The Myth of the Matching Principle as a Tax Value

Deborah A. Geier
*Cleveland State University, d.geier@csuohio.edu*

Follow this and additional works at: https://engagedscholarship.csuohio.edu/fac_articles

Part of the Tax Law Commons

How does access to this work benefit you? Let us know!

Original Citation
The Myth of the Matching Principle as a Tax Value

DEBORAH A. GEIER*

Table of Contents

I. INTRODUCTION ................................................ 18

II. THE MATCHING PRINCIPLE IN FINANCIAL ACCOUNTING 
    AND THE ROLE OF GAAP IN TAX ACCOUNTING .......... 27

III. THE MATCHING PRINCIPLE IN TAX ACCOUNTING ....... 41
    A. CAPITALIZATION, DEPRECIATION, AND THE INCOME-TAX VALUE .................. 41
       1. Capitalization ........................................ 42
       2. Depreciation ....................................... 58
    B. ACCRUAL ACCOUNTING—DEDUCTIONS .................. 71
       1. The Anderson Case .................................. 71
       2. Financial Accounting as “Science”? ............ 75
       3. The Other Early Cases: Drawing the Line at “Contingent” Liabilities....... 84
       4. Coming to Understand the True Tax Value at Stake: The Anti-Tax Arbitrage Value and the Income-Tax Value Revisited ........................................ 91
       5. Modern Decisionmaking ................................ 102
    C. ACCRUAL ACCOUNTING—INCOME .................... 113
       1. Prepaid Gross Receipts .......................... 113
       2. Other Income ...................................... 139

* Professor of Law, Cleveland-Marshall College of Law, Cleveland State University.
I would like to thank Charlotte Crane, Calvin Johnson, Michael Lang, and George Yin for their helpful comments on an earlier draft. As several of them did not agree with positions taken in the Article, the reader should be careful in ascribing their agreement to the views discussed. I would also very much like to thank Joseph Dodge and Cliff Fleming, who were gracious enough to ask me to join with them in writing Federal Income Tax: Doctrine, Structure and Policy. The seeds for this Article were germinated during that project. While we do not always agree on everything, I have learned, and continue to learn, a great deal from them. Finally, I would like to thank law librarian Marie Rehmar, whose tireless help in finding some of the historical material was invaluable.

17
Those of us in the tax law business know that we are bright, engaging, and athletic; we combine animal magnetism with erudition. However, tax lawyers are lumped with accountants in the public mind, and are burdened with the images of thick spectacles, green eyeshades, cluttered minds, and unlimited capacities for boredom. One commentator has even stated that a “tax lawyer is a person who is good with numbers but who does not have enough personality to be an accountant.”

I. INTRODUCTION

It is high time we tax lawyers did a better job of educating the world that tax law is not about financial accounting. It is important that we do so not because we dislike accountants; some very nice ones have been students in my classes. It is important because the often implicit assumption that financial accounting presumptively guides tax accounting can and has undermined tax values. This Article is one modest contribution in the continuing efforts toward the emancipation of tax law from financial accounting.

Those steeped in a financial accounting background often have trouble letting go of that culture when they cross over the great divide into the tax realm. Perhaps more important, those who are not steeped in financial accounting—such as judges—often assume without reflection that financial accounting principles ought to govern tax accounting. This tendency is often the strongest when it comes to the financial accounting norm commonly referred to as “the matching principle.”

The principle that expenditures ought to be deducted in the same period as the income to which they relate is a sacrosanct
one in the financial accounting world. The income tax, however, is not uniformly wedded to this matching principle. In some cases, the Code seems to require what smacks of "matching," not in the financial accounting sense described above, but in the sense that income or expenses can be deferred to the future or accelerated in order to be accounted for in the same period as offsetting deductions or inclusions. One example is the rule in section 1211 that deductible capital losses are allowable in any year only to the extent of includable capital gain; unused losses must be deferred. Sections 163(d), 465, 469, and 1092 similarly require delay of otherwise deductible amounts to future years in which income is realized. The capitalization of expenditures that do not create or purchase a distinct asset but will produce a significant economic benefit in future years is a similar, though distinct, manifestation of the phenomenon, as is depreciation. And the matching of inclusion and deduction between two different taxpayers, required by sections 83(h), 267(a)(2), 483, 404(a)(5), and the original issue discount rules of sections 1271-1275, is yet another distinct facet of the idea.

But the income tax (and cases construing it) also selectively departs from the matching principle. Prepaid services income received by an accrual basis taxpayer must usually, though not always, be included in the year of receipt under current law, even though the related expenses will not be incurred (and deducted) until future years. Similarly, the "economic performance" requirement of section 461(h) may result in what accountants would argue is a "mismatch" of income and deduction.

These income tax rules that require deviation from the matching principle are usually perceived by accountants as either indefensible or as introducing unnecessary complexity to the tax accounting world. They are also often perceived as unfair, in that they sometimes combine to create a "one-way street" in favor of the fisc. Accountants typically argue that tax

2. For a fuller description of the matching principle, see infra notes 25-29 and accompanying text.
3. All references are to the Internal Revenue Code of 1986, as amended, unless otherwise noted.
4. See infra notes 319-414 and accompanying text.
5. See infra notes 255-288 and accompanying text.
6. See infra notes 31-37 and accompanying text.
7. See William L. Raby & Burgess J.W. Raby, 'Abuse of Discretion' and 'Clearly Reflect Income', 71 Tax Notes 227, 229 (Apr. 8, 1996) (chastising "indiscriminate IRS attempts to switch all and sundry to methods of accounting that will maximize the Trea-
accounting should simply follow financial accounting.\textsuperscript{8} Even some tax lawyers, policymakers, and judges (and justices), insufficiently conscious of the tax values that should inform tax accounting and with no formal background in financial accounting, are often lulled into agreement with the rhetoric of the financial accountants. As recently as 1992, for example, the Supreme Court has (unfortunately) stated: "The Code endeavors to match expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes."\textsuperscript{9} Accounting norms can exude an enticing siren song to those insufficiently schooled in tax values. Accounting norms seem to some to be formal, tested, and have the aura of an entire profession behind them,\textsuperscript{10} which can lend them solidity in the unquestioning judge's eye. And, after all, both tax accounting and financial accounting measure "income," don't they?

Nowhere does this tension between the income tax world and the world of financial accounting manifest itself so explicitly as in section 446(b), which provides that "if the [taxpayer's accounting method] does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income." Under this authority, the Commissioner can challenge not only the taxpayer's use of a particular regime of tax accounting in general, such as the cash method, the accrual method, or inventory accounting, but also the taxpayer's treatment of a particular item or transaction under those methods.

Most courts are quite deferential to the Commissioner's exercise of authority under this provision.\textsuperscript{11} Yet, the authority is not without limits under the statute, for it is constrained by the

\textsuperscript{8} See Harold Dubroff et al., \textit{Tax Accounting: The Relationship of Clear Reflection of Income to Generally Accepted Accounting Principles}, 47 ALB. L. REV. 354, 359 n.20 and 389 n.143 (1983) (both collecting authorities); Raby & Raby, \textit{supra} note 7.


\textsuperscript{10} See, e.g., \textit{United States v. Anderson}, 269 U.S. 422, 440 (1926) (viewing the ability of taxpayers to use the accrual method of accounting if they kept their financial books using that method as sanctioning the use of "scientific accounting principles"); infra notes 57-76 and 180-225 and accompanying text (challenging this characterization).

\textsuperscript{11} See Dubroff et al., \textit{supra} note 6, at 363-66; Erik M. Jensen, \textit{The Deduction of Future Liabilities By Accrual-Basis Taxpayers: Premature Accruals, the All Events Test, and Economic Performance}, 37 U. FLA. L. REV. 443, 470 (1985) [hereinafter Jensen, \textit{Premature Accruals}].
command that the Commissioner's proposed method must, itself, "clearly reflect income."\textsuperscript{12} Section 446(b) itself does not provide any guidance for the court (or the Commissioner, when exercising his power under that section) regarding what those words mean.\textsuperscript{13} It thus presents a wonderful—and difficult—exercise in statutory interpretation. What should guide a court's analysis of whether the Commissioner's (or the taxpayer's) method of accounting "clearly reflect[s] income"? Because the matching principle is thought by the accounting profession to be premised on a "clear reflection" notion, it is quite often cited by the parties or courts in their discussion of whether the taxpayer's method (or the government's proposed method) clearly reflects income,\textsuperscript{14} even though "neither the Code nor the Regulations generally require a taxpayer to match the gross income and deductions from a trade or business."\textsuperscript{15} This approach is buttressed by the Treasury Regulations, which provide that "[a] method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year . . . ."\textsuperscript{16} Sometimes the matching principle is accepted as persuasive, but sometimes it is rejected, as discussed below. The analytical approach often seems to be ad hoc, however, and sometimes is based on what should be irrelevant considerations if tax values were well understood by courts.

\textsuperscript{12} Simply to call the section 446(b) determination a matter of Commissioner discretion is meaningless without some notion of the standard of judicial review that will be applied to exercises of that discretion." Karl S. Coplan, Protecting the Public Fisc: Fighting Accrual Abuse with Section 446 Discretion, 83 COLUM. L. REV. 378, 394 (1983).

\textsuperscript{13} "As a self-defining standard, 'clear reflection of income' is woefully inadequate." Dubroff et al., supra note 8, at 365.

\textsuperscript{14} "Most commentators have assumed, often without explanation, that clear reflection of income has the same meaning for tax cases as it has for financial accounting: matching of costs and revenues." Alan Gunn, Matching of Costs and Revenues as a Goal of Tax Accounting, 4 VA. TAX REV. 1, 11 (1984). "In many instances, tax law has uncritically adopted the matching principle as its own." Jensen, Premature Accruals, supra note 11, at 473.

\textsuperscript{15} Leo F. Nolan II, Can the Cash Method of Accounting Clearly Reflect Income?, 74 TAX NOTES 1175, 1178 (Mar. 3, 1997).

\textsuperscript{16} Treas. Reg. § 1.446-1(a)(2).
I have argued elsewhere that courts should accept guidance from the larger structure created by the entire text of the Internal Revenue Code when construing particular provisions within it.\textsuperscript{17} I believe in the primacy of statutory text. Imaginatively reconstructing the “immediate purpose”\textsuperscript{18} various members of Congress might have had in mind when passing a particular provision within the larger statute and construing the provision to implement that purpose is fraught with institutional difficulties, including separation-of-powers concerns. But the search for meaning of statutory text need not be—indeed, should not be, in my view—limited to the words of the particular provision in isolation, uprooted from the linguistic landscape that creates the context for examining it, the landscape which gives it meaning. The collection of Code sections that create the income tax system is itself statutory text that can provide much insight into the construction of individual provisions within the Code; no resort to “intent” or “purpose” in the sense much maligned by some commentators is necessary, even if such an approach were possible. This inquiry is particularly rich when attempting to construe undefined tax terms with no intuitive or common meaning, such as “clearly reflect income,” as well as “capital expenditure” and “economic performance.”

This Article builds on the work of others\textsuperscript{19} by arguing that the matching principle is not, properly understood, a tax value. While the matching principle is a highly valued one in the financial accounting profession, for quite understandable reasons, it is not one that should be considered a value at all in a system that seeks to collect revenue, and to do so based on “income.” Those provisions in the Code where matching seems to be memorialized should be understood as based on independent tax

\textsuperscript{17} See, e.g., Deborah A. Geier, Albertson’s, Statutory Interpretation, and Correcting Misconceptions, 71 TAX NOTES 826 (May 6, 1996); Deborah A. Geier, Interpreting Tax Legislation: The Role of Purpose, 2 FLA. Tax Rev. 492 (1995) [hereinafter Geier, Purpose]; Deborah A. Geier, Textualism and Tax Cases, 66 TEMP. L. REV. 445 (1993); Deborah A. Geier, Tufts and the Evolution of Debt-Discharge Theory, 1 FLA. TAX REV. 115 (1992) [hereinafter Geier, Debt-Discharge Theory].


\textsuperscript{19} See, e.g., Gunn, supra note 14, at 2 (“[T]ax accounting should not, and characteristically does not, accept matching as a central principle.”); Jensen, Premature Accruals, supra note 11, at 475 (“[T]he matching principle lacks a coherent theoretical basis for tax purposes.”).
values that can be articulated independently. That a few of them require matching is descriptively accurate, but matching for the sake of matching is not the value underlying these provisions. Continued use of the matching rhetoric often skews analysis and decisionmaking, leading to poor—or at least haphazard—results. I hope, with this Article, not only to deflate the notion that matching is a tax value but also to affirmatively articulate the tax values that are at stake and that should be driving the analysis.

The easiest and most straightforward illustration of this idea is section 1211, which delays the deduction of realized capital losses until future years when it can be matched with capital gain inclusions. One might be tempted to say that such matching of gains and losses in the same period is perhaps loosely based on the matching idea from financial accounting, even though the gains and losses may be unrelated to one another. But every student in the basic tax course knows that section 1211 illustrates tax values far removed from financial accounting. As implied by the text of section 1001, changes in the value of property owned by a taxpayer are not taken into account for tax purposes until realized by some realization event, most often a sale or exchange of the property. The realization rule means that a taxpayer with a portfolio of unrealized gains and losses could selectively realize his losses, leaving his gains unrealized, and create a tax loss where the taxpayer has no net economic losses. Section 1211 prevents such "cherry picking." While it is true that the deferral mechanism used in section 1211 results in what loosely looks like matching in fact, that result is descriptive only.

History is an important part of the story here. The early income tax statutes did not define the all important term "income." Early judges, seeking guidance to help them in crafting a meaning for the term, understandably imported notions developed in other disciplines. One source of guidance on the meaning of this ambiguous term "income" was, not surprisingly, financial accounting. And thus the rhetoric of the matching

20. See Joseph M. Dodge et al., Federal Income Tax: Doctrine, Structure & Policy 592-93 (1995). The operation of section 1211 is crude in that it defers losses even when the taxpayer has no unrealized gains.

21. Section 1092, which defers straddle losses to the extent they exceed related unrecognized straddle gains, is a much more sophisticated and complex example of the same tax value that underlies section 1211.
principle was accepted almost by rote. And the matching principle adopted from financial accounting endures in many minds as a value in tax as well, particularly since some provisions do seem to require such matching, at least as a descriptive matter. But beginning in the 1930s and 1940s, the Internal Revenue Service (the Service) began to argue that matching income and deductions in the same period actually distorted "income" for tax purposes in some contexts even as it might have accurately described it for purposes of financial accounting. The reasoning was imprecise; something just did not "feel" right. With hindsight, we can now articulate why the Service's instincts were right as a matter of theory, as I shall describe below. But at the time, the deviations from the matching principle were premised on reasoning that was mostly entirely beside the point. The tax values at stake were simply not widely appreciated.

Beginning in the 1980s, however, sophisticated understanding of these tax values became more widespread, at least in academia, which contributed to enactment of several major provisions that either deviated from the matching principle, such as the economic performance rule of section 461(h), or strengthened it, such as the passive activity loss rules of section 469. These provisions were really evidence of the increasing legislative appreciation that "matching" is not a tax value. Judicial recognition of the tax values that underlie these amendments have been slower in coming, however. Indeed, one recent Supreme Court opinion that honors the tax value underlying the notion of "capital expenditure" still uses matching rhetoric as justifying its opinion.22 This rhetoric lies in wait, under the rubric of stare decisis, to infect future opinions.23 It is time for this rhetoric—that the matching principle is a value in the income tax—to be put to rest. It is also time for courts and administrative guidance to explicitly recognize and discuss the real tax values underlying those provisions and doctrines that happen to coincide

22. See supra note 9 and accompanying text.
23. As Professor Glenn Coven put it:

In the past decade the sophistication of the analysis of the relationship between income taxation and the passage of time by both scholars and Congress has increased enormously. Little of that sophistication, however, has rubbed off on the courts. In this increasingly critical area, the Supreme Court remains 20-50 years out of date . . . .

THE MYTH OF MATCHING

descriptively with the matching principle. Coherent development of the law is otherwise sacrificed.

My intended audience for this Article is judges, practitioners, and administrators who have not immersed themselves in the literature developing the time value of money principles and the difference between an income tax and a consumption tax, and who therefore have not before thought critically about these issues. These are the people who often unknowingly perpetuate the myth of the matching principle as a tax value and thereby often unknowingly damage tax values. My aim is thus to consolidate, in an accessible primer, the intellectual history of the matching principle in the income tax for those who are confronted daily with issues implicating this big picture. The insights described in this Article are not original with me, but they seem to be well understood only within tax academia, not within the day-to-day practices of the lawyer, judge, and administrator. I perceive my role in this Article as a bridge between those on the front lines and those in the ivory tower. A clearer understanding of how the painting evolved over time does not, of course, make all decisionmaking easy—judging will always entail judgment, and statutory amendment may be necessary if the latest thinking is to be implemented—but it does provide a coherent framework through which the analysis can be refocused. It provides a structure, grounded in solid tax values, for the inquiry. I hope it also provides judges, practitioners, and administrators with the strength to refocus the rhetoric of old tests and inquiries that grew up, and became solidified through stare decisis, in eras in which the theory discussed here was not widely appreciated.

The tax values I have in mind are the “anti-tax-arbitrage value” and the “income-tax value,” though these values are not neat, little boxes but rather blend at the margins. The anti-tax-arbitrage value discourages the creation of profit from the Treasury itself, while the income-tax value allows the taxpayer to receive tax-free income of a kind clearly intended to be taxed under an “income” tax, though it would not be under a consumption tax. These are purely “tax” concerns, not concerns that are relevant to financial accounting, and both have timing principles at their foundations. The time value of money is critically important in a system that measures tax liabilities periodically. The matching principle, as developed by financial accounting, is often antithetical to time-value-of-money principles. As greater
appreciation of the time value of money has infiltrated our understanding of tax phenomena, Congress has amended the Code again and again to reflect concern for these tax values. These amendments are part of the statutory text and should inform our evolving notions of such ambiguous terms as “clearly reflect income,” “capital expenditure,” and “economic performance.”

Most recently, Congress enacted the Roth IRA in 1997. This enactment shows acceptance of the principle of the yield-exemption phenomenon that exemplifies the difference between a consumption tax and an income tax. As will be explored, the yield-exemption phenomenon provides that allowing a deduction under a traditional IRA for an outlay that will produce income in future years (providing consumption-tax treatment) is the economic equivalent of not allowing an initial deduction but exempting from tax all returns from the outlay under the Roth IRA (also providing consumption-tax treatment). But since the “income” portion of the return is supposed to be taxed under an income tax, allowing immediate deduction of outlays producing significant future returns replicates consumption-tax treatment, effectively exempting the future returns from tax (even though they are nominally included in gross income). The income-tax value stands for the proposition that consumption-tax treatment should not be allowed absent a clear indication by Congress that such treatment was intended or unless the income-tax value is outweighed by values of administrative convenience if the distortion is minimal. In other words, my position is that consumption-tax treatment of an item not mandated by the language of the Code should not result by accident or through inadvertence in administering the remaining provisions of the Internal Revenue Code.

I begin by briefly discussing the role of the matching principle in the financial accounting world. I then shift to the world of tax accounting and the uneasy relationship over time between the financial accounting norm of “matching” and tax norms. In so doing, I discuss an interrelated series of issues, including the capitalization concept and depreciation, the accrual of future costs, the accrual of prepaid receipts and receipts not yet received, and symmetrical treatment of the two sides of a transaction. I take as a given the continuation of our current tax sys-

24. For an exhaustive article, see Lawrence Lokken, The Time Value of Money Rules, 42 Tax L. Rev. 1 (1986).
tem and discuss suggested judicial and administrative changes in rhetoric and focus with this backdrop in mind.

II. THE MATCHING PRINCIPLE IN FINANCIAL ACCOUNTING AND THE ROLE OF GAAP IN TAX ACCOUNTING

The centrality of the matching principle in financial accounting can be illustrated by its status as a "pervasive principle." In 1970, the Accounting Principles Board (predecessor to the Financial Accounting Standards Board)25 identified three levels of accounting principles: "(1) pervasive principles, which relate to financial accounting as a whole and provide a basis for the other principles; (2) broad operating principles, which guide the recording, measuring, and communicating processes of financial accounting, and (3) detailed principles, which indicate the practical application of the pervasive and broad operating principles."26 In illustrating the difference among the three levels of principles, McCullers and Schroeder wrote:

As an illustration of these different levels, we might consider matching to be a pervasive principle because much of financial accounting is based upon the perceived need to match revenues and expenses. If matching is considered to be a pervasive principle the next step is to move to the broad operating principle(s) that will implement the basic principle. Perhaps one of those principles would be cost allocation for assets that provide service over time. A procedure, or detailed principle, for cost allocation, might be depreciation on a straight-line basis.

This three-level structure provides a frame of reference so that any given accounting activity can be related to the structure in a consistent and logical manner. For example, if a question is raised about depreciation, the accountant can respond that depreciation is a means of cost allocation, which is necessary if we are to achieve a proper matching of revenues and expenses. Matching, in turn, is considered to be a fundamental goal of financial accounting. Ideally, we should be able to relate all accounting...

25. See infra notes 57-76 and 180-225 and accompanying text (briefly describing the evolution of "generally accepted accounting principles" and the organizations responsible for articulating them).

principles to the other two levels. Unfortunately, that is not always possible because many accounting practices have simply evolved without being based upon any higher level principles.27

Dubroff, Cahill, and Norris provide a succinct articulation of the “matching principle” in financial accounting:

The matching principle requires that for any period in which income is to be reported, revenue to be recognized should be determined according to the revenue principle; then the expenses incurred in generating that revenue should be determined and reported for that period. It follows, therefore, that if revenue is carried over from past periods or deferred until a future period in accordance with the revenue principle, any expense related to that revenue should also be carried over or deferred until the appropriate period. Careful matching is an essential element of financial accounting; it ensures that there is a proper determination of periodic net income.28

Stanger, Vander Kam, and Polifka give a thicker description by listing the five tenets of the matching principle:

(1) Revenues are recognized as entering into the determination of income when sales are made or services are rendered.

(2) The mere receipt of money or the promise of another person to pay money for goods or services does not represent revenue which should be recognized in the period of receipt if it is burdened with an obligation to deliver goods or render services in the future. Items of this nature are treated as resulting in liabilities or deferred credits until they are earned through the fulfillment of the required performances.

(3) Costs and expenses directly identifiable with revenues are chargeable against the income of the period in which revenues are recognized. Expenses, such as insurance, rent, property taxes and interest, which are for particular periods of time are chargeable over such periods. Other expenses incurred in the general conduct of the business are chargeable against the income of the period in which they are incurred unless it is clearly evident that they are for the benefit of future periods and there is a reasonable basis, both as to amount and time, for allocating them to future periods, in which event they should be deferred and charged to such periods.

27. MCCULLERS & SCHROEDER, supra note 26, at 13-14.
28. Dubroff et al., supra note 8, at 359 n.19 (citations omitted).
(4) If the precise amount of any costs or expenses is not determinable at the time they are chargeable against income, they should be recognized on the basis of reasonable estimates.

(5) Accounting recognition of costs and expenses which cannot be determined with a reasonable degree of accuracy at the time they would otherwise be charged against income of a particular period should be deferred until such determination is possible.29

Therefore, under the matching principle, cash in hand may not be included in revenue because not yet earned if future performance is required. Costs not yet paid may nevertheless reduce revenue already included. And capital expenditures should not be deducted in the year of payment but amortized over the income stream produced by that expenditure. This matching of revenues with costs is intended to produce a more accurate periodic account over time of the financial health of the business enterprise for those who will make judgments based on this profit picture. "A primary function of accounting is to accumulate and communicate information essential to our understanding of the activities of an enterprise. The information so communicated is used by management, by owners, and by other interested parties in making judgments relating to the operation of the entity."30 An accurate reflection of periodic profit over time is necessary if the banker making a loan or the shareholder contemplating a stock purchase or the manager making a business judgment is to make an informed decision. For example, rollercoaster profits from year to year, suggesting volatility, should reflect real rollercoaster profits, not the happenstance of bunched receipts and bunched outlays in connection with a business that is actually steadily growing more profitable.

Accountants often chastise the Service or courts for failing to deify the matching principle in the income tax. Messrs. William L. Raby and Burgess J.W. Raby, who write a regular column entitled Tax Practice and Accounting News for the widely read Tax Notes magazine, are regular critics of the failure of tax accounting to adhere to the matching principle. "All this," they


have written, "offends the matching principle that is so important to accountants but has been at odds with the more legalistic ‘all events’ test since the taxation of business income began." Their lack of appreciation of the significance of the time-value-of-money principles often underlying the tax values discussed in this Article is revealed in the following passage of the same article:

Maybe we need to go back to the 1954 Internal Revenue Code, as originally enacted, reinstate section 462, and restore proper matching of expense with income as a primary goal of income tax accounting. *Most of the statutory fine-tuning of business tax accounting has actually done little more than create timing differences by moving items from one year to another.* That is where the great complexity lies. That is where much of the time is spent when the IRS agent makes an audit. We think that the tax process would be improved if consistency were restored to its throne and conceptual precision given the boot.32

In discussing a Technical Advice Memorandum in which the Service required capitalization of the cost of major engine inspections of turprop aircraft engines undertaken by a scheduled air carrier about every four years,33 Messrs. Raby and Raby stated:

As we have commented before, financial accounting puts a high value on the proper matching of costs against revenues to which they relate. Proper financial accounting would, in fact, set up a reserve out of income over the four years preceding each major engine inspection. While the IRS is unlikely to go quite that far, absent a reenactment of section 452, it does sometimes seem to recognize the significance of this matching principle, although only sporadically. . . .


32. Raby & Raby, *Consistency*, supra note 31, at 926 (emphasis added). Section 462 allowed the deduction by accrual basis taxpayers of additions to reserves for future expenses. It was the companion to section 452, which allowed such taxpayers to defer inclusion of prepaid income until earned. Both were retroactively repealed within one year of enactment. See infra notes 341-345 and accompanying text (discussing these sections in more detail).

Even when the IRS ignores matching expense with income, the courts sometimes come to the taxpayer's rescue. . . .

Accounting Professor Dennis J. Gaffney has similarly bemoaned the fact that "[t]oo many courts simply do not understand basic financial accounting concepts," including the matching principle. And this attitude among accountants is not a new one. Writing in 1939, Stephen Gilman collected similar quotations from his time.

Thus Canning speaks of "ill-considered and changing statistical determinations of taxable income," while Bryerly writes: "the income-tax point of view has, I think, affected the ideas as to sound accounting which have insinuated themselves into many of us." Stempf, Chairman of the American Institute Committee on Federal Taxation, refers to the "ever-widening breach between 'tax accounting' and 'business accounting.' " He thinks also that "too many managements, and likewise accountants, permit tax attitudes to color their reasoning and distort the application of sound principles of accounting." Even the fair and conservative Journal of Accountancy commented editorially upon one income tax ruling in these words: "General counsel's memorandum 20021, promulgated in May, 1938, again exemplifies the needlessly irritating and futile variance between commercial practice and the highly legalistic concept of income held by the Bureau of Internal Revenue.

But why should the matching principle be honored in tax accounting simply because it is sacrosanct in financial account-

34. William L. Raby & Burgess J.W. Raby, Capitalizing the Costs of Aircraft Engine Overhauls, 71 Tax Notes 1221, 1222 (May 27, 1996). See infra notes 81-125 and accompanying text (discussing the tax values that should drive the capitalization/expense inquiry).

35. Dennis J. Gaffney, Rotable Spare Parts: How Did a 'Terrible' Accounting Method Become So Bad?, 70 Tax Notes 1009, 1012 (Feb. 19, 1996). In the cases discussed by Professor Gaffney, the courts invoked the matching principle but applied it incorrectly under financial accounting standards. By criticizing the courts' poor application of the matching principle under financial accounting standards, Professor Gaffney implies, of course, that the matching principle properly controlled. He just did not like the way the courts went about applying its tenets. I, in contrast, would have liked the courts to have recognized that the matching concept has no independent tax value and to have resolved the case using tax values. For a fuller description of the problem at issue in Professor Gaffney's article, see infra notes 139-147 and accompanying text.


ing? In the celebrated 1979 case of Thor Power Tool Co. v. Com-
missioner, the Supreme Court explicitly recognized that tax
values and accounting values often diverge. While not directly
involving the matching principle, the case is nevertheless
worth discussing here.

Thor Power Tools was in the business of selling merchan-
dise and thus was required to use “inventory” accounting. To
compute gross income derived from business under section
61(a)(2) for a business selling merchandise, the taxpayer must
subtract the “cost of goods sold” from “gross receipts.” Comput-
ing the cost of goods sold is not done by tracking the cost basis
of each item of inventory actually sold. Rather, inventory ac-
counting computes the cost of goods sold on a mass basis by
starting with the cost of the opening inventory pool at the be-
inning of the year, adding inventory purchased or produced
during the year, and subtracting closing inventory (the goods re-
mainin on hand at the end of the year). The number obtained
represents the inventory disposed of during the year. Closing in-
ventory becomes opening inventory for the next year. Notice
that if the number used for closing inventory can be lowered,
the cost of goods sold increases, which decreases gross income
from the sale of inventory for tax purposes. Because closing in-
ventory becomes opening inventory for the next year, this deferral of income is perpetual so long as the business continues.

39. Because the case dealt with inventory accounting, it did deal indirectly with
the matching principle. An allocation of the costs of goods sold to the revenues included
in the period from the sale of inventory “matches” such costs to the revenues and is thus
required under the matching principle for financial accounting purposes. As will be de-
developed later, inventory accounting is consistent with tax values as well. See infra notes
139-147 and accompanying text.
40. See Treas. Reg. § 1.471-1 (requiring the use of inventories if “the production, purchase, or sale of merchandise is an income-producing factor”).
41. See Treas. Reg. § 1.61-3(a).
42. Closing inventory is done by first doing a physical count of the items of inven-
tory on hand. These numbers are matched to purchase invoices—if the items were pur-
bred—by using one of two conventions: the last-in-first-out method (LIFO) or the first-
in-first-out method (FIFO). Under LIFO, for example, if 100 items are on hand in inven-
tory at the end of the year, the invoices for the earliest received 100 items are used for pur-
poses of calculating closing inventory. See DODGE ET AL., supra note 20, at 634-35.
43. Assume, for example, that opening inventory is $300, inventory purchased is
$200, and closing inventory is $400. The cost of goods sold would be $100 ($300 + $200 -
$400). If gross sales proceed are $300, then gross income derived from sales is $200
($300 - $100). If the taxpayer can increase the cost of goods sold to $200 by decreasing
closing inventory by $100, gross income is decreased to $100 ($300 - $200).
Under Treasury Regulations, Thor Power Tool was entitled to use the lower of cost or the fair market value of the items in closing inventory in calculating the cost of goods sold.\(^\text{44}\) For the year at issue, Thor Power Tool wrote down the cost of closing inventory by nearly $1 million, an amount management thought reflected a reduction to scrap value of excess inventory that it would not be able to sell, though it continued to produce and sell these items at the same price charged for "nonexcess" inventory. It was less costly for Thor Power Tool to maintain excess production than risk subsequent production runs should they run short, entailing costly retooling and delays in filling orders. Thor Power Tool's write-down of closing inventory was consistent with generally accepted accounting principles (GAAP).

The Court denied the write-down for "excess inventory" as not "clearly reflecting income" under section 446(b). Some might argue that the Court's denial was based on the tax value of realization, since using a value for closing inventory that is lower than its original cost is tantamount to allowing a deduction for that as-yet-unrealized loss in value. That reasoning is not fully persuasive in this context, however.\(^\text{45}\) Like the tax values discussed later in this Article, the realization requirement is a general tax value that must give way if the Code or regulations specifically sanction violation of the value in the particular instance.\(^\text{46}\) And—for better or worse\(^\text{47}\)—the regulations specifi-

\(^{44}\) See Treas. Reg. § 1.471-2(c).

\(^{45}\) For a discussion of the tax values implicated by inventory accounting see infra notes 139-147 and accompanying text (discussing inventory accounting for rotable spare parts).

\(^{46}\) See, e.g., I.R.C §§ 475 & 1256 (requiring mark-to-market accounting in violation of the realization requirement).

\(^{47}\) Many would say "for worse" based on the realization-requirement value. An interesting aside: The use of lower of cost or value apparently did not originate in financial accounting but in tax accounting—specifically as a means to lower taxable income. Writing in 1939, Stephen Gilman said,

The illogical rule of cost or market [in inventory accounting], while not originating in this country, became popular here upon the advent of the Federal income tax program. Paton says that: "The early American enthusiasm for the device . . . was not a tribute to the merits of the scheme as a worthwhile accounting mechanism—but as an immediate method of reducing taxable income."

GILMAN, supra note 37, at 17 (quoting W.A. Paton, Comments on "A Statement of Accounting Principles," J. ACCOUNTANCY 202 (1938)); Gilman, id. at 440-45 (recounting the origin of the rule in England in 1904 and its adoption by the U.S. Treasury Department in 1917). Thus the rule seems to further neither sound tax theory nor financial accounting goals. Its retention is a testament to both inertia and the lobbying power of corporate America. See Deborah A. Geier, A Brilliant Instance of Flabby Thinking, 76 TAX
callly condone using the lower of cost or value.

The real problem was an evidentiary one. The regulations define "market" price as "the current bid price prevailing at the date of the inventory for the particular merchandise in the volume in which usually purchased by the taxpayer," which had been uniformly interpreted to mean replacement cost. Where no open bid market exists, the regulations instruct to use the best evidence available, "such as specific purchases or sales by the taxpayer or others in reasonable volume and made in good faith, or compensation paid for cancellation of contracts for purchase commitments." Lower prices could be used only under two circumstances: if the taxpayer actually offers and sells merchandise at lower than these market prices or if the merchandise is defective, neither of which pertained to Thor Power Tool.

Although the taxpayer conceded that an active market existed in the inventory at issue, it made no effort to obtain the objective replacement cost of its excess inventory in the market. Rather, the "market" prices used were based on the "best guess" of management in light of the president's twenty years of experience. The Court concluded:

The Regulations demand hard evidence of actual sales and further demand that records of actual dispositions be kept. The Tax Court found, however, that Thor made no sales and kept no records. Thor's management simply wrote down its closing inventory on the basis of a well-educated guess that some of it would never be sold. The formulae governing this write-down were derived from management's collective "business experience"; the percentages contained in those formulae seemingly were chosen for no reason other than that they were multiples of five and embodied some kind of anagogical symmetry. The Regulations do not permit this kind of evidence. If a taxpayer could write down its inventories on the basis of management's subjective estimates of the goods' ultimate salability, the taxpayer would be able, as the Tax Court observed, "to determine how much tax it wanted to pay for a given year."52

NOTES 124

50. Id.
52. Thor Power Tool, 439 U.S. at 536 (citations omitted).
Thus, the Court's decision ultimately rested on a tax value different from the realization requirement: the prevention of taxpayer manipulation, which is an administrative value.

