 28 VA. TAX REV. 477, 488–98 (2009).

43 *Id.* at 490–94. Entailed property was deemed to be owned by the current owner and his heirs, which prevented the current owner from selling it.

44 255 U.S. 509 (1921).

45 *Id.* at 516 (citing Revenue Act of 1916, ch. 463, § 2(a), 39 Stat. 756, 757).

In fact, as noted above, subjecting returns on capital to taxation was precisely the goal of the income tax. Nonetheless, Congress quickly acted to reduce the tax rates on capital gains,<sup>46</sup> leaving the income tax rule unchanged but moving the treatment of capital gains closer to the trust accounting practice of excluding such gains from the definition of income. While there has been much debate since then over the appropriate treatment of capital gains under the income tax,<sup>47</sup> the notion that the income definition and associated accounting regimes for tax and trust or financial purposes should differ has gone unchallenged.

### *Basis, Damages, and Gifts*

Another example of early efforts to develop a tax-specific income definition and disentangle tax accounting from other accounting systems can be seen in efforts to develop the concept of basis, especially as applied to damages and gifts. As Joseph Dodge and Deborah Geier have explained, the notion that income should be taxed only once is one of the key tenets of an income tax.<sup>48</sup> Thus, tracking previously taxed dollars is of utmost importance.<sup>49</sup> This tracking is accomplished through the now-familiar concept of basis. Thus, property purchased with after-tax dollars is given a basis equal to cost,<sup>50</sup> which is subtracted when the asset is sold to determine gain or loss.<sup>51</sup>

The tax-free return of basis is often referred to as a recovery of capital, a phrasing that derives directly from the trust and financial accounting concepts initially imported into the tax laws. As described below, using trust and financial accounting concepts led early administrators to issue tax rulings regarding both damages and gifts that were unworkable from a tax perspective. When the difficulties of using uniform rules for tax and other accounting systems became apparent, tax authorities developed tax-specific accounting rules to accomplish the income tax's goals.

One of the early issues raised was whether the proceeds of accident insurance received as a result of personal injuries should be included in income. Borrowing from trust law, the U.S. Attorney General issued an opinion holding that such proceeds were not taxable.<sup>52</sup> The opinion relied heavily upon *Doyle v. Mitchell Bros. Co.*, a U.S. Supreme Court case construing the corporate excise tax of 1909,<sup>53</sup> in which the Court was asked to decide whether the sale of capital should produce income and, if so, how much. The Court borrowed from trust and financial accounting principles to distinguish income from capital, and it held that amounts paid to replace capital should be received tax free. Only the *gain* on the sale of capital—that is, amounts received above

46 Revenue Act of 1921, Pub. L. No. 67-98, § 206(b), 42 Stat. 227, 233.

47 The capital gains rate has been changed numerous times over the 100-year history of the income tax, including a brief time from 1986 to 1990 when capital gains were taxed at the same rate as other income. For a discussion of the rationales offered for taxing capital gains at lower rates, see Walter J. Blum, *A Handy Summary of the Capital Gains Arguments*, 35 TAXES 247 (1957).

48 See JOSEPH M. DODGE, *THE LOGIC OF TAX: FEDERAL INCOME TAX THEORY AND POLICY* 20 (1989); Deborah A. Geier, *Murphy and the Evolution of "Basis,"* 113 TAX NOTES 578 (2006).

49 Equally important is the idea that expenses should be deducted once. Thus, a system for tracking deductions to prevent a double benefit is necessary.

50 26 U.S.C. §§ 1011, 1012.

51 *Id.* §§ 61, 165, 1001. For example, if Chloe purchases a vacation home for \$100,000, she gets a basis of \$100,000 under Code §§ 1011 and 1012. When she later sells it for \$120,000, her taxable gain is the amount realized (i.e., \$120,000) less her basis (i.e., \$100,000), or \$20,000. *Id.* § 1001(a). She receives the remaining \$100,000 tax free.

52 See *Income Tax—Proceeds of Accident Insurance Policy*, 31 Op. Att'y Gen. 304, 308 (1918).

53 247 U.S. 179, 182 (1917).



and beyond the original value of that capital—should be taxed.<sup>54</sup> Based on this reasoning, the Attorney General opined that insurance proceeds received on account of personal injury could not be considered income because they simply replaced capital lost in the accident. Later that year, the U.S. Department of Treasury issued a decision adopting this position.<sup>55</sup> Congress quickly followed suit.<sup>56</sup>

Missing from this analysis was the *reason* capital should be recovered tax free, namely because it has already been subject to tax. This notion was implicit in the idea that only the gains in the value of capital were properly considered income for tax purposes,<sup>57</sup> but early authorities missed that idea. Both the original value of capital and its increase were capital in the hands of the corporation in *Doyle*. The reason only the gain was subject to tax was that it had not previously been taxed, whereas the original value was deemed to have been taxed as of December 31, 1908, the day before the corporate excise tax went into effect. In other words, it had basis. Applying this reasoning to damages, recovery should be tax free only if a taxpayer had basis in the amounts recovered. People do not typically have basis in their reputations, bodies, or labor (sometimes referred to as human capital), and therefore the entire amount of most personal injury damage recoveries should be considered gain.<sup>58</sup>

By the time the tax authorities understood this concept, the tax-free recovery of damages for certain personal injuries was enshrined in statute, and there was nothing they could do to alter this treatment.<sup>59</sup> However, in other contexts, the tax authorities quickly moved away from these trust and financial accounting concepts to develop basis accounting rules that carried out income tax objectives. Thus, in 1944, when the U.S. Court of Appeals for the First Circuit considered the question of damage recovery in *Raytheon Production Corp. v. Commissioner*, it easily found that Raytheon's recovery of damages for a destroyed subsidiary—a clear recovery of its capital—should be subject to tax because Raytheon had no basis in the destroyed company.<sup>60</sup>

A similar progression can be seen in the treatment of gifts. Consistent with the trust and financial accounting notion of capital, the early tax rules permitted the basis of gifts to be recorded as the fair market value at the time of the gift.<sup>61</sup> This was, after all, the value of the capital the donee received. Tax authorities quickly recognized that this rule permitted taxpayers to avoid tax on the sale of appreciated assets by simply giving them to someone else, who could sell them immediately with no gain. The proceeds could then be given back as a gift or spent as directed by the donor.

In 1921, Congress amended this rule to require that the donee take the donor's cost as his basis, thus preventing this gambit.<sup>62</sup> This new rule was immediately challenged on the ground that it was unconstitutional. In particular, the taxpayer argued that the gift “became a capital asset of the donee to the extent of its value when received and, therefore, when disposed of by her no part

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54 For an in-depth discussion of this case, see Joseph M. Dodge, *Murphy and the Sixteenth Amendment in Relation to the Taxation of Non-Excludable Personal Injury Awards*, 8 FLA. TAX REV. 369, 407–18 (2007).

55 T.D. 2747, 20 Treas. Dec. Int. Rev. 457 (1918).

56 See Revenue Act of 1918, ch. 18, § 213(b)(6), 40 Stat. 1057, 1066.

57 *Doyle*, 247 U.S. at 185.

58 Some have suggested that people should have a basis in their human capital equal to its fair market value. See Elizabeth A. Rose, Note, *Murphy's Mistakes: How the Circuit Court Should Analyze Section 104(a)(2) upon Rehearing*, 60 TAX LAW. 533 (2007). However, such a result would mean that exchanging labor for wages would yield little or no income.

59 See *supra* note 56.

60 144 F.2d 110 (1st Cir. 1944).

61 *Taft v. Bowers*, 278 U.S. 470, 471–72 (1929) (argument for petitioner).

62 Revenue Act of 1921, ch. 136, § 202(a), 42 Stat. 227, 229.

of that value could be treated as taxable income in her hands.”<sup>63</sup> The U.S. Supreme Court noted that adhering to trust and business accounting practices would be inconsistent with enforcing the general scheme of taxation. It upheld the new rule as constitutional, essentially recognizing both the need for, and Congress’s right to craft, special accounting rules for taxation consistent with a tax-specific income definition.

### *Capitalization, Depreciation, Accrual Accounting, and the Income Tax*

Accountants insist that accrual accounting is the most accurate measure of income because it takes income and expenses into account when they are earned or incurred as opposed to when cash is received or spent.<sup>64</sup> Under this system, a company that spends \$100,000 in Year 1, but which is then scheduled to receive a \$110,000 payment in Year 2, will be seen to have \$10,000 of income in Year 1, and not a \$100,000 loss in Year 1 and a \$110,000 gain in Year 2, as would be the case for a company using the cash method. Accrual accounting effectively matches expenses incurred with the income they generate.<sup>65</sup> From the perspective of one seeking to assess a company’s financial health, the former seems a far more accurate depiction than the latter. Similarly, the capitalization and depreciation rules ensure that expenses that generate future income (e.g., those used to acquire an income-producing asset) are matched with the income they generate, thereby minimizing distortions caused by timing differences in outlays and receipts.

In 1916, Congress permitted companies that used the accrual method for financial accounting purposes to do so for tax purposes as well.<sup>66</sup> In the years since, it has required an increasing number of companies to use the accrual method.<sup>67</sup> However, advances in the understanding of the time value of money and the effects it can have on a tax system suggest that accrual accounting can seriously distort the amount of tax paid in present-value terms, yielding results consistent with a consumption tax.<sup>68</sup> As Deborah Geier notes, to ensure that income—and not just consumption—is taxed: (1) investments must be made with after-tax dollars; *and* (2) the income generated by such investments must be subjected to tax.<sup>69</sup> Disassociating income inclusion and deductions from cash receipts and outlays violates the first of these two requirements and therefore can convert a nominal income tax into a de facto consumption tax. This insight has significant implications when considering aligning book and tax accounting.

### *Capitalization and Depreciation*

Before turning to accrual accounting, it may help to discuss these concepts in the context of the capitalization and depreciation rules, which apply to both cash method and accrual accounting regimes. Under financial accounting rules, companies are not entitled to a deduction when they purchase an asset. With regard to the balance sheet, when a company purchases an asset, its cash balance declines, but it adds an asset of the same value to its balance sheet, leaving total assets,

63 *Taft*, 278 U.S. at 481.