Of particular importance here is the Court's response to the taxpayer's argument that since the write-down conformed to GAAP, it must be accepted for tax purposes as well under Treasury Regulation § 1.446-1(a)(2), which provides that "[a] method of accounting which reflects the consistent application of generally accepted accounting principles . . . will ordinarily be regarded as clearly reflecting income." Thor Power Tool argued that this regulation creates a rebuttable presumption in favor of the taxpayer if its method of accounting conforms to GAAP and that the burden shifts to the Commissioner to demonstrate affirmatively that the method "demonstrably distorts income" or that its use was "motivated by tax avoidance." The Court rejected the argument.

The Regulations embody no presumption; they say merely that, in most cases, generally accepted accounting practices will pass muster for tax purposes. And in most cases they will. But if the Commissioner, in the exercise of his discretion, determines that they do not, he may prescribe a different practice without having to rebut any presumption running against the Treasury.

Among the reasons the Court dismissed the taxpayer's argument are the very disparate goals and purposes of tax and financial accounting.

The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested; the major responsibility of the accountant is

53. Id. at 539-40 (citations omitted).
54. Id. at 540. Justice Blackmun's commonsensical point that in most instances financial accounting will "pass muster" is worth stressing. This is an important point because it is easy to lose sight of the "general rule" in an Article devoted to exceptions. It is perfectly reasonable to allow taxpayers to use GAAP in tax accounting as a matter of administrative simplicity in those cases in which no substantial damage to other tax values would result. Some would argue that simplification demands that departures from GAAP should not be required even in those cases where substantial tax values are at risk—except perhaps in the most abusive of cases. The case for using GAAP on simplification grounds is certainly overstated, however. Taxpayers must keep two sets of books in any event. It is unavoidable, unless taxpayers are willing to give up such things as favorable depreciation schedules unheard of in GAAP. Even if taxpayers were so willing, the malleability of GAAP is too big a problem to countenance full scale adoption of GAAP as a replacement for the Internal Revenue Code. See infra notes 57-76 and accompanying text.
to protect these parties from being misled. The primary goal of the income tax system, in contrast, is the equitable collection of revenue; the major responsibility of the Internal Revenue Service is to protect the public fisc. Consistently with its goals and responsibilities, financial accounting has as its foundation the principle of conservatism, with its corollary that "possible errors in measurement [should] be in the direction of understatement rather than overstatement of net income and net assets." In view of the Treasury's markedly different goals and responsibilities, understatement of income is not destined to be its guiding light. Given this diversity, even contrariety, of objectives, any presumptive equivalency between tax and financial accounting would be unacceptable. 55

Equally important, however, the Court also noted that the sheer malleability of GAAP violates tax values.

Accountants have long recognized that "generally accepted accounting principles" are far from being a canonical set of rules that will ensure identical accounting treatment of identical transactions. "Generally accepted accounting principles," rather, tolerate a range of "reasonable" treatments, leaving the choice among alternatives to management. Such, indeed, is precisely the case here. Variances of this sort may be tolerable in financial reporting, but they are questionable in a tax system designed to ensure as far as possible that similarly situated taxpayers pay the same tax. If management's election among "acceptable" options were dispositive for tax purposes, a firm, indeed, could decide unilaterally—within limits dictated only by its accountants—the tax it wished to pay. Such unilateral decisions would not just make the Code inequitable; they would make it unenforceable. 56

Because GAAP (including the matching principle) does have for many an enticing aura of "theoretical soundness" that makes deferring to it in the tax arena an appealing method of argument, Justice Blackmun's point is worth developing further.

Use of the word "principles" in "generally accepted accounting principles" 57 may be misleading if it suggests that the ac-

55. 439 U.S. at 542-43 (citations omitted).
56. Id. at 544 (footnotes omitted). "'Accounting has never been and will never be an exact science and a precise measurement exercise,' said Timothy S. Lucas, director of research at the [Financial Accounting Standards Board]. 'There is an element of judgment that will always be necessary.'" Jon E. Hilsenrath, On the Books, More Fact and Less Fiction, N.Y. TIMES, Feb. 16, 1997, § 3, at 1, 5 (national edition).
57. See infra notes 180-225 and accompanying text (providing a short synopsis of the origin of the term "generally accepted accounting principles").
counting method is based in theory apart from practice; practice can be theory when it comes to GAAP. As George O. May, one early and influential commentator in the field of accounting, put it, "[T]he rules of accounting, even more than those of the law, are the product of experience rather than of logic." McCullers and Schroeder put it this way:

The expression *generally accepted accounting principles* (GAAP) has thus come to play a significant role in the accounting profession. The precise meaning of the term, however, has evolved rather slowly. In addition to official pronouncements [of the Federal Accounting Standards Board], another method of developing principles is to determine whether other accountants are actually following the particular practice in question. There is no need for complete uniformity; rather, when faced with a particular transaction, the accountant is to review the literature and current practice to determine if a treatment similar to the one proposed is being used. For example, if many accountants are using sum-of-years-digits (S-Y-D) depreciation for assets, this method becomes a GAAP. In the theoretical sense, depreciation may not even be a principle; however, according to accounting theory formation, if many accountants are using S-Y-D it becomes a GAAP.

According to the Accounting Principles Board (APB), generally accepted accounting principles "does not mean that GAAP is based on what is most appropriate or reasonable in a given situation but simply that the practice represents a consensus." Moreover, "[t]he description of present generally accepted accounting principles is based primarily on observation of accounting practice. Present generally accepted accounting principles have not been formally derived from the environment, objectives, and basic features of financial accounting." Keller and Zeff captured the distinction pithily when they wrote, "'Generally accepted' must be distinguished from 'generally acceptable.'" And Gilman wrote, "[T]he word 'principles' is commonly

59. MCCULLERS & SCHROEDER, supra note 26, at 2-3.
60. Id. (emphasis in original) (quoting APB No. 4, supra note 26). See infra notes 180-225 and accompanying text (describing the birth and death of the APB).
61. MCCULLERS & SCHROEDER, supra note 26, at 12-13 (quoting APB No. 4, supra note 26).
62. 2 FINANCIAL ACCOUNTING THEORY vi (Thomas F. Keller & Stephen A. Zeff eds., 1969). Another has said, "The so-called accounting principles followed in preparing ac-
used to characterize the common law of accounting.  

In a footnote appending the word “principles,” he wrote, “[T]he use of this word does not indicate its approval . . . .” While rule 203 of the American Institute of Certified Public Accountants (AICPA) Code of Professional Ethics does require compliance with accounting principles established by the Financial Accounting Standards Board (FASB), accountants may consult industry practices in determining GAAP in the absence of such guidance. This practice leaves a lot of room for “acceptable” variation, leading one commentator to call for the creation of an “Accounting Court.”

Counting reports to the public constitutes a hodge-podge of entrenched traditional practices. They have few if any objective standards, and they have grown up and gained authority largely by precedent and tradition. . . .” Leonard Spacek, Business Success Requires an Understanding of Unsolved Problems of Accounting and Financial Reporting, in Financial Accounting Theory, id. at 135, 136.

63. Gilman, supra note 37, at 169.
64. Id.
67. Spacek provides a detailed example showing how the use of alternative generally accepted accounting principles can dramatically affect the earnings report of two fictional companies. See Financial Accounting Theory, supra note 62, at 139-41. “It is wholly possible,” he concludes, “to have the stock of these two comparable companies selling at prices as much as 100% apart, merely because of the differences in accounting practices.” Id. at 139.
68. Leonard Spacek, The Need for An Accounting Court, Accounting Rev. 368 (July 1958). In referring to the certification that accountants must sign to the effect that the report conforms with “generally accepted accounting principles,” see infra notes 196-199 and accompanying text, he wrote:

[N]owhere does it say that for the same transaction there are acceptable alternative principles which produce widely different results and which destroy comparability with other companies, or sometimes make impossible a realistic appraisal of the company itself. On this point we should ask ourselves this question which is an important moral one: Do the readers know that in giving the standard certificate we have a choice of principles, practices or conventions applicable to the same transactions, and that each choice can be certified without qualification even though the profits reported would vary widely, depending on which principle of accounting was chosen?

In fact, [the accountant] will often certify statements which reflect identical transactions in different companies, recorded in widely different ways and with material differences in the results obtained. The only defense for this latitude of choice is that alternative principles which produce such widely varying results are all classified as “generally accepted.”

Would a doctor be justified in passing on to his patient the choice of anesthetic just because there are several types that are acceptable without the doctor being
Within an article recounting a study by the respected investment firm Goldman, Sachs regarding recent improvements in the veracity of earnings reports, for example, Jon Hilsenrath gives a flavor of the tractability of GAAP.

Executives don't have to risk committing fraud to play with the earnings. The Goldman study notes somewhat archly that accounting rules still give financial officers plenty of "opportunities"—all quite legal—to massage income statements. Using different approaches, financial officers can shift earnings from the present to the future, paving the way for steady earnings growth. They can also take tomorrow's earnings and place them on today's income statements, pleasing impatient investors. And if the auditors do not object, these executives can get away with reporting revenues well before their time.69

He provides several examples, one of which was the manner in which I.B.M. accounted for its acquisitions of the Lotus Development Corporation, Tivoli Systems, Inc., and Object Technology International, Inc., in 1995 and 1996. "Because of the accounting method that it chose, I.B.M. was able to show a significant jump in earnings from 1995 to 1996. It was also able to set up its financial statements to show earnings growth in the future."70 It did this by declining to amortize over a term of years the $2.275 billion attributable to the "goodwill" it purchased in these acquisitions, choosing instead to deduct this amount immediately as an expense attributable to "purchased in-process research and development" instead of goodwill.71 In other words, it chose to take a "quick hit" to earnings in 1995 and 1996 in order to prevent a drag on earnings in the years to come. Using this technique, I.B.M. reported income for 1996 of $5.4 billion, an increase of $1.2 billion over 1995. "If the company had written off this goodwill over a more traditional period, such as five years, rather than taking a one-time expense,

---

69. Hilsenrath, supra note 56, at 5.
70. Id.
71. Id.

---

Id. at 373-74. Cf. Reed K. Storey, The Search for Accounting Principles 6 (1964) (referring to Mr. Spacek's speech, which was given at the 1957 annual convention of the American Accounting Association and later published, as "revolutionary in the view of most accountants" and as contributing to renewed efforts to formulate uniform principles for the profession).
profits for 1996 would have been $5.5 billion, down from $5.8 billion in 1995.  

While I.B.M. chose to hurry earnings reductions to make the future earnings trend rosier, some companies, particularly young ones under pressure to show a profit rather quickly, take the opposite tack, delaying earnings reductions to future periods. America Online did this by choosing to characterize marketing expenses, which immediately reduce earnings, as outlays requiring amortization over several years. The outlays at issue were the costs associated with shipping millions of trial diskettes to prospective customers. While it listed those costs as "deferred subscription acquisition costs" that had to be amortized for financial accounting purposes, "[m]ost companies would have immediately listed those costs as an expense . . . ." By the end of its fiscal year on June 30, 1996, it listed $237 million of such deferred costs, nearly eight times its reported net income for that year of $30 million. By September 30, 1996, the costs had grown to $385 million. Finally, faced with widespread complaints by analysts (not accountants, note), it charged off the $385 million all at once.

In referring to a "pathbreaking, as-yet unpublished study" that empirically quantified the extent of earnings manipulations to meet certain thresholds, Roger Lowenstein of the Wall Street Journal said dryly:

Companies will strive to meet three supposed thresholds [when reporting earnings]: (1) positive earnings, (2) prior-year results and (3) analyst-expectations.

Most of them will do so, though often by only a whisker. A few, on the other hand, will miss by a mile.

---

72. Id. Professor Baruch Lev, an accounting professor at the Stern School of Business at New York University, relates that this technique is called the "big bath" in accounting jargon, and he estimates that more than 300 companies have used similar techniques in the last two years in accounting for acquisitions of high technology companies. See supra notes 57-76 and accompanying text (describing how practice becomes GAAP). For the tax treatment of acquired goodwill, see infra notes 148-50 and accompanying text.

73. Hilsenrath, supra note 56, at 5 (quoting Howard Schilit, an adjunct accounting professor at American University).

74. Id.

75. Roger Lowenstein, How to Be a Winner in the Profits Game, WALL ST. J., Apr. 3, 1997, at C1 (referring to Francois Degeorge, Jayendu Patel, and Richard Zeckhauser, Earnings Manipulation to Exceed Thresholds (unpublished)).
This is not due to chance, nor smiling fates. Companies manipulate their earnings to make it come out that way. Those that are going to fall short or that are comfortably ahead “save up” earnings for next time. Those who expect to come close will “borrow” earnings from the future.\textsuperscript{76}

In sum, \textit{Thor Power Tool} tells us that the divergent goals of tax accounting and financial accounting, as well as the malleability of GAAP itself, renders GAAP inappropriate as the lodestar for tax accounting.\textsuperscript{77} But I have not yet discussed with any kind of precision—other than to collect revenue in a fair and administrable manner—the goals of tax accounting. The bottom-line question thus becomes: What \textit{tax} values are relevant to contexts in which courts and accountants are apt to invoke the matching principle permeating GAAP? The stories of I.B.M. and America Online illustrate how the issues here are obviously matters of timing. As we shall see, however, while the timing of income and deductions is important to financial accounting because of the earnings picture such timing portrays over time, it is important to tax accounting for very different reasons.

\section*{III. \textsc{The Matching Principle in Tax Accounting}}

\subsection*{A. \textsc{Capitalization, Depreciation, and the Income-Tax Value}}

Capitalization and depreciation to the financial accountant are notions premised wholly on the matching principle. Recall that McCullers and Schroeder referred to matching as a “pervasive principle” and described cost allocation for assets that provide service over time, \textit{i.e.}, depreciation, as a broad operating principle intended to implement the pervasive principle of

\textsuperscript{76} Id.
\textsuperscript{77} This point needs to be stressed again and again, however. Courts sometimes continue to be swayed by arguments that certification that the treatment under review complies with GAAP means, by definition, that it also clearly reflects income for tax purposes. See, \textit{e.g.}, Wal-Mart Stores v. Commissioner, 73 T.C.M. (CCH) 1625 (1997); Dennis J. Gaffney et al., \textit{Inventory Accounting: Recent Decision Could Save Taxes for Retailers}, 75 \textit{TAX NOTES} 1255 (June 2, 1997) (criticizing the decision). In \textit{Wal-Mart}, the Tax Court allowed Wal-Mart to use inventory accounting methods certified by a CPA to be in accordance with GAAP even though inventory shrinkage estimates were used when actual shrinkage was both known and significantly less, significant inventory was never counted (which allowed a backdoor write-off of a kind that was disallowed in \textit{Thor Power Tool}), and inventory that was counted was improperly priced.
matching. Thus, for example, acquired goodwill can be amortized under financial accounting norms.

Capitalization and depreciation have wholly different functions in an income tax. Capitalization is what differentiates an income tax from a tax based solely on consumption, and depreciation in a realization-based income tax system allows passage-of-time "final" losses to be deducted. Neither of these tax concepts is premised on the matching principle.

1. Capitalization

A pure Shanz-Haig-Simons income tax base is comprised of consumption plus net wealth increases (or less net wealth decreases). An outlay in the form of a capital expenditure—the purchase of an investment asset, for example—does not decrease the taxpayer's wealth; it merely changes the form in which that wealth is held. Therefore, an income tax disallows deductions for capital expenditures, i.e., deductions for savings. A cash flow consumption tax, in contrast, would exempt savings from tax by allowing a deduction for the purchase of nonconsumption assets, such as an investment asset. Thus, the capitalization principle is the defining feature of an income tax.

The economic effect of inappropriately allowing a deduction in an income tax for a capital expenditure is dramatic. E. Cary Brown, writing in 1948, demonstrated that, under certain conditions, allowing immediate deduction of the cost of an investment yielding future income is economically equivalent to not allowing a year-1 deduction but exempting all the future returns on the investment from tax. In other words, inappropriately al-

---

78. See supra notes 26-27 and accompanying text.
79. See supra notes 69-72 and accompanying text and note 127.
80. But see Douglas A. Kahn, Accelerated Depreciation—Tax Expenditure or Proper Allowance for Measuring Net Income?, 78 Mich. L. Rev. 1 (1979) (taking the position that depreciation is simply a cost allocation mechanism, as it is in financial accounting).
81. See Dodge et al., supra note 20, at 26-27. The realization requirement of our current income tax means that only realized wealth changes are taken into account.
83. See Dodge et al., supra note 20, at 411.
lowing a deduction of a capital expenditure means that the fu-
ture income generated by that investment, though nominally in-
cluded in income under the Internal Revenue Code, is
economically exempt from tax, as though the investment were
being taxed under a consumption-tax regime. That the invest-
ment return is nominally included in the tax base can cause
casual observers to fail to understand that it is effectively free
from tax.

The reason that this phenomenon holds true under stated
conditions is that the cost of an investment is (in theory, at
least) simply the present value of the anticipated future returns
that will be generated by the investment. Thus, deducting the
original purchase price—the present value of the future re-
turns—turns out to be equivalent to not taxing those future re-
turns. The equivalence of not allowing a deduction for business
and investment capital expenditures but exempting all the fu-
ture returns on the capital expenditure, on the one hand, and
deducting a capital expenditure but taxing the future returns,
on the other, can be illustrated with the following example. The
example also compares these results with the result that should
occur under an income tax, where capital expenditures are not
deducted and the portion of the future return consisting of “in-
come” (the portion of the gross return exceeding the tax-free ba-
sis recovery) is taxed.

Assume that Investor has a $100,000 wage bonus at the end
of year 0 to invest, the interest (and discount) rate is 10 percent
compounded semi-annually, the tax rate is a flat 30 percent,
and the $100,000 investment is held for one year, at which time
the total net return (income and principal after tax) is
consumed. 86

86. The example is taken from DODGE ET AL., supra note 20, at 416-20.
<table>
<thead>
<tr>
<th></th>
<th>No deduction of C/E and “income” return</th>
<th>Deduction of C/E and all returns</th>
<th>No deduction of C/E and all returns</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Gross Investment</strong></td>
<td>$100,000</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td><strong>Tax (30%)</strong></td>
<td>30,000</td>
<td>0</td>
<td>30,000</td>
</tr>
<tr>
<td><strong>Net Investment</strong></td>
<td>70,000</td>
<td>100,000</td>
<td>70,000</td>
</tr>
<tr>
<td><strong>Gross Return</strong></td>
<td>77,000</td>
<td>110,000</td>
<td>77,000</td>
</tr>
<tr>
<td><strong>Tax on $7,000 “Income”</strong></td>
<td>2,100</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>Tax on Gross Return</strong></td>
<td>0</td>
<td>33,000</td>
<td>0</td>
</tr>
<tr>
<td><strong>Net Return</strong></td>
<td>74,900</td>
<td>77,000</td>
<td>77,000</td>
</tr>
<tr>
<td><strong>Present Value</strong></td>
<td>67,364</td>
<td>70,000</td>
<td>70,000</td>
</tr>
</tbody>
</table>

Column one above illustrates the treatment of this investment capital expenditure under our current income tax: no deduction of the outlay coupled with taxation of the “income” portion of the return (with basis recovery going untaxed). Column two illustrates treatment under a cash flow consumption tax: deduction of the savings outlay (the purchase of the investment asset) coupled with taxation of all returns on the investment as consumption. Column three illustrates that the economic result of column two can be accomplished if the investment capital expenditure is not deducted, as under an income tax, but all returns on the investment are exempted from tax, the E. Cary Brown yield-exemption phenomenon.87

The equivalence of columns three and two—consumption-tax regimes—demonstrates that allowing a deduction for a capital expenditure is the economic equivalent of not allowing an initial deduction but exempting from tax all the returns from the capital expenditure. But, as column one illustrates, the “income” portion of the return is supposed to be taxed under an income tax. At bottom, allowing immediate deduction of capital expenditures replicates consumption-tax treatment and thus violates what I call the “income-tax value” in an income-tax regime by failing to tax the “income” portion of the investment’s return and replicating consumption-tax treatment. Acceleration of a de-

---

87. Column three also provides an example of the wage tax, colloquially called the “flat tax,” that has been suggested as a consumption-tax replacement for our current tax system. See Robert E. Hall & Alvin Rabushka, The Flat Tax (2d ed. 1995); Deborah A. Geier, Cognitive Theory and the Selling of the Flat Tax, 71 TAX NOTES 241 (Apr. 8, 1996).
duction produces the same yield-exemption effect. 88

Enactment of the Roth IRA shows acceptance of the yield-exemption phenomenon by Congress. Since I believe that statutory interpretation should take account of the words in the Internal Revenue Code, even in other Code sections, I think this event was significant. Both the Roth IRA and traditional IRA are explicit consumption-tax components of our hybrid tax system, and the Roth IRA is explicitly premised on this idea that not allowing an up-front deduction of an investment but allowing the returns to be received tax-free under the Roth IRA is the equivalent of allowing an up-front deduction but taxing the yield under a traditional IRA. Both yield consumption-tax treatment, not income-tax treatment.

While the importance of the yield-exemption phenomenon seems to be widely understood now in academia, 89 judges and the Commissioner have thus far not demonstrated complete or consistent awareness of the economic significance in an income tax of allowing a deduction for investments that will produce significant future income. Their rhetoric never recognizes it.

This discussion reveals that the sine qua non of a capital expenditure in the tax sense is any outlay that will produce significant future income. Immediate deduction of such an outlay is inappropriate in an income tax, not because of the matching principle, but because it is the equivalent of exempting from tax the future returns from the outlay. Such a result replicates a consumption-tax outcome and is inconsistent with an income tax, 90 violating the income-tax value. 91 Note that while capitali-

---


90. Treatment of some investments under a consumption-tax regime when others are treated under an income-tax regime means that the former are taxed at effective rates lower than the statutory rate. According to Professor Johnson, "The lower effective rate means that high-bracket investors will drive out lower bracket competitors and that poorer investments, judged by their economic merit, will win out over better ones." Cal-
zation does defer the deduction of the outlay producing future income until the future, matching does not drive capitalization under an income tax, even though it may describe it. That is an important distinction to appreciate, since if one thinks the matching principle is the tax value that drives capitalization, the matching principle will be raised inappropriately in other contexts to support a treatment that would violate the income-tax value, such as in the area of accrual of prepaid gross receipts. The problem is the familiar one of mistaking a descriptive trait for a substantive one.

Appreciation of this nuance can be gained by considering what would happen if Congress were to replace the current Internal Revenue Code with a pure, cash flow consumption tax. Capitalization would be a thing of the past for tax purposes. Yet, financial accountants would continue to capitalize costs to match future income. Capitalization simply serves very different purposes in the two worlds. In the tax world, capitalization protects the tax on income from investments and avoids inadvertent consumption-tax treatment,92 while in the financial ac-

91. Professor Johnson phrases it, "Costs with significant future value are investments and in an income tax, investments need to be made and continued with non-deductible moneys. Except where the costs are too small or the future benefits are too speculative to count, costs with future value need to be capitalized." Id.

92. One rationale behind the passive activity loss rule might be that it protects capitalization and the income-tax value. Tax shelters provide up-front deductions, such as interest and depreciation deductions of basis created by debt, coupled with delayed income inclusions. For an example, see DODGE ET AL., supra note 20, at 528-29 (recounting the story of Sara Surgeon who purchases a $100,000 apartment building with $95,000 of nonrecourse debt and whose rental income from the building is offset by current expenses, leaving the depreciation deduction to produce a series of tax losses until the building is sold).

The way § 469 operates is to net passive activity losses against passive activity gains; only the net overall loss is deferred. The idea of aggregating investments and deferring any net overall loss is plausible if one adopts a "portfolio" view of an individual taxpayer's investment activity; that is, a net overall investment loss for a year is a price one sometimes pays in managing the risks of a diversified portfolio over time. Thus, losses are a "cost" of overall profitability, which suggests "capitalization" of net overall losses, which is exactly the result achieved by deferral . . . .

DODGE ET AL., supra note 20, Teacher's Manual, at 289. I thank Joseph Dodge for this insight. In other words, capitalization of the early losses incurred by Sara Surgeon's investment ensures that the future income from that investment is not, in effect, partially exempted from tax. This approach differs from the traditional one in thinking about tax shelters, which focuses on their elimination of the current tax on other income, such as income from Sara's surgical practice.
counting world, it serves to match costs with related income solely for informational purposes. Congress may decide someday to replace the current tax system with a pure consumption tax, but until it does, judges and the Commissioner should endeavor to realign their rhetoric around the central tax idea of capitalization in an income tax world: the likelihood of significant future returns from the outlay. Consumption-tax treatment for an item not mandated by the language of the Code should not result by “accident” in administering the remaining provisions of the Internal Revenue Code.

This realignment in rhetoric seemed eminently possible after the Supreme Court’s decision in INDOPCO, Inc. v. Commissioner. INDOPCO provides the opportunity to jettison outdated rhetoric that pre-dated INDOPCO and which dances around the underlying tax values, described above, that are at stake. Whether it will have this salutary long-term effect remains to be seen.

INDOPCO was the successor corporation to National Starch and Chemical Corporation. National Starch incurred significant investment banking fees and lawyers fees, amounting to more than $2.5 million, as the target in a friendly merger with Unilever United States, Inc., and the issue in the case was whether these fees were immediately deductible as “expenses”

Other deferral rules may be similarly explained. For example, the deferral of investment interest deductions under section 163(d) until investment income is included protects the taxation of that investment income.

I should note that Charlotte Crane is also absolutely right in pointing out to me that, on the flip side of the coin, section 469 has destroyed any hope of “matching” for the real economic losses of passive investors who cannot sell and have no offsetting positions.

93. There are several important consumption-tax features in our current system. For example, the exclusion or deduction of qualified pension contributions under sections 401-420, deductions under sections 174 or 179 or Treas. Reg. §§ 1.162-6 and -12(a) (allowing deduction of certain capital expenditures), and the deferral of tax on unrealized asset appreciation under the realization requirement are cash flow consumption-tax features of our current tax system, while the exemption of interest under section 103 is a wage or “flat” tax feature of our current system. Just as with other tax values, the Congress and the Code sometimes deviate from the income-tax value in delineated circumstances.


95. Because of corporate reorganization problems, this transaction would not have gone forward had it not been for the creativeness of the tax lawyers involved. I am always amazed that the lawyer’s fees for tax counsel as well as general representation amounted to only $490,000 along with $15,069 for out-of-pocket expenses compared with the investment banking fees for the fairness opinion of $2,200,000 along with $7,586 for out-of-pocket expenses and $18,000 for legal fees! See 503 U.S. at 82.
under section 162 or whether they constituted nondeductible capital expenditures under section 263. On its final income tax return, National Starch maintained that the outlays constituted "expenses" by default, arguing that in order for an outlay to be a capital expenditure it must create or enhance a separate and distinct additional asset and that no such asset was created here.

The Supreme Court disagreed that no outlay could be categorized as a capital expenditure absent a link with a separate and distinct asset. The language had originated in an earlier Supreme Court opinion in which the Court labeled as a capital expenditure an outlay that had created a separate and distinct asset, but the INDOPCO Court clarified that creation of a separate asset was not a necessary but merely a sufficient condition for capitalization.

The Court's language in INDOPCO had both good and bad points. The following passage was one of the unfortunate ones, as it assumes that matching is a tax value.

The primary effect of characterizing a payment as either a business expense or a capital expenditure concerns the timing of the taxpayer's cost recovery: While business expenses are currently deductible, a capital expenditure usually is amortized and depreciated over the life of the relevant asset, or, where no specific asset or useful life can be ascertained, is deducted upon dissolution of the enterprise. Through provisions such as these, the 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.

96. The particular outlays at issue might have been best characterized as constructive dividends to the shareholders of the target corporation. See Calvin H. Johnson, The Expenditures Incurred by the target Corporation in an Acquisitive Reorganization are Dividends to the Shareholders, 53 Tax Notes 463 (Oct. 28, 1991).

97. See 503 U.S. at 86.


99. See 503 U.S. at 86-88.

100. After reading repeated assertions of this kind in various judicial decisions, some practitioners and judges find it very difficult to understand why, for example, it is appropriate to require accrual basis taxpayers to include prepaid receipts immediately upon receipt while at the same time disallowing deduction of related future expenses, thus violating this "matching principle." For this reason alone, it is important to jettison the matching rhetoric in favor of the true tax values that inform each of these contexts.

101. 503 U.S. at 83-84 (citations omitted).
The Court clearly failed to realize the role that capitalization plays in the income tax, i.e., protection of the income-tax value by ensuring taxation of the net future returns on investments and thus avoiding a consumption-tax result. Moreover, its unfortunate language once again implied that the matching principle not only is a tax value but explains capitalization when coupled with depreciation.

Ultimately, however, the Court's decision did focus emphasis in the right direction. It confirmed that "deductions are exceptions to the norm of capitalization," an important perspective in viewing the appropriateness of a current deduction for an outlay. Such a norm is critical if the income-tax value is to be respected. Moreover, it confirmed that the proper inquiry to undertake in determining whether an outlay must be capitalized was that taken by the lower courts in the case: Outlays that create substantial future benefits (presumably economic) must be capitalized.

This perspective, focusing on the likelihood of substantial future income—as opposed to past or current-year income—makes perfect sense once one understands the income-tax value. Since taxation of that future income would be effectively avoided if the initial outlay were currently deducted, which is an inappropriate result under an income tax, the focus logically should rest on whether there is a likelihood of substantial future income. Outlays that do not generate substantial future income can be deducted in the current year as an "expense" without damaging the income-tax value. Trying to determine which outlays contribute significantly to substantial future income is not an easy task, of course, but it is clearly the appropriate task to undertake if the outlay is to be taxed in accordance with income-tax principles rather than consumption-tax principles.

**INDOPCO** has created a lot of unrest in the practitioner community, which worried that it might render nondeductible many outlays that had been previously expensed without ques-

---

102. See id. at 84.

103. Because the Court seemed to fail to understand the income-tax value, however, it did not rely upon it in confirming that deductions were the exceptions to the norm in an income tax. It relied instead on two things. One was the fact that since deductions are specifically enumerated in the Code while nondeductible capital expenditures are not, capitalization must be the norm as a matter of statutory interpretation. See id. The other was Professor Johnson's article espousing a "strong law of capitalization" in the income tax. See id. at 84 n.4 (quoting Johnson, supra note 96, at 478).
Resistant to change, practitioners also were very wary of the language regarding substantial future benefits, even if the deductibility outcomes under it were the same as under pre-INDOPCO law. The Service has responded by issuing several Revenue Rulings and private rulings regarding the deductibility of items in the post-INDOPCO world. It has also solicited comments from the bar regarding further guidance under INDOPCO.

Both the courts and the Commissioner (as well as the Treasury Department, through new regulations) should use INDOPCO to refocus the analysis often undertaken in the past in capitalization cases. For example, a great deal of energy has been expended in trying to determine whether a particular outlay constitutes a deductible "repair" or a nondeductible "permanent improvement or betterment." Regulations issued in 1958 provide that the cost of "incidental repairs which neither materi-

104. See Burgess J.W. Raby & William L. Raby, Tax 20 Forum: Practitioner Reaction to INDOPCO, 73 Tax Notes 1581, 1581 (Dec. 30, 1996) (expressing "concern that INDOPCO would not be limited to its rather unique facts but would lead to increased IRS aggressiveness in capitalizing all manner of expenses").

105. See Timothy V. McCormally, Rev. Rul. 96-62: A Lump of Coal or a Nicely Wrapped Present?, 74 Tax Notes 797 (Feb. 10, 1997) (aptly describing the paranoia in the tax bar over INDOPCO, which chastised even rulings that confirmed current deductibility).

106. See, e.g., Rev. Rul. 96-62, 1996-2 C.B. 9 (ruling that routine employer training costs were deductible expenses notwithstanding future benefits unless connected to a new trade or business); Rev. Rul. 94-12, 1994-1 C.B. 36 (confirming that INDOPCO does not affect treatment of incidental repair costs as expenses); Rev. Rul. 94-38, 1994-1 C.B. 35 (ruling that hazardous waste clean-up costs were deductible except the cost of constructing a groundwater treatment facility, which was a capital expenditure); Rev. Rul. 94-77, 1994-2 C.B. 19 (confirming that severance pay was currently deductible); Rev. Rul. 92-80, 1992-2 C.B. 57 (confirming that "plain vanilla" advertising expenses remain deductible after INDOPCO).

107. See, e.g., T.A.M. 9627002 (June 17, 1996) (ruling that environmental investigation clean-up costs were currently deductible); T.A.M. 9618004 (Jan. 23, 1996) (ruling that costs incurred for major inspections of turboprop aircraft engines resulting in replacement of a significant number of engine parts must be capitalized); T.A.M. 9544001 (July 21, 1995) (ruling that the costs of converting to just-in-time manufacturing must be capitalized); T.A.M. 9547002 (July 18, 1995) (ruling that the costs of replacing vines, etc., because of vineyard pest infestation must be capitalized); T.A.M. 9240004 (June 29, 1992) (ruling that the costs of asbestos removal in a manufacturing plant must be capitalized).


ally add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition" may be categorized as an expense. Regulations of that same vintage provide that amounts expended for "permanent improvements or betterments made to increase the value of any property" or made in "restoring property" or to "substantially prolong [its] useful life" or "to adapt property to a new or different use" must be capitalized. The language in vintage "repair" cases, such as American Bemberg Corp. v. Commissioner, really miss the mark, though stare decisis (and the regulations, of course) has the effect of perpetuating it.

American Bemberg built a factory near a river in 1925-1928. In 1940 and 1941, portions of the factory floor caved in, and American Bemberg expended almost $1 million to fill in large cavities in the subsoil above the bedrock and under the floor with grout (essentially a low grade cement) and sought to deduct the costs as current expenses. The Tax Court said:

In deciding whether the expenditures may be classed as expenses of the business or whether they were capital expenditures, we think it is appropriate to consider the purpose, the physical nature, and the effect of the work for which the expenditures were made.

In connection with the purpose of the work, [the outlays were] intended to avert a plant-wide disaster and avoid forced abandonment of the plant. The purpose was not to improve, better, extend, or increase the original plant, nor to prolong its original useful life. Its continued operation was endangered; the purpose of the expenditures was to enable petitioner to continue in operation not on any better scale, but on the same scale and as efficiently as it had operated before. . . .

In connection with the effect of the work, the accomplishment of what was done forestalled imminent disaster and gave petitioner some assurances that major cave-ins would not occur in the future . . . .

112. Treas. Reg. § 1.263(a)-1(a), (b).
113. 10 T.C. 361 (1948), aff'd, 177 F.2d 200 (6th Cir. 1949) (per curiam).
114. 10 T.C. at 376-77.
Thus, the court allowed current deduction of the nearly $1 million outlay.\textsuperscript{115}

The outlay certainly did not contribute to past income, nor can it be limited to the earning of 1941-42 income. The outlay, beyond question, contributed substantially to the creation of substantial future income. The court’s language does not focus, however, on the outlay’s connection to substantial future income but rather to the “purpose, physical nature, and the effect of the work,” taking a dictionary approach to the word “repair.” Such an approach was understandable—excusable, as an historical matter—since it was developed during eras when we did not have a full or widespread understanding of the relationship between a consumption tax and income tax and how the immediate deduction of an outlay creating future income creates the economic equivalent of a consumption tax, effectively exempting the return on the investment from tax. Today, however, the American Bemberg court’s kind of analysis misses the mark. Today, “repair” and “permanent improvement” should best be perceived as mere shorthand in trying to determine which outlays will likely create substantial future income and which will not. The focus in American Bemberg on the literal language—as though the terms had independent significance—derails the underlying inquiry, which is the likelihood of future benefits. Perhaps it would even be better simply to drop the “repair” versus “permanent-improvement” shorthand and get right to the real issue, though I realize that that suggestion is too radical for realistic adoption.\textsuperscript{116} At the least, however, courts and administrative guidance should use INDOPCO and the income-tax value underlying it to inform the inquiry regarding where the line should be drawn between an “expense” and a “permanent improvement.”

\textsuperscript{115.} See also Illinois Merchants Trust Co. v. Commissioner, 4 B.T.A. 103 (1926) (similarly allowing current deduction of the substantial cost of replacing pilings under a building after the pilings, which had been submerged in water, developed dry rot. The court reasoned that the replacement did not extend the life of the building beyond what it would have been had the dry rot not occurred).

\textsuperscript{116.} As Professor Johnson put it:

Repairs and other remedial costs are not different from any other costs. They should prove to be capitalized under INDOPCO if they provide significant future benefits. Deductible repairs are those repairs that have expired by year-end or that can be treated as if they had expired without material distortion.

Johnson, After INDOPCO, supra note 90, at 1334-35.
Has *INDOPCO* changed the rhetoric in such cases to better reflect the underlying theory at stake? The report card is mixed. No court or ruling explains in plain English the income-tax value at stake underlying tax capitalization; articles by practitioners are also similarly limited. All nonacademic commentators either fail to discuss the theory underlying tax capitalization at all or implicitly assume that it is a matching rationale. They therefore are not guided by the deep structural theory of capitalization advanced here. Moreover, the rhetoric doggedly carries forward the pre-INDOPCO analysis, tacking on the INDOPCO inquiry only as an add-on at the end. Nevertheless, some cases and rulings have begun to require capitalization in appropriate cases even when the outlay clearly seeks merely to allow continuation of the operation on the same scale as previously, as in *American Bemberg* itself.

As an example from the Commissioner, consider a Technical Advice Memorandum dealing with the deductibility of asbestos removal. Because both the Federal Occupational Safety and Health Administration and the state in which the taxpayer operated imposed new regulations regarding permissible levels of airborne asbestos fibers in the workplace, the taxpayer decided to remove the asbestos lining in its business equipment and replace it with alternative insulation. Alternatively, the taxpayer could have continuously monitored the levels of asbestos during ordinary repairs. The taxpayer rejected the latter option because of its more significant long-term costs, the risk of being found in violation of federal or state law, and the risk of equipment downtime. The replacement insulation was 10 percent less efficient than the asbestos. The cost, while significant, was minor in relation to overall maintenance costs for the facility and in relation to the equipment's assessed value for property tax purposes.

The Commissioner used *INDOPCO* primarily for its statement that deductions are exceptions to the general rule of capitalization. It then went immediately to pre-INDOPCO analysis, weighing the facts to determine whether the asbestos removal

---

117. See, e.g., Peter L. Faber, *INDOPCO: The Still Unsolved Riddle*, 47 TAX LAW. 607, 634 (1994) (arguing against the presumption in favor of capitalization and implicitly failing to understand that immediate deduction of a capital expenditure, by definition, fails to reflect income clearly in the income tax sense since it allows consumption-tax treatment); id. at 635 (explicitly adopting the matching rationale).

constituted an incidental repair or a permanent improvement or betterment. The ruling concluded that the equipment was permanently improved because it became more marketable after the asbestos removal. It rejected the taxpayer's American Bemberg-type argument that the asbestos removal did not increase the value of the property but merely restored it to its original value before the asbestos problem was discovered. The distinction was disingenuous: It noted that the work done in American Bemberg did not cure the underlying geological defect but dealt only with its consequences, while the taxpayer's asbestos removal cured the underlying problem—a distinction which has nothing to do with the connection of the outlay to substantial future income and the underlying tax values at stake. It nevertheless served notice that American Bemberg-type arguments are going to be given short shrift today.

The ruling returned to INDOPCO at the end, after a "finally," unfortunately indicating that it provides only an add-on analysis rather than the embodiment of the capitalization inquiry. The ruling concludes that the asbestos removal created long-term benefits, including safer working conditions, reduced liability risks for owners and investors, and increased marketability. The ruling gave no indication that the future-benefits inquiry is what underlies the repair-permanent improvement dichotomy. That is, it displayed no understanding that the pre-INDOPCO tests essentially try to get at the INDOPCO question via indirect methods. The drafting implied that the INDOPCO analysis was an independent, additional reason for concluding that the outlay had to be capitalized here. All that really needed to be said in this ruling after a clear explanation of the income-tax value and how capitalization protects it is that, under INDOPCO, it is clear that the significant outlays did not pertain to past or current-year income but rather contributed substantially to future income. Thus, capitalization is necessary to prevent the effective sheltering of that future income from tax.

From the courts, consider the post-INDOPCO case of The Swig Investment Co. v. United States.119 The Commissioner challenged the current deduction of $3,023,347 incurred to replace "an entablature, which had been constructed in 1907 and consisted of five foot high unreinforced terra cotta and concrete parapets with overhanging cornices around the entire roof perime-

"ter" of the Fairmont Hotel in San Francisco. The parapets and cornices were not deteriorated or in otherwise poor condition. They were replaced solely because they failed to comply with a city earthquake ordinance that increased the safety standards applicable to such appurtenances. The engineering team hired to rectify the problem replaced the cornices and parapets with replicas made of glass-fiber-reinforced concrete rather than terra cotta. Moreover, they were attached to the hotel using welded connections instead of wire supports.

The court agreed with the Commissioner that the outlay constituted a capital expenditure, even though it merely brought the building into conformity with the city ordinance and allowed it to continue operations on the same basis as before. It cited INDOPCO and concluded that the outlay produced significant benefits that extended beyond the tax year. But its rhetoric was not otherwise helpful. This court, too, failed to appreciate and explain the role of capitalization in an income tax. The court cited the unfortunate language from INDOPCO quoted earlier that bought into the rhetoric of the matching principle. It did not point out that the capitalization of outlays that contribute significantly to the earning of future income ensures that such future income is effectively taxed. In short, it failed to understand, as did the Supreme Court, that matching has nothing to do with it. And it, too, used the INDOPCO inquiry as though it constituted a separate consideration from the repair-permanent improvement analysis. Under the latter analysis, the court concluded that the replacements significantly improved the structural soundness of the hotel and thus increased its value. Rather than being an incidental repair, the court concluded that the work "was a major replacement project." It could simply have said that the income earned with respect to the significant outlay cannot be limited to the current year's receipts or past receipts but rather will contribute to significant earnings far into the future.

And some courts still come to the wrong results. Consider the Seventh Circuit's reversal of the Tax Court in A.E. Staley Manufacturing Co. v. Commissioner. Staley sought to deduct investment banking and advisory fees in connection with its ultimate acquisition by Tate & Lyle PLC. The only difference be-

120. See supra note 101 and accompanying text.
121. 105 T.C. 166 (1995), rev'd, 119 F.3d 482 (7th Cir. 1997).
tween the facts of this case and those in \textit{INDOPCO} was that the Tate & Lyle offer was at first invited, then rejected, and then after much maneuvering finally accepted when there was no alternative and the Board of Directors was obligated under law to recommend acceptance to the shareholders of what was considered by the investment bankers to be a fair offer.\footnote{122. The facts are drawn from 105 T.C. at 168-80.} Tax Court Judge Halpern, writing for the majority, required capitalization of the fees under \textit{INDOPCO}, notwithstanding that the acquisition was at one point resisted—was "hostile," in trade parlance. He wrote, "Neither the investment bankers' fees nor the printing fees related to current income production or needs of the immediate present. Those fees were incurred in connection with a change in ownership with indefinite and extended future consequences."\footnote{123. \textit{Id.} at 197.}

The Seventh Circuit reversed, focusing on the fact that this was a "hostile" attack and not the friendly merger undertaken in \textit{INDOPCO}. Judge Ripple, writing for the court, noted that Tate & Lyle promised to sell the business (which it ultimately did). Judge Ripple saw the hostile offer as an attack on Staley's business; he thus reasoned that the costs of defending that business should be currently deductible as would the costs of defending a lawsuit.\footnote{124. See 119 F.3d at 490.}

\textit{INDOPCO} does not require a court to get into a debate about whether the merger or other capital transaction was a good idea.
It asks whether the corporation's capital structure and future were affected, indulging in the polite fiction that the board did what it thought would benefit the corporation.

The Seventh Circuit in Staley sincerely believed the management argument that the business itself and management's philosophy—for which read the foolish decision to diversify—were under attack. But it does not follow that responding to such a threat should be immediately deductible. If that was the case, then why wouldn't the court understand that the hostile takeover defense costs were, as management claimed, intended to ensure the long-term future of Staley as a conglomerate? If the life of the business and not just the manager's personal comfort is at stake in a hostile takeover defense, why aren't those properly capitalized? The Seventh Circuit believed that the fate of Staley was at stake. Win or lose, the cost of ensuring that ought to be capital.

[Judge Ripple] ignored the fact that, once the professional wrestling was over, the board and management had a duty under Delaware law to get out of the way and get the highest price for the shareholders.125

The critical fact was that the change in ownership structure did occur, and costs allocable to changes in ownership structure should always be capitalized, period.

In short, both the Service and the courts should strive to further widespread understanding of the role of capitalization in an income tax by focusing on the income-tax value in their rulings and cases. Discussion of the role of capitalization in an income tax would lead to better development by practitioners and courts of the appropriate analysis of the cases: whether the outlay contributes significantly to future income, on the one hand, or past or present income, on the other. The line-drawing will not be any easier under this inquiry than it was under pre-IN-DOPCO rhetoric, but it is the correct inquiry to make. Discussions of whether an outlay constitutes a "repair" or "permanent improvement" in the literal, dictionary sense for example, are merely indirect methods of trying to get at the same inquiry. It would be healthier to the future development of the law if that inquiry were done aboveboard, directly, explicitly.

2. Depreciation

Just as capitalization serves a purpose in the income tax that is wholly different from the matching purpose that it serves in financial accounting, the role of depreciation in an income tax also has nothing to do with matching revenues and costs. Its tax role is to allow the deduction of final, passage-of-time losses of income-producing property. And just as with capitalization, failure to understand this tax role can lead to premature deduction of capitalized costs and thus violation of the income-tax value.

With few exceptions, our current income tax system adopts the principle of "realization," under which gains and losses in the value of property owned by taxpayers are not taken into account until the value change is made final by a "realization event," typically disposition of the property other than by gift. But certain gains and losses are not transient, i.e., subject to market forces, but rather are final and thus "realized" in the tax sense even before the property is disposed of. I am referring to gains and losses that arise solely because of the ineluctable passage of time.

On the gain side, for example, consider an original issue discount obligation held by Lender. Lender transfers $10,000 to Borrower in exchange for a debt instrument entitling Lender to collect $12,597 at the end of three years. The instrument requires the payment of no "interest," but Lender knows that the repayment terms are equivalent to repayment of the $10,000 at the end of three years coupled with payment of 8 percent compound interest each year. At the end of each year of ownership, we know with certainty that the value of Lender's debt instrument has increased in value by an amount that is not subject to market forces but rather is due solely to the passage of time. The amount of the permanent, realized increase in value of the instrument at the end of the first year can be obtained by multiplying $10,000 by 8 percent, or $800. The amount of the permanent, realized increase in value at the end of year 2 is $864 ($10,800 multiplied by 8 percent), and the amount for year 3 is

126. See, e.g., I.R.C. §§ 475, 1256 (requiring mark-to-market accounting for certain financial investment products owned by certain taxpayers).

127. It may also decrease in value because of market forces, such as the increasingly precarious solvency of Borrower. But those kinds of value changes may be transient and thus are not taken into account for tax purposes until actually realized, such as when the debt instrument becomes worthless. See I.R.C. §§ 165(g), 166.
$933 ($11,664 multiplied by 8 percent). The original issue discount rules require Lender to include these “final” gains each year as they are realized through the sheer passage of time, even though the property (the debt instrument) has not yet been disposed of or retired.

Depreciation is the flip side of the coin. While fluctuations in the value of business or investment property due to market forces are not generally realized, and thus taken into account for tax purposes, until the property is disposed of, “the concept of a ‘sustained’ loss encompasses events short of disposition. Thus, destruction or abandonment of business or investment property produces a ‘sustained’ loss, as does worthlessness. A ‘sustained’ loss thus means, in a realization-based income tax system, a final or irretrievable loss.” Passage of time losses due to the encroaching end of a finite useful life are final losses and thus appropriately deducted in a realization-based income tax system.

Since financial theory tells us that an asset's value is the sum of the present values of all net future receipts expected to be realized from the asset, there are four possible causes for a loss in an asset's value.

First, the expected aggregate amount (as opposed to the number) of future net receipts may decline from the initial projection. Second, the discount rate may increase so that the present value of the future receipts may turn out to be less than expected. Third, the time at which future receipts are anticipated to occur may turn out to be later than previously estimated. Fourth, the number of future receipts may decrease, because the asset has a finite income-generating capacity.

The first three of these factors are subject to countervailing and transient changes from time to time, and thus losses attribu-

---

128. See Dodge et al., supra note 20, at 663-64 (describing this hypothetical).
129. See I.R.C. §§ 1271-1275.
131. That depreciation was not intended to be considered an “exception” to the realization requirement is buttressed by history. The first income tax statute allowed depreciation deductions, i.e., allowed deductions of the basis of an asset prior to its disposition. See Act of Oct. 3, 1913, 38 Stat. 167. At that time, however, the realization requirement was thought to be constitutionally mandated. See Eisner v. Macomber, 252 U.S. 189 (1920). Deductions attributable to depreciation, in other words, have always been considered—at least implicitly—to be realized losses, and only losses that are “final” are realized.
table to them cannot, at any particular point in time, be considered "sustained." With respect to an asset with a finite useful life, however, the number of future receipts (the fourth factor above) must decrease with the passage of time: As the remaining income-producing life gets shorter, the number of remaining receipts must inevitably decline. Since value loss produced by this phenomenon is permanent, the loss is appropriately considered to be "sustained." . . .

In sum, depreciation, under a tax system with a realization principle, is the method by which "sustained" losses due solely to the passage of time (factor four above) are reckoned. Thus, depreciation is necessarily a function of useful life, and the other factors that affect value are not decisive, including fair market value itself. 132

Consider, for example, 133 Investor's purchase of a machine for $300,000 that will produce income for three years and then be valueless. Because Investor has merely changed the form of her wealth, i.e., she has made a capital expenditure, she is not allowed to deduct the $300,000 outlay at the time of purchase, in order to protect the income-tax value. That is, immediate deduction of the $300,000 would effectively exempt the returns nominally included in the tax base in the future from tax, as under a consumption tax. 134 Assume that the machine will generate three level payments that will yield a recovery of Investor's $300,000 outlay plus a return equal to the current discount rate of 10 percent. Under these assumptions, Investor will earn a gross yield of $120,634 in each of the three years.

Gross Annual Return on $300,000
3-Year Investment at 10% Discount Rate

<table>
<thead>
<tr>
<th>Year</th>
<th>Gross Receipts</th>
<th>Present Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$120,634</td>
<td>$109,668</td>
</tr>
<tr>
<td>2</td>
<td>120,634</td>
<td>99,698</td>
</tr>
<tr>
<td>3</td>
<td>120,634</td>
<td>90,634</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$300,000</td>
</tr>
</tbody>
</table>

132. Dodge & Geier, supra note 130, at 623.
133. The example is taken from id. at 624.
134. See supra notes 81-125 and accompanying text.
Investor should be allowed to reduce the gross receipts by the $300,000 capital expenditure incurred to produce them, but how should the cost recovery be scheduled? If we consider cost recovery under the accountant's "matching principle," where the matching of revenues and costs is the paramount value, perhaps the cost should be deducted in accordance with the expected scheduling of receipts. Since Investor expects to earn three level payments of $120,634, perhaps the cost should be matched against those receipts in equal amounts of $100,000 each year in order to measure income "accurately," according to financial accounting tenets of accurate income measurement.\textsuperscript{135}

Such a scheduling for tax purposes, however, would violate the realization principle, as it overstates the sustained losses in years 1 and 2 and understates the sustained loss in year 3. "Correct" realization depreciation in year 1 would be $90,634, which is the excess of the $300,000 (the value at the beginning) less the sum of $109,668 and $99,698 (or $209,366). That sum comprises the present values at the end of year 1, using the original discount rate, of the two remaining receipts. The $90,634 difference between these two numbers represents the irretrievable loss in value of the machine due solely to the fact that the machine is one year nearer to the end of its income-producing life. The "correct" depreciation deductions for years 2 and 3 would be $99,698 and $109,668, respectively, when the same principles are applied to those years.\textsuperscript{136} Thus, $100,000 deductions in each of the three years overstates the sustained loss realized in years 1 and 2. And recall the significance of allowing premature deduction of a portion of a capital expenditure: It is tantamount to exempting the return from that portion from tax, as though the return were being treated under a consumption-

\textsuperscript{135} This is a simple example of a unit-of-production or income forecast method, which also happens to replicate the results in this simple hypothetical of straight line depreciation, or even proration over the recovery period. "[U]nder the unit of production method or income forecast methods, the remaining basis of the asset is multiplied by a fraction, the numerator of which is units of use (or dollars of income received, as the case may be) and the denominator of which is total remaining expected units of use (or dollars of income)." Dodge & Geier, supra note 130, at 624 n.41. Actually, "[f]inancial accounting traditionally [has] allowed the business to elect among several methods of computing depreciation, so long as the methods were rational and were followed consistently." Id. at 624 n.42.

\textsuperscript{136} This method of determining depreciation is commonly called "sinking-fund" depreciation or "Samuelson" depreciation. See generally Paul A. Samuelson, Tax Deductibility of Economic Depreciation to Insure Invariant Valuations, 72 J. Pol. Econ. 604 (1964).
tax regime instead of an income-tax regime. Therefore, while the $100,000 deductions in each of the three years might measure income “accurately” in the financial accounting world, where the matching principle reigns supreme, such a scheduling of deductions would violate the income-tax value and thus would fail to reflect income “clearly” in the tax sense. This illustrates once again that the matching principle has no role as a tax value and sometimes is actually antithetical to tax values.

Appreciation of this nuanced difference between the role that depreciation plays in the different worlds of financial accounting and the income tax can once again be gained by considering what would happen if Congress replaced the current Internal Revenue Code with a pure, cash flow consumption tax. Because capitalization would be a thing of the past for tax pur-

137. See supra notes 81-125 and accompanying text; authorities cited in supra note 89.

138. Some commentators continue to be insufficiently sensitive to the role of tax depreciation and adopt the matching principle as a tax value. For example, the hypothetical in the text demonstrates how the income forecast method can violate tax values by matching depreciation deductions with the fluctuating income earned by the asset. Such depreciation methods “are flawed under the realization principle, because they implicitly take into account temporary fluctuations of income.” Dodge & Geier, supra note 130, at 624 n.41. Yet, Professor Mary LaFrance wrote:

In principle, the income forecast method offers a reasonable means of determining the rate at which a taxpayer’s investment in a motion picture or similar asset is exhausted because it bases annual depreciation on the productivity of the asset during the year in question. This method, therefore, matches income and expense in a way that produces a “clear reflection of income” as required by the Code.

Mary LaFrance, Trouble in Transamerica: Deferred Compensation, Contingent Debt, and Overstated Basis, 15 VA. TAX REV. 685, 691 (1996). See also id. at 715 (explicitly adopting a matching rationale for tax depreciation with no citations to authorities recognizing that only Samuelson depreciation is consistent with the income-tax value by preventing premature deduction of capital expenditures, regardless of fluctuating income). Under the tax values discussed here, however, Professor LaFrance was nevertheless correct in the larger point of her article. She argued that deferred compensation and other future liabilities should not be included in the basis of films depreciated under the income forecast method. Inclusion of such future expenses in the basis of depreciable films would result in premature deduction of these costs.

As with other deviations from tax values discussed in this Article, Congress has chosen to deviate from the income-tax value in the context of depreciation by allowing accelerated depreciation, including the income forecast method in some cases, over artificially short useful lives, which allows the capital expenditure to be depreciated much faster than Samuelson depreciation would dictate. See I.R.C. § 168(b), (c), and (e) (prescribing depreciation schedules and recovery periods, none of which require sinking-fund depreciation over actual useful lives). The stated reasoning in the legislative history for these decisions was to provide an investment stimulus for economic expansion. See infra notes 151-162 and accompanying text.
poses, there would be no need for tax depreciation; all such costs would be immediately expensed. Yet, financial accountants would continue to capitalize costs and then allow depreciation to match future income. Capitalization and depreciation simply serve very different purposes in the two worlds. In the tax world, we saw that capitalization protects the tax on income from investments and depreciation allows deduction of final, sustained losses. Premature depreciation of capitalized costs violates the income-tax value and thus must be avoided in the absence of specific Congressional authorization. In the financial accounting world, on the other hand, both capitalization and depreciation serve simply to match costs with related income for informational purposes.

There is a wonderful example in this context that shows how accountants and tax theorists approach this issue very differently. Because the financial accounting approach and tax theory approach both point to the same result in the example, it also implicitly illustrates how easy it can be for some judges and practitioners to blithely assume that financial accounting values and tax values—in particular the matching principle—are coterminous.

In Hewlett Packard Co. v. United States,\(^{139}\) the taxpayer's predecessor sought to depreciate a pool of rotable spare parts that it kept on hand from year to year and used as necessary to repair computers it had previously sold to customers. The pool was created with original computer parts from its manufacturing business. When a replacement part was needed in the course of a repair, the taxpayer would substitute the malfunctioning part with one from the pool, repair the old part, and return it to the pool. Thus, the pool was maintained from year to year at a constant level. The Service argued that the parts in the pool were part of the taxpayer's inventory and thus could not be depreciated. While the lower court agreed with the Service, the Federal Circuit reversed and allowed the taxpayer to depreciate the spare parts.

Whether or not the taxpayer was required to inventory the spare parts depended “on whether the exchange of rotable spare parts for the original parts in [the] customers' computers constituted the 'sale of merchandise' as an 'income-producing fac-

\(^{139}\) 71 F.3d 398 (Fed. Cir. 1995), rev'g Apollo Computer, Inc. v. United States, 32 Cl. Ct. 334 (1994). The facts are drawn from 71 F.3d at 398-99.
tor.’” The Federal Circuit concluded:

The undisputed facts show that [the taxpayer’s] maintenance business was a service business in which it maintained the pool of rotatable spare parts in order to provide better service to its customers. In any realistic sense [the taxpayer’s] substitution of a rotatable spare part for a malfunctioning original part in a customer’s computer was not a sale of that part to the customer. Accordingly, in the language of the regulation, the “sale of merchandise” was not an “income-producing factor” in the conduct of [the taxpayer’s] repair business.

The court, in other words, approached the language of the controlling regulation in a literal manner, seeking illumination in the scope of the regulation from neither the “matching principle” from financial accounting nor the role and purpose of inventory accounting in the protection of tax values.

Both Professor Dennis J. Gaffney, an accounting professor who served as an expert witness for the federal government in the case, and Professor Calvin H. Johnson, a law professor, who was considered but not used as a government expert in the case, have written scathing commentaries on the court’s result and reasoning. But though both agree that the rotatable spare parts should have been considered inventory and thus should not have been depreciable, they argue for their positions on very different grounds, reflecting their very different perspectives as accounting theorist and tax theorist.

Professor Gaffney wrote that “much of the error results from a failure of some courts to understand basic financial accounting concepts such as ‘expired’ costs, ‘unexpired’ costs, and ‘matching.’” He went on to explain in some detail how the matching principle required treatment of the rotatable spare parts as inventory that is not depreciable under financial accounting principles:

140. 71 F.3d at 400 (quoting Treas. Reg. § 1.471-1).
141. Id.
142. Calvin H. Johnson, Federal Circuit Plays Dirty Pool With Inventory Accounting, 70 Tax Notes 111 (Jan. 1, 1996) [hereinafter Johnson, Dirty Pool]; Gaffney, supra note 35. The fact that the government chose to use the accounting professor as an expert witness instead of the tax professor provides implicit confirmation that many courts fail to understand fully that financial accounting values and tax accounting values can diverge.
143. Gaffney, supra note 35, at 1009.
The matching concept associates the consumption of an asset's service potential (i.e., the diminution of an asset's ability to generate future economic benefits) with a period. Depending on the circumstances, the "match" of cost consumption to a period is made through: 1. a revenue, 2. an event, or 3. an allocation.

If there is a direct cause-and-effect relationship between a revenue and the consumption of the service potential represented by a cost, expense is recognized in the same period that the revenue is recognized. An obvious example of this direct "match" is the normal sale of merchandise transaction; the cost of a good sold is recognized in the same period as the revenue from the sale of that good.

There are two mutually exclusive approaches to recognizing as expense the consumption of costs not directly associated with particular revenues. I refer to the first as a "matching-based-on-events" and to the second as a "matching-based-on-allocation." Note that depreciation (fixed asset) accounting reflects the last approach, a matching-based-on-allocation approach, to expense recognition. Unless the difference in results is trivial in all periods affected, it is inappropriate to match costs to periods on the basis of allocation when those costs could be matched to periods on the basis of events. Allocations, by their very nature, involve an element of arbitrariness. Allocations are made when there is no better way to do what needs to be done. Accounting strives to determine periodic income as accurately as available methodologies permit and, therefore, accounting employs allocations only when no better methodology is available.

What accounting methodology produces the best "match" of costs to periods in these rotatable spare parts cases, an inventory approach or a fixed asset (depreciation) approach? The best "match" results from the inventory methodology, since the loss in utility of the rotatable spare parts pool results from an identifiable event, the installation of a functioning part in the customer's computer, and the increases and decreases in the utility of the pool can be both identified ("tracked") and measured. There is no need for cost allocation.144

---

144. Id. at 1011-12 (emphasis in original). Professor Gaffney goes on to describe how the court's allowance of depreciation of the rotatable spare parts pool provides a roadmap to manufacturers providing warranty, maintenance, or repair work on their products for circumventing Thor Power Tool:

The approach would be simple. Create a pool of rotatable spare parts, segregate the pool from the inventory used in the manufacturing activity, treat the pool as a depreciable fixed asset, transfer inventory including that which might otherwise be regarded as "excess" inventory into the pool, and then use the parts in the de-
Thus, Professor Gaffney's appraisal was made through the prism of financial accounting and the matching principle that is at its heart. Inventory accounting in general, in which the cost of the good sold is deducted against the revenue earned on the sale in the same period, is justified in the financial accounting world because it provides a match of the related costs and revenues in the same period. The costs of the spare parts, though not associated with any particular revenue stream, should not be allocated (depreciated) across periods under financial accounting principles because the expiration of the costs can be linked to an identifiable event, which requires accounting for the cost in the period of the event.

This analysis is quite different from the tax analysis proffered by Professor Johnson. Inventory accounting in tax is not premised on the matching of costs and revenues for the sake of matching. It is true that inventory accounting delays deduction of the costs of the goods sold until revenue is earned on the sale and thus "matches" the costs and revenues in the same period. But this is descriptive only and does not explain the tax value at stake in inventory accounting. The tax value protected by the delay of the deduction of costs of goods on hand for sale in future years is the income-tax value. Such costs for goods on hand are capital expenditures. The taxpayer's wealth has changed form upon the purchase or manufacture of inventory but there has been no decrease in wealth. Hence, premature deduction of the capital expenditures representing the cost of goods on hand for sale would effectively exempt the future sales revenues from tax, violating the income-tax value. The same analysis explains why the rotatable spare parts maintained from year to year should not be depreciable.

Deducting or deprecating inventory costs that are still on hand and still valuable is a violation of the fundamental norms of an income tax. Under an income tax, costs that remain part of wealth cannot be deducted, even when the costs are profit-related. Investments, in an income tax, are made and continued with cash that has not been deducted. Costs that remain part of

preciable fixed asset pool to provide warranty, maintenance, and time-and-materials repairs. The excess inventory could effectively be written down (and, ultimately, written off) through depreciation deductions; this avoids the need to offer the excess inventory to potential customers at a reduced price.

Gaffney, supra note 35, at 1012.
the taxpayer's wealth and investment must not be deducted, but must remain part of basis.

The ability to deduct unexpired costs that remain part of wealth and investment is an extraordinary privilege within an income tax. Deducting unexpired costs is like exempting subsequent income generated by the costs from tax: The ability to make an investment with deducted or untaxed "soft money" can ordinarily be expected to be as valuable as not having to pay tax on the subsequent income. The effective tax rate on the income generated by the investment is zero.\textsuperscript{146}

In other words, capitalization and the protection of the income-tax value informs the role of inventory accounting in tax, and that is what is sought to be captured by the test fashioned in the controlling regulation, regarding whether "the sale of merchandise" is an "income-producing factor."\textsuperscript{146} The Hewlett-Packard court demonstrated no understanding at all of this tax value and how its decision undermined it. The court did not turn to the structural underpinnings of an income tax, including the role of capitalization and the income-tax value it protects, in order to help give it guidance regarding what the words of Treasury Regulation § 1.471-1 meant.\textsuperscript{147}

While both Professor Gaffney's "matching-principle" approach from financial accounting and Professor Johnson's "income-tax value" approach from tax accounting would have reached the same result if applied correctly by the Hewlett-Packard court, it is dangerous for courts to assume that they would reach similar results in all cases and that, therefore, the matching principle is itself a tax value as well. There are many costs that are permissibly depreciated or amortized under the matching principle for financial accounting purposes that cannot

\textsuperscript{145} Johnson, Dirty Pool, supra note 142, at 112.

\textsuperscript{146} Treas. Reg. § 1.471-1.

\textsuperscript{147} The Hewlett-Packard court is not alone in this habit. See infra notes 427-451 and accompanying text. As discussed there, the Service has attempted to force cash basis taxpayers to use the accrual method of accounting (required of all taxpayers who are also required to use inventory accounting) by arguing that they sold "merchandise" in the course of providing services to taxpayers and that the sale of such merchandise was an "income-producing factor," even though the taxpayers kept no inventory from year to year. There, too, the courts parsed this language in a literal fashion with no guidance from the underlying structure of an income tax and the role of inventory accounting within it and required taxpayers who had no inventory from year to year but rather who purchased merchandise on an as-needed basis for each job to switch to the accrual method of accounting under the "inventory" shoehorn.
be similarly depreciated or amortized for tax purposes without violating the income-tax value.

For example, consider the cost of goodwill when one business purchases another.\textsuperscript{148} In the absence of "pooling-of-interest" accounting, where the creation of goodwill is avoided, "purchase" accounting in the financial accounting world provides that such goodwill can (indeed must) be amortized over a number of years after the business combination.\textsuperscript{149} For tax purposes, however, goodwill is not considered to have an ascertainable useful life and thus is not generally depreciable.\textsuperscript{150} The critical importance of the "useful-life" requirement is appreciated only when one understands the tax role of depreciation. Without an ascertainable useful life, no sustained losses arise with the passage of time. Depreciation deductions for a capital expenditure that has no ascertainable useful life would effectively exempt the future income of that investment from tax, violating the income-tax value. These concerns are inapposite in financial accounting, where the matching of revenues and costs requires amortization of acquired goodwill, even though the goodwill may have a long and indeterminate useful life.

The cases of \textit{Simon v. Commissioner}\textsuperscript{151} and \textit{Liddle v. Commissioner}\textsuperscript{152} are examples of recent decisions where the matching rhetoric and the absence of an understanding of the role of tax depreciation contributed to the wrong results and created dangerous reasoning for future cases. The Tax Court and Second

\begin{itemize}
  \item \textsuperscript{148} By "goodwill" I generally mean the excess of the purchase price over the value of the identifiable tangible and intangible assets constituting the purchased business. The excess value represents such things as going-concern value and the expectation of continued patronage by old customers of the acquired business.
  \item \textsuperscript{149} \textit{See infra} note 211 and accompanying text.
  \item \textsuperscript{150} "An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. . . . No deduction for depreciation is allowable with respect to good will." Treas. Reg. § 1.167(a)-3. Inability to deduct the costs of acquired goodwill until sale or termination of the acquired business enterprise prompted much litigation by taxpayers attempting to show that a component of purchased goodwill could be segregated and proven to have an ascertainable useful life—and thus the costs for its purchase could be amortized. \textit{See, e.g.}, \textit{Newark Morning Ledger Co. v. United States}, 507 U.S. 546 (1993). Congress became concerned with the administrative costs of the case-by-case litigation associated with these fact-bound cases and the unfairness inherent in a process that was effectively open only to taxpayers with the financial resources to litigate. It thus enacted section 197 in 1993, which generally allows 15-year amortization for the costs of purchased goodwill acquired as part of a going concern. Section 197 is properly understood as primarily reflecting the tax value of administrability.
  \item \textsuperscript{152} 103 T.C. 285 (1994), \textit{aff'd}, 65 F.3d 329 (3d Cir. 1995).
\end{itemize}
Circuit held in *Simon*\(^{153}\) that professional musicians could deprecate their 19th century violin bows made by the premier bow-maker, François Xavier Tourte. The Tax Court and the Third Circuit held in *Liddle*\(^{154}\) that a professional musician could depreciate his 17th century bass viola built by Francesco Ruggeri. In both cases, these instruments had substantial value in the collector market when their playing lives were finished and thus had no ascertainable useful life. Yet, because the instruments demonstrated some physical wear and tear with use (which did not diminish their worth in the collector market), the courts held that the instruments were eligible for depreciation under section 167, which allows a depreciation deduction “for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)” of business and investment property. While that language had always been interpreted to mean that only wasting assets could be depreciated, and while that language had not been amended since it was enacted in 1954, the Tax Court, Second Circuit, and Third Circuit each concluded that the unamended language took on a new meaning—one that negated the requirement that an asset have an ascertainable useful life in order to be depreciable—when in 1981 Congress created artificial recovery periods that no longer corresponded to actual useful lives.