64 For a discussion of the matching principle and the central role it plays in accrual accounting, see Deborah A. Geier, *The Myth of the Matching Principle as a Tax Value*, 15 AM. J. TAX POL’Y 17, 29–30 (1998).

65 *Id.* at 27–29.

66 Revenue Act of 1916, ch. 463, § 13(b), 39 Stat. 756, 770.

67 *See, e.g.*, 26 U.S.C. § 448 (requiring most C corporations to use the accrual method of accounting).

68 *See Geier, supra* note 64, at 25–26.

69 *See* DEBORAH A. GEIER, AN INTRODUCTION TO THE U.S. FEDERAL INCOME TAXATION OF INDIVIDUALS 34 (2014).

liabilities, and owner's equity unchanged. The purchase merely effects a change in the form of wealth, like changing a single \$20 bill into four \$5 dollar bills. For this same reason, the company would not be entitled to a deduction on its income statement.

Nonetheless, financial accounting permits businesses to take depreciation deductions both on the balance sheet and against income. On the balance sheet, the deduction reflects the presumed decline in value of the asset; on the income statement, the deduction is consistent with the matching principle, a core accounting concept that motivates many of financial accounting's rules.<sup>70</sup> Under this principle, a portion of an asset's cost should be deducted each year against income over the asset's useful life to paint an accurate picture of the business's income.<sup>71</sup> Otherwise, timing differences between expenditures and income will distort the picture of the business's overall income.

Tax accounting has capitalization and depreciation rules similar to financial accounting. Amounts spent to acquire or create assets are not deductible.<sup>72</sup> Instead, they are recorded as basis, which, in turn, is used to calculate both depreciation deductions (where appropriate) and the gain or loss realized on the asset's disposition.<sup>73</sup> It would be tempting to conclude that the ideas that motivate financial accounting justify the tax rules, and indeed, some of the key tax cases appear to endorse the matching principle as the justification for capitalization and depreciation in the tax system.<sup>74</sup> However, a deeper look at tax principles reveals that capitalization and depreciation serve a different and important function in an income tax that may justify significant deviations between tax and financial accounting in other contexts, such as the propriety of accrual accounting.

One way to get at the role of capitalization in an income tax is to compare similarly structured income and consumption taxes. The income tax measures income by tracking cash inflows (or in the case of accrual accounting, income earned), allowing deductions for most income-producing expenditures (or in the case of accrual accounting, obligations undertaken). In contrast, a cash-flow consumption tax measures consumption indirectly by tracking a taxpayer's cash inflow and permitting a deduction for income-producing expenditures and savings.<sup>75</sup> One of the key differences between the two taxes is capitalization and depreciation, which have no place in a cash-flow consumption tax.

So, what do capitalization and depreciation do in an income tax? The financial accounting answer would be that they match spending with income, so that net income can be properly determined and then taxed, and, indeed, some courts have suggested that this is their purpose.<sup>76</sup> Another possibility, and one more firmly grounded in tax theory, is that they are consistent with the Haig-Simons-Schanz income definition, which posits that income is the sum of consumption and change in wealth.<sup>77</sup> Capital expenditures should not lead to current deductions because they do not

<sup>70</sup> See Geier, *supra* note 64, at 27.

<sup>71</sup> Otherwise, the company that purchases a machine for \$100,000 might report a \$100,000 loss on the purchase and \$10,000 per year of income from the machine over the next 15 years, as opposed to a net \$50,000 gain. If the amount must be capitalized and no depreciation deductions are allowed, the result would be \$10,000 of income each year and then a \$100,000 loss when the spent asset is abandoned.

<sup>72</sup> 26 U.S.C. §§ 263, 263A.

<sup>73</sup> *Id.* §§ 167, 168, 1001, 1011, 1012, 1016.

<sup>74</sup> See, e.g., *INDOPCO, Inc. v. Comm'r*, 503 U.S. 79, 83–84 (1992) (“[T]he Code endeavors to match expenses with revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes.”).

<sup>75</sup> See William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974).

<sup>76</sup> See *supra* note 74.

<sup>77</sup> See Geier, *supra* note 64, at 42.

reflect consumption or a decrease in wealth. Depreciation deductions arguably reflect decreases in wealth as assets subject to wear and tear decline in value over time.<sup>78</sup> Yet another answer is that disallowing deductions for capital expenditures prevents taxpayers from taking advantage of the time value of money to turn a nominal income tax into a de facto consumption tax. It is this third answer that has broader implications for arguments to align financial and tax accounting and to which we now turn.

Income and consumption taxes that impose the same tax rate typically produce different after-tax results because the income tax covers both consumption and returns on capital, while consumption taxes only impose a tax on consumption. E. Carey Brown demonstrated in the 1940s that income and cash-flow consumption taxes yield identical after-tax results when taxpayers are permitted to deduct amounts used to purchase income-producing assets.<sup>79</sup> Allowing a current deduction for asset purchases violates one of the core requirements for an income tax; namely, that returns be earned on after-tax dollars.<sup>80</sup> Permitting a deduction for asset purchases is economically equivalent to excusing the income that the asset will produce from taxation,<sup>81</sup> that is, it produces results equivalent to consumption taxation.