In other words, the courts took a new and literal approach to the “wear and tear” language, demonstrating no understanding of the role that depreciation plays in an income tax and showing no appreciation of the underlying income-tax value that is violated when capital expenditures are allowed to be deducted prematurely without clear Congressional permission, effectively exempting the future returns from tax.\(^{155}\) In so doing, they minimized the all important useful-life requirement for tax depreciation. While Congress has allowed depreciation deductions to be taken over artificially short useful lives using methods that frontload the deductions in the early years (in order, according to the legislative history, to encourage investment in depreciable

---

\(^{153}\) The facts are drawn from 103 T.C. at 248-52.

\(^{154}\) The facts are drawn from *id.* at 286-88.

\(^{155}\) As always, Congress can deviate from fundamental structural principles, but courts should be loath to deviate from them in the absence of clear language requiring it. The language at issue in the case did not. For an exhaustive examination of the weaknesses of the courts' decision, see Dodge & Geier, *supra* note 130.
property), it did not amend the threshold requirement that only wasting assets can be depreciated. Indeed, the very legislative history that these courts relied upon in reaching their decisions that Congress intended to eliminate the requirement that only assets with ascertainable useful lives are eligible for depreciation, i.e., intended implicitly to change the meaning of the unamended "wear and tear" language, also explicitly confirmed prior law that only wasting assets were depreciable.

When the majority and concurring opinions did advert to the theory underlying the allowance of a depreciation deduction, they used language evidencing a belief that depreciation serves the same function in the tax world as it does in the financial accounting world, where assets with indeterminate useful lives can permissibly be depreciated under the matching principle. In Simon, for example, Tax Court Judge Laro wrote for the majority that "[t]he primary purpose of allocating depreciation to more than one year is to provide a more meaningful matching of the cost of an income-producing asset with the income resulting therefrom; this meaningful match, in turn, bolsters the accounting integrity for tax purposes of the taxpayer's periodic income statements." He also wrote:

Allowing petitioners to depreciate the Tourte bows comports with the text of [the statute], and enables them to match their costs for the Tourte bows with the income generated therefrom. Refusing to allow petitioners to deduct depreciation on the Tourte bows, on the other hand, would contradict [the statute] and vitiate the accounting principle that allows taxpayers to write off income-producing assets against the income produced by those assets.

Writing for the Second Circuit majority in Simon, Judge Winter wrote that "[t]he original rationale for the depreciation deduction was to allow taxpayers to match accurately, for tax accounting purposes, the cost of an asset to the income stream that the asset produced." In Liddle, Tax Court Judge Laro included the

156. See Simon, 103 T.C. at 254-58.
157. See id. at 270-71 (Hamblen, C.J., dissenting).
158. See supra notes 148-150 and accompanying text (discussing the differing treatment of goodwill under financial and tax accounting).
159. 103 T.C. at 253 (Laro, J.).
160. Id. at 261.
161. 68 F.3d at 44.
same sentences, *verbatim*, quoted above. In each case, these judges cited prior decisions that themselves misinterpreted the role of depreciation in an income tax. In this way, ill-informed theory is carried forward to infect the law indefinitely.

B. ACCRUAL ACCOUNTING—DEDUCTIONS

1. The *Anderson* Case

The first income tax statute, enacted in 1913, provided that "net income" should be computed by including gross income received and deducting expenses paid, losses sustained, and interest and taxes paid. In other words, the statute required use of the cash receipts and disbursements method of accounting currently mentioned in section 446(c)(1). While this general rule was retained in section 12(a) of the 1916 statute, Congress added an important exception in section 13(d):

A corporation . . . keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect its income, may, subject to regulations by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, make its return upon the basis upon which its accounts are kept, in which case the tax shall be computed upon its income as returned . . . .

It was this provision that first allowed use of the accrual method of accounting for tax purposes now found in section 446(c)(2). One introductory accounting textbook explains accrual accounting for financial accounting purposes (as opposed to tax purposes) in the rhetoric of the matching principle.

Accrual accounting "attempts to record the financial effects on an enterprise of transactions and other events and circumstances . . . in the periods in which those transactions, events, and circumstances occur rather than only in the periods in which cash is received or paid by the enterprise." In other words, *accrual accounting consists of all the techniques developed by accountants to*

162. See 103 T.C. at 289, 294-95.
apply the matching rule.\textsuperscript{165}

That is, accrual accounting, for financial accountants, \textit{is} the matching principle personified. It makes no sense to financial accountants to label any method of accounting deviating from the matching principle as an "accrual" method.

The taxpayer in \textit{United States v. Anderson},\textsuperscript{166} the Yale & Towne Manufacturing Company, used the accrual method of accounting in keeping its books and filed its income tax return for 1916 and 1917—the tax years at issue—using this method. Yale & Towne, which was engaged in the manufacture of munitions, was required to pay a federal munitions tax on its 1916 profits. On its books, Yale & Towne created an account entitled "reserves for taxes," listing various kinds of taxes for which it became liable by reason of its 1916 operations, including the munitions tax at issue. Although these reserves were deducted on its books in 1916, Yale & Towne did not deduct the munitions tax for income tax purposes until 1917, the year in which the tax was actually assessed and paid.

The Commissioner argued that since Yale & Towne accrued the tax on its books in 1916 under the accrual method of accounting, it must also deduct the taxes for federal income tax purposes in 1916, not 1917, thus substantially increasing the taxpayer's 1917 tax bill.\textsuperscript{167} This view was supported by Treasury Decision 2433, issued in January 1917 but prior to Yale & Towne's preparation of its 1916 tax return. It provided that taxpayers using the accrual method of accounting could accrue liabilities, including reserves for liabilities the "amount of which or date of maturity"\textsuperscript{168} were not definitely determinable. The decision included procedures for adjusting the reserves when the liabilities became definite and also provided that if "'accrual or reserves' did not reflect true net income, the taxpayer would not

\begin{thebibliography}{99}
\bibitem{166} 269 U.S. 422 (1926).
\bibitem{167} 269 U.S. at 435-36. The increased income tax rates in 1917 accompanying WWI explains the Commissioner's desire to flout conventional wisdom and argue that the deduction should have been taken earlier rather than later.
\bibitem{168} \textit{Id.} at 438.
\end{thebibliography}
be permitted to make its return on any other basis than that of 'actual receipts and disbursements.'”

The Court agreed with the Commissioner that Yale & Towne must deduct the tax in 1916.

The Court first rejected the taxpayer's argument that section 12(a), providing the “general” rule that taxes are deductible when paid, trumps the “exception” in section 13(d) on which the Commissioner relied in requiring 1916 accrual of the taxes. In so doing, the Court traced the enactments of sections 12(a) and 13(d). It described how businesses “found [it] impracticable to comply strictly” with the cash method of accounting. Treasury regulations predating section 13(d) thus authorized the use of inventories and allowed the deduction of accrued but unpaid liabilities—except for taxes paid. It was this early regulatory exception for taxes that Yale & Towne relied upon in arguing that, when Congress essentially codified these regulations by enacting section 13(d), it carved out taxes. The Court, however, concluded that the purpose underlying the enactment of section 13(d) was clear and to the contrary.

It was to enable taxpayers to keep their books and make their returns according to scientific accounting principles, by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period; and indeed, to require the tax return to be made on that basis, if the taxpayer failed or was unable to make the return on a strict receipts and disbursements basis.

The Anderson Court also rejected the taxpayer's alternative argument that the munitions tax did not accrue until 1917 because a tax cannot be considered accrued until it is due and payable. In rejecting this argument the Court enunciated lan-

169. Id.
170. Id. at 437-40.
171. Id. at 439.
172. As the Court rephrased the argument:
From this it is argued that Congress, by reenacting in § 12(a) of the Act of 1916 the corresponding provisions of the earlier acts, adopted the settled administrative practice, and that accordingly under that act, as well as under the earlier acts and Treasury regulations, taxes could be deducted only in the year when paid. Id. at 439.
173. Id. at 440.
174. Id. at 440-42.
guage that was later seized upon as the accrual test in tax accounting: the all events test.

In a technical legal sense it may be argued that a tax does not accrue until it has been assessed and becomes due; but it is also true that in advance of the assessment of a tax, all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it. In this respect, for purposes of accounting and of ascertaining true income for a given accounting period, the munitions tax here in question did not stand on any different footing than other accrued expenses appearing on appellee’s books. In the economic and bookkeeping sense with which the statute and Treasury decision were concerned, the taxes had accrued.\textsuperscript{175}

While it seems clear that the Court was merely attempting to capture the standard for accrual of an expense from within the financial accounting perspective that it was importing, the so-called all events test has taken on a life of its own in the tax arena.\textsuperscript{176} Later cases adopted it as the talisman for tax accrual, and Treasury regulations now use it as the standard for determining not only when expenses must be deducted but also when income must be included under the accrual method.\textsuperscript{177} That evolution was not inevitable. The Court was merely trying to articulate the essence of what financial accountants were trying to capture in the accrual idea—the matching principle. The language was descriptive only. The Court could just as easily have said that if an item is accrued for financial accounting purposes, then it must be accrued for tax purposes, avoiding the all events language entirely. But, as will be seen, the elevation of this language to an exalted talisman was, with hindsight, fortunate, for it provided a means by which accrual accounting in tax could evolve in a manner that accorded with the tax values that are ignored in financial accounting.

Several points are clear from this discussion. It is clear that the Court believed that Congress intended to import “scientific accounting principles” into income tax accounting, that the Court believed that such principles embodied the matching rule,

\textsuperscript{175} Id. at 441.

\textsuperscript{176} Cf. Raby & Raby, Consistency, supra note 31 (deriding the “legalistic all-events test”).

\textsuperscript{177} See Treas. Reg. § 1.446-1(c)(1)(ii). Cf. I.R.C. § 461(h) (the only place in the Code mentioning the all events test).
and that the matching rule required deduction of the munitions tax in 1916. It is equally clear, however, that the Court did not attribute any tax value other than administrative ease to this migration of financial accounting into tax accounting. The "impracticability" of the cash method for many businesses drove the enactment of section 13(d)—nothing more. Administrability is an important tax value, but, as will be shown, larger tax values may come to outweigh it in particular contexts.

2. Financial Accounting as "Science"?

The Anderson Court's characterization of accounting "principles" as "scientific" implies both a uniformity and an underlying theoretical base that was not accurate in the field of accounting when the Court issued its decision in 1926. While the roots of financial accounting practice are ancient, "most organized efforts at developing accounting theory have occurred since 1930." There was no national organization of accountants until 1905 when the American Association of Public Accountants was formed, renamed in 1917 the American Institute of Accountants and eventually becoming the American Institute of Certified Public Accountants (the AICPA). In 1916 the American Association of University Instructors in Accounting was organized, renamed in 1935 the American Accounting Association (the Association). These two organizations became the instruments for the development of accounting thought.

In many ways, they operated independently of one another, with different priorities and approaches to accounting thought. The Association took a "top-down" approach, attempting to define broad standards from a conceptual point of view and distill applications from them. The AICPA adopted a "bottom-up" style,

178. In the same year that Anderson was decided, William Z. Ripley, a professor of economics at Harvard, published a scathing article in the Atlantic Monthly on the inadequacies of corporate financial reporting. See James Don Edwards & Homer A. Black, The Modern Accountant's Handbook 7 (1976). See also William Z. Ripley, Main Street and Wall Street ch. 7 (1927).

179. A "surprisingly elaborate accounting system" had been used in Greece since the fifth century B.C. See McCullers & Schroeder, supra note 26, at 1.

180. Id.


182. Id. at 4, 33-38.

approaching issues in a piecemeal and more practical fashion,\textsuperscript{184} eschewing until 1958 any notion of “principles” that went beyond “a distillation of experience.”\textsuperscript{185}

Because the [AICPA] made principles equivalent to conventions and procedures, it ruled out the possibility of making a complete and comprehensive codification. The Association, on the other hand, attempted from the outset to formulate a complete and comprehensive set of standards by which to evaluate rules and procedures. Accordingly, it used a conceptual approach and was led to a consideration of some underlying assumptions of accounting practice. This method also inevitably led to some propositions which were in conflict with principles distilled from practice, that is, to standards which were not accepted by practicing accountants.

It is not surprising, then, that the [AICPA] . . . had more impact on the practice of accounting than did the pronouncements of the Association.\textsuperscript{186}

A brief review of the history of how accounting thought was developed by these two organizations may be helpful in putting the “science” of accounting into context.

In 1924 the Association formed a committee to draw up a revised constitution in order to add research as a function of the Association. Two years before Anderson was decided, “accounting practice was characterized, according to the committee, by ‘absurdities and inconsistencies,’ for ‘much of the theory is made up of carelessly considered ideas . . . and is loose, uncodified, and difficult to apply with any degree of uniformity.’”\textsuperscript{187} The committee dismissed the notion that practitioners would spearhead improvements in practice and theory. “Practitioners have little time and less inclination to undertake adequate consideration of theory. They are not interested, as a rule, in testing its application from a scientific point of view. With rare exceptions, their writings are not scholarly and indicate hasty consideration

\textsuperscript{184} See id. at 40-58.
\textsuperscript{185} Id. at 47.
\textsuperscript{186} Id. at 47-48; KELLER & ZEFF, supra note 62, at 3 (noting that while the Association “joined the attempt to crystallize thinking on ‘generally accepted accounting principles,’ yet it was the [AICPA’s] efforts that attracted the greatest attention and respect”).
\textsuperscript{187} STOREY, supra note 68, at 29 (quoting Report of the Committee on Revision of the Constitution and By-laws, Papers and Proceedings of the Ninth Annual Meeting (Feb. 1925)).
and treatment of subjects presented." Nothing was accomplished, however, in the way of research in the next four years. Writing in 1928—two years after Anderson—one member impatient with this lack of progress wrote:

Students and writers debated alternatives, without any sense of obligation to make a choice, reach a conclusion, establish a standard, or propound a rule. Discussions and published papers were rambling, diverse, and indeterminate; they showed erudition and deliberation, coupled with indecision and irresponsibility. Teachers for the most part viewed and reported on existing practice, [but] made little attempt to guide it.

To many of us this seemed like an ignoble role for presumptive leaders in academic work. . . . I voiced the conviction that teachers should be leaders, not followers, and should concentrate on what ought to be done, not merely on what was being done.

The stock market crash of 1929 and the Great Depression that followed brought dissatisfaction with accounting practices to a head, leading to the enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934. The latter act vested in the Securities and Exchange Commission (SEC) the authority to regulate accounting practices at publicly held companies. While the SEC has chosen to focus primarily on disclosure matters, leaving the profession to develop accounting practices, it has retained an oversight role.

Even before 1933, however, the air of impending regulation was strong enough to cause the AICPA to begin a collaboration with the New York Stock Exchange in 1932, leading to publication in 1934 of Audits of Corporate Accounts. The AICPA Committee was chaired by George O. May, and the work of the Committee was chiefly his product.

188. Id.
189. Id. at 29-30 (quoting Howard C. Greer, Benchmarks and Beacons, 31 The Accounting Rev. 3-4 (1955)).
190. Edwards & Black, supra note 178, at 7-8.
191. Id. at 8.
192. Keller & Zeff, supra note 62, at 2-3. "[W]hile the SEC has the authority to decide arbitrarily what constitutes 'generally accepted accounting principles,' this authority has usually been exercised in the form of persuasion rather than edict." McCullers & Schroeder, supra note 26, at 11.
This proved to be a seminal document. Not only did it set forth principles to be followed in financial reporting but it also led to the first standard form of auditor's report and to a requirement that the financial statements of companies applying for listing with the Exchange be independently audited.\textsuperscript{195}

The new form of certificate created with this agreement was important for two reasons. It shifted emphasis from the balance sheet to the income statement. It also required the accountant to sign a statement that the documents “fairly represent, in accordance with accepted principles of accounting consistently maintained by the Company during the year under review,” the Company’s operating results for the year.\textsuperscript{196} This phrase was soon changed to the “generally accepted accounting principles” with which we are familiar. But no attempt was made to define what these “principles” were beyond the five broad statements included in the report.\textsuperscript{197} Indeed, “[t]he Securities and Exchange Commission, through its chief accountant, seriously questioned the significance of the term ‘generally accepted accounting principles.’ ”\textsuperscript{198} Writing in 1939—thirteen years after Anderson—Stephen Gilman said, “[A]ccountants are in the unenviable position of having committed themselves in their certificates as to the existence of generally accepted accounting principles while between themselves they are quarreling as to whether there are any accounting principles and if there are how many of them should be recognized and accepted.”\textsuperscript{199}

Meanwhile, the Association, through its Executive Committee, published in 1936 a list of twenty principles of accounting affecting corporate reports in the Association's Journal, \textit{The Accounting Review}.\textsuperscript{200} The four and one-half page paper was cautiously entitled, “A Tentative Statement of Accounting Principles Underlying Corporate Financial Statements.”\textsuperscript{201} Some of the enunciated “principles” departed from current practices.\textsuperscript{202} Few practicing accountants subscribed to the \textit{Review}, and the docu-

\textsuperscript{195} \textit{Id.}
\textsuperscript{196} \textit{Gilman, supra note 37, at 170.}
\textsuperscript{197} \textit{Id. at 170-71.}
\textsuperscript{198} \textit{Id. at 171.}
\textsuperscript{199} \textit{Id.}
\textsuperscript{200} \textit{McCullers & Schroeder, supra note 26, at 2.}
\textsuperscript{201} \textit{Zeff, supra note 181, at 42.}
ment garnered little attention. Those practitioners "who did see it felt that the teachers were trespassing on a preserve that belonged to practitioners. Only practitioners and the practitioners' organization, they believed, were justified in speaking for the accounting profession. The [AICPA] itself took no official notice of the "Tentative Statement." In 1938, the AICPA formed the Committee on Accounting Procedure, which assumed the task of issuing pronouncements in the form of Accounting Research Bulletins regarding accounting practice and procedure in order to establish "generally accepted accounting principles." Because of the AICPA's piece-meal, practical approach to "principles" as meaning "acceptable" rather than meaning "conceptually defensible," however, the bulletins resulted in the sanctioning of a wide variety of practices.

The bulletins were successful against the working of a sort of Gresham's law of accounting procedures in which "bad" practices threatened to drive out "good" ones. As a result, however, accountants increasingly found themselves with a superabundance of "good" practices. One development in accounting ... has been an increase in the number of important areas in which numerous alternative methods and procedures have been sanctioned. Although some of these alternatives have been clearly superior to others, even the poorest have often been able to squeeze past the minimum barriers and have been cloaked with the respectability inherent in "general acceptance." This development was apparently not anticipated by the leading accountants of the thirties, although it was probably inherent in an approach which emphasized disclosure and consistency rather than specific principles.

The committee's work thus came under increasing criticism.

In the 1950s, the controversy over "uniformity" versus "flexibility" of accounting practices erupted, and it was sensed by an increasing number of practitioners and educators that the succession of arguments over "right," "best," or "true" accounting principles and practices—including the uniformity-flexibility controversy—should somehow be brought closer to resolution by a more
concentrated research effort toward developing a body of accounting theory. Thus was established the [AICPA's] Accounting Research Division in 1959, together with a 21-member Accounting Principles Board to replace the 21-member Committee on Accounting Procedure . . . . It was hoped that the Board would commission research studies on major accounting questions and would use the findings from these studies as a theoretical base from which to derive logically consistent principles and practices.208

So it was not until 1959 that there was any real institutional effort by the AICPA to go beyond practice to theory—to the “science” alluded to in 1926 by the Anderson Court.

But that effort, too, was doomed to fail. The failure was due to “the fundamental weakness of a private sector group attempting to carry out a regulatory function without the authority to do so.”209 The Accounting Principles Board (APB) had no authority to enforce its mandates. The SEC was the sole enforcer. That led to two consequences. First, it led the APB to reject propositions that it deemed too controversial. If it adopted proposals that were routinely ignored, its respectability would be undermined. “Although highly regarded scholars did a commendable job in finding basic postulates and broad principles of accounting, the APB promptly rejected the studies as being ‘too radically different from present generally accepted accounting principles for acceptance at this time.’ ”210 Second, it prompted power struggles between practicing accountants and the APB, leading practitioners to seek relief from Congress. A few examples from the 1960s and early 1970s—dealing with accounting for business combinations, accounting for the investment tax credit, and mark-to-market accounting for marketable securities—give a flavor of the dynamics of the time.

After taking an initial unequivocal position on accounting for business combinations based on principle, which would have ruled out pooling-of-interests accounting, the APB was hit by intense pressures to modify that position. As the months went by and pressures mounted, the APB backed down step by step to a weak position under which poolings remain alive and well and living in

210. Id. at 9.
the United States today. Industry and the accounting profession joined in fighting the APB. Some groups wrote to key congressional committees suggesting that this subject should more appropriately be left to the legislative and regulatory functions of the federal government. Others threatened to sue the APB if the Opinion was issued.\textsuperscript{211}

With respect to the investment tax credit enacted in 1961, the APB had a strong majority of the opinion that the credit was equivalent to a cost reduction and that the only permissible way to account for the credit would be to amortize its effect over the

\textsuperscript{211} Id. at 10. Cf. Elizabeth MacDonald, Merger-Accounting Method Under Fire, \textit{WALL ST. J.}, Apr. 15, 1997, at A2. The article describes how business combinations can be accounted for under either pooling-of-interest accounting or purchase accounting. Under pooling-of-interest accounting, the combined companies simply add together the book value of their assets and liabilities. Under purchase accounting, the goodwill generated on the combination, equal to the excess of the purchase price over the book value of the acquired entity, must be amortized over periods as long as 40 years. These future deductions thus penalize future earnings, reducing the profit picture. Pooling-of-interest accounting avoids this hit against future earnings. The article describes a FASB proposal to restrict or end pooling-of-interest accounting by 1999. The proposal generated such controversy that FASB soon made noises about backing off. See Elizabeth MacDonald, \textit{FASB May Back Off From Its Threat To Limit or End Poolings of Interest}, \textit{WALL ST. J.}, July 1, 1997, at A4. Cf. Calvin H. Johnson, \textit{Time to Get Out of the Pool: Pooling Method for Acquisitions}, 76 \textit{TAX NOTES} 810 (Aug. 11, 1997); Robert Willens, \textit{Suppressing Goodwill in a Nonpooling of Interests Context}, 75 \textit{TAX NOTES} 701, 701 (May 5, 1997) (noting that “where pooling status cannot be attained, accounting alternatives available to at least minimize goodwill will be enthusiastically pursued”); \textit{infra} notes 216-220 and accompanying text (noting the susceptibility of FASB to popular pressure). But the plot continues to thicken. In February of 1998, FASB reported that it was continuing to consider restricting the use of pooling accounting and that it was also considering requiring purchasers to set out the separate components of acquired goodwill and amortize each over periods shorter than the 40 years that apparently is not atypical practice today. Amortization over shorter periods would reduce earnings more dramatically than amortization over 40 years. See Elizabeth MacDonald, \textit{FASB Renews Bid to Tighten Merger Accounting}, \textit{WALL ST. J.}, Feb. 27, 1998, at A3. Most recently, however, FASB seems to be considering abandoning ship altogether. It now is considering allowing companies that use purchase accounting to eliminate the write-off of goodwill entirely if they could show that the goodwill has not lost value in order to make the abandonment of pooling more palatable. See Elizabeth MacDonald, \textit{FASB May Change M&A Accounting to Favor Cash Over All-Stock Deals}, \textit{WALL ST. J.}, Apr. 27, 1998, at A3 (quoting a member of the FASB’s executive advisory council as saying, “This could really be big.”); Melody Petersen, \textit{Market Place}, \textit{WALL ST. J.}, May 13, 1998, at C8 (noting that “in a surprising twist” FASB might allow “all the benefits of pooling and then some” by requiring purchasing accounting, which allows assets to be revalued to fair market value, instead of pooling, which carries over book values, but easing up on the requirement to amortize goodwill). The irony here is obvious. Prior to the adoption of section 197, purchased goodwill was not amortizable for tax purpose, while it was amortizable for financial accounting purposes. See supra note 150. If these recent FASB proposals become practice, purchased goodwill will not be required to be amortized for financial accounting purposes, though it is now amortizable for tax purposes. Talk about two ships passing in the night!
useful life of the acquired asset. Several large public accounting firms flouted the guidance, however, and reported the effects in the single year in which the asset was acquired.

Business executives and professional accountants went directly to members of Congress with the story that the APB was trying to remove an economic incentive granted by Congress. No amount of accounting logic about matching costs and revenues could overcome this economic argument—and legislative challenge. Congress responded by writing into law that no taxpayer shall be required to use any particular method of accounting for the credit. Here was a display of raw power that should forever be a lesson to those who wish to set rules without having authority to do so.

In 1971 the APB considered requiring marketable securities to be marked to market, with changes in market value included in income currently without realization. Several chief executives of insurance companies complained to the SEC "and effectively forced the APB to drop the project."

Hence, the APB was replaced by the Financial Accounting Standards Board (FASB) in 1973. Unlike the APB, whose members were all from the AICPA, the members of the FASB include representatives from various organizations. Moreover, the members are paid and work full time, unlike the APB members, who were unpaid volunteers and who had full-time jobs apart from their APB responsibilities. But FASB, like the APB, remains without real authority. "The success of the FASB . . . depend[s] on the willingness of the SEC to support it on controversial issues." And practitioners can still turn to Congress when

---

212. Edwards & Black, supra note 178, at 11-12; McCullers & Schroeder, supra note 26, at 6.
214. Id. at 12.
215. Id. Also at this time, leasing companies began lobbying Congress to head off any attempt by the APB to require capitalization of leases. Id.
216. McCullers & Schroeder, supra note 26, at 7-9.
217. Id.
218. Edwards & Black, supra note 178, at 13. The FASB issues four different kinds of pronouncements:

1. Statements of Financial Accounting Concepts—releases designed to establish the fundamentals upon which financial accounting standards are based.
3. Interpretations—modifications or extensions of issues related to previously issued FASB Statements, APB Opinions or Accounting Research Bulletins. They re-
FASB threatens to issue an unpopular accounting standard. For example,

[FASB] underwent the embarrassment of issuing a standard for accounting for income taxes and then, in the face of widespread criticism, backing down and changing the standard.

And perhaps most humiliating, the threat of Congressional action forced the board to retreat from a proposal to make companies treat the value of stock options handed out to employees as an expense. It settled for requiring companies to put in their footnotes to financial statements what the cost would have been had they treated it as an expense.219

Finally, "[c]ritics say the Big Six are not speaking on behalf of what they think is best accounting [when they address FASB proposals] but on behalf of what they think their customers want."220

It is clear from this brief synopsis that financial accounting was no more based in science in 1926 than tax accounting itself, and its scientific pedigree remains in doubt today if "scientific" means that accounting "rules" are uniformly rooted in theory rather than practice and that there is widespread uniformity in accounting practices. Regarding the matching principle itself, this discussion reveals that the matching principle in financial accounting did not come to central prominence until the 1930s with the shift in emphasis from the balance sheet to the income statement, and the distillation of the matching principle from principle to practice continues to result in a variety of "acceptable" treatments. "The basic form of financial accounting as a process of cost allocation based on the matching of revenues and expenses crystalized [during the late 1930s]."221 But "[b]asic agreement involving the goal to be achieved did not result in agreement regarding the method of reaching it. Acceptance of matching as the basis of income determination did not result in

quiere the support of a majority of the Board.

4. Technical Bulletins—guidance on accounting and reporting problems issued by the staff of the FASB.

McCULLERS & SCHROEDER, supra note 26, at 10.

219. Floyd Norris, From the Chief Accountant, a Farewell Ledger, N.Y. TIMES, June 1, 1997, § 3, at 4. "It became obvious that if we had pursued the expense-recognition requirement there was a virtual certainty that we would have been overruled by either Congress or the S.E.C." Id. (quoting former FASB chairman Dennis R. Beresford).

220. Id.

221. STOREY, supra note 68, at 19-20.
Whether or not financial accounting was sufficiently “scientific” in 1926 to warrant the characterization, it is not surprising that the Court looked to an outside discipline for help in giving shape to this relatively new term “income.” With little or no developed literature and thought regarding what the term “income” should mean in tax terms, the Court often borrowed from other areas of thought in the early years of the income tax. For example, there were early disagreements regarding whether gain from the sale of an asset—capital gain—was properly considered “income” for tax purposes in view of the fact that such gains were not considered “income” in everyday parlance or for trust accounting purposes. That is, if a trust instrument prescribed that income from the trust’s assets should go to the beneficiary with the corpus going to the remainder, capital gains went to the remainder. They were considered additional capital, which could produce income for the beneficiary, not income itself. With increased understanding of tax values, which of course have nothing to do with how the return on a trust corpus should be divided between current beneficiaries and the remainder, these early questions regarding whether capital gain was “income” were eventually put to rest. The role of financial accounting in tax accounting, in contrast, remains ambiguous.

3. The Other Early Cases: Drawing the Line at “Contingent” Liabilities

Anderson cannot be understood simply as a decision to defer to the Commissioner, who asked for the 1916 deduction accrual in lieu of 1917 accrual. In American National Co. v. United States, decided little more than a year after Anderson, the Supreme Court stuck by its guns and permitted a taxpayer to accrue deductions earlier than the Commissioner thought would clearly reflect income. The taxpayer was the receiver for the F.B.

222. Id. at 41.
223. In Victorian times, it was not unusual to think of gains from selling assets as “capital” that would itself produce periodic “income.” See DODGE ET AL., supra note 20, at 49.
Collins Investment Company, which used the accrual method of accounting in keeping its books and filing its tax return for 1917, the year at issue. The Company was in the business of making secured real estate loans and selling the paper to investors. The real estate loans were five-year balloon loans with semi-annual interest payments at 5 percent. These notes were sold to investors. Each of the borrowers also executed a second note in favor of the company equal to 10 percent of the amount loaned. These notes were due in two years and were interest-free. These "commission notes" generated the Company's income, and the Company accrued the total amount of these notes in the year executed. At first, the Company sold the five-year notes through brokers, paying a commission for the services, but by 1917 it sold the notes directly to investors. As an enticement to investors, the Company gave the buyers a "Guarantee" or "bonus contract," under which the Company agreed to pay the investor 1 percent of the note's principal amount during each of the five years the note was outstanding. (Thus, the investor's return was increased from 5 percent to 6 percent.) The Company accrued the full face amount of these "bonus" payments in the year the loans were sold to investors both on its books and tax return. The Commissioner argued that only "such portion [of the bonus contracts] as became due within the year" could be accrued. The Commissioner won in the lower court, but the Supreme Court reversed, holding in favor of the taxpayer, saying,

These contracts were not analogous to obligations to pay interest on borrowed money, but were expenses incurred in selling the loan notes in as real a sense as if under its original system of doing business the Company had paid these amounts to brokers as fees for selling the loans or given them notes for such fees. The Company's net income for the year could not have been rightly determined without deducting from the gross income represented by the commission notes, the obligations which it incurred under the bonus contracts, and would not have been accurately shown

227. The statement of facts is drawn from id. at 101-03.
228. Id. at 103.
229. As the Court recounted:

   The Government, although conceding that the bonus contracts "represented an expense" of the Company's business, contends that their total amount was not deductible as an expense "incurred" in 1917, on the grounds that only a part of the obligations "accrued" within that year, and that the method used by the Company in keeping its books did not clearly reflect its true income.

Id.
by keeping its books or making its return on the basis of actual receipts and disbursements. The method which it adopted clearly reflected the true income. And, just as the aggregate amount of the commission notes was properly included in its gross income for the year—although not due and payable until the expiration of two years—so, under the doctrine of the Anderson case, the total amount of the bonus contracts was deductible as an expense incurred within the year, although it did not "accrue" in that year, in the sense of becoming due and payable. 230

Note that, as in Anderson, the Court upheld reporting consistent with the taxpayer's treatment of the item for financial accounting purposes. 231

When it came to contingent liabilities, however, the Court was willing to defer to the Commissioner's desire to delay the deduction of reserves created on the taxpayer's books, notwithstanding the earlier Treasury Decision 2433, quoted in Anderson, that expressly allowed accrual of reserves for contingent liabilities, and notwithstanding that such reserves were accrued on the taxpayer's books for financial accounting purposes. In the 1930 case of Lucas v. American Code Company, 232 the Company fired an employee in 1919 who was under contract to work for 18 more years and who was to be paid by commissions on sales. The employee brought a suit for breach of contract, which resulted in a judgment in his favor of $21,019.19. The Company appealed, and the appellate court affirmed the judgment in 1923, at which time the Company paid the damages.

After the employee filed suit, the Company immediately created on its books a reserve in 1919 equal to $14,764.79, the amount of unpaid commissions for the year. It increased the reserve by $32,994.09 in 1920. The 1921 books were not yet closed when the trial resulted in the $21,109.10 judgment, and the Company adjusted its reserve account for 1921 to equal the damage award. It sought to deduct the amount in 1919, arguing that

---

230. Id. at 105.

231. Cf. Commissioner v. Ox Fibre Brush Co., 281 U.S. 115 (1920) (affirming, consistent with the taxpayer's financial accounting, a 1920 deduction for bonuses awarded and paid by the Board of Directors in that year for services performed by officers in prior years, rejecting the Commissioner's argument that the bonuses accrued in the earlier years in which the services were performed).

all the facts which gave rise to the liability were fixed in that year; that damages must be assessed as of the date of the breach; that the loss therefore occurred in that year; and that it is immaterial that the amount of the damages was not determined or paid until later.233

The Court, in an opinion by Justice Brandeis, upheld the Commissioner's denial of the accrual, using language heavily relying upon deference to the Commissioner to determine whether an accounting method clearly reflects income.

And the direction that net income be computed according to the method of accounting regularly employed by the taxpayer is expressly limited to cases where the Commissioner believes that the accounts clearly reflect the net income. Much latitude for discretion is thus given to the administrative board charged with the duty of enforcing the Act. Its interpretation of the statute and the practice adopted by it should not be interfered with unless clearly unlawful.234

The Court reasoned that because the Company contested the liability, it was uncertain whether or not any amount would be paid.235 The Court explicitly distinguished Anderson and American National Company on these grounds, since the taxpayer's obligation to make the future payments listed in the reserve accounts was certain.236 Recall that the Court refused to defer to the Commissioner's desire to defer reserve accruals in American National Company,237 so the outcome in American Code Company cannot be understood simply as knee-jerk deferral to the Commissioner whenever the Commissioner asked for it under the clearly reflect income language. The Court perceived a difference in substance in these two cases that justified deferring to the Commissioner only in the contingent liability scenario.