This insight has implications for depreciation. Depreciation can be justified under income tax principles only if it is seen as an attempt to account for an irretrievable loss in wealth occasioned solely by the passage of time, similar to the way the value of an original issue discount bond increases solely with the passage of time.<sup>82</sup> While deducting losses in value absent a realization event is typically not allowed, losses occasioned *solely* by virtue of the passage of time are arguably realized because they are irretrievable.<sup>83</sup>

This justification for depreciation has significant implications for the appropriate amount of depreciation under income tax principles. Under the accounting system's matching principle, the appropriate depreciation amount is proportional to the income the asset will earn in a given year.<sup>84</sup> In contrast, the amount of depreciation appropriate under the income tax principle described above should be the diminution in value due solely to the passage of time; that is, it is a function of

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78 Typically, changes in asset value are not included in the tax base until there has been a realization event (i.e., an asset has been sold or otherwise disposed of). However, exceptions do exist (e.g., the mark-to-market rules for certain assets), and the argument could be made that depreciation deductions warrant an exception as well. See Geier, *supra* note 64, at 58–60.

79 E. Cary Brown, *Business-Income Taxation and Investment Incentives*, in *INCOME, EMPLOYMENT AND PUBLIC POLICY: ESSAYS IN HONOR OF ALVIN H. HANSEN* 300, 300–16 (1948).

80 See Geier, *supra* note 69, at 35.

81 For a numeric example, see Geier, *supra* note 64, at 44. This is precisely the insight that led to the creation of Roth IRAs. Allowing a deduction for traditional IRA contributions and then taxing the money when withdrawn is economically equivalent to disallowing the deduction on contribution and not taxing the gains.

82 This is often referred to as Samuelson depreciation. See Paul A. Samuelson, *Tax Deductibility of Economic Depreciation to Insure Invariant Valuations*, 72 *J. POL. ECON.* 604 (1964). While Samuelson depreciation works well for financial assets with fixed lives and income streams, it is virtually impossible to calculate for other assets.

83 See JOSEPH M. DODGE ET AL., *FEDERAL INCOME TAX: DOCTRINE, STRUCTURE, AND POLICY* 663–708 (4th ed. 2012) (discussing theories of depreciation).

84 For a numeric example, see Geier, *supra* note 64, at 60–61. This is a “straight-line” approach. The accounting rules are flexible and permit a range of approaches, so long as they are consistently applied. That a number of approaches are acceptable reinforces the view of many that GAAP accounting rules are not suitable for tax purposes.

expected cash flows<sup>85</sup> and less than would be appropriate under financial accounting.<sup>86</sup> Allowing a depreciation deduction greater than appropriate under income tax principles violates the same income tax principle as the failure to capitalize in that it permits a taxpayer to earn returns using deducted, or pre-tax, dollars. The result is that some of the return will functionally be exempted from tax. Such a result is antithetical to a true income tax.<sup>87</sup>

### *Accrual Accounting*

The insights described above have significant implications for the propriety of using accrual accounting in an income tax regime. As Daniel Halperin and others have explained, permitting taxpayers to deduct amounts that they have not yet paid or to exclude from income amounts that they have received but not yet earned has the same effect as allowing immediate expensing of capital expenditures or overgenerous depreciation deductions—it effectively exempts returns on capital from tax and undermines one of the core values of an income tax.<sup>88</sup>

For instance, the accrual of expenses in cases where the taxpayer has yet to actually incur the cost allows an investment return to be earned on pre-tax dollars (the tax savings created by the deduction), producing the same consumption-tax result that occurs with the premature deduction of capital expenditures.<sup>89</sup> Similar concerns arise regarding prepaid income, which effectively presents a mirror image of accelerated deductions. Accounting rules permit companies to exclude up-front, lump-sum payments for future services from income until they are earned. The difficulty with this practice from a tax perspective is that the taxpayer would have tax-free use of the money until it is earned.<sup>90</sup> While the interest earned on this prepaid income is subject to tax, excluding the initial payment from tax until it is earned violates the rule that investments be made with after-tax dollars. The result is economically equivalent to including the initial payment in income and excluding from tax the interest earned on it. In other words, it yields consumption-tax treatment.<sup>91</sup>

As originally enacted, the Code required taxpayers to use the cash method of accounting.<sup>92</sup> Congress first permitted accrual accounting in 1916.<sup>93</sup> Early court decisions held that accrual

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85 See Christopher H. Hanna, *Tax Theories and Tax Reform*, 59 SMU L. REV. 435, 445 (2006) (citing MARVIN CHIRLESTEIN, *FEDERAL INCOME TAXATION* ¶ 6.09 (10th ed. 2005)).