In Brown v. Helvering,238 decided four years later, Justice

---

233. Id. at 448.
234. Id. at 449.
235. Id. at 450-51.
236. Id. at 452. The Court also argued that the Company did not, in fact, set up a reserve for the damages incurred. Rather, the reserve on the taxpayer's books equaled the commissions owing to the employee under the contract. Because the employee had a duty to mitigate damages, actual damages might not—indeed did not—approach the amount of commissions that went unpaid under the contract. Id. at 451-52. The Court thus seemed to imply that the usual force that financial accounting has in this context loses force when the bookkeeping itself appears lax.
237. See supra notes 226-231 and accompanying text.
Brandeis went even farther than mere deference to the Commissioner in denying accrual of reserves for contingent liabilities. He concluded that such accruals are not allowable unless "authorized specifically by the Revenue Acts, or by any regulation applying them," notwithstanding their use for financial accounting purposes. Arthur Brown, as a general agent for fire insurance companies, was entitled to "gross overriding commissions" from the companies based on the net premiums derived from local agents working under him. Policy holders paid premiums in advance for insurance coverage of one, three, or five years. If they canceled coverage, they were entitled to receive a return premium, payable by the general agent. The Commissioner argued that Brown should be taxed on the full commissions received during the year. Brown, in contrast, argued that he should be able to accrue a deduction for a reserve for cancellations expected to occur in future years based on past experience. Brown established the reserve for "return commissions" on his books in 1923. The years before the Court were 1923, 1925, and 1926. The Court agreed with the Commissioner, denying deduction for the accounting reserve because the liability was not "fixed and absolute."

It is true that where a liability has "accrued during the taxable year" it may be treated as an expense incurred; and hence as the basis for a deduction, although payment is not presently due, . . . and although the amount of the liability has not been definitely ascertained. But no liability accrues during the taxable year on account of cancellations which it is expected may occur in future years, since the events necessary to create the liability do not occur during the taxable year. Except as specifically provided by statute, a liability does not accrue as long as it remains contingent.

239. Id. at 205.
240. Id. at 195.
241. Id. at 196.
242. Id. at 195. Alternatively, he argued that he should be able to delay accruing a portion of the commissions until future years. Citing North Am. Oil Consol. v. Burnet, 286 U.S. 417 (1932), the Court denied delaying the income accrual. "When received, the general agent's right to [the commissions] was absolute. It was under no restriction, contractual or otherwise, as to its disposition, use or enjoyment." See infra notes 319-414 and accompanying text (considering the accrual of prepaid income).
244. Id. at 200 (citations omitted).
Citing *Lucas v. American Code Company*, the Court said that "[m]any reserves set up by prudent business men are not allow­able as deductions."245

The Court continued to deny accrual of reserves for contingent liabilities in later cases. For example, in *Spring City Found­ry Co. v. Commissioner*,246 the Court disallowed a deduction for an addition to a reserve for partially worthless bad debts be­cause the statute did not specifically allow it; the statute al­lowed deduction of only wholly worthless debts. With respect to the taxpayer's argument that "good business practice"247 de­manded accrual of the reserve, the Court foreshadowed *Thor Power Tool*248 in noting that the goals of financial accounting may not be consistent with tax accounting.

But that is not the question here. Questions relating to allowable deductions under the income tax are quite distinct from matters which pertain to an appropriate showing upon which credit is sought. It would have been proper for the taxpayer to carry a sus­pense account awaiting the ultimate determination of the amount that could be realized upon it, and thus to indicate the status of the debt in financial statement's of the taxpayer's condition. But that proper practice, in order to advise those from whom credit might be sought of the uncertainties in the realization of assets, does not affect the construction of the statute, or make the debt deductible in 1920, when the entire debt was not worthless, when the amount which would prove uncollectible was not yet ascer­tained, rather than in 1923 when that amount was ascertained and its deduction allowed.249

Thus, the Court sanctioned for tax accounting purposes a deviation from financial accounting when the latter allowed de­duction of contingent liabilities. And the all events test, which was articulated in *Anderson* merely as an attempt to encapsu­late the matching rule of financial accrual accounting, fortui­tously became the means that the Court used to *depart* from fi­nancial accounting in the tax realm: Because the liability was contingent, all the events had not occurred to establish the fact

245. *Id.* at 202.
246. 292 U.S. 182 (1934). *See also* Dixie Pine Prod. Co. v. Commissioner, 320 U.S. 516 (1944) (denying accrual of a tax that was contingent and contested by the taxpayer); Security Flour Mills Co. v. Commissioner, 321 U.S. 281 (1944) (same).
247. *Spring City Foundry*, 292 U.S. at 189.
248. *See supra* notes 38-56 and accompanying text (discussing *Thor Power Tool*).
249. *Spring City Foundry*, 292 U.S. at 189-90.
of liability. Yet, the Court nowhere explicitly discussed why the contingency of the liability should prevent accrual for tax purposes when it does not prevent accrual for financial accounting purposes. It need not have seized upon the all events language of Anderson; it could have said that the Anderson language was nothing more than an attempt to incorporate financial accounting principles into tax accounting and allowed the deduction of the contingent liability since it is allowable for financial accounting purposes. The Court nevertheless chose to defer to the Commissioner's discretion under the "clear reflection" language in this context but not in the fixed liability context.\textsuperscript{250} But the Commissioner likewise did not explain why tax accrual was not appropriate for contingent liabilities. While the Spring City Foundry Court seemed to recognize that tax accounting and financial accounting have different goals, it never articulated any tax value that would be undermined by deductions for contingent liabilities in accordance with financial accounting practices.

Though not discussed explicitly, the implied reasoning of the Court's pool of future-payment cases up until this point can be inferred. The Court allowed accrual of reserves for future payments, consistent with financial accounting, when the future payment was sure to be made—even when the Commissioner argued that current accrual failed to reflect income clearly.\textsuperscript{251} When the reserve was for a future payment that was contingent, however, the Court deferred to the Commissioner's desire to disallow accrual as not clearly reflecting income, even though such accruals were consistent with the taxpayer's financial accounting.\textsuperscript{252} The Court must therefore have implicitly reasoned that

\textsuperscript{250} Presumably, the result [in the contingent liability case of Brown v. Helvering] would have been different if the agent had sought to deduct a future refund obligation arising from a policy already canceled." Jensen, Premature Accruals, supra note 11, at 454.

\textsuperscript{251} Anderson, 269 U.S. at 422 (upholding Commissioner's desire for 1916 accrual of noncontingent tax instead of 1917 accrual); American Nat'l Co., 274 U.S. at 99 (denying Commissioner's challenge of 1917 accrual of noncontingent future expenses contracted for in 1917). In both cases, the taxpayer's tax reporting was consistent with the taxpayer's financial accounting of the item.

\textsuperscript{252} American Code Co., 280 U.S. at 445 (upholding Commissioner's challenge of 1919 accrual of contract damages that the taxpayer was challenging in court and which were not paid until 1923 after the taxpayer was held liable); Brown, 291 U.S. at 193 (upholding Commissioner's challenge of 1923, 1925, and 1926 accruals of future premium repayment obligations that were not certain to ripen); Spring City Foundry, 292 U.S. at 182 (upholding Commissioner's challenge to accrual of partially worthless bad debts); Dixie Pine Prod. Co., 320 U.S. at 516 (upholding Commissioner's challenge to accrual of a
the *contingency* of the liability is the determining factor regarding the appropriateness of deferring to the Commissioner's power to disallow the accrual of reserves for future payments. While allowing a deduction for contingent liabilities is consistent with the conservatism of financial accounting, a reduction in taxes, the Court implied, should result only from amounts that are certain (except for de minimis uncertainty) to be paid.

4. Coming to Understand the True Tax Value at Stake: The Anti-Tax Arbitrage Value and the Income-Tax Value Revisited

Although the Court disallowed accrual of reserves for future liabilities only if the liability was contingent, the contingency of the liability is not really the problem—or at least not solely the problem—from the vantage point of tax values. The real problem is that the liability was to be paid *in the future*—period. Viewed from the perspective of the individual taxpayer, a current deduction for a payment that will certainly be made but not until some point in the future results in violation of tax values. One way to think about this issue—perhaps the most common way—is to observe that it would violate the anti-tax arbitrage value. Although appreciation of the tax-arbitrage opportunities in the context of premature accruals was not widespread until the early 1980s, the Code has long contained provisions that recognize the tax value of disallowing transactions that profit solely because of the existence of the income tax.

For example, since 1917 the predecessor of section 265(a)(2) has prohibited deductions of interest incurred on debt used to purchase or carry bonds that produce interest that is exempt from federal income tax. Absent the denial of the interest deduction, a taxpayer could make a profit borrowing at an interest rate higher than the interest rate of the bonds purchased if the interest paid was deductible and the interest received was not includible. Take Profiteer, who borrows $100,000 from National Bank at 10 percent interest to purchase $100,000 of tax-exempt municipal bonds yielding 7 percent interest. Assume
Profiteer is in the 40 percent tax bracket. If the interest paid on the loan were deductible, the transaction would produce a profit after tax:

<table>
<thead>
<tr>
<th>Interest received (less zero tax)</th>
<th>$7,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>less Interest paid ($10,000)</td>
<td></td>
</tr>
<tr>
<td>reduced by tax saved ($4,000)</td>
<td>$6,000</td>
</tr>
<tr>
<td>Profit (after taxes)</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

Without the tax system, this transaction produces an economic loss for Profiteer, but with the tax system Profiteer makes out nicely.\(^{255}\) The system's reaction is to deny the interest deduction, preserving the economic loss and denying the tax-arbitrage profit.\(^{256}\) Thus, there is an anti-tax-arbitrage value inherent in

\(^{255}\) Appreciation for this phenomenon is what reduces the likelihood of implementation of a system for indexing the basis of assets to reflect inflation. If we index the basis of assets for inflation, we must also index the basis of debt instruments, assets owned by lenders. When debt basis is increased, a portion of what is nominally called "interest" on the debt really becomes a return of "principal." That would produce terrible perception problems, since it would look as though borrowers, such as homeowners, were being "penalized" by being denied a deduction for a portion of what they consider "interest," while lenders were being "favored" by allowing them to exclude from gross income (as the return of borrowed principal) what is nominally called "interest." See Dodge et al., supra note 20, at 601.

Indexing the basis of assets except debt—to avoid these perception problems—would be absolutely disastrous, allowing well-informed taxpayers to engage in tax arbitrage and make a profit solely from the Treasury. Assume a taxpayer purchases an asset for $1,000, which increases in value by 10% over one year, with $1,000 of borrowed money at 10% stated interest per year. The taxpayer sells the property for $1,100 at the end of the first year and repays the $1,000 debt plus the $100 in "interest," realizing not a dime of economic profit or loss. This should be a wash for tax purposes as well.

But assume further that inflation is 5% for that year, increasing the asset's basis to $1,050 and reducing the nominal $100 sale gain to $50 under a system of basis indexation. If the stated "interest" of $100 is fully deductible, unreduced by that same inflation factor, the taxpayer reports a tax loss of $50 from the property ownership, even though there was no economic loss. Indeed, taxpayers would be able to report tax losses on property that showed a real economic profit! In short, the perception problems and complexities of indexing debt make it unlikely, but indexing debt is absolutely essential if we index the basis of other assets.

\(^{256}\) This example is deliberately simplistic in order to illustrate the basic idea of tax arbitrage. A comprehensive discussion of the tax arbitrage literature is beyond the scope of this Article, including arguments that anti-tax-arbitrage provisions are unwise since the market will fully or partially capitalize tax subsidies or even that anti-tax-arbitrage provisions retard full capitalization. See Koppelman, supra note 254, at 1172-92 (discussing the relationship between anti-tax-arbitrage provisions and market adjustments for tax incentives).
the income tax structure, created by such provisions as section 265.257

The ability to engage in tax arbitrage in the context of premature accruals is illuminated in the following excerpt.258

Assume that an accrual-method florist injures a two-year-old pedestrian with his delivery truck. To settle his liability, the florist agrees to pay the victim $100,000 fifteen years from now (year 16), just when the child should be starting college. Because the liability arose in connection with the florist's business, the settlement payment is clearly a deductible item under § 162. But when?

Since the settlement agreement establishes both the fact and the amount of the florist's liability, the all-events test would allow the florist to accrue and deduct the $100,000 payment in year 1 when the agreement is made, not in year 16 when payment occurs. Furthermore, the florist would be allowed to accrue the full $100,000 face amount of the liability in year 1, not just the present cost of providing a year-16 payment of that amount.

To understand the significance of this outcome, assume that the florist is taxed at 36% and that the correct after-tax compound interest rate for figuring present value is 8%. If the $100,000 were paid to the victim in year 1, the florist would have a present tax saving of $36,000 ($100,000 x .36) from this deduction to offset against the $100,000 settlement payment. Accord-

257. There are times when the Code will consciously depart from the anti-tax-arbitrage value in the name of other nontax values. For example, the low-income housing credit in section 42 can produce a profit from the tax system with respect to transactions that would not otherwise be economically profitable. Cf. Treas. Reg. § 1.42-4 (providing that section 183, which can deny deductions for economically unprofitable activities, will not apply to reduce deductions attributable to ownership and operation of a building eligible for the low-income housing credit). That, however, is precisely the intention behind section 42: to encourage the building of low-income housing that would not otherwise be built because not economically profitable.

Another example is the deduction for qualified residence interest under section 163(h)(3), even though the imputed income from owner-occupied housing is tax-exempt. Whether wise or not, whether it works or not, the deduction is there for nontax reasons: to encourage home ownership. And interest incurred on loans to purchase property whose income is deferred due to the realization requirement and then is taxed at the lower capital-gains rates also produces tax arbitrage.

The point is that, as with all tax values (including the administrability value itself at times!), the Code does not uniformly respect the anti-tax-arbitrage value. When the Code explicitly departs from it, the taxpayer prevails. But the value is itself part of the statutory text and should inform judgment when it is unclear whether a particular transaction is covered by an "exception." In other words, the exceptions do not undermine the anti-tax-arbitrage value itself; they are the exceptions that prove the rule.

258. The excerpt is from DODGE ET AL., supra note 20, at 460-61. My thanks to Cliff Fleming, whose calculator crunched these numbers.
ingly, the net cost to the florist of his negligence would be $64,000 ($100,000 - $36,000). But on the actual facts, the payment will be deferred for fifteen years. This will create a windfall profit for the florist that can be illustrated in two ways.

First, we can compare the florist's year-1 tax saving ($36,000) with the present cost of the year-16 payment. Under our interest assumption, this present cost is only $31,524. That is, if the florist invests only $31,524 in year 1 at 8% after-tax compound interest, the investment will grow over the next fifteen years to $100,000 and will fully fund the year-16 payment to the victim. The florist's year-1 deduction is not, however, limited to the $31,524 present cost; the florist deducts the full $100,000 in year 1 and saves $36,000 in tax. Thus, instead of incurring a $64,000 net cost for his negligence, the all-events test would give him a $4,476 net profit ($36,000 year-1 tax saving - $31,524 present cost of year-16 payment).

The florist's windfall can be demonstrated a second way by comparing the future value of the year-1 tax saving against the future cost of the settlement payment. Thus, if the florist invests his $36,000 year-1 tax saving at 8% after-tax compound interest for the next fifteen years, the investment will grow to $114,198, and the florist will have a $14,198 profit when he pays $100,000 to the victim. This amount ($14,198) is simply the sum that would be produced by investing the florist's present value profit of $4,476 (calculated above . . .) for fifteen years at 8% after-tax compound interest. Thus, the two ways of illustrating the florist's windfall are economically equivalent.

More important, regardless of which way you prefer to understand the florist's good fortune, he has clearly swung from a $64,000 net cost for incurring a tort liability to a net profit (a $4,476 profit if present tax saving is compared to present cost and a $14,198 profit if the future value of the tax saving is compared to the future cost of the settlement). Furthermore, the profit does not result from any daring act of entrepreneurship or any creative business innovation; it results purely because the tax system creates a deduction/payment mismatch.259

259. While these numbers are extreme for the sake of illustration, the principle operates whenever a deduction for a payment is allowed in a year prior to the year in which the taxpayer actually makes the payment. Current deduction reduces the after-tax cost of the payment from what it would have been if the deduction were delayed until the year of payment.

For an alternative approach to this issue, see infra notes 455-486 and accompanying text (discussing two-party matching).
As Professor Gunn memorably put it, "If this is the law, well-advised accrual-method businesses should cancel their liability insurance and run down pedestrians at the rate of at least one a year."260

But perhaps the better way to think about this issue today is to observe that deduction of the $100,000 in year 1 would violate the income-tax value, effectively allowing the investment return on the $100,000 (which the florist retains in hand) to go untaxed between years 1 and 16. The investment return, while nominally included on the taxpayer's tax return, is effectively free from tax unless we require the $100,000 investment producing the return to itself be taxed in year 1 (through the denial of a deduction). This is because allowing deduction of an investment is the economic equivalent of exempting from tax the return on the investment.261 Only if we both tax the $100,000 in year 1 by denying a year-1 deduction and tax the investment return as it accrues will that return effectively be taxed. And failure to tax it is inappropriate if we are seeking to tax "income" rather than "consumption." The nominal inclusion of the investment return on the $100,000 in the tax base can lull the decisionmaker into a false conviction that no damage to the tax base of "income" results if we allow financial accounting norms to control. The nominal inclusion can be misleading to those who do not understand the yield-exemption phenomenon and the difference between an income tax and consumption tax. At bottom, taxpayers should not be able to use accrual accounting to effect taxing a particular item under a consumption-tax regime rather than an income-tax regime without clear evidence from Congress that this result was intended.

In other words, the financial accounting value that expenses should be matched with related income in the same accounting period in order to avoid misleading roller-coaster profits has no independent tax value. While the florist might be forced by his financial accountants to reduce his year-1 income statement to reflect the future tort liability in order to avoid overstating the florist's profitability, the only tax value reflected in a year-1 de-

---


261. See supra notes 81-93 and accompanying text (comparing consumption taxes to the income tax).
duction is administrative ease in allowing the taxpayer to keep only one set of books. But because the taxpayer must keep two sets of books in any event (because of differing depreciation schedules and other differences), this administrability value should give way when it conflicts with other tax values in a magnitude that is more than de minimis. The income-tax value is a strong one and should counsel against allowing current accruals for future payments unless the deferral is so small (in either amount or in time) that administrability trumps.

This discussion illustrates that the passage of time is thus important to financial accounting and tax accounting for very different reasons, and this is the crux of the matter (and this Article). The passage of time is important to the financial accounting system because of the multiyear progression of the profit picture, where trends are critical to those interested in the accountant's information. Reporting related income and outlays in the same year is consistent with this perspective of time and the goal of providing accurate profit trends over multiple years. *When* payments are actually made or receipts are actually in hand in a multiyear picture is unimportant from this perspective. The reporting of gross receipts and expenses upon receipt and payment may actually, because of bunching, mislead those who rely on the financial accountant's information. It is important to stress that no payment obligations, such as a tax, arise from the accountant's tabulation of "income" for any particular year. The timing of income inclusions and deductions are important only for the picture of economic health they portray over time.

The passage of time is important to the tax accounting system, in contrast, because real liabilities arise year by year based on when items are reported, and the time value of money affects the real definition of the tax base that produces those tax liabilities. A tax base of "income" seeks both to tax the making of an investment (through denial of deduction for capital expenditures, for example) and to tax the return on the investment. Allowing a year-1 deduction for payments not yet made, when there has not yet been a wealth decrease, effectively exempts from tax the investment return on that cash between the time of deduction and payment. While deferring deduction might make sense for financial accounting when the goal is to provide an accurate portrait of the profit picture over time, it distorts the tax base for tax purposes, turning the tax on "income" into a
tax on “consumption” for the item at issue solely because of the happenstance of the taxpayer's method of accounting. Thus, the terms “clearly reflect income” have very different meanings in the financial accounting world and in the tax world.

Because the Supreme Court deferred to the Commissioner’s requests to defer tax accrual of deductions that are accrued for financial accounting purposes only in cases of contingent liabilities, however, lower courts wishing to defer to the Commissioner's wish for deduction deferral were forced to cabin the argument for deferral in this pigeonhole. Thus, in the often-cited case of *Mooney Aircraft, Inc. v. United States,* the Commissioner argued, and the Fifth Circuit agreed, that a contract payment that was not contingent under the contract's terms but was not to be made until far into the future, perhaps more than twenty years, was nevertheless “contingent” for tax purposes and thus not properly accrued.

Mooney manufactured and sold small airplanes. With each purchase, it provided the buyer with a so-called Mooney bond, which entitled the buyer to a $1,000 payment when the aircraft was retired. Retirement could occur more than twenty years in the future. The court implied that Mooney accrued the full $100,000 for financial accounting purposes in the year of sale, and it sought to do so for tax purposes as well. With a prelude that seemed to embrace the matching principle from financial accounting as a tax value as well, the court first specifically rejected the Commissioner's argument that the all events test was not satisfied. It nevertheless agreed that current deduction would not clearly reflect income. The tax arbitrage problem or, alternatively, the income-tax value were not identified by either the Commissioner or the court; in 1969 neither the tax arbitrage possibilities in the premature deduction context nor the yield-exemption phenomenon and the income-tax value were fully appreciated. But something, apparently, just did not “seem right” about a current deduction for an amount to be paid so far in the future, and the feeling was enough for

---

262. 420 F.2d 400 (5th Cir. 1969).
263. The facts are drawn from id. at 401-02.
264. See id. at 402-04.
265. See Jensen, *Premature Accruals,* supra note 11, at 477-78: There is no evidence that the time value of money influenced the Commissioner and those courts which disallowed current deductions for future payments. But it is probable that economic concerns played an implicit [role]. An obligation to be
the court to defer to the Commissioner's authority, even though there were no legal contingencies involving the future payment. While not relying on the Supreme Court's contingent liability cases, the court squeezed the facts, if a bit uncomfortably, into the spirit of those cases by focusing on the practical contingencies that might prevent payment because of the substantial delay involved.\textsuperscript{266} It also raised the matching principle as a defensive weapon: Because of the long interval between the time the obligation was incurred and actual payment, it was unrealistic to view the liability as an "expense of doing business in the current year . . .\textsuperscript{267} In other words, proper matching itself did not require current accrual. Once again, the court seemed to accept the matching principle as a tax value.

Even when appreciation of the tax arbitrage possibilities and the income-tax value in this context became more widespread with more sophisticated understanding of the time value of money, some commentators and Congress were unable to sever completely their attachment to the notion that the matching principle, as implemented by financial accountants, has independent value in the tax arena as well. There are two ways to fix the problem in accounting for future payments. Year-1 deductions could be discounted to their true present cost. In the florist example recounted above, that amount would be $31,524.\textsuperscript{268} Alternatively, the deduction could be deferred until the year of payment and deducted in full. The florist would deduct $100,000 in year 16 when paid.\textsuperscript{269} These methods are economically fulfilled in the distant future may have met the technical requirements for deductibility, but something must have seemed amiss.

\textsuperscript{266} The longer the time between the issuance of the bond and payment under it, "the less probable it becomes that the liability, though incurred, will ever in fact be paid." 420 F.2d at 410.

\textsuperscript{267} Mooney, 420 F.2d at 410.

\textsuperscript{268} DODGE ET AL., \textit{supra} note 20, at 461:
The deduction would then generate a year-1 tax saving of $11,349 ($31,524 x .36). Over the next fifteen years, the $31,524 present cost would grow, at 8%, to $100,000, the $11,349 year-1 tax saving would grow to $36,000, and the net cost to the florist of the year-16 settlement payment would be $64,000 ($100,000 - $36,000), the same cost as if he had paid the $100,000 to the victim in year 1.

\textit{Id.}

\textsuperscript{269} \textit{Id.} "At that point, the florist would have $36,000 of year-16 tax savings to offset against the $100,000 year-16 payment, and his net cost would be $64,000—the same as if he had paid $100,000 to the victim in year 1." \textit{Id.}

A third possibility proffered by a few critics would be to allow a year-1 deduction discounted to present value using a pre-tax rate of return (instead of an after-tax rate) coupled with annual deductions reflecting the increase in the present value of the liabil-
equivalent. Perhaps the tax value of administrability favors the delayed deduction alternative, to avoid the task of discounting to present cost, but otherwise no tax value points to a preference of one of these methods over the other. Yet, writing in 1980, Aidinoff and Lopata, who readily recognized the tax arbitrage problems inherent in current deductions for future liabilities, nevertheless advocated that the year-1 deduction discounted to present cost was the only correct solution—because of the matching principle.

One of the basic principles embodied in the concept of accrual accounting is the matching in the same period of revenues and the costs of earning such revenues. Indeed, the purpose of permitting taxpayers to utilize the accrual method of reporting, the Supreme Court itself has stated in *United States v. Anderson*, is to enable them to “make their returns . . . by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period.”

If a liability is incurred or if the amount of an existing liability increases, the liability or increases reduces net wealth (computed on an accrual basis), and thus reduces income. By its very nature, the present value of a liability underlying a premature accrual obligation increases each year as the time for performance approaches. The critics argue that to properly measure income the obligor's income, these increases must be taken into account. Since the deferral rule [of § 461(h)] fails to do this, the critics argue that investments involving premature accrual obligations are overtaxed. By taxing these investments more heavily than others, the deferral rule creates a bias against them, and makes them relatively less attractive.

Id. at 591. Professor Cunningham proceeds to argue convincingly against the perceived neutrality of this alternative and in favor the of the section 461(h) deferral approach. See id. at 599-621.


271. Id. at 796-97 (footnotes omitted).
They failed to recognize the Court's own blind acceptance of the matching principle in *Anderson* in an era when independent tax values were not developed and other areas of law were imported into the tax realm out of sheer necessity to fill the void of tax thought at the time. And they unquestioningly accepted the notion that matching continues today to have independent value in the tax realm as well, requiring a preference for year-1 deduction, though at a discounted value.272 Thus, they thought that the *Mooney* court's conclusion "that fifteen to thirty years is simply too long a gap between accrual and payment is open to serious question."273 "[F]rom the point of view of the correct matching of income and related expenses . . . the taxpayer should have been permitted a deduction in the same year as the revenues from the sale of the planes to which the 'bonds' logically related were taken into income,"274 though they did concede that the deduction should be discounted to present cost in order to prevent the "windfall"275 that would otherwise occur on deduction of the full face amount.276

When Congress enacted section 461(h) in the Tax Reform Act of 1984277 to address the problem of deductions for future liabilities, it, too failed to eradicate completely the matching principle from its misplaced pedestal in the tax realm. And the Commissioner's prior failure to elucidate the real problem in deductions for future liabilities is to blame. Instead of articulating the tax base distortion that occurs with the undiscounted deduction of future liabilities under its "clear reflection" authority—as it should have—the Commissioner often argued prior to 1984 that the all events test required that deductions could not be accrued until "economic performance" occurred by, for example, rendering future services.278 "The original theoretical justifica-
tion for the performance requirement is lost in the mists of antiquity, but it "seem[s] to be based rather loosely on matching." It is likely based on the idea that economic performance is likely to bring the timing of the deduction closer to the time of payment, because once performance has occurred, the performer is going to want to be paid. Congress adopted the idea wholesale in section 461(h).

Congress rejected the year-1 deduction for future liabilities at a discounted rate as too cumbersome. It should have, therefore, required delay in deduction until the time of payment in all cases. Instead, however, it provided that the all events test is not to be considered met any sooner than the time of economic performance, and "payment" constitutes economic performance under the statute only in cases of worker's compensation payments and payments of tort liabilities. If the liability arises out of the provision of property or services to the taxpayer or by the taxpayer, then economic performance occurs as the property or services are provided. Congress delegated authority to the Treasury Department to determine when economic performance occurs with respect to liabilities that are not described in the statute. The statute also provides that deduction of future liabilities is allowable prior to economic performance if the all events test is satisfied, the deferral is de minimis (using an eight and one-half-month benchmark), the item is reported consistently, and either the item is immaterial or accrual in the year that the all events test is satisfied "results in a more proper matching against income than accruing such item in the taxable year in which economic performance occurs."

While only in the exception language, the matching principle has made it into the statute! It perhaps can be defended

279. Id. at 477.
280. Gunn, supra note 14, at 36.
281. See Jensen, Premature Accruals, supra note 11, at 480.
282. See I.R.C. § 461(h)(2)(C). Professor Calvin Johnson has argued to me that "economic performance" will defer deduction until the party on the other side of the transaction would likely demand the payment of interest and thus is an appropriate tool for determining the proper timing of the expense deduction. One simple response to that is that interest will not always be demanded or willingly paid upon economic performance. The only sure cure for the problem described here is to delay deduction until actual payment.
283. See I.R.C. § 461(h)(2)(A) & (B).
here, however, since the exception itself is premised on allowing
deferece to financial accounting norms when damage to tax
values is de minimis and thus the administrability value pre­
dominates. The objectionable part of the statute is the use of an­
other than payment as “economic performance” under the
general rule. As Professor Jensen has noted, “a premature ac­
crual is still possible if a lag time between economic perform­
ance and payment exists and economic performance occurs
first.”

Congress should eliminate these shortcomings, as well as
the ambiguities of trying to determine “economic performance”
for certain categories of transactions, by amending section
461(h) to delay accrual of future liabilities until payment—pe­
period. That is the only cure that precisely matches the ailment of
premature accruals described earlier.

5. Modern Decisionmaking

What should courts and the Treasury Department, within
its rulemaking powers, do in the meantime? When discussing
the “clear reflection standard,” they should forthrightly discuss
the real tax value at stake in this context under time value of
money principles—the anti-tax-arbitrage and income-tax val­
ues—and forthrightly dispel the lingering notion that the
matching principle found in financial accounting is a tax value
as well. In light of these premises, they should bend over back­
wards in situations that are not clearly addressed by the statute
to conclude that deductions for future payments must be de­
ferred until the payments are made, unless the deferral is so in­
substantial that the tax value of administrability (assumed to
inhere in allowing deduction at the same time shown on the tax­
payer’s books for financial accounting purposes) takes prece­
dence over these tax values.

As an example of the Treasury Department at work, con­
sider the question of when economic performance should be
deemed to occur with respect to jackpot payments made by pro­

286. Jensen, Premature Accruals, supra note 11, at 483. Moreover, there should be
no theoretical problem with the deduction of prepayments of the costs of services or
property prior to economic performance, so long as the all events test is satisfied and
payment does not constitute a capital expenditure. Because most prepayments providing
future benefits do constitute capital expenditures, not many would be deductible in any
event. See supra notes 81-125 and accompanying text (discussing capitalization).
gressive slot machines. A progressive slot machine is one that has a jackpot that progressively increases until a gambler pulls the winning combination. These machines can take as long as 35 months to pay off, though they pay off in an average of four and one-half months. In United States v. Hughes Properties, Inc., a case decided after enactment of section 461(h) but dealing with a year not subject to it, the Supreme Court concluded that the all events test regarding the casino's liability to pay the amount added to the jackpot each year accrued at the end of each year. When does economic performance occur for purposes of years governed by section 461(h)? “If providing entertainment constitutes the provision of services and gamblers are entertained by merely playing slot machines provided by a casino, economic performance occurs as the machines are played.” In that case, deductions would continue to be allowed at the end of each year equal to the portion of the jackpot tallied that year. But Treasury Regulations issued under the authority of section 461(h)(2)(D) provide that economic performance occurs only upon payment. The statutory language does not clearly categorize gambling activities, so there was room for appreciation of the anti-tax-arbitrage value and income-tax value to lead the Treasury to opt for payment as economic performance, a sound approach to statutory interpretation.

The progressive jackpot situation does not fit easily within any of the statutory definitions of economic performance. When doubt remains about the time of economic performance after legitimate attempts have been made to apply those definitions, the deduction should be deferred until payment. In other words, when in doubt, defer.

The Supreme Court's performance, on the other hand, has left much to be desired. In 1986 and 1987, within ten months of each other, the Court decided two cases considering whether future liabilities had accrued for purposes of the all events test:

United States v. Hughes Properties, Inc. and United States v. General Dynamics Corp. Neither case involved years in which the economic performance requirement applied. Writing in 1988, Professor Jensen summarized the Court's performance as follows:

The time value of money dominates the current theoretical tax literature, and timing is an important practical issue as well. All other things being equal, informed taxpayers seek to accelerate deductions and to defer the inclusion of income. On an issue of such importance, one expects the Supreme Court, when it exercises its discretionary jurisdiction twice within such a short period of time, to promulgate well-crafted, thoughtful opinions.

But the Court wrote as neither craftsman nor theoretician. The cases apply the same prong of the "all-event" test, which addresses the timing issue. Nevertheless, the cases fit together poorly, if at all, and the Court's attempted reconciliation reflects an analysis made at the most mundane conceptual level. Moreover, the two decisions are of surprisingly limited scope. The Tax Reform Act of 1984 substantially modified the law governing the time of deductions, but neither case involved facts governed by the new statute. Finally, in the cursory majority opinion in General Dynamics, the Court made a misleading suggestion about the law after the Tax Reform Act of 1984 and advanced an ill-considered proposition about the construction of tax statutes. Indeed, the opinion evidences an astonishing lack of both research and analysis. Shoddy judicial work warrants criticism for its own sake, and criticism is particularly justified when the Supreme Court misreads, and therefore possibly misdirects, post-1984 law.

As noted earlier, Hughes Properties concerned the timing of casino deductions for payments to be made when a gambler pulled the winning combination on a progressive slot machine. The Court decided the case by focusing on the bald language of the all events test and the contingent liability body of case law decided under it, divorced from the time value of money revolution in tax thought that had occurred. In short, it ignored the intellectual history of the matching principle in the tax law recounted here. It sought simple refuge in the talisman that the

all events test had come to occupy. The opinion could have been written in the 1940s.

There was no dispute regarding the amount of the liability, the second prong of the all events test. Rather, the parties and Court framed the issue as whether all the events had occurred to establish the fact of liability, the first prong. The government sought to fit within the contingent liability cases.

[The casino's] obligation to pay a particular progressive jackpot matures only upon a winning patron's pull of the handle in the future. Until that event occurs, [the casino's] liability to pay the jackpot is contingent and therefore gives rise to no deductible expense. Indeed, until then, there is no one who can make a claim for payment.

The casino, on the other hand, argued that there was a reasonable expectation that payment would be made at some future date, that the casino's liability was fixed and irrevocable under Nevada law, that the accrual of those amounts conformed with generally accepted accounting principles, and that deductibility effected a timely and realistic matching of revenue and expenses.

The Claims Court allowed the accrual because, in part, "[a] contrary result would mismatch [the casino's] income and expenses." The Supreme Court affirmed the Claims Court and allowed the accrual. After reciting the all events test and its centrality to tax accounting, it mechanically described the contingent liability cases, concluding that the liability must be "final and definite in amount," "fixed and absolute," and "unconditional" to be accruable. It then proceeded to evaluate the parties' arguments regarding whether the liability to pay the amount shown on the jackpot's meter was sufficiently "fixed" at the end of each year to justify accrual, concluding in the end that it was.