86 For a numeric example, see Geier, *supra* note 64, at 61.

87 To be clear, the current income tax rules are also inconsistent with income tax principles. For instance, Code § 179 permits the immediate deduction of some amounts used to purchase certain types of assets. Code § 168(k) permits bonus depreciation under certain circumstances in the year an asset is put into service. The accelerated depreciation (and even the straight-line amounts) permitted in Code § 168(b) allows more depreciation to be deducted than would be justified under strict income tax principles. From an income tax perspective, these provisions can only be justified as tax expenditures or efforts to simplify the tax system to make it more administrable.

88 See, e.g., Daniel I. Halperin, *Interest in Disguise: Taxing the "Time Value of Money,"* 95 YALE L.J. 506 (1986); Daniel I. Halperin, *The Time Value of Money—1984*, 23 TAX NOTES 751 (1984).

89 For a numerical example, see Geier, *supra* note 64, at 93–95.

90 As discussed below, the courts have limited this possibility in some cases, but the problem persists.

91 The opposite problem arises in cases where taxpayers accrue income long before it is received. Current inclusion requires that taxes be paid today on money taxpayers do not have, resulting in overtaxation. As with accrued deductions of future expenditures, the worst of these problems are dealt with by findings that the future payment is somehow contingent, thus permitting deferral until payment is received. See I.R.S. Tech. Adv. Mem. 97-15-004 (Dec. 16, 1996).

92 See *supra* note 3.

93 See *supra* note 66.



accounting for tax purposes should follow the financial accounting regime.<sup>94</sup> Nonetheless, the courts established a test—eventually evolving into the all-events test—that did not require that result in all cases. For instance, courts permitted deductions of unpaid amounts where it seemed certain that the expense would ultimately be paid.<sup>95</sup> However, they drew the line at contingent liabilities.<sup>96</sup> In some cases they even deemed future liabilities to be contingent to avoid allowing a deduction.<sup>97</sup> Finally, in 1984, Congress enacted Code § 461(h), which precluded deductions absent economic performance. This rule effectively requires payment before deductions are allowed, which is consistent with income tax principles, and functionally put accrual method taxpayers on the cash method with regard to their deductions.

Conversely, with regard to prepaid income, where the dates on which prepaid income will be earned are certain, the U.S. Court of Appeals for the Seventh Circuit has permitted deferral until such amounts are earned, consistent with the financial accounting rules.<sup>98</sup> However, where the time at which the income will be earned is uncertain, the U.S. Supreme Court has required immediate inclusion, consistent with income tax principles.<sup>99</sup> The inquiry into when income is earned is critical from an accrual accounting perspective but less so from a tax perspective. As demonstrated above, if taxpayers are allowed to receive money and invest it without first paying tax, the amounts earned on such money will effectively be exempted from tax, and the very purpose of the income tax will be thwarted.

### Income Tax Theory and the Book–Tax Alignment Debate

The foregoing should give considerable pause to those arguing that tax accounting should be aligned with financial accounting. The decision to adopt an income tax in the late nineteenth and early twentieth centuries reflected a clear understanding that consumption alone should no longer be subjected to tax. Rather, reformers believed that the tax base should also include changes in wealth, including returns on capital. Such a system would better align tax burdens with the ability to pay, a core value underlying the income tax.

Accrual accounting works well for financial accounting purposes precisely because it considers a business's rights to income and expenditure obligations independent of cash flows. The matching principle helps ensure that timing differences between income and expenses do not distort the picture of overall income. This is exactly the type of information an investor or corporate manager would want. Cash flow is not irrelevant; however, what matters most when assessing the financial health of a business is a complete picture of anticipated income and expenses.

By disassociating income inclusion and deductions from cash flow, accrual accounting can convert a nominal income tax into a de facto consumption tax by excusing returns on capital from tax. Early tax authorities spent significant effort developing a tax-specific income definition and the

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94 *E.g.*, *United States v. Anderson*, 269 U.S. 422 (1926).

95 *Id.* at 441.

96 *E.g.*, *Lucas v. Am. Code Co.*, 280 U.S. 445 (1930) (company prevented from deducting damages in year when final amount had not yet been set and was not reasonably predictable).

97 *E.g.*, *Mooney Aircraft, Inc. v. United States*, 420 F.2d 400 (5th Cir. 1969) (company prevented from taking a current deduction for bonds due far into the future, with the court straining to classify the expenditures as contingent to avoid the result the taxpayer wanted).

98 *Artnell Co. v. Comm'r*, 400 F.2d 981 (7th Cir. 1968).

99 *Schlude v. Comm'r*, 372 U.S. 128 (1963); *Am. Auto. Ass'n v. United States*, 367 U.S. 687 (1961); *Auto. Club of Mich. v. Comm'r*, 353 U.S. 180 (1957).

accounting rules that would make it possible to tax *all* components of income and make sure that it was taxed only once. Despite the rules permitting taxpayers to use accrual accounting, Congress and the courts crafted tax-specific accounting rules, such as Code § 461(h), that permitted and indeed required deviation from financial accounting norms where those norms would lead to improper reductions in taxes owed. Many of these changes serve to ensure that income is included upon receipt of cash and deductions disallowed until actual payment is made.<sup>100</sup> Aligning book and tax accounting would undo these important rules and significantly increase a taxpayer's ability to use the financial accounting rules to lower their tax liabilities.