295. The Court, citing a 1961 case, confirmed that the all events test was the "touchstone" for determining accrual of deductions and was "a fundamental principle of tax accounting." Hughes Properties, 476 U.S. at 600.
298. Id. at 598.
299. Id.
300. Id. at 600.
[The casino's] liability, that is its obligation to pay the indicated amount, was not contingent. That an extremely remote and speculative possibility existed that the jackpot might never be won, did not change the fact that, as a matter of state law, [the casino] had a fixed liability for the jackpot which it could not escape. 301

Perhaps the relatively short deferral means that the outcome is not particularly troublesome, but the weak opinion certainly is. One can imagine an opinion that would have been much more effective in curbing misunderstanding and misuse of the matching principle, in explicitly articulating and promoting more widespread understanding of the underlying tax values that are at stake, and in promoting coherent development of the law in this and related areas. The Court should have taken this opportunity—its first since the development of tax thinking that illuminated the real problem at issue—to review the evolution of the legal and intellectual currents that brought the state of the law to where it was.

The Court should have first explained that the language of the all events test it articulated in *Anderson* those many decades ago was an attempt to encapsulate the matching principle of accrual financial accounting in the early days of the income tax, when independent tax thought was fledgling, at best. The Court should have recounted how the contingent liability cases were the first to allow the Commissioner to depart from accrual financial accounting treatment under the "clear reflection" authority, but that current thinking has shown how current deductions for future payments violate tax values even if future payment is absolutely certain. The Court should have explained how the matching principle in financial accounting has no independent tax value other than administrative convenience in allowing the taxpayer to use financial accounting records in filing its tax return. The Court should have explained how the passage of time is important to financial accounting and tax accounting for very different reasons. The Court should have explained that financial accountants wish to match revenues and related profits in the same time period (regardless of when received or paid) in order to show an accurate picture of the profit progression over multiple years to parties who will make decisions based on that profit progression. The Court should have

301. *Id.* at 601-02 (footnote omitted).
explained that the timing of receipt and payment, an irrelevance for purposes of financial accounting, has independent tax significance since such timing can alter the very tax liability that results from the process of computing the tax yardstick—"income"—because of the time value of money. Matching revenues and expenses in the same period for tax purposes—while perhaps aesthetically satisfying—actually distorts the tax measurement when there is a significant delay in receipt or payment. It then could have concluded, if it wished, that because the payment deferral in this case was minimal—averaging no more than a year—the administrative convenience value of allowing the taxpayer to use its financial accounting records outweighed the income-tax value.

Indeed, had the Court written an opinion like this a few years before the 1984 economic performance amendments, the amendments could have been much simpler and more straightforward. Congress would have needed only to craft a bright line de minimis rule in order to avoid case-by-case determinations regarding how much delay is too much. That is, Congress could have provided that deductions accrue at the later of accrual for financial accounting purposes or payment, with an exception allowing accrual before payment if the delay is within, say, the eight and one-half months that Congress seized upon in the recurring items exception of section 461(h)(3). Instead, we got a mechanistic, narrow opinion, which failed to illuminate the big picture or failed even to recognize the advancements and refinements in thought that had occurred since cases decided in the Anderson era.302

The Court wrote precisely the same kind of tunnel-vision opinion in General Dynamics,303 mired in the narrow language of the first prong of the all events test, with the only difference being that the taxpayer lost and was denied deduction accrual. General Dynamics304 self-insured its employee health plan, reimbursing employees who filed claims for covered medical care. It

302. The dissent did not do any better. Justice Stevens, with whom Chief Justice Burger joined, also couched his mechanistic opinion within the contours of whether or not the liability was "fixed." Because the obligation to pay the liability would disappear if the casino surrendered its operating license under Nevada law, Justice Stevens believed the liability was not sufficiently fixed to be accruable. See id. at 607-09 (Stevens, J., dissenting).

303. 481 U.S. at 239.

304. The facts are drawn from id. at 241-42.
sought to accrue deductions for reimbursements that had not yet been approved, and thus not yet paid to employees, for medical care provided to the employees in the tax year. The deductions included reimbursements with respect to claims that had been filed with General Dynamics but not yet approved as well as claims that were not yet filed with General Dynamics but were, from past experience, expected to be filed. The Government did not challenge the evidence regarding the number of claims, asking the Court to resolve the case solely on the issue of which event was the final event fixing the taxpayer's liability to reimburse the employee: the filing of a claim form or the receipt by the employee of covered medical care. The Court decided on the former and denied deductions for unfiled claims.

General Dynamics was . . . liable to pay for covered medical services only if properly documented claims forms were filed. Some covered individuals, through oversight, procrastination, confusion over the coverage provided, or fear of disclosure to the employer of the extent or nature of the services received, might not file claims for reimbursement to which they are plainly entitled. Such filing is not a mere technicality. It is crucial to the establishment of liability on the part of the taxpayer. Nor does the failure to file a claim represent the type of "extremely remote and speculative possibility" that we held in Hughes did not render an otherwise fixed liability contingent. 305

As this decision was rendered prior to enactment of the Americans With Disabilities Act, 306 which makes unlawful certain kinds of disability discrimination against employees in the workplace, the Court's ultimate conclusion, within the parameters the Court set for itself, is perhaps not surprising. But once again, the contours of those parameters are themselves open to criticism. Once again, the Court bypassed the opportunity to bring order to chaos by writing more broadly of the issue in its intellectual and historical context, choosing instead to focus on applying the controlling "test" in a manner that amounts to simple disagreement with the lower court on the particular facts before it. No guidance can be gleaned from the opinion. 307 More-

305. Id. at 244-45 (footnote and citation omitted).
307. Because the Court's approaches were so fact bound and because the 1984 enactment of section 461(h) diminished the role of the all events test for all years after 1984, Professor Jensen puzzled over the Court's decision to grant certiorari in Hughes Properties and General Dynamics. See Erik M. Jensen, Hughes Properties and General
over, the Court misleadingly implied that for future years, to which the economic performance requirement of section 461(h) would apply, the reimbursements would not be deductible until paid.\footnote{308}

Justice O'Connor's dissent, joined by Justices Blackmun and Stevens, was likewise too narrow in its approach, focusing on the language of the all events test, wholly detached from the underlying tax values at stake. She simply disagreed that the case was adequately distinguishable from \textit{Hughes Properties}.\footnote{309} She believed that the issue was whether the filing of a claim form was a trivial step. Believing it was, she characterized it as a mere "ministerial act." Displaying a lack of understanding of the underlying tax values at stake, she cited an income accrual case for this proposition:

\begin{quote}
[\textit{I}n \textit{Continental Tie & Lumber Co. v. United States,} the Court held that an accrual basis taxpayer should immediately include as income a federal payment to railroads created by statute, but neither claimed by the taxpayer nor awarded by the Federal Government until years later. The Court explained that although no railroad had any vested right to payments under the statute until a claim was made by the railroad and awarded by the Interstate Commerce Commission, "[t]he right to the award was fixed by the passage of the Transportation Act. What remained was mere administrative procedure to ascertain the amount to be paid." Clearly, the right to reimbursement for medical benefits under any of the medical benefits plans at issue in this case arises once medical services are rendered; the filing and processing of a claim is purely routine and ministerial, and in the nature of a formal contingency, as correctly perceived by the courts below.\footnote{310}]
\end{quote}

As discussed in a later section, the \textit{Continental Tie & Lumber} case may itself have been an unwise decision.\footnote{311} At the least, it is clearly unwise to cite income accrual cases in the deduction context, and \textit{vice versa}. While they are similar in the sense that they are the flip sides of the same coin, the time value of money

\begin{footnotes}
308. \textit{See} 481 U.S. at 243 n.3; Jensen, \textit{Supreme Court, supra} note 287, at 256-69; Treas. Reg. § 1.461-4(d)(6)(i) (confirming that economic performance occurs as medical care is provided to the covered employee).


310. \textit{Id.} at 250 (citation omitted) (O'Connor, J., dissenting).

311. \textit{See infra} notes 415-426 and accompanying text (discussing the accrual of income not yet received).
\end{footnotes}
analysis that should serve to defer the deduction in the future expense scenario should also serve to delay the income inclusion in the future receipt scenario, an issue discussed in greater detail in part C. The point here is that Justice O'Connor and her fellow dissenters did not even seem to question whether an income accrual case and deduction accrual case raised distinct issues.

In short, none of the four opinions in Hughes Properties and General Dynamics is commendable in its form and approach to the real tax values at stake and to the history of thought in this area. Through its example, the Court’s opinions cemented a narrow focus on the language of the all events test, though with the economic performance requirement that test becomes less important. It encouraged taxpayers and lower courts to engage in constructing “imagined contingencies”312 and their likelihood of actual occurrence in determining whether the test was satisfied or whether the contingent liability cases should be deemed to control instead of focusing on the underlying tax values at stake. And they did nothing to dispel the notion that the matching principle of financial accounting has independent tax relevance. As noted earlier, one purpose of this Article is to encourage courts to do better with their rhetoric, since opinions allow the courts to educate and further sound development of the law.

The Tax Court, also dealing with a pre-1984 tax year (and thus dealing only with the all events test and the clear reflection gloss without the added economic performance requirement), did better in the 1994 case of Ford Motor Co. v. Commissioner.313 Ford entered into a series of structured settlements in 1980 with respect to various personal injury and accidental death claims.314 The injuries allegedly resulted from manufacturing defects in vehicles manufactured by Ford. Ford sought to accrue as a tax deduction in 1980 the entire face amount of the settlement awards, totaling $24,477,699, even though the awards were to be paid out over various periods, the longest of which was 58 years. Ford purchased single-premium annuities for a total cost of $4,424,587 to cover the structured settlements. The payments under the annuities were structured to mirror

312. Jensen, Supreme Court, supra note 287, at 243.
313. 102 T.C. 87 (1994).
314. The facts, a bit simplified for purposes of discussion, are drawn from id. at 87-91.
Ford's structured settlement payments. Ford owned the annuities and remained responsible for the deferred payments under the structured settlement. For financial accounting purposes, Ford deducted $4,424,587 in 1980. The Commissioner argued that only $4,424,587 was allowed as a tax deduction in 1980, which was essentially the present discounted value of the future payments. While the Commissioner argued both that the all events test was not satisfied and that the clear reflection standard required the discount to present value, the Tax Court reached only the second argument, agreeing with the Commissioner.

The opinion is noteworthy for choosing to rely on the clear reflection standard instead of trying to shoehorn the analysis into the contingent liability exception for accrual under the all events test, as the Supreme Court did in Hughes Properties and General Dynamics. Unlike these earlier decisions, the Tax court opinion explicitly recognized that the real problem was not only the contingency of the future payment because of the long time delay. Using an example much like the florist example recounted earlier, the Tax Court discussed how the delay between deduction and even a certain payment results in tax arbitrage, a violation of tax values. (It did not mention that an alternative way of looking at the problem here is that it violates the income-tax value.) The court recognized that, with 1980 deduction of the undiscounted face amount of the future payments, Ford could realize a profit for tax purposes that it would not realize had the tort claims never been filed. The court concluded that prevention of such tax arbitrage by allowing only a discounted, present value deduction of the future payments was thus within the Commissioner's discretion under the clear reflection language.

The Tax Court explicitly rejected the taxpayer's argument that the matching principle required allowing full deduction of the undiscounted amount of the future liabilities in 1980.

[Ford] argues that [the Commissioner's] position mismatches income and expense. We do not agree. . . .

In the instant case, we think that the method of accounting [Ford] used for financial reporting purposes resulted in a better matching of its income and expenses than the method used for

315. See supra note 258 and accompanying text.

316. See 102 T.C. at 92-94.
tax purposes. Although a basic principle of financial accounting is the matching of income with related expenses, the principal purpose of tax accounting is the accurate reflection of the taxpayer's income, a concept which does not necessarily correlate with the goal of financial accounting. In the instant case, for financial reporting purposes, [Ford] expensed only the costs of the annuities it purchased, which were not exceeded by the present value of the deferred payments it was obligated to make. As we see it, the true economic costs of [Ford's] losses to the tort claimants are the amounts it paid for the annuities. . . . Consequently, the accrual method of accounting which [Ford] used for financial reporting purposes resulted in the proper matching of income and expense and clearly reflects petitioner's income.\textsuperscript{317}

One wishes that Ford had accrued the full face amount of the obligations for financial reporting purposes, requiring the court to expressly reject the taxpayer's financial reporting of the item for tax purposes and to expressly reject the matching principle as a tax value. The court's language seems to accept the notion that matching is also a tax goal; it just so happened that the goal was satisfied in this case with a deduction limited to present value. And perhaps the court's approach could have been more firmly rooted in the intellectual evolution in thought that is described here: a more robust account of the origins and development of the all events test to import accrual accounting into tax accounting for administrative ease, the first deviations from financial accounting principles in the contingent debt cases, the growing realization that the delay in payment is as troublesome as the contingency of the payment, in light of the anti-tax-arbitrage value and income-tax value, which have long been rooted in statutory language and structure.\textsuperscript{318} The Ford

\textsuperscript{317} Id. at 103-04 (citations and footnotes omitted).

\textsuperscript{318} Perhaps such a fuller opinion might have persuaded the three dissenting judges that the clear reflection standard supported the Commissioner's position. The clear reflection standard surely is malleable enough to evolve with tax thinking that demonstrates that a taxpayer's chosen method of accounting violates tax values evident in the Code's language in other provisions. The dissenters believed that time value of money principles simply had no root in statutory language and structure until 1984 and that the majority's opinion resulted in retroactive application of the spirit, though not the letter, of the economic performance requirement of section 461(h). See 102 T.C. at 112-13 (Gerber, J., dissenting). (Had section 461(h) actually applied, the deductions for the settlement payments would have been delayed until made. See I.R.C. § 461(h)(2)(C).) In essence, the dissent implied that the clear reflection standard had an understood, finite meaning prior to 1984 that did not include time value of money notions. At bottom, then, the majority and dissent essentially disagreed over the scope of the Commis-
opinion is nevertheless to be commended for its forthright reliance on the clear reflection language and its primary reliance on tax values in determining what "clear reflection" means in the present day.

C. ACCRUAL ACCOUNTING—INCOME

1. Prepaid Gross Receipts

For financial accounting purposes, gross receipts are not included in income, even if in hand, until they are earned through, for example, the provision of future services or the future delivery of goods. Under the matching principle, the expenses incurred to produce those gross receipts are deducted in that same future period.\textsuperscript{319} When should prepaid income be included in income by the accrual basis taxpayer for tax purposes, in view of the fact that the taxpayer has the cash in hand (and thus the ability to pay taxes in the year of receipt) and in view of the material discussed in parts A and B above?

One way of looking at the problem is to observe that the failure to include the prepaid income in the year of receipt would have precisely the same economic effect as immediate deduction of future payments, because "deferral of income is tantamount to inclusion coupled with an acceleration of the future expenses that are estimated will be incurred in earning that income."\textsuperscript{320} Thus it would violate the anti-tax-arbitrage value for the same reasons delineated through the earlier florist example.

Assume, for example, that our accrual basis florist from the earlier example\textsuperscript{321} receives $100,000 in year 1 for flowers to be delivered in year 16.\textsuperscript{322} Assume for now that the florist will incur costs of $100,000 in year 16 to purchase the flowers from the wholesaler. For purposes of financial accounting, the florist would not include the $100,000 in income until it is earned in year 16, when the florist would also deduct the $100,000 costs incurred in performing the contract under the matching princi-

\textsuperscript{319} See supra notes 28-29 and accompanying text.

\textsuperscript{320} DODGE ET AL., supra note 20, at 470.

\textsuperscript{321} See supra note 258 and accompanying text.

\textsuperscript{322} The example is outlandish, but it is helpful to stick with the same example for purposes of illustration. For more extended numerical illustrations of the time value of money, see Fellows, supra note 89, at 730-33.
ple, yielding no profit for the year-16 income statement. What would happen if the florist similarly deferred inclusion of the $100,000 cash in hand until year 16 for tax purposes, yielding no tax liability in year 1? The economic effect would be the same as if the florist included the full $100,000 in income in year 1 and then deducted the $100,000 future expenses in year 1 (resulting in the year-1 zero tax bill). But the first florist example showed that accelerating the $100,000 deduction to year 1 without discounting violated tax values. Thus, under the same time value of money analysis, the florist should include the $100,000 in income in year 1 when it is received.

There is another, equally valuable (perhaps better) way to view the problem here: Failure to include the receipts when received violates the income-tax value by effectively exempting from tax the investment return on the receipt between the time of payment and inclusion. Regardless of whether we force the taxpayer to include the $100,000 prepaid gross receipts in income in year 1, the year of receipt, the return earned on those receipts when they are invested will be included over the years in the taxpayer's gross income as it accrues. But even though the return is nominally accrued in gross income as it accrues, it is not effectively taxed if we allow the taxpayer to exclude the year-1 receipt. This is because allowing deduction of an investment (or the equivalent, allowing an exclusion of the prepaid receipt in this case) is the economic equivalent of not allowing the deduction but exempting from tax the return. Only if we both tax the prepaid receipt in year 1 on receipt and tax the investment return as it accrues will that return effectively be taxed. And failure to tax it is inappropriate if we are seeking to tax "income" rather than "consumption." Use of the accrual method should not allow taxpayers to effect taxation of a particular item under a consumption-tax regime rather than income-tax regime.

323. This "no profit" scenario when the florist has the investment value of the $100,000 for 16 years prompted Professor Johnson to argue that the deferral of prepaid income until earned makes no sense for financial accounting purposes as well. See Johnson, "Earned" Requirement, supra note 36, at 395-402.

324. The result should be the same even if the future costs are less than $100,000, say $80,000. The $20,000 excess of the prepaid income over the undiscounted future costs still represents a better ability to pay taxes in year 1, when the cash is in hand, than in year 16.

325. See supra notes 81-93 and accompanying text (comparing consumption taxes to the income tax).
without clear evidence from Congress that this result was intended.

The immediate inclusion of prepaid income coupled with delayed deduction of future expenses under section 461(h) that will be incurred in performing services or delivering goods for that prepaid income demonstrates most forcefully that the matching principle is not a tax value. This situation, however, is the one thought the most “unfair” by those who believe the matching principle to be a tax value.\textsuperscript{326} Yet, it is not unfair in light of the differing roles that time plays in the financial accounting world and tax world. While the timing of actual receipt and payment is unimportant for financial accountants, the timing of gross income inclusions and expense deductions will distort the actual tax liability owing under the measuring stick of “income” if such receipts and expense payments are reported in periods that differ substantially from actual receipt and payment because of the time value of the money in the hands of the taxpayer. Far from being “unfair,” requiring inclusion of prepaid gross receipts while deferring deduction of the expenses of earning that income until those costs are actually paid conforms most closely to the actual wealth accession and actual loss accompanying that receipt and payment. Moreover, and most important, it ensures that the investment income does not effectively escape taxation (even though it is nominally taxed), as it would under a consumption-tax regime.

But because the matching principle has had such a strong hold on the thinking of many thinkers and jurists, especially until the 1980s when time value of money principles came to the fore, courts and commentators were uncomfortable with this situation. They gave lip service to matching as a tax goal because they did not fully understand that there is no reason matching should be deemed to be a tax value. Yet, at the same time something simply must not have “seemed right”\textsuperscript{327} with the deferral of cash actually in hand, for in a celebrated trilogy of cases in the 1950s and 1960s, the Supreme Court agreed with the Commissioner that failure to include such receipts in the particular cases before the Court failed to reflect income clearly. Because neither the Court nor the Commissioner understood back then

\begin{flushright}
326. See infra notes 365-376 and accompanying text (describing work of Professor Malman).
327. See supra note 265 and accompanying text.
\end{flushright}
the time value of money analysis, the reasoning contained in those cases was mostly beside the point.\textsuperscript{328} The faulty analysis, however, opened the door for the inappropriate deferral of prepaid gross receipts on different facts.

In the 1957 case of \textit{Automobile Club of Michigan v. Commissioner},\textsuperscript{329} the taxpayer included in income for tax purposes for each year only the portion of prepaid membership dues that it recorded on its books for financial accounting purposes as being earned in that year.\textsuperscript{330} Membership dues were prepaid for one year, and the taxpayer credited on its books $1/12$ of the income at the end of each month of the twelve-month contract. The Commissioner relied on the "claim of right doctrine" in arguing that the taxpayer should accrue the entire amount in the year received.\textsuperscript{331} The taxpayer argued that the accrual method of reporting its income for financial reporting purposes clearly reflected its income for tax purposes as well, but the Court deferred to the Commissioner under the clear reflection standard in a short passage:

The pro rata allocation of the membership dues in monthly amounts is purely artificial and bears no relation to the services which petitioner may in fact be called upon to render for the member. [The clear reflection language] vests the Commissioner with discretion to determine whether the petitioner's method of accounting clearly reflects income. We cannot say, in the circumstances here, that the discretionary action of the Commissioner, sustained by both the Tax Court and the Court of Appeals, exceeded permissible limits.\textsuperscript{332}

Implied, perhaps, in the Court's language regarding "purely artificial" allocations that bore no relation to any services that the taxpayer might have to perform is the notion that matching is indeed a tax value, but that if the taxpayer cannot show when future expenses will be incurred the matching rationale is not a justification for deferring income in hand to match such

\textsuperscript{328} For this reason, the Court's performance might be more easily forgiven than its performance in \textit{Hughes Properties} and \textit{General Dynamics}, supra notes 292-312 and at accompanying text. It simply did not know any better in the 1950s and 1960s, and at least it got to the right result. There was no excuse for the 1980s Court to be so unaware of the underlying tax values at stake.

\textsuperscript{329} 353 U.S. 180 (1957).

\textsuperscript{330} The facts are drawn from \textit{id.} at 188-89.

\textsuperscript{331} See infra note 347 (discussing the doctrine).

\textsuperscript{332} 353 U.S. at 189-90 (footnotes omitted).
uncertain future expenses. In a loose sense, this analysis is simply the flip side of the coin of the contingent liability analysis that the Court seized upon in the future payment context a decade earlier to sanction deviation from financial accounting standards. In that context, the contingency of the future liability gave the Court the excuse to defer to the Commissioner's power under the clear reflection standard and bless deviation from financial reporting (and the matching principle embodied there) on the deduction side. Here, the contingency of future expenses to which the gross receipts should be matched gave the Court the excuse to defer to the Commissioner and bless deviation from financial reporting on the income side. But, as will be explored below, just as the contingency was not the real problem in the future payment context, but rather the delay between deduction and payment, so the contingency or certainty of the future expenses in this context is not the real problem, but rather the delay between receipt and inclusion. Again, the economic value of the time between reporting wealth receipts and losses and actually receiving or parting with such wealth is at the heart of the matter.

In the 1961 case *American Automobile Association v. United States*, the American Automobile Association (AAA) chose to press the case again, this time with better statistical evidence regarding the rate at which future costs would be incurred. Like the Automobile Club of Michigan, AAA filed its tax returns using the same accrual method of accounting that it used in keeping its books and included in income for each month only the portion of prepaid membership dues that were considered “earned” in that month. Therefore, the portion of prepaid dues attributable to months falling in the following taxable year was not reported in the year of receipt but rather was “deferred [as] unearned income reflecting an estimated future service expense to members.” As in the earlier case, the Commissioner con-

333. “[Automobile Club of Michigan] has been recognized as one that simply held that, in the absence of proof that the proration used by the taxpayer reasonably matched actual expenses with the earning of related revenue, the Commissioner was justified in rejecting the taxpayer's proration.” American Automobile Ass'n v. Commissioner, 367 U.S. 687, 703 (1961) (Stewart, J., dissenting).
334. See supra notes 226-252 and accompanying text.
336. The facts are drawn from id. at 688-90.
337. Id. at 688.
tended that the prepaid dues must be included in income in the year of receipt under *Automobile Club of Michigan*. AAA, however, attempted to distinguish that case, even though in both cases there was a failure to match deduction and inclusion with actual timing in the loss of wealth or receipt of wealth. AAA argued:

*Michigan* does not control this case because of a difference in proof, *i.e.*, . . . in this case the record contains expert accounting testimony indicating that the system used was in accord with generally accepted accounting principles; that its proof of cost of member service was detailed; and that the correlation between that cost and the period of time over which the dues were credited as income was shown and justified by proof of experience. 338

The Court again held for the Commissioner, requiring inclusion of the prepaid income in the year of receipt. The Court concluded, essentially, that no statistical evidence would be sufficient because future services are performed solely at the demand of individual members. The Court rejected an approach that established the rate of future costs by looking to service demand from the members as a pool.

The Code exacts its revenue from the individual member's dues which, no one disputes, constitute income. When their receipt as earned income is recognized ratably over two calendar years, without regard to correspondingly fixed individual expense or performance justification, but consistently with overall experience, their accounting doubtless presents a rather accurate image of the total financial structure, but fails to respect the criteria of annual tax accounting and may be rejected by the Commissioner.339

Because both the time and extent of the future services provided to individual members could not be established in view of the demand nature of the services, deferring income to match expenses that might never arise is not necessary to reflect income clearly under the matching principle, the Court apparently reasoned. "Not only did individually incurred expenses actually vary from month to month, but even the average expense varied—recognition of income nonetheless remaining ratably con-

---

338. *Id.* at 691.
339. *Id.* at 692.
stant." Thus, the exercise of the Commissioner's discretion under the clear reflection language was not "unsound."

As additional support for its holding, the Court cited the enactment and subsequent retroactive repeal of sections 452 and 462, which would have allowed the treatment AAA sought. Those sections would have sanctioned conformance of tax accrual accounting with GAAP, specifically allowing deferral of prepaid income and allowing the deduction of reserves for future liabilities. They were retroactively repealed because, apparently, inadequate transition rules would have allowed some income to escape inclusion entirely and would have allowed double deductions for some expenses. Moreover, Congress had meanwhile enacted section 455, which allows deferral of prepaid magazine subscription income until earned, specifically rejecting a proposal to extend such treatment to automobile club subscriptions. The Court took this as an indication that Congress was actively considering the matter of the proper treatment of prepaid dues of automobile clubs and thus chose to defer to Congress on the issue.

The four dissenters thought that AAA's pool evidence was sufficient to justify deferral of the income in order to match future expenses incurred in servicing the member contracts:

[AAA] proved, and the Court of Claims found, that the method of accounting employed by the petitioner during the years in issue was in accord with generally accepted commercial accounting principles and practice, was customarily employed by similar taxpayers, and, in the opinion of qualified experts in the accounting field, clearly reflected [AAA's] net income.

The dissent argued that the "claim of right" doctrine, upon which the Commissioner relied in Automobile Club of Michigan though not in AAA, applies to determine whether or not a receipt is income, not whether a receipt must be accrued in advance of performance. It similarly rejected any notion that the

340. Id. at 693.
341. See id. at 698.
342. See id. at 694-97.
343. See id. at 698 n.12; id. at 708-09 (Stewart, J., dissenting).
344. Congress has since done so. See I.R.C. § 456.
345. See 367 U.S. at 708-09 (Stewart, J., dissenting).
346. Id. at 698 (Stewart, J., dissenting).
347. See id. at 699-700 (Stewart, J., dissenting). Properly understood, the "claim of right" doctrine is indeed a when-is-income doctrine, not a what-is-income doctrine. The
annual accounting requirement requires accrual before the income is earned for financial reporting purposes.\textsuperscript{348} Finally, it saw no mandate in the enactment and subsequent repeal of sections 452 and 462 to defer to Congress the job of deciding this issue.\textsuperscript{349}

Neither the majority nor the dissent recognized the real problem regarding the delay in time between receipt of wealth and the reporting of that wealth in income for tax purposes. As noted earlier, time value of money principles were not well understood in this era. Both the majority and dissent seemed to accept uncritically that the matching principle from financial accounting was a tax accounting value as well. While they never explicitly said so, that acceptance pervades the opinions: Their essential point of disagreement was whether there was sufficient evidence of the rate at which future costs would be incurred to justify deferring income in hand to a future period to match those future costs. Neither the Court nor the Commissioner recognized that AAA's income inclusion reflecting this wealth accession already in hand would be diluted if it were deferred to a future year. That the tax liability attaching to one dollar of income will be less in real dollars, because of the time value of money, if that income can be deferred for one year is something that every law student learns today in the basic income tax class. But this distortion in taxation was simply not appreciated well at this point in the intellectual history of taxation.

The Supreme Court did not change its approach two years later in \textit{Schlude v. Commissioner.}\textsuperscript{350} The Schludes operated a dance studio.\textsuperscript{351} Pursuant to contracts entered into with their students, they received prepaid gross receipts for a specified number of dance lessons to be given in the future. The contracts

---

\textsuperscript{348} See 367 U.S. at 701-02 (Stewart, J., dissenting).
\textsuperscript{349} See \textit{id.} at 703-11 (Stewart, J., dissenting).
\textsuperscript{350} 372 U.S. 128 (1963).
\textsuperscript{351} The facts, somewhat simplified, are drawn from \textit{id.} at 130-33.
varied from five lessons to 1,200 hours of instruction to two lessons per month for life. None of the lessons were scheduled for certain dates or times; the students arranged for the lessons to which they were entitled at their future convenience. The contracts were nonrefundable. The Schluses, who used accrual accounting for purposes of keeping the dance studio's books, reported the prepaid gross receipts over time as lessons were taught (or as contracts were canceled without lessons). "Three certified public accountants testified that in their opinion the accounting system employed truly reflected the net income in accordance with commercial accrual accounting standards." The Commissioner argued that the prepaid gross receipts should be included in income upon receipt for tax purposes in order to reflect income clearly for tax purposes, and the Court once again agreed.

The Court felt that the interim enactment of section 456, which extended to taxpayers like AAA the income deferral it sought, justified its deference to Congress, which seemed to be "treating this problem by precise provisions of narrow applicability." More important, the Court noted that the Schluses' situation was essentially the same as that in Automobile Club of Michigan and AAA. The Schluses could not establish either the time or the extent of future services to be rendered since the dance lessons were scheduled only on demand by the students.

The Court rejected the taxpayer's system as artificial since the advance payments related to services which were to be performed only upon customers' demands without relation to fixed dates in the future. The system employed here suffers from the very same vice, for the studio sought to defer its cash receipts on the basis of contracts which did not provide for lessons on fixed dates after the taxable year, but left such dates to be arranged from time to time by the instructor and his student. Under the contracts, the student could arrange for some or all of the additional lessons or could simply allow their rights under the contracts to lapse. But even though the student did not demand the remaining lessons, the contracts permitted the studio to insist upon payment in accordance with the obligations undertaken and to retain whatever prepayments were made without restriction as to use and without

352. Id. at 132.
353. See supra notes 342-345 and accompanying text (describing analogous provisions).
354. 372 U.S. at 135.
obligation of refund. . . . Clearly, services were rendered solely on
demand in the fashion of the American Automobile Association
and Automobile Club of Michigan cases.

Because of the time value of money distortion that would
result if there were a receipt/inclusion mismatch, the cases de-
nying deferral were correct. But once again, the opinions did not
discuss the real underlying tax values at stake. Indeed, they
seemed to solidify the notion that the matching principle is a
tax value. All the talk of whether there was sufficient certainty
regarding the time and extent of future services was really be-
side the point. Yet, the language hovered out there (and con­tin­ues to hover to this day) for lower courts to work with, and
while some courts have resisted it,\footnote{355} it has resulted in inappro­
priate deferral in cases not involving the performance of services
only on demand.

The most celebrated case\footnote{356} is Artnell Co. v. Commis­
ioner.\footnote{357} Chicago White Sox, Inc., received substantial revenue
early in the 1962 baseball season, attributable to ticket sales,
broadcasting and television rights, and sales of parking books.\footnote{358}
It used the accrual method of accounting, and normally its taxa­
ble year ended on October 31. Before May 31, 1962, however,
Artnell Company acquired all the stock of Chicago White Sox,
Inc., which was liquidated on that date. As of May 31, the books
of White Sox, Inc., showed as deferred unearned income the por­
tion of the prepaid gross receipts received that was allocable to
games to be played after May 31. As the successor in interest to
Chicago White Sox, Inc., Artnell Company filed the final tax re­
turn for Chicago White Sox, Inc., and it did not include the de­
ferred prepaid gross receipts, including these receipts instead on
Artnell Company's first tax return. The Commissioner argued
that the prepaid receipts were includable on receipt under the

\footnote{355. See, e.g., RCA Corp. v. United States, 664 F.2d 881 (2d Cir. 1981), cert. denied,
457 U.S. 1133 (1982) (disallowing deferral of prepaid services income); Union Mut. Life
Ins. Co. v. United States, 570 F.2d 382 (1st Cir.), cert. denied, 439 U.S. 821 (1978) (disal­
lowing deferral of prepaid interest); Hagen Adver. Displays, Inc. v. Commissioner, 407
F.2d 1105 (6th Cir. 1969) (disallowing deferral of prepaid sales income).

356. See also Morgan Guar. Trust Co. v. United States, 585 F.2d 988 (Ct. Cl. 1978)
(allowing deferral of prepaid interest until earned); Collegiate Cap and Gown Co. v.
Commissioner, 37 T.C.M. (CCH) 960 (1978) (allowing deferral of prepaid cap and gown
rental fees); Boise Cascade Corp. v. United States, 530 F.2d 1387 (Ct. Cl.) (per curiam),

357. 400 F.2d 981 (7th Cir. 1968).

358. The facts are drawn from id. at 982-83.
clear reflection standard and the Supreme Court trilogy and thus should have been included on the final return of Chicago White Sox, Inc. The Seventh Circuit rejected the claim:

All three [of the Supreme Court cases] held, upon consideration of the particular facts, that the commissioner did not abuse his discretion in rejecting a deferral of income where the time and extent of performance of future services were uncertain. . . .

The uncertainty stressed in those decisions is not present here. The deferred income was allocable to games which were to be played on a fixed schedule. Except for rain dates, there was certainty. We would have no difficulty distinguishing the instant case in this respect. 359

Knowing both the time and extent of future costs that will be incurred with respect to the prepaid gross receipts is important in determining whether deferral of the gross receipts is required in order to match such expenses only if the matching principle is accepted as a tax value. As already described, however, there is no tax reason to encourage the matching of gross receipts with related expenses in the same tax period (except administrative ease in allowing the taxpayer's financial accounting books to control), while there are strong tax reasons why deferral of cash in hand should not be allowed even if the timing and extent of future costs are certain. Even if there are no contingencies regarding related future costs, deferring the income inclusion to match those costs understates those inclusions or, alternatively viewed, effectively exempts from tax the investment return on the receipt arising between the time of receipt and the time of inclusion. As with premature deductions for future expenses, the contingency of the item is really not the problem; the reporting/payment mismatch is the problem because of the time value of money. There is simply no tax significance to the "earned" requirement of financial accounting; receipt of the cash is the significant tax event. 360

Neither courts nor the Commissioner have recognized in their writings that the deferral of prepaid income is the flip side of the coin of the immediate deduction of future expenses. Neither have they realized that allowing deferral of the income effectively exempts the investment return on the receipt from

359. Id. at 983-84.

360. Moreover, some prepayments linked to the future performance of services are pure profit, with no related future expenses.
tax, as though the receipt were being taxed under a consumption-tax regime. The Supreme Court did not cite its contingent liability cases\textsuperscript{361} in the trilogy of prepaid income cases, even though they are essentially based on the same reasoning the Court used. \textit{Artnell} demonstrates how lower courts since then have been mired in the "uncertainty" element of the future costs.