Accrual accounting also deviates from the ability-to-pay principle that underlies the income tax. A promise to pay someone five years into the future does not diminish one's current ability to pay taxes. Conversely, a right to receive income in the future does not increase one's ability to pay taxes now, unless the right is somehow negotiable. Such concerns motivate the installment sales rules found in Code § 453, which impose tax liability only when money is actually received. Aligning book and tax accounting to allow full accrual accounting would thus undermine this important value as well.

To protect income tax values and ensure that returns on capital are actually subjected to tax, Congress should not align financial and tax accounting. Rather it should consider a return to the original income tax rule, which required taxpayers to use the cash method of accounting for tax purposes, subject to a strong capitalization requirement. If this proposal is deemed a bridge too far, Congress should tighten the tax accounting rules to ensure that disconnects between income and expense reporting and cash flow do not undermine the tax base. Moreover, it should amend Code § 446(b) to make clear that the IRS may challenge a taxpayer's accounting method whenever the accounting method in question significantly undermines the income tax base. Absent congressional action, courts should construe Code § 446(b) as broadly as possible.

### *Congress Should Consider a Return to Cash Accounting for Tax Purposes*

To ensure that income is fully taxed, Congress should require taxpayers to use the cash method of accounting for tax purposes, subject to a strong capitalization rule, regardless of their financial accounting method. This was the rule in the original income tax.<sup>101</sup> Congress first permitted companies that used the accrual accounting method for financial purposes to do so for tax purposes in 1916.<sup>102</sup> Since then, it has required an increasing number of taxpayers to use the accrual method.<sup>103</sup> Congress has also enacted a number of provisions that deviate from what a pure income tax would require. For instance, Congress allows significant deductions on the purchase of assets.<sup>104</sup> It also permits taxpayers to exclude from income amounts contributed to 401(k) plans and traditional IRAs.<sup>105</sup> In both cases, permitting returns to be earned on pre-tax dollars yields consumption-tax treatment.

Given this history, one could conclude that Congress has embraced accrual accounting as another exception to income tax norms and would be loath to abandon it. However, Congress's decision to

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100 *E.g.*, 26 U.S.C. § 461(h).

101 *See supra* note 3.

102 *See Geier, supra* note 64, at 71.

103 *E.g.*, 26 U.S.C. § 448 (requiring most C corporations to use the accrual method of accounting).

104 *E.g., id.* §§ 168(k), 179.

105 The traditional IRA violates the rule that investments should be made with after-tax dollars, while the Roth IRA violates the rule that returns on capital should be included in income. In both cases, this means that the return on IRA investments is excluded from tax.

enact Code § 461(h), which requires payment before most deductions, suggests otherwise. In fact, Congress's expansion of accrual accounting may reflect an effort to *avoid* the timing mismatches that undermine core income tax values.<sup>106</sup> The initial decision to allow accrual accounting appears to have been a concession to companies at a time when the definition of income for tax purposes was being developed<sup>107</sup> and the impact of accrual accounting was not fully understood. Companies that kept their books on an accrual basis were permitted to use that method for tax purposes, so that they did not need to create a second set of books.<sup>108</sup>

That Congress significantly expanded the use of accrual accounting in 1986, after the effects of accrual accounting were well known,<sup>109</sup> is far more difficult to explain. While some evidence suggests that Congress believed that accrual accounting reflected income for tax purposes better than cash accounting,<sup>110</sup> the move toward accrual accounting could also be seen as an effort to solve a problem occasioned by a deduction and income-inclusion mismatch *between* taxpayers.<sup>111</sup> Most expenses incurred by taxpayers lead to income for others. When taxpayers use different accounting methods, the deduction of an expense may precede the inclusion of income, significantly reducing the amount of taxes collected. For example, this might occur when an accrual method taxpayer incurs an obligation to make a payment to a cash method taxpayer.<sup>112</sup> As with a deduction taken before cash payments are made, amounts earned on the tax savings will be excluded from tax.<sup>113</sup> In other words, a mismatch between expense deduction and income inclusion on transfers between taxpayers can convert a nominal tax on income into a *de facto* consumption tax, just as accrual accounting can do the same for a single taxpayer. Requiring most C corporations to use accrual accounting ameliorates this problem.<sup>114</sup>

This argument is not meant to suggest that the cash method is free of problems. If receipts are lumped together in one year, taxpayers may end up in a higher tax bracket and pay more in taxes. Lumping deductions into a given year may also change a taxpayer's tax bracket. Companies that have no income over a two-year period, for instance receiving \$100,000 in income in year one and spending \$100,000 to earn it in year two, would be required to pay income tax and then seek a refund using the net operating loss provision.<sup>115</sup> Moreover, moving to the cash method will put significant pressure on the constructive-receipt and cash-equivalent doctrines, because

106 See Geier *supra*, note 64, at 100–01.

107 Henry Simons did not publish his seminal work, incorporating the insights of Robert Haig and George Schanz, until 1938. See HENRY C. SIMONS, *PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY* 50 (1938); see also Robert Murray Haig, *The Concept of Income—Economic and Legal Aspects*, in *THE FEDERAL INCOME TAX* 1, 7 (Robert Murray Haig ed., 1921); Georg von Schanz, *Der Einkommensbegriff und die Einkommensteuergesetze*, 13 FINANZARCHIV 1 (1896).

108 Given the advanced state of computing, requiring companies to restate their books on a cash basis would now impose a small burden.

109 For example, Code § 7872 governing below-market loans, the original issue discount (OID) rules, and various other sections imputing interest.

110 See H.R. REP. NO. 99-426, at 605 (1985).

111 See *id.*

112 But see 26 U.S.C. § 267(a)(2).

113 See Geier, *supra* note 64, at 152–58.

114 The same is true for the OID rules found in Code § 163(e), which require taxpayers to report OID using the accrual method, thus putting individuals receiving such amounts on the same accounting method as those who pay them.

115 26 U.S.C. § 172.

taxpayers will have significant incentives to push income into future years.<sup>116</sup> However, most firms would likely be willing or able to push income only into the immediately succeeding year because delaying income would require firms to forego cash. The timing benefit of doing so would be relatively minimal because it would entail only a one-year delay in the inclusion of the income.

The extent to which the cash method would create more problems than the accrual method is empirical and may differ from taxpayer to taxpayer. Moreover, not all financial accounting rules create timing problems that undermine income tax values. Accordingly, adopting cash method accounting for tax purposes is not a step Congress should take lightly. However, Congress should at the very least develop data to determine which accounting system best protects both taxpayers and the values underlying the income tax. Ultimately, Congress must decide whether a system that explicitly eschews accrual accounting is better than one that purports to embrace it and then weakens the embrace through case law and provisions such as Code § 461(h), which force taxpayers onto the cash method.

### *Congress and the Courts Should Tighten the Tax Accounting Rules*

Assuming that Congress is not yet ready to abandon accrual accounting, it should still act to protect the income tax base. First, Congress should create rules that limit the ability of taxpayers to exploit timing differences to reduce their tax burdens, as it did when it enacted Code § 461(h). For instance, Congress should enact rules that require taxpayers to include prepaid income in gross income when received, unless it will be earned within a very short period. Second, as a backstop measure, Congress should make clear that Code § 446(b), which grants the IRS the power to challenge a taxpayer's accounting method when that method does not "clearly reflect income," permits the IRS to challenge a tax accounting method whenever timing effects threaten to undermine the goal of taxing returns on capital.

If, as most accountants believe, accrual accounting is the most accurate way to measure income, then the power granted under Code § 446(b) is an empty one, at least in regard to companies that use accrual accounting. It would be the rare case, indeed, where some other method of accounting yielded a more accurate measure of income. However, accrual accounting is considered accurate for financial accounting purposes because it ignores timing differences. In contrast, timing is everything in tax. Significant divergence between the reporting of income and the receipt of cash or between the deduction of expenses and the payment of cash can result in returns on capital escaping tax entirely despite being nominally taxed. Accordingly, the term "clearly reflect income" in Code § 446(b) should be understood to cover situations where timing issues convert a nominal income tax into a de facto consumption tax. Put differently, income is not clearly reflected for tax purposes where the accounting regime fails to impose a tax on both components of income.

To avoid any question regarding the proper interpretation of Code § 446(b), Congress should amend the language of that section. One option would be to add the words "in an income tax sense" after "clearly reflect income" to eliminate claims that accrual accounting is the most accurate way to measure and report income. Congress could authorize the Treasury to issue regulations fleshing out the added language. Alternatively, Congress could be more explicit in the statute, using language such as "yields a result consistent with consumption taxation." To protect accrual

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<sup>116</sup> For an explanation and examples of the doctrine of constructive receipt, see Treas. Reg. § 1.451-2. For the doctrine of cash equivalency, see Treas. Reg. § 1.446-1(c)(i), which indicates that, in addition to cash, items to be included in the calculation of gross income include receipts and disbursements of property or services.

accounting in the main, either the statute or regulations could include a threshold below which no challenge would be allowed. For instance, the IRS could be permitted to act only if timing effects caused more than a 15 percent reduction in taxes when compared to an income-tax baseline. Or the threshold could be based on a specific dollar amount, say \$10,000.

Assuming Congress fails to act, the courts should construe the existing statute to permit the IRS to challenge a taxpayer's accounting method when timing issues distort the amount of tax owed in net-present-value terms. The phrase "clearly reflect income" appears in a taxing statute and, therefore, it is logical to construe "income" in a tax, as opposed to a financial accounting, sense. Moreover, if the phrase is to have any meaning, it must give the IRS some power to challenge accrual accounting results. The income tax was designed to reach returns on capital. Congress has clearly shown that it knows how to deviate from this goal.<sup>117</sup> In light of this history, courts should be loath to afford consumption-tax treatment absent express congressional approval. Nothing suggests that Congress made its decisions to permit or expand accrual accounting with this purpose in mind.