In 1971, the Commissioner issued Revenue Procedure 71-21,\textsuperscript{362} which allows accrual method taxpayers to defer the inclusion in gross income of amounts received in one taxable year for services that, under the terms of the contract, must be performed by the end of the next succeeding taxable year, even if services must be performed only upon demand. The one-year deferral rule applies only to prepayments for services, not prepayments of rent or interest. The ruling contains no reasoning. One reason why the Commissioner might have felt compelled to issue this ruling was to reduce litigation. Like the recurring item exception in section 461(h),\textsuperscript{363} it might not be unreasonable to allow financial reporting (deferral) to control so long as the deferral is de minimis. The one-year rule might be considered a reasonable place to draw the line, but Revenue Procedure 71-21 should be viewed as nothing more than that. It is not based in tax theory. Congress, as it did in section 461(h), should draw the line in the statute regarding how much deferral is too much and make clear that deferral beyond that line is impermissible. In the meantime, it would be nice to see the proper time value of money analysis articulated in a prepaid gross receipts opinion or ruling, using the clear reflection standard as its basis.

As with the issue of deduction of future liabilities, commentators were slow to let go of the matching principle in the tax arena with respect to prepaid gross receipts prior to the mid-1980s when time value of money principles became more widely understood. For example, writing in 1981, Professor Laurie Malman\textsuperscript{364} seemed at first to recognize that the deferral of prepaid income had the same economic consequences as the premature deduction of a future liability.\textsuperscript{365} Yet, she believed \textit{Artnell} to

\begin{itemize}
  \item \textsuperscript{361} See supra notes 226-252 and accompanying text.
  \item \textsuperscript{362} 1971-2 C.B. 549.
  \item \textsuperscript{363} See supra note 285 and accompanying text.
  \item \textsuperscript{364} Laurie L. Malman, \textit{Treatment of Prepaid Income—Clear Reflection of Income or Muddied Waters}, 37 TAX L. REV. 103 (1981).
  \item \textsuperscript{365} For example, in discussing \textit{Brown v. Helvering}, see supra notes 238-245 and
be rightly decided and disagreed with lower courts after the trilogy who failed to distinguish the Supreme Court cases and allow deferral if future performance was certain. Similarly, Professor Alan Gunn, writing in 1984, argued that while undiscounted deductions for future liabilities fail to reflect income clearly, prepaid gross receipts could be deferred until earned without distortion. Professor Malman's bottom line conclusion was that "[d]eferred should be allowed if the contract between the parties requires performance and the facts and circumstances indicate that performance is reasonably certain." Discounting the distortion of the economic value of the income inclusion due to the time value of the deferral, she blessed even twenty- or thirty-year deferrals. She did not appear to recognize that allowing deferral would be tantamount to exempting from tax the investment return on the receipt between the time of receipt and inclusion, violating the income-tax value.

But in the end, arguments based solely on the length of the period of deferral would be nothing more than the government's age-old fear of allowing unrestricted funds to go unreported for a long time. . . . [T]he reasoning of Mooney can be criticized and, as long as a date for reporting (based on performance) can be predicted with reasonable certainty, deferral would still seem to be appropriate.

accompanying text, she wrote, "The Commissioner argued that since the taxpayer had earned and received the commissions when he sold the policies, the deduction of a reserve for possible cancellations (the effective equivalent of excluding a portion of the commissions from income) before they actually occurred was inappropriate." Malman, id. at 108. Similarly, she described Schuessler v. Commissioner, 230 F.2d 722 (5th Cir. 1956), as a case "permit[ting] the analogue of deferring prepaid receipts by allowing the present deduction of a reserve for future expenses." Malman, id. at 111. Though she argued for the deferral of prepaid income, she maintained that "this article's analysis of prepaid receipts does not propose the allowance of a present deduction for future estimated expenses." Id. at 154.

366. See Gunn, supra note 14, at 25-32.
367. See id. at 20-25. Professor Gunn ultimately argues, however, for immediate taxation of prepaid receipts. See id. at 25. Like Professor Halperin, he considered treating prepayments as below-market loans in order to tax the payor on the foregone interest and thus relieve the economic incentive that can otherwise encourage prepayments where they would otherwise not occur, principally when the payor is unable to deduct the cost of the goods or services purchased with the prepayment. See id. at 20-25 (using prepaid tuition plans to illustrate the principal); infra notes 478-481 and accompanying text (considering this argument in more detail). Because such treatment is not currently available, however, he argues that immediate taxation of prepaid receipts would more often discourage tax-motivated behavior changes. See Gunn, supra note 14, at 25.
368. Malman, supra note 364, at 151.
369. Id. at 154. As the following excerpt shows, she did understand the economic
She seemed to accept the notion that the matching principle is a tax value without explaining why reporting gross receipts and related expenses in the same period has tax value. "For tax purposes, it is also appropriate to defer advance receipts on the basis of this matching notion, since deferral reflects the accrual method, and, equally important, deferral does not distort income."\footnote{Id. at 147.} She failed to explain her gauge of what "distort" means in the tax sense, however, as opposed to the financial accounting sense. She asserted: "If a taxpayer receives an advance of $120 for the performance of a service which will generate $60 of expenses, the current inclusion of the full $120 without a corresponding current deduction of $60 distorts income in a very real sense."\footnote{Id. at 147.} She did not, however, explain what that very real sense is. She seems to wish to look at the taxpayer's bottom line net income over a multiple-year period for a single transaction and report the outcome for that single transaction in a single tax year. But it is not clear why reporting $120 of gross receipts in income in year 1 and $60 of expense deductions in a future year distorts income for tax purposes—which is about annual accessions to wealth and losses in wealth—rather than financial accounting purposes. Reporting the $120 wealth accession in year 1 accurately reflects the increase in wealth actually realized by the taxpayer \textit{in that year}. The cash is in hand and—unlike the principal of a loan, the taxation of which is deferred until repaid\footnote{Id. at 152-53. She seemed to make no distinction between the obligation to repay amounts to a lender and the necessity to spend money (i.e., incur expenses to third parties) as a part of earning gross receipts from customers.}—is not subject to an absolute obligation to repay.

value of the deferral; she simply rejected its importance, choosing the matching principle as the superior good. In defense of her choice, she pointed to the deferral allowed with respect to the receipt of loan proceeds.

Commentators contend, however, that distortion arises because taxpayers receiving advance payments for future performance are receiving an economic benefit (measured by the value of the use of funds) and should be taxed on this benefit. . . . However, the economic benefit which results from the present use of funds in some cases may be no greater than the benefit enjoyed by a taxpayer who receives borrowed funds. Yet the tax laws have long held that no income results from the receipt of borrowed funds.

\textit{Id.} at 152-53. She seemed to make no distinction between the obligation to repay amounts to a lender and the necessity to spend money (i.e., incur expenses to third parties) as a part of earning gross receipts from customers.
Similarly, the $60 payment of expenses in a later year represents a decrease in wealth in that year. Deferring the gross receipts inclusion to a later year when the cash is in hand understates the wealth accession in the only real sense that counts—the economic sense—just as would deducting the $60 future payment in year 1 without discounting it to present value. If the gross receipts inclusion is to be deferred until the year in which the $60 deduction is taken, it must be augmented to an amount above $120 to reflect the time value of the dollars in the taxpayer's hands, just as a year-1 deduction of the expense pay-

event at the point of repayment of the principal by excluding the loan proceeds from gross income on receipt but taxing the income used to repay the principal amount.

Professor Malman was convinced by the loan analysis.

The arguments for excluding loans or deposits from income would seem applicable to the deferral of prepaid receipts. In each case, the funds received are burdened by an offsetting obligation. In the case of advance receipts, as long as future performance is reasonably assured, there is a preexisting, offsetting obligation—a contractual obligation as binding as that of repayment—and income should be reported at the time of that offsetting obligation.

Malman, supra note 364, at 154.

In my opinion, this misperceives the borrowing exclusion. The proceeds of a loan are excluded from gross income only because the present value of the repayment obligation precisely equals the current receipt—and that fact is known at the time of receipt—so that there is no accession to wealth. Indeed, if the present value of the repayment obligation is less than the present receipt, even a portion of the proceeds of a "loan" are includable in many situations. See infra notes 305-313 and accompanying text (discussing section 7872). The relationship between gross income and the expenses incurred to produce that gross income is so immensely imprecise that any analogy to the loan exclusion is unpersuasive. The accession to wealth equal to the amount of the gross receipt in year 1 cannot be negated in the same way, as there is no assurance—except in the most extraordinary situations, which should not be used to create a general rule—that the present value of future expenses incurred will precisely equal the amount of the present receipt, negating the accession to wealth. The relationship between gross income and expenses is simply too tenuous to analogize it to the relationship between the receipt and repayment of loan proceeds. In other words, while Professor Malman wished to allow deferral under the loan analogy upon a showing only that future performance is certain, deferral based on a loan analogy requires that there be repayment in cash and that the amount of future repayment be certain as well. Cf. Johnson, "Earned" Requirement, supra note 36, at 386 ("Whether the prepayment is for goods or services, the consideration for the profit element cannot be used to offset cash and cause the cash to be treated as a loan.").

Professor Malman, on the other hand, argued that the Supreme Court's trilogy distorted income in the economic sense, though by failing to account for the time value of the money in the taxpayer's hands, it is unclear in what sense she was using the term "economic." She wrote, "If the Supreme Court's decision in Schluke and the rest of the trilogy is read as requiring that income be taxed on receipt, regardless of when earned, the Supreme Court has prescribed a method of accounting that at least in an economic sense distorts income." Malman, supra note 364, at 117.
ments would clearly reflect income only if it were discounted from $60 to their present value.\textsuperscript{374} Deferring inclusion to a later year at the unaugmented $120 face amount distorts income in the tax sense (even if it might comport with financial accounting norms\textsuperscript{375}) by understating the year-1 wealth accession in the economic sense, or, alternatively viewed, by effectively exempting the investment return on the receipt from tax, as though the return were being treated under a consumption-tax regime instead of an income-tax regime.

In attempts to avoid inclusion of prepaid income under the trilogy, taxpayers began to argue that the amounts received were not, in fact, prepaid gross receipts for future services or the future delivery of goods but rather were the proceeds of a loan—a "deposit."\textsuperscript{376} Because loans are not taxed until repaid with after-tax dollars,\textsuperscript{377} characterization of the prepaid receipt as a loan allowed the taxpayers to argue for deferral by excluding the amounts under the common-law "borrowing exclusion." This alternative characterization of such receipts finally reached the Supreme Court in 1990 in Commissioner v. Indianapolis Power & Light Co.\textsuperscript{378} The Court's performance, as in Hughes Properties and General Dynamics, showed once again that it had not participated in the understanding of time value of money principles that had occurred in tax academia.

The Indianapolis Power & Light Company (IPL), an accrual basis taxpayer, required customers with poor credit ratings to make deposits equal to twice their estimated monthly bills.\textsuperscript{379} IPL paid 6 percent interest on deposits that were held for at least twelve months. The deposits were refunded on termination of service or upon an earlier demonstration of acceptable credit. The refund was usually made in cash or by check, but the customer could choose to have the refund amount applied against future electric bills. IPL argued that it had an absolute obligation to repay the deposits, either in cash or in kind, and thus the deposits were excludable from gross income as the proceeds

\textsuperscript{374} See supra notes 258-286 and accompanying text.
\textsuperscript{375} But see Johnson, "Earned" Requirement, supra note 36, at 395-402 (arguing that deferral of prepaid receipts is inconsistent with financial accounting purposes as well).
\textsuperscript{376} See Malman, supra note 364, at 139-42; supra note 369.
\textsuperscript{377} See supra note 372.
\textsuperscript{378} 493 U.S. 203 (1990).
\textsuperscript{379} The facts are drawn from id. at 204-07.
of a loan. The Commissioner argued that deposits that serve to secure the payment of future income are properly analogized to advance payments for goods or services and thus are includable on receipt under the Court's earlier trilogy of prepaid receipts cases.

The Court stated that "the issue turns upon the nature of the rights and obligations that IPL assumed when the deposits were made." It then went on to quote Commissioner v. Glenshaw Glass that income is "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion" and to conclude that IPL lacked "complete dominion" over the deposits because the repayment obligation was absolute. Thus, the Court allowed exclusion of the deposits under the borrowing exclusion.

IPL hardly enjoyed "complete dominion" over the customer deposits entrusted to it. Rather, these deposits were acquired subject to an express "obligation to repay," either at the time service was terminated or at the time a customer established good credit. So long as the customer fulfills his legal obligation to make timely payments, his deposit ultimately is to be refunded, and both the timing and method of that refund are largely within the control of the customer.

Perhaps surprisingly, the Commissioner did not make an alternative argument that would also require immediate inclusion: that the receipt, if not prepayments for electricity, were nevertheless includable because accompanied only by a contingent—rather than absolute—obligation to repay. The contingency is reflected in the "so-long-as" language of the above quotation. A re-

380. Id. at 209.
381. Id. (quoting 348 U.S. 426, 431 (1955)).
382. The Court's reliance on the dominion and control language of Glenshaw Glass in a case concluding that the amount received could be excluded under the borrowing exclusion is confusing. As noted earlier, see supra note 291, the borrowing exclusion is based on the accession to wealth language of Glenshaw Glass. The proceeds of a bona fide loan are excludable from gross income only because the present value of the repayment obligation precisely equals the current receipt—and that fact is known at the time of the receipt—so that there is no accession to wealth. The dominion and control language of Glenshaw Glass is perhaps helpful in justifying inclusions under the assignment of income doctrine, see, e.g., Helvering v. Clifford, 309 U.S. 331 (1940), and in justifying exclusions of some forms of in-kind personal consumption received by a taxpayer, see, e.g., United States v. Gotcher, 401 F.2d 118 (5th Cir. 1968), but it is irrelevant to the borrowing exclusion.
383. 493 U.S. at 209.
ceipt coupled with only a contingent obligation to repay, even if not an advance payment for goods or services, is includable in the year of receipt under the claim of right doctrine. 384 Repayment, if the contingency occurs, raises a deduction issue in the year of repayment. 385 While at least an arguable characterization of the actual facts of the case, neither the Commissioner nor the Court raised it.

But that is quibbling. The Court's characterization of the repayment obligation as absolute is not clearly wrong. 386 But even if we accept the Court's "loan" characterization as reasonable enough on the facts, the opinion again showed a lack of concern for the time value of money that underlies the tax values at stake. The loan at issue was at a below-market rate of interest. (Even if 6 percent were a "market rate," the failure to pay interest for the first twelve months surely reduced the loan to a below-market loan.) Because money has value over time, the substance of a loan with stated interest at below-market rates can be characterized as a loan at a market rate of interest coupled with a deemed payment from the lender to the borrower (treated as compensation, a dividend, a gift, or some other payment for tax purposes) which the borrower then uses to fund the increased interest payment. With better appreciation of the time value of money in the 1980s, Congress enacted section 7872 in the Tax Reform Act of 1984, 387 which accomplishes just this result. In two influential articles, Professor Daniel Halperin argued that all instances of prepaid gross receipts can be analyzed under section 7872 precepts. 388 While not all agree with that po-

384. See supra note 347.
385. This basic postulate of the tax law has one important exception pertaining to the receipt of property in the employment context subject to a substantial risk of forfeiture: The inclusion can be delayed until the property vests. I.R.C. § 83. This exception to the usual rule was enacted because of the tax rate differential between ordinary income and capital gain. Deferral results in more of the income inclusion being taxed at ordinary rates than would be the case with immediate inclusion.
386. The Court ultimately concluded that in those cases in which IPL kept the proceeds, the transaction should be recast into two steps: (1) a repayment of the deposit under its absolute obligation to repay followed by (2) immediate repayment from the utility customer. "Although, for the sake of convenience, the parties may combine the two steps, that decision does not blind us to the fact that in substance two transactions are involved." 493 U.S. at 212.
388. See Halperin, Disguised Interest, supra note 89; Halperin, 1984, supra note 89; infra notes 452-482 and accompanying text (discussing two-party matching in more detail and revisiting deductions for future expenses and prepaid income from within this
The appropriateness of applying section 7872 to "true" loans is almost beyond question. And the Court bought the loan characterization in *Indianapolis Power & Light*. In the context of that case, therefore, Professor George Yin noted:

Where inadequate interest is paid, the transaction is not completely a loan. Rather, it must be bifurcated: a portion of the deposit, reflecting the repayment obligation incurred by the utility, should be treated as a loan; however, the balance, reflecting the absence of adequate interest, is additional consideration—a premium charge—paid by the customer to the utility presumably as compensation for the additional risks associated with the noncreditworthy customers. The latter portion of the deposit should have been taxed as income to the utility upon receipt.

This is precisely how section 7872 would tax the loan, once implementing regulations are issued. Since the tax years at issue in *Indianapolis Power & Light* were 1974 through 1977, section 7872 did not apply. But the Court's decision was issued in 1990—long after the economic realities underlying section 7872 were widely appreciated—and yet the Court failed once context).

389. See, e.g., Johnson, "Earned Requirement, supra note 36, at 408-10; JOSEPH M. DODGE, THE LOGIC OF TAX 203-07 (1989) (recognizing the loan analogy in the prepaid receipts context but defending full current inclusion on the grounds of both administrative simplicity and consistency with other accrual principles).

390. The reason is that "real lenders do not give interest-free loans . . . [T]here is no such thing as an interest-free loan. If the interest was not stated, it is not because there was no interest, but simply because the parties did not disclose it." Johnson, "Earned Requirement, supra note 36, at 387. One holdout to the notion that loans can be truly interest-free is Professor Glenn Coven. See Glenn E. Coven, Redefining Debt: Of *Indianapolis Power and Fictitious Interest*, 10 VA. TAX REV. 587 (1991).

391. Y'in, supra note 89, at 483.

392. The payment of the increased interest by IPL would be deductible, but this payment would not negate in full the earlier inclusion. See id. at 483 n.55. Failure to account for this below-market loan also undertaxes the utility customer, as the deemed interest payments are not included. This failure is tantamount to allowing the customer a deduction for a nondeductible personal expense. See id.

To the extent provided in regulations, section 7872 applies to any loan "if the interest arrangements of such loan have a significant effect on any federal tax liability of the lender or the borrower." I.R.C. § 7872(c)(1)(D). The Conference Report indicated that a loan has such an effect if, among other things, it results in the conversion of a nondeductible expense into the equivalent of a deductible expense. H.R. CONF. REP. NO. 861, 98th Cong., 2d Sess. 1019-20 (1984). Professor Yin noted, however, that "no mention of the possible application of section 7872 . . . is made in the . . . Revenue Procedure describing how certain utilities can obtain the Commissioner's automatic consent to change their method of accounting for customer deposits to be in accordance with *Indianapolis Power*. See Rev. Proc. 91-31, 1991-21 I.R.B. 27." Yin, supra note 89, at 483 n.55.

393. See 493 U.S. at 205.
again to grasp the time value of money. The Court was not troubled at all by the below-market rate of interest on the customer deposits.

Nor is it especially significant that these deposits could be expected to generate income greater than the modest interest IPL was required to pay. Again, the same could be said of a commercial loan, since, as has been noted, a business is unlikely to borrow unless it believes it can realize benefits that exceed the cost of servicing the debt. A bank could hardly operate profitably if its earnings on deposits did not surpass its interest obligations; but the deposits themselves are not treated as income. Any income that the utility may earn through use of the deposit money of course is taxable, but the prospect that income will be generated provides no ground for taxing the principal.394

Thus, IPL succeeded in gaining the one result that is clearly inappropriate when tax values are well understood: deferral of the inclusion by labeling the receipt as a “loan” subject to an absolute obligation to repay (instead of an includable receipt because subject to only a contingent obligation to repay) coupled with the failure to bifurcate the loan to account for the below-market rate of interest.

Regulations applying section 7872 to the fact situation described in Indianapolis Power & Light may not come any time soon. Determining the term of the loan is difficult,395 and taxing the utility customers on their deemed interest payments would be similarly difficult. Professor Yin describes a way around the obstacles that make application of section 7872 difficult on the utility side. The economic effects of section 7872 with respect to the utility could be replicated by requiring full inclusion of the advance payment on receipt and then, if repayment does occur after all, allowing an augmented deduction at that time to account for what is now perceived as an “erroneous” inclusion. “A method of rectifying that error after-the-fact is to provide the recipient with a deduction at the time of refund whose present value (in year 0) equals the amount of the erroneous income inclusion.”396 He provides a helpful example to illustrate how an

394. Id. at 210 (footnote omitted).
395. Since the customer cannot call the loan on demand, it cannot be categorized as a demand loan for purposes of section 7872(a) and thus must be characterized as a term loan under section 7872(b).
396. Yin, supra note 89, at 488.
augmented deduction in the year of repayment can negate the "erroneous" inclusion in the earlier year.397 This approach would likely need implementing legislation, however, which would no doubt be difficult to accomplish. The augmented deduction would be viewed by the typical voter unschooled in the nuances of the time value of money as an unjustifiable subsidy to utilities and like taxpayers. And there is no easy indirect method of taxing the utility customer on the imputed interest that would arise under section 7872.398

In the absence of regulations implementing section 7872 in this context, both full inclusion and full deferral arguably distort income under time value of money principles. Full deferral distorts income by ignoring the time value of the money in the hands of the taxpayer prior to the reporting of the receipt for tax purposes. Because only a portion of the receipt should be considered includable income upon receipt under section 7872, however, full inclusion on receipt also distorts income if the receipt is, with hindsight, recharacterized as truly a loan because it is repaid.

So what should courts (and the Commissioner) do in the future with respect to prepaid gross receipts? First, there will always be difficult factual distinctions to make, such as whether the receipt really pertains to future goods or services or past or present services.399 Only in the case of future goods or services can the taxpayer even attempt to raise the "earned" requirement of financial accrual accounting in an attempt to prevent current inclusion.400 With respect to those situations that do deal with

397. Id.
398. See id. at 488-89.
399. See id. at 481 ("Sometimes, what may appear to be an 'early payment' is, in reality, nothing more than a payment for a current reciprocal benefit.") (emphasis added).
400. Compare Barnett Banks of FL, Inc. v. Commissioner, 106 T.C. 103 (1996), with Signet Banking Corp. v. Commissioner, 106 T.C. 117 (1996), aff'd, 118 F.3d 239 (4th Cir. 1997). Decided the same day in the Tax Court, these cases demonstrate how the resolution of this factual issue is often decisive. Both cases dealt with the issue of whether annual fees paid to credit card issuers could be included ratably over 12 months under Rev. Proc. 71-21. The court allowed the deferral in Barnett Banks while, the same day, it denied the deferral in Signet Banking. In Barnett Banks, the court was convinced that the fees pertained to future services performed for the cardholder over the course of the 12 months and thus were deferrable in part under Rev. Proc. 71-21. One important fact to the court was the ratable refund of the fee if the cardholder canceled the card. In Signet Banking, the annual fee was not refundable upon cancellation of the card, and the cardholder "agreement" recited that the fee was in consideration of the issuance of a card
receipts not yet earned, courts and the Commissioner should first explicitly reject the matching principle as a tax value.\textsuperscript{401} They should explicitly review the history explored above revealing that accrual accounting was imported into tax accounting only for administrative convenience and that, when tax values conflict with the matching principle embodied in financial accrual accounting, tax values should take precedence unless the distortion is de minimis, as perhaps in the deferral allowed under Revenue Procedure 71-21. They should explicitly discuss in their reasoning the time value of money distortions that occur in this context, explaining how the “test” focusing on the time and certainty of future performance that evolved out of the Supreme Court trilogy took shape in an era when these tax values were poorly understood and is irrelevant to the tax values at stake.\textsuperscript{402} Doing just that much would bring much needed co-

\footnote{401. As recently as 1996, the Tax Court continued to espouse the matching principle as a tax value in the context of prepaid income. See Barnett Banks, 106 T.C. at 116: "[I]f the credit card is cancelled, [Barnett] makes a pro rata refund . . . [for] the number of months remaining in the one-year period. Thus, if anything, [Barnett's] method provides a more reasonable matching of income and expense than what [the Commissioner] seems to espouse."}

\footnote{402. "[D]eferring taxation until a receipt is earned is bad economics, bad accounting and bad tax law, even if the time the future services will be performed is known." Johnson, “Earned” Requirement, supra note 36, at 379.}

and the establishment of a credit limit. The court thus concluded that the fee was not contingent on the rendering of any future services and thus no part was deferrable under Rev. Proc. 71-21.
herence to the future development of the law in this area.

Second, the “loan” theory should not be available to allow deferral in cases not involving the possibility of a refund of the prepaid receipts to the payor. That is, deferral under a “loan” theory should not be allowed on the reasoning that future expenses, such as rent and salaries, will be incurred in connection with the earning of the prepaid gross receipts and that such future expenses are analogous to the repayment of part of the gross receipts (albeit to other parties), justifying loan treatment.403 Similarly, deferral under the loan theory should not be permissible in the case of prepaid receipts where there is no certainty of a refund in the future if services are not performed or goods not delivered.404

hand or, on the other, the undermining of the 20-year carryover limitation in section 172 as well as the section 382 limitation. The 20-year limitation in section 172 is itself arbitrary. Perhaps the only quasi-theoretical reason for requiring NOL carryovers to sunset after a specified number of years is the argument that losses incurred so many years earlier have a much less tenuous connection to the earning of current income. That is not a very strong rationale, however. The possibility that the section 382 limitations would be undermined is perhaps more serious. Whether “right” or “wrong” in its choice regarding the greater evil, though, the deferral approach required by the Notice and the Regulations in this unique situation should not be universalized as broad theory. The deferral still does distort income in the tax sense and should not be seen as any broad sanctioning of the idea that income should properly be deferred in all cases until earned. The distortion is seen as acceptable only because the threats to sections 172 and 382 are perceived as grave enough to require it.

403. See supra notes 365-376 and accompanying text (describing Professor Malman’s earlier view that the incurrence of future expenses that are certain can be analogized to the obligation to repay loan proceeds, thus negating an accession to wealth on receipt).

404. Cf supra note 401 (discussing the importance of the refund feature in Barnett Banks and Signet Banking). See also Herbel v. Commissioner and Webb v. Commissioner, 106 T.C. 392 (1996). In these consolidated cases, the taxpayers owned all the stock of a Subchapter S Corporation, Malibu Petroleum, Inc., which had contracted to sell gas to Arkansas Louisiana Gas Co. (Arkla) under a take-or-pay contract. When Arkla failed to purchase gas or pay for the gas not purchased in the amounts allegedly required under the contract, Malibu sued Arkla. In settlement of that suit, Arkla paid $1,850,000 to Malibu, while amending the prior gas delivery contract to eliminate the take-or-pay feature for a few years. The settlement agreement referred to the payment as “a prepayment in advance for natural gas to be delivered by [Malibu] to [Arkla],” id. at 398, for the remaining duration of the contract. Arkla was entitled to recoup the settlement payment through purchases of future gas, with 50% of such gas received without further payment until the prepayment was fully recouped. The settlement agreement also provided that the prepayment would be refunded in cash if Malibu cancelled the contract or if the wells ran dry. Malibu recorded the receipt on its books as the proceeds of a loan, though no notes were executed and no interest was paid on the “principal.” The Tax Court declined to accept the loan characterization, noting in passing that no interest was charged and focusing more heavily on the fact that the events that would trigger a refund were not within the control of Arkla (as the court argued they were
That leaves the most difficult situation (under the constraints of current law at least): the treatment of prepaid receipts where there is an absolute refund feature. If the recipient pays a market rate of interest on the prepayment, treatment as a loan does not distort income. If, however, the recipient pays no interest or below-market interest, the taxpayer will either be overtaxed (full inclusion on receipt with an unaugmented deduction on repayment) or undertaxed (full deferral when a portion of the receipt does not represent a loan but rather other income) if section 7872 does not apply. In this situation of imperfect choices, the best interests of the tax system points toward overtaxation of the recipient when the present value of the amount transferred (the true loan portion of the transfer) comprises less than, say, 50 percent of the gross amount transferred. In this scenario, one can justify treating the transfer as more “not a loan” than a “loan.” And with overtaxation as the penalty for failing to pay a market rate of interest, the recipient might be encouraged to pay market interest, resulting in an income inclusion on the customer side that also avoids taxation absent application of section 7872. Overtaxation is the lesser evil from an institutional standpoint, as the mere threat of overtaxation would perhaps encourage a change in behavior that leads to correct taxation of both parties.405 Undertaxation would encourage the opposite response.406

For example, consider a recent Technical Advice Memorandum,407 which ruled that noninterest-bearing “membership deposits” received by a country club were not advance payments of membership fees but rather nontaxable loans. Members of the country club were required to pay both regular membership...

---

405. Cf. Julie A. Roin, Unmasking the “Matching Principle” in Tax Law, 79 VA. L. REV. 813, 823 (1993) (advocating potential overtaxation in mismatches that operate to the detriment of the government and to the benefit of taxpayers in order to avoid erosion of the tax base as taxpayers change their behavior to exploit the loophole).

406. Cf. Coven, supra note 390 (deferral of prepaid receipts is appropriate if interest is charged and not appropriate in the absence of interest); Gunn, supra note 14, at 25 (concluding that immediate taxation of prepaid receipts would discourage tax-motivated prepayments).

dues as well as “membership deposits,” which would be repaid no later than thirty years from the date of acceptance as a member or, if earlier, when the member resigns or when the club terminates memberships. If a member fails to pay the regular member dues, the membership may be terminated and arrears deducted from the membership deposit.

The ruling concluded that the deposits were excludable loans for tax purposes because of the absolute obligation to repay the amounts in no later than thirty years.

In the present case, the Club has an obligation to refund the member's deposit in 30 years if the deposit has not been repaid at an earlier time. This obligation to refund is absolute and is not premised on the occurrence of a contingency. Because of the Club's obligation to repay, the deposits are not received by Taxpayer under a claim of right. Further, the deposits generally will not be used to satisfy a member's delinquencies (except for any amounts owed by a resigning member). A member's failure to pay required dues results in the forfeiture of membership privileges, and not in an immediate satisfaction from the member's deposit. Therefore, the deposits should not be treated as advance payments to Taxpayer in the year of receipt.

The Club's satisfaction of amounts a resigning member owes to the Club from the member's deposit does not defeat the Club's continuing obligation to repay the deposit to the member. However, any amount by which the obligation to repay is reduced in order to cure a delinquency in membership dues and charges constitutes gross income to Taxpayer in the year of reduction.408

In other words, the author of the ruling declined to conclude that, as in the Mooney Aircraft case, the repayment obligation was so far down the road that repayment itself was doubtful, resulting in immediate inclusion. The absolute obligation to repay, even though thirty years down the road, was enough to qualify the payment as a "loan" for tax purposes under Indianapolis Power & Light.410

Moreover, the ruling also concluded that the loan was not a "significant-effect loan" under section 7872(c)(1)(E) because the Treasury Department has not yet issued regulations to give that section effect. Citing the legislative history underlying section

408. Id.
409. See supra notes 262-267 and accompanying text.
410. See supra notes 379-395 and accompanying text.
The ruling recognized that "if a member of a club makes a non-interest-bearing refundable deposit to a club in lieu of part or all of his or her membership fee, the member is paying the fee with money that has not yet been included in his income, i.e., the investment income from the proceeds of the deposit, and has, in effect, converted the fee into the equivalent of a deductible expense." The author was visibly frustrated by the lack of governing regulations that would allow taxation of the transaction under section 7872.

The facts of this ruling illustrate the extreme distortion that occurs in such scenarios. The present value of every $1 of "membership deposit" is less than 17.5 cents at a 6 percent after-tax interest rate. In other words, the "real principal" of the loan is only 17.5 cents for every dollar transferred by the member. In extreme instances such as this, perhaps the Service should argue—in the absence of section 7872 regulations—that because of the extreme disparity between the amount of the true loan between the parties and the amount actually transferred, the amount transferred does not pass muster as a "loan" at all. As mentioned earlier, such an all-or-nothing approach overtaxes the Club by the amount of the "true loan," but the alternative exclusion of the entire proceeds is even more egregiously wrong in view the fact that less than 20 percent of the amount transferred constitutes the principal of a loan. Moreover, the ruling encourages the structuring of abusive transactions of this sort. The presence of section 7872 should not stand in the way of such a ruling. While the presence of section 7872 indicates that full inclusion is "wrong," it equally indicates that full exclusion is also "wrong." In other words, section 7872 tells us what would be the "correct" treatment, but it does not indi-

412. The ruling said:

The legislative history of section 7872 of the Code indicates Congress envisioned that membership organizations that accept membership deposits like the Taxpayer in the instant case would be covered by section 7872. Further, a below-market loan to a membership organization in lieu of part or all of a membership fee was cited in the Notice of Proposed Rulemaking regarding below market loans to be an example of a loan that results in the conversion of a nondeductible expense into the equivalent of a deductible expense, i.e., a significant effect loan. However, since proposed regulations defining significant effect loans have not yet been published, the loan cannot presently be classified as a loan under section 7872(c)(1)(B).

Id.
cate which of two "incorrect" treatments should be applied in its absence. When the present value numbers indicate that less than 50 percent of the amount transferred constitutes the principal of a loan, it is more reasonable to treat the transfer as "not a loan" than as a "loan."\textsuperscript{413}

2. Other Income

Accrual of income outside the prepaid gross receipts context seems to be litigated less frequently than other accrual issues. Yet, the time value of money principles developed above have obvious implications for the accrual of income not yet received. Just as allowing a full face amount expense deduction, undiscounted to present cost, significantly prior to payment understates the true economic cost of the wealth reduction (and thus fails to reflect income clearly in the tax sense), requiring a full face amount inclusion of a gross receipt item, undiscounted to present value, significantly prior to receipt overstates the true economic benefit of the wealth accession.