This is precisely what the U.S. Tax Court did in *Ford Motor Co. v. Commissioner*.<sup>118</sup> In that case, Ford incurred tort liabilities that it satisfied by purchasing annuities. For financial reporting purposes, it deducted the amounts paid for the annuities. However, for tax purposes, it sought to deduct the full value of the obligations it had incurred, as opposed to the amounts paid for the annuities. Using a time-value-of-money analysis, the court showed that permitting such a deduction would actually leave the taxpayer in a better position than if the accident had never happened. The court found that the IRS did not abuse its discretion in finding that Ford's accounting method did not clearly reflect its income, even if the claimed deductions satisfied the all-events test.

Despite the taxpayer's seemingly egregious position, one tax court judge dissented. Judge Gerber argued that Ford had met the all-events test and therefore was entitled to the deduction, regardless of the effect on the company's after-tax result. This case pre-dated Code § 461(h), and therefore payment was not required before a deduction was allowed. As Judge Gerber noted, a taxpayer who had not purchased annuities, thus incurring a current present value for future obligations would likely have been allowed to deduct the full amounts, creating inconsistent treatment and a huge tax incentive not to purchase annuities.

While the particular issue in *Ford Motor Co.* has been taken care of by Code § 461(h), other situations exist, especially on the income side, that raise the same questions. Judge Gerber's dissent supports the need for a statutory or regulatory clarification that elevates the impact on tax liability above compliance with technical accounting rules, thus providing guidance to both the courts and the IRS. Most cases are not nearly as clear as *Ford Motor Co.* in that the timing differences will lessen tax liability, not put taxpayers in a better position than they would have been in had they not incurred the liability. It is not at all clear when timing distortions rise to the level that income is not being clearly reflected.

Current jurisprudence focuses on whether a particular item of income or expenditure fits within the technical financial or tax accounting rules governing accrual. Fixing the tax accounting rules to prevent timing effects from undermining the income tax would be the best solution. Failing that, clarifying the statutory language in Code § 446(b) would give the IRS a potent tool that gets to the heart of the matter in a way that technical accounting rules cannot.

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117 For example, traditional and Roth IRAs.

118 102 T.C. 87, 92-94 (1994).



## Conclusion

A number of commentators have argued that many of the problems in the tax system could be resolved easily by requiring companies to report the same figures to the IRS as they do to investors. It has been argued that doing so would simplify tax and financial accounting obligations, broaden the tax base, and impose a check on some types of aggressive tax planning. In *Thor Power Tool*, the U.S. Supreme Court focused on the different purposes underlying financial and tax accounting and the effects these purposes had on the respective regimes as a reason to keep them separate. In particular, the Court noted that financial accounting is designed to provide information to managers and investors and is thus flexible, permits estimates, and should be conservative in nature. In contrast, tax accounting is designed to collect revenue and ensure that similarly situated taxpayers are treated similarly. As a result, it cannot abide the flexibility of financial accounting, does not allow estimates, and eschews a conservative approach to calculating income.

In this chapter, I have argued that a difference in purpose far more fundamental than that identified in *Thor Power Tool* warrants keeping financial and tax accounting separate. To give a complete picture of a business's financial health, financial accounting divorces the reporting of income and deductions from the actual flow of cash. As demonstrated above, this mismatch between income and expense reporting and cash flow can undermine the income tax goal of ensuring that *all* elements of income, including both consumption and returns on capital, are subjected to tax. The income tax can survive with flexibility, estimates, and even a conservative approach to income calculation. However, if alignment effectively eliminates the tax on returns on capital—undoing rules like Code § 461(h) that are specifically designed to prevent such a result—it will be an income tax in name only. Rather than align financial and tax accounting, Congress should push them further apart, either by requiring companies to use the cash method accounting for tax purposes or by making clear that the IRS may challenge taxpayers' methods of accounting when they undermine the core goal of the income tax to ensure that all elements of income are subjected to tax.

I do not argue that financial and tax accounting should deviate in all regards. Indeed, as Lily Kahng notes in Chapter 6, the two regimes should probably be closer in a number of areas, including the treatment of expenditures that create intellectual capital. It would be a good thing if the Code were used primarily to measure economic income and stripped of the numerous provisions designed to promote some other public policy, such as the exclusion of municipal bond interest in Code § 103. Ridding the Code of the timing rules that permit immediate deductions for capital purchases (e.g., Code §§ 179 and 168(k)) would also be a good idea.

Where Kahng and I differ is the justification for conformity, which necessarily informs our views on when the two regimes should differ. Kahng believes that the tax accounting rules should more closely hew to those found in financial accounting because the latter more accurately reflect economic income. However, measuring economic income is not the core goal of an income tax. Rather, it is imposing a real tax upon all elements of income. Any measurement system that fails to accomplish this goal undermines the very purpose of the income tax. Capitalization of expenditures used to create intellectual capital is appropriate not only because such a rule better reflects economic income but also because capitalization ensures that a real tax is imposed on returns on that investment. Over the past century, significant effort has been made to create a tax-specific income definition and to create a tax-specific accounting regime. Where fundamental tax principles and goals conflict with financial accounting rules, as is the case with accrual accounting, tax accounting should forge its own path, regardless of the claim that accrual accounting is the best measure of economic income.