Using the numbers from the earlier florist example for ease of comparison,\textsuperscript{414} assume that Widget Co., an accrual basis taxpayer, is contractually entitled to receive $100,000 in year 16 for services rendered in year 1. The all events test is satisfied in year 1, since all the events have occurred to fix the right to receive the $100,000 gross receipt, and the amount of the receipt is known with precision. Even the matching principle from the financial accountant's world should argue for full inclusion in year 1, since the amount was "earned" with performance and the expenses incurred to earn the income would have been incurred in year 1. Yet, full inclusion of $100,000 in year 1 when the payment will not be received until year 16 overstates the wealth accession for tax purposes for the same reason that full deduction by our florist of $100,000 in year 1 overstates the year-16 wealth reduction: Both ignore the time value of money between the payment date and the time it is taken into account for tax purposes. Widget Co. should have to include only the present value of that $100,000—or $31,524 under the assump-

\textsuperscript{413}. In the case of a demand loan rather than a term loan, where it would be impossible to determine the portion of the amount transferred constituting the real principal, overtaxation by requiring full inclusion would still be the better choice from an institutional standpoint.

\textsuperscript{414}. \textit{See supra} note 258 and accompanying text.
tions stated in the hypothetical—if the inclusion occurs in year 1. Alternatively, the inclusion could be deferred until year 16 when actually received and included at the full $100,000 face amount. In other words, the analysis mirrors the deduction of future expenses. Yet, no analogue to section 461(h) exists with respect to the accrual of income that will be received in the future. If analysis is limited to whether the all events test is satisfied, and if the clear reflection gloss fails to consider the time value of money distortions that occurs with a full $100,000 accrual in year 1, Widget Co. will be overtaxed.

Perhaps not surprisingly in view of the evolution in the premature deduction context, the Commissioner has responded to the premature income context by squeezing the problem into the “contingent income” box. Recall that, in the premature deduction context, the courts and the Commissioner delayed current undiscounted deductions for future expenses (prior to enactment of section 461(h)) by concluding that the expenses were really “contingent” and thus that all the events had not occurred to fix the liabilities.415 Even though delayed deduction was inconsistent with the financial accountant’s matching principle, tax values were honored (though more implicitly than explicitly) by delaying the deduction through any means possible. The “contingency” of the future liability was the means seized upon to give effect to tax values. Even when the future liability was not contingent under contract law, as in Mooney Aircraft, the court squeezed the facts into the contingent liability pigeonhole by arguing that the significant payment delay itself made the future payment uncertain in fact.416 Neither the courts nor the Commissioner explicitly recognized that the problem was really one of the time delay between payment of the expense and accounting for it under the tax system. The Commissioner is now resorting to the flip side of this same analysis to allow deferral of income that is not going to be received for some time. Such an approach honors underlying tax values, but resort once again to constricted, superficial modes of analysis under the language of the all events test—in lieu of a forthright discussion of the underlying tax values that should drive the analysis—is unfortunate.

415. See supra notes 226-252 and accompanying text.
416. See supra notes 262-267 and accompanying text.
For example, in a recent Technical Advice Memorandum,\footnote{417} the Service confronted the issue of whether an accrual basis public utility must include in gross income amounts attributable to future rate increases that were mandated by the state Public Utilities Commission. The amount of the future rate increases were known with certainty and were scheduled to be phased in over ten years. For the reasons discussed above, full face amount inclusion of the rate increases in year 1, undiscounted to present value, would overstate the utility’s gross income and thus not reflect income clearly in the tax sense because of the time value of money. Either a discounted inclusion in year 1 or delayed inclusion until the gross receipts were received would clearly reflect income in the tax sense.

It would have been refreshing to see a forthright analysis, using time value of money principles, that discussed the overstatement that occurs if future receipts, even if certain to occur, are required to be included in income at full face value in a year prior to receipt. The task would then focus on fashioning an administrable de minimis rule, just as section 461(h)(3) provides a de minimis rule that allows current deduction of future expenses in situations that involve neither a large absolute amount of money nor significant deferral,\footnote{418} and just as Revenue Procedure 71-21 allows deferral of prepaid gross receipts if the deferral is minimal.\footnote{419} Borrowing the yardstick from Revenue Procedure 71-21 might be defensible for the sake of consistency, since the underlying tax values at stake are the same. Under that approach, acceleration of income at full face amount would not clearly reflect income if it was not certain to be received by the end of the following taxable year. Alternatively, the yardstick of section 461(h)(3) (eight and one-half months beyond the taxable year) could be adopted. Outside whatever de minimis rule is considered reasonable, the income inclusion should either be discounted to present value in order to reflect income clearly, just as Ford’s deduction for future expenses in a year prior to enactment of section 461(h) was reduced to present cost,\footnote{420} or delayed until the year of receipt.

\footnote{417} T.A.M. 9715004 (Dec. 16, 1996).
\footnote{418} See supra note 285 and accompanying text.
\footnote{419} See supra note 363 and accompanying text.
\footnote{420} See supra notes 313-318 and accompanying text. 
The revenue agent argued that the utility should immediately accrue at full face amount the gross income attributable to the mandated rate increases that would occur over the 10-year period. The utility argued that it should not be required to include the future rate increases until it provided electricity at the increased rates (sort of an "economic performance" argument on the income side). The Service did (correctly, in my view) conclude that the utility need not include the rate increases in income until received, but it did so not under the analysis discussed here but under the rationale that it was not certain that the rate increases would in fact be received. The contingency that the Commissioner relied upon was that the utility was not entitled to receive the mandated increase until it actually sold electricity under the new rates to customers—even though those sales were virtually certain to occur.

What if the rate increases had related to past sales of electricity? The clear implication under the ruling's stated reasoning is that the future rate increases, though not yet received, would be accruable at full face amount in year 1 in that case. Revisit, for example, Continental Tie & Lumber Co. v. United States.421 The Continental Tie & Lumber Co. was a railway company that was seized and operated by the United States government for a period during WWI. Because Continental Tie & Lumber sustained a deficit in operating income during the period of federal control (compared to a pre-WWI test period), the company was eligible for a government payment of $25,000 under the Transportation Act of 1920. The amount of the $25,000 award was determined and paid in 1923, though the act pursuant to which it was awarded was enacted in 1920. Continental Tie & Lumber, an accrual basis taxpayer, argued that the award was not includable until received in 1923, while the Commissioner argued that the income accrued in 1920 when the act was passed.

Any expense deductions attributable to the income at issue in Continental Tie & Lumber would have already been taken prior to the year the described statute was enacted, as the award related to past operations of the railway. Allowing the taxpayer to defer the income accrual would thus not serve any

421. 286 U.S. 290 (1932); supra notes 309-311 and accompanying text (discussing Justice Connor's reference to the case in her dissent in General Dynamics). See also Georgia School-Book Depository v. Commissioner, 1 T.C. 463 (1943) (requiring current accrual, undiscounted to present value, of future receipt).
“matching” of income with expenses under financial accounting rhetoric. Yet, current accrual at full face value in 1920, undiscounted to present value, would still violate tax values. While the Court had by this time already demonstrated a willingness to deviate from financial accounting values in order to protect tax values by delaying current accrual of future deductions under the “contingent liability” out,\textsuperscript{422} it had no problem with requiring Continental Tie & Lumber to accrue the 1923 award in 1920, undiscounted to present value. The Court concluded that the filing for the award and actual calculation of the amount of the award were only ministerial acts that did not prevent accrual of the income.\textsuperscript{423} The Court failed to understand that the tax distortion arose not only in the case of contingent liabilities or income but with any significant time delay between even a certain receipt or payment and the tax accounting of the item (unless the item is perhaps so small as to render the tax distortion minimal).\textsuperscript{424} Because the Court has failed to progress beyond the contingency analysis in the modern era,\textsuperscript{425} it is extremely doubtful that Continental Tie & Lumber would come out any differently today. The Technical Advice Memorandum, focusing on the future performance required in order to be entitled to receive the gross receipt, further implies that this is the case.

3. Final Thoughts

What should be clear by now is that—at least with respect to true gross receipts and true expense items—income is most

---

\textsuperscript{422} The first case blessing a deviation from financial accounting treatment, \textit{i.e.}, the matching principle, to accord with tax values was decided two years earlier. \textit{See} Lucas v. American Code Co., 280 U.S. 445 (1930); \textit{supra} notes 232-237 and accompanying text (discussing case).

\textsuperscript{423} \textit{See} 286 U.S. at 295.

\textsuperscript{424} Indeed, Professor Yin has pointed out to me that the implications of this argument mean that the constructive receipt doctrine is perhaps unsound unless the acceleration is minimal. Viewed solely from the perspective of the cash basis recipient, immediate inclusion at full face amount (as opposed to an amount discounted to present value) \textit{would} seem to overtax the recipient. Perhaps the answer lies in switching vantage points to that of Professor Halperin. \textit{See infra} notes 451-461 (describing Professor Halperin’s work). If the payor deducts the amount immediately, even though not yet paid, we need to tax the recipient on the interest component (the amount equal to the difference between the discounted present value and the full face amount) immediately in order to ensure that the interest component does not fall through the cracks and escape taxation to anyone. I admit that I have to give further thought to this problem.

\textsuperscript{425} \textit{See supra} notes 292-312 and accompanying text (discussing the Hughes Properties and General Dynamics cases).
clearly reflected for tax purposes when the items are accounted for in the same year as actual receipt or actual payment under our current realization-based tax system unless the amount deducted or included is adjusted to take account of the time value of the mismatch between the time of payment and the time it is taken into account for tax purposes, as in the *Ford* case, at least if we limit our analysis to the individual taxpayer rather than to the tax base as a whole. (If an advance receipt is not really an advance gross receipt but a “loan” because of the absolute obligation to repay to the transferor the amount of the principal, then partial exclusion under the principles of section 7872 accurately reflects income. Moreover, if expenses are prepaid, they are not really expenses but “capital expenditures” that require capitalization in order to protect the income-tax value. Tax accounting for a significant gross receipts item or expense item in a year significantly separated from the year of receipt or payment distorts income for tax purposes if it is accounted for at full face value. The matching principle from financial accounting that drives “accrual” of an item in the financial accounting world simply has no place in deciding whether the tax accounting of an item clearly reflects income in the tax sense, in view of the very different roles, purposes, and effects that timing has in the financial accounting and tax worlds.

Accrual accounting for true gross receipt and expense items was imported into the tax accounting world solely for taxpayer

426. In an ideal system that does not incorporate the realization requirement, or which works around it, deduction would occur when costs are “incurred,” using the nomenclature of Professor Fellows. But the amount and timing of the deduction would take into account the time value of money principles central to the observations made in this Article, which assumes continuation of our current realization-based system. See Fellows, *supra* note 89, at 792-801 (discussing how future costs would be accounted for under a system that does not presuppose realization). See generally Jeff Strnad, *Periodicity and Accretion Taxation: Norms and Implementation*, 99 YALE L.J. 1817 (1990) (discussing implementation issues for an income tax system that rejects the realization requirement).

427. See *supra* notes 313-318 and accompanying text.

428. See *infra* notes 452-482 and accompanying text (considering two-party analysis).

429. See *supra* notes 81-125 and accompanying text (discussing why outlays that produce substantial future benefits must be capitalized under an income tax rather than be characterized as “expenses” that are immediately deductible); Williamson v. Commissioner, 37 T.C. 941 (1962) (requiring capitalization of prepaid rent); Commissioner v. Boylston Mkt. Ass’n, 131 F.2d 966 (1st Cir. 1942) (requiring capitalization of prepaid insurance premiums); Johnson, *After INDOPCO*, *supra* note 90, at 1332-34.
ease. In the great majority of everyday items, the use of accrual accounting from the financial accountant's world should not distort income in the tax sense simply because significant delays of gross receipts or payments are likely the exceptions rather than the rule in the real world. But when those exceptions arise, and a significant amount of money or significant deferral is at stake, tax values, such as the anti-tax-arbitrage value and the income-tax value, should take precedence, requiring either delay of tax accounting until the year of receipt or payment or a modification of the amount of inclusion or deduction to reflect the time value of the time differential.

A full shift to cash accounting is not necessary to protect tax values in those cases where they are at risk. For administrative ease, it is quite reasonable to start with the taxpayer's accrual books that are kept for financial accounting purposes, making adjustments at the margins for those relatively few items that threaten tax values. The economic performance requirement of section 461(h), while unnecessarily complex (in that it should simply look to the later of accrual or payment), serves to protect tax values in the premature deduction context. On the accrual of future income side, a similar delay in accrual (or discount to present value) should occur outside the de minimis context for the same reasons, even though the statute fails to provide for this result and taxpayers must argue within the "contingency" pigeonhole fashioned by the Commissioner and the courts to succeed in delayed inclusion. Prepaid gross receipts, until addressed through regulations under section 7872, should in most cases be includable upon receipt—regardless of the certainty of the extent and time of the future performance for which the receipts are received—with "loan" characterization (and thus exclusion) available only in cases in which the recipient pays market-rate interest to the payor of the advance receipt cum loan.

This emphasis on the cash basis of accounting for gross receipts and expense items as most clearly reflecting income in the tax sense in order to protect the anti-tax-arbitrage value and income-tax value may be perceived by some to be flatly inconsistent with both the Service's increased efforts to require cash basis taxpayers to switch to accrual accounting and the 1986 enactment of statutory limitations on use of the cash basis of accounting. A closer look at each development, however, shows that each can be explained without any unspoken pre-
Consumption that accrual accounting of gross receipt and expense items more clearly reflects income—again, solely for tax purposes—than cash accounting.

Since at least 1957, Treasury regulations have provided that "[i]n any case in which it is necessary to use an inventory the accrual method of accounting must be used with regard to purchases and sales . . . ." And since at least 1958, they have also provided that a taxpayer must use inventory accounting whenever "the production, purchase, or sale of merchandise is an income-producing factor." Inventory accounting must be used if the taxpayer carries an inventory from year to year. In that context, inventory accounting requires that assets in an inventory pool (and related expenses) be capitalized and not be depreciable, since inventory is not used up in the current year to produce gross income. The basis of the inventory, unreduced by depreciation, offsets the gross receipts from the sale. As discussed in part A, the use of inventories is necessary to clearly reflect income in the tax sense whenever there is a pool of merchandise that is sold over time, as the basis of the pooled merchandise, maintained from year to year, should not be eligible for depreciation over a multiyear ownership period. Allowing depreciation of assets in pooled inventory carried from year to year would violate the income-tax value.

Such concerns are not present, however, where no pools of inventory are maintained. Yet, these same regulations have increasingly caused the Commissioner to challenge cash basis accounting by taxpayers who predominantly perform services for their customers but also sell property to the customers in connection with the services performed. These taxpayers do not maintain a multiyear inventory stock; rather, they purchase

431. Treas. Reg. § 1.446-1(c)(2)(i). Unlike the practice today, there was no preamble to the regulations in the Federal Register containing an explanation of the reasoning behind them. The likely reason was sheer adherence to financial accounting practices. As noted earlier, inventory accounting in financial accounting is an example of the matching principle. See supra note 81 and accompanying text. Thus, the rest of the "matching principle"—accrual accounting—was likely imported into the tax realm for the sake of consistency. The use of inventory accounting for a pool of inventory maintained from year to year can be can be seen, in the tax world, as necessary to protect the income-tax value. See supra notes 139-147 and accompanying text.
434. See supra notes 139-147 and accompanying text (discussing accounting for rotatable spare parts).
(and resell) items to customers on an as-needed basis. In this particular context, the Commissioner’s desire to argue that the taxpayer must use inventory accounting because property sales constitute an income producing factor seems to be merely the means to force the use of the accrual method. The Commissioner wishes to force accrual in these cases because the taxpayers have substantial accounts receivable that will be taken into income at an earlier time. In other words, the Commissioner’s action in many of these cases seems to be purely revenue driven; it does not seem to be based on grand theory.

For example, in *Sheahan v. Commissioner*, the taxpayer was a construction contractor whose principal business was commercial roofing repair. He had never used inventory accounting for the roofing materials he used in his business or the accrual method of accounting, either for financial accounting purposes or tax purposes. The taxpayer did not maintain a supply of roofing materials. Rather, he inspected each job site and purchased the materials as they were needed and used for each job. He therefore deducted the materials and supplies purchased for each roofing repair job in the year of purchase. Unused materials and supplies were usually returned to the supplier for credit, though leftover materials and supplies from jobs for its principal customer, Dow Chemical Co., were sometimes earmarked for other jobs. Because it had no year-end inventory, the taxpayer claimed that it need not use inventory accounting and thus need not use the accrual method.

The Tax Court, however, agreed with the Commissioner, reasoning that use of inventory accounting, and thus the accrual method, was required “because (1) the taxpayer separately stated the cost of the roofing materials on the invoice, (2) the cost of the roofing materials represented a substantial amount of the total invoice, and (3) the taxpayer added a 25 percent markup to the invoiced cost of the roofing materials.” The fact


that the taxpayer maintained no year-end inventory and purchased materials only for particular jobs as they were required was irrelevant to the court. The taxpayer's use of the cash method did not produce substantially the same results as the accrual method because the taxpayer's business generated substantial accounts receivable. The accumulation of a sizable amount of accounts receivable convinced the Tax Court that the taxpayer had "crossed the line." It is not clear what "line" was crossed, since cash basis taxpayers may wait until the account receivable is paid before reporting the gross receipt, no matter how substantial the receivables.

Similarly, in Independent Contracts, Inc. v. United States, the taxpayer was a heating and air conditioning subcontractor that used the cash method of accounting for both financial accounting and tax purposes. The company bid to supply and install heating and air conditioning units for a fixed price. It purchased the units as needed and had them shipped directly to the installation site (and thus did not carry an inventory of units at year end). The District Court noted that accounts receivables were almost ten times the amount of accounts payable and that over 50 percent of the gross receipts could be attributed to the materials. The court concluded that, given the "uncertain area such as presented here" and "the present state of the legal precedent," the "Commissioner should be accorded great deference." Thus, it sanctioned the Commissioner's switch from the cash method to the accrual method.

The fact that these cases were revenue driven rather than based in tax theory is revealed by the Tax Court's resort to the matching principle to support its decision to force use of the accrual method. The Sheahan court expressly argued that the problem with use of the cash method by the taxpayer was the mismatching of income and costs to produce that income when those costs are deducted in years prior to the taxable years in

437. The "substantial-identity-of-results" test, first articulated in Wilkinson-Beane, Inc. v. Commissioner, 420 F.2d 352, 356 (1970), provides that, if the cash method of accounting produces substantially identical results as the accrual method of accounting, the Commissioner has abused his discretion in requiring a switch from the cash to accrual method.

438. 63 T.C.M. (CCH) at 2847.

439. 94-1 U.S.T.C. (CCH) ¶ 50,135 (N.D. Ala.), aff'd per curiam, 40 F.3d 390 (11th Cir. 1994).

440. Id.
which the income is received.\footnote{63 T.C.M. (CCH) at 2847.} The court, implying something amiss here, noted that "petitioner managed to defer income to a later year while currently deducting costs incurred to generate that income."\footnote{Id.} With the unmasking of the matching principle as a tax value, no reasoning supports the accelerated inclusion at full face value of gross receipts not yet received.\footnote{Perhaps the Internal Revenue Service will be less likely to resort to the rhetoric of the matching principle in these cash method cases in the courts after issuance of T.A.M. 9723006 (Feb. 7, 1997). There, the Service ruled that "in the case of a service provider that is not required to maintain inventories, the failure of the cash method to match income and expenses may not be used as a basis for disallowing use of the cash method." The taxpayer at issue was a cash method personal service corporation that operated several medical clinics. The corporation's accounts receivables increased significantly in the years at issue, and the corporation reported net operating losses. The corporation's purchases of merchandise as well as materials and supplies (including office supplies) amounted to less than 8% of its gross receipts for the challenged years. Because the sale of merchandise, such as bandages and medicines, was not deemed to be an income-producing factor, the taxpayer could not be shunted into the accrual method via the inventory rule of the Regulations. See Treas. Reg. § 1.446-1(c)(2)(i). The revenue agent nevertheless argued that the accrual method was warranted because of the severe mismatch between expense deductions and gross income inclusions. As noted above, the Service rejected that reasoning. Note, however, that if the sale of merchandise had contributed a large enough portion of the corporation's gross income to be deemed an income-producing factor, the clinic would have been bootstrapped into the accrual method under the inventory rule—even if the clinic did not maintain inventories of the merchandise from year to year.} We have already seen how delaying deduction under section 461(h) of expenses that will not be paid until the future while requiring inclusion of prepaid income clearly reflects income for tax purposes even as it mismatches receipts and expenses and thus fails to reflect income clearly for financial accounting purposes. This scenario is no different. The costs that were deducted were supported by current outlays, \textit{i.e.}, represented a current loss in wealth.\footnote{The outlays were not capital expenditures, where current deduction would violate tax values. See \textit{supra} notes 81-125 and accompanying text.} The future gross receipts were not yet in fact received and including them at full face value overstates the wealth accession and thus fails to reflect income clearly for tax purposes. The \textit{Independent Contracts} court failed to engage in any reasoning at all, deciding the case wholly on faith in the Commissioner's judgment in an area in which the court clearly felt itself inexpert. The drive for revenue by the Commissioner, and nothing more, appears to be at the heart of these cases.
That theory often fails to inform the courts thinking in this area was also displayed in a case in which the taxpayer won. In Galedrige Construction, Inc. v. Commissioner,\textsuperscript{445} the taxpayer was engaged in the business of asphalt paving and related services. It used the cash method of accounting. The Commissioner argued that because the taxpayer sold asphalt in the course of his business, he must use inventories and, therefore, the accrual method of accounting. Like the taxpayers in Sheahan and Independent Contracts, the taxpayer did not maintain a store of the item at issue. Rather, it purchased asphalt for each job from a supplier and took it directly to the job site, where it had to be laid within two to five hours before it became rock hard and would have to be thrown away. The Tax Court admitted that the taxpayer's argument, \textit{i.e.}, because it carried no inventory from job to job it could not be required to use inventory accounting and thus the accrual method, had "commonsense appeal."\textsuperscript{446} Yet, the court declared that the failure to carry inventory was "not dispositive"\textsuperscript{447} of whether the taxpayer must use inventory accounting. The court instead focused myopically on the meaning of the term "merchandise" in Treas. Reg. § 1.471-1 and concluded that it excluded material that must be used within so short a time before becoming worthless. In other words, the taxpayer won for an irrelevant reason. The taxpayers in Sheahan and Independent Contracts had the unfortunate luck to install material that would not become worthless if not installed quickly. Such a distinction should have no relevance in the tax analysis. The important point is that none of these taxpayers carried an inventory but rather purchased materials as they were needed for each job.

Congress also seems to have at least implied that the accrual method more accurately reflects income for tax purposes when it reduced the number of taxpayers able to use the cash method of accounting in 1986 by enacting section 448, which prevents use of the cash method of accounting by most C corporations,\textsuperscript{448} partnerships with C corporations as partners, and tax

\textsuperscript{445} 73 T.C.M. (CCH) 2838 (1997).

\textsuperscript{446} \textit{Id.}

\textsuperscript{447} \textit{Id.}

\textsuperscript{448} Apparently, the strength of the farm lobby and the American Bar Association succeeded in exceptions for farming businesses and "qualified personal service corporations," including incorporated law firms. See I.R.C. § 448(b), (d).
shelters. One portion of the legislative history supports such a view. The House Ways and Means Committee Report states:

The committee believes that the cash method frequently fails to reflect accurately the economic results of a taxpayer's trade or business over a taxable year. . . . [The cash method] may result in the recognition of income and expense items without regard to the taxable year in which the economic events giving rise to the items occurred and, therefore, generally is not in accord with generally accepted accounting principles. 449

The very next sentence, however, provides an alternative reason. “The cash method also produces a mismatching of income and deductions when all parties to a transaction use different methods of accounting.”

This second sense of “matching” is distinct from the GAAP sense focusing on a single taxpayer's reporting of related income and expense items. Rather, it refers to the matching of inclusions and deductions of an item between two separate taxpayers to a transaction. For example, a cash method taxpayer will not include an item of gross income until received, while an accrual basis payor of that same item may be able to deduct the item in an earlier year as an expense. This sense of matching is wholly irrelevant for financial accounting purposes, where a single transaction can be reported in very different ways by the parties to the transaction without offending GAAP. 450 This alternative “matching principle” is discussed next in section D. Suffice it to say here that this alternative notion of matching, based on protecting the system-wide tax base, may have been the more important impetus for narrowing the class of taxpayers eligible to use the cash method of accounting. This might be particularly so since so many tax lawyers and judges continued even in the 1980s (indeed, as we have seen, continue even today) to recite unthinkingly that the matching principle of GAAP constitutes a tax value. It would have been easy to throw that into the mix to support a proposal whose primary rationale was more subtle. While that rationale is theoretical, the reasoning is not one based on the superiority of financial accrual accounting (and the matching principle that is the defining force in financial accrual accounting) but rather on the tax values that can be under-

450. See supra notes 57-76 and accompanying text (discussing development of GAAP).
mined with systematic mismatch between two taxpayers with respect to the reporting of a given transfer between them. Ironically, as we shall see, the tax values that support matching among taxpayers are of the same genre that we have seen require *deviations* from the financial accountant's matching principle with respect to accounting for gross receipt and expense items of a single taxpayer. So let us get to it.

**D. TWO-PARTY MATCHING**

1. In General

   Unlike the matters discussed in previous parts, this part does not focus on the matching of deductions and inclusions of a single taxpayer in the same period, the focus of the accounting profession's "matching principle." Rather, this part briefly considers the matching of inclusions and deductions required by the Internal Revenue Code between two separate taxpayers in certain contexts. A short survey of this distinctive tax "matching principle" deepens our understanding of the notion that tax values are independent of financial accounting values and must be understood on their own terms.

   For financial accounting purposes, a payment made from one business to another may permissibly be deducted in year 1 by the payor even though it is not included by the payee until year 2. Financial accounting, in other words, has no system-wide consistency; it is entirely an individualized enterprise that focuses wholly on the business before it, without regard to how other parties to a transaction will account for the same matter. This makes perfect sense if we recall the *raison d'être* of financial accounting: to provide interested parties with useful information about the economic health of the particular business under examination. There is no system-wide dollar value gained or lost with inconsistent reporting; there are simply no system-wide consequences at all, as there is no larger "system" in the same sense as in the system-wide tax base.

   Because the calculation of "income" for tax purposes results in the payment of dollars to the Treasury, there are system-wide consequences when two parties to a transaction report the timing of deductions and inclusions inconsistently: Investment income—disguised interest income—that should be taxed to someone can fail to be taxed to anyone, thus reducing overall
Treasury receipts. While not precisely the same as the income-tax value discussed in earlier sections, the tax value sought to be protected by requiring consistent reporting smacks of the same idea, but the focus is slightly different. The common feature of these tax values is protection of the tax base, ensuring that income that ought to be taxed under an income tax, even though it would not be taxed under a consumption tax, does not escape taxation. While the income-tax value focuses more on ensuring that income of a particular taxpayer does not escape taxation, the provisions considered here seek to ensure that income does not fall through the cracks between taxpayers.

The clearest examples of two-party matching in the Internal Revenue Code are contained in sections 83(h), 267(a)(2), and 404(a)(5). Each of these provisions delays deductions to accrual basis taxpayers for future payments made to cash basis taxpayers until the year in which the payee includes the item in income. While section 267(a)(2) applies to taxpayers who are related in some way, sections 83(h) and 404(a)(5) apply to payments of unvested and deferred compensation, other than under so-called qualified plans, whether or not the parties are related. Thus, there appears to be a “matching principle” unique to tax. But just as with instances when the one-party version of the matching principle seemed to apply in the tax context, two-party matching is not itself an independent value; it is descriptive only. The underlying tax value at stake is one of ensuring taxation of the investment income earned with respect to the delayed payments, which could be accomplished in ways other than matching, meaning that matching is descriptive only; the real value is to ensure taxation of investment income to someone.

Professor Daniel Halperin’s pathbreaking work in the 1980s explores this phenomenon. Consider his example of

453. See Halperin, 1984, supra note 89, at 753.
Employee, who uses the cash method of accounting and who is entitled to a $1,000 bonus in year 0. The bonus is withheld by her accrual basis Employer for one year and invested to earn 10 percent interest before tax. Both Employee and Employer are subject to a marginal tax rate of 40 percent.

Case 1 considers the outcome under current law. Under section 404(a)(5), Employer's deduction for the $1,000 bonus is delayed until year 1 to match the timing of Employee's inclusion. Employer thus must pay tax on the $1,000 in year 0, leaving $600 to invest. After earning 10 percent interest, or $60, and paying tax of $24, Employer retains $636. Because the entire payment to Employee is deductible (including the portion representing the interest return), Employer can, with an out-of-pocket cost of only $636, pay more than that amount to Employee. If Employer pays $1,060 to Employee, at a 40 percent marginal rate, it will save $424 in tax, and the net cost will be $636. Employee pays tax of $424 on receipt of the $1,060 and retains $636.

As Professor Halperin notes, however, this result could be obtained via a route other than delaying Employer's deduction to match Employee's inclusion, as considered in Case 2. We could allow Employer an immediate deduction of $1,000 in year 0, but prohibit Employer from deducting the interest credited to the Employee on the deferred funds. In that case, the entire $1,000 would be available for investment in year 0. It would earn $100 before taxes, leaving $60 after taxes or a total accumulation of $1060 to distribute to Employee, with no further deduction of the $60 investment return on the distribution to Employee. Employee would pay tax of $424 and retain $636—the same outcome as in Case 1.

The crux, then, is the taxation of the interest income earned on the delayed payment, not matching per se. This fact is made even more clear by considering Case 3, where Employer is allowed to accrue the deferred payment in year 0, as in Case 2, but then is not taxed on the interest return. Because the $1,000 is deducted in year 0, the entire amount is invested and earns $100, as in Case 2. But because the interest is not taxed to the Employer, unlike Case 2, Employee can receive the full $1,100 in year 1. After paying tax of $440 Employee retains $660 after tax (instead of only $636, as in Cases 1 and 2). In other words, deferral of tax by the cash basis Employee would permit the Employee to obtain an advantage equal to the benefit of a tax-
free return on reinvestment of the net, after-tax interest—unless
the payor bears an extra burden because of a delay in its deduc-
tion. The effect of these sections is to tax the payee’s investment
income on the deferred payment to the payor in order to ensure
that it does not escape taxation altogether.

As Professor Halperin wrote,

It is not, I believe, widely understood that the key factor in
[current law, Case 1] is not the deferral of [Employer’s] deduction
but the fact that [Employer] had to pay tax on the $60 of invest-
ment income. If it did not, it would have accumulated $660 which
would have permitted a distribution of $1,100 to [Employee] as in
Case [3] . . . . That is why the result in [current law, Case 1] can
be obtained even if [Employer] is permitted to accrue the $1,000
expense (as in Case [2]), as long as no further deduction [for the
interest income paid to Employee] is permitted.

These examples illustrate that timing of deduction and in-
come may not be crucial if the amount is adjusted to account for
the advantage or disadvantage of delay or acceleration. [Em-
ployer] can in effect be taxed on [Employee’s] investment income
whether it is allowed to use the cash or accrual method for com-
pensation as long as the accrued deduction is limited to the cash
paid, discounted at [Employee’s] after-tax rate of return and no
further deduction is allowed. Thus in Case [2], [Employer’s]$1,000 deduction is equal to the present value of the actual pay-
ment of $1,060 discounted at 6 percent, the after-tax rate of in-
terest. The equivalence of these two approaches, not as yet noted
in the case of compensation, has been explicitly recognized by
Congress in connection with [§ 461(h)].

The bottom line is that the underlying tax value that drives
matching in sections 83(h), 267(a)(2), and 404(a)(5) is ensuring
that the investment return on the delayed payment does not es-
cape taxation, which could otherwise occur when cash basis tax-
payers do business with accrual basis taxpayers. Indeed, this is
one reason why use of the cash method was restricted in 1986—
to reduce the loss of tax revenue that occurs when investment
income escapes taxation in transfers between cash and accrual
taxpayers not covered by sections 83(h), 267(a)(2), and
404(a)(5).

454.  Id. See infra notes 463-473 and accompanying text (discussing application of
these ideas to section 461(h) and the problem of premature accrual of future outlays).
455.  See supra notes 449-451 and accompanying text.
In sections 83(h), 267(a)(2), and 404(a)(5), the interest return is taxed to the payor rather than the payee, even though the payee might seem to be the true beneficiary of the interest, as though the Employer were investing the Employee's deferred compensation on her behalf. But in other situations, as Professor Halperin explains, Congress has chosen to tax the beneficiary on the interest income. For example, revisit the treatment of original issue discount (OID). Earlier, I described the OID rules as being premised on the realization requirement, as they require inclusion by the payee of final, passage-of-time gains. An alternative way to view the treatment of the OID rules is that they, like sections 83(h), 267(a)(2), and 404(a)(5), ensure taxation of the investment return on the delayed interest payments. Under the paradigm established in sections 83(h), 267(a)(2), and 404(a)(5), the payor could have been taxed on the reinvested returns by requiring accrual basis payors to delay their interest deductions until the cash basis payees included the interest in income. Unlike that paradigm, however, the OID rules tax the payee, instead of the payor, on those returns by requiring the payee to include the interest in income as it accrues.

Reinforcing the notion that the true tax value at stake here is ensuring that disguised interest is taxed as such is section 7872, which shares this goal with the above sections but which—unlike those sections—does not involve the matching of inclusions and deductions between taxpayers. Consider an interest-free demand loan by a corporation to its shareholder. Under section 7872, the corporation/lender is considered to receive an annual interest payment that is returned to the borrower/shareholder as a dividend. Because the deemed payment to the corporation of interest is includable and the deemed payment of a dividend to the shareholder is not deductible, section 7872 serves to capture the investment income earned by the corporation that would otherwise escape the tax base. It thus has more in common with the sections discussed above than is apparent.

456. One problem with this kind of surrogate taxation is that the tax rates of the two taxpayers might not be the same. "Matching cannot stop shifting investment income to exploit a difference in tax rates." Halperin, Disguised Interest, supra note 89, at 512. See generally Fellows, supra note 452, at 1532-37 (considering the limitations of surrogate taxation in more detail).

457. See supra notes 126-129 and accompanying text.

on its face.\textsuperscript{459}

Full implementation of the ideas described here in order to protect the system-wide tax base is unlikely. As Professor Charlotte Crane has written:

Although arguably attractive as a means of preserving the revenue base, such a generalized implementation of the [the ideas underlying two-party matching] would likely be highly undesirable. Transactions which appeared similar from the facts known to the taxpayer would have different results. Thus, for most of the tax law, the most obvious place to stop has been with the information that is within the reach of the individual taxpayer. It is the exception when we seek to relate a taxpayer's tax consequences with those of another, and we are apt to do so only when the taxpayers have a special ongoing relationship, or when the treatment for both can be dictated in a single statute. As a consequence, we sacrifice our ability to obtain the appropriate aggregate tax base in favor of obtaining the appropriate individual tax base. We seem to be much more willing to tolerate errors in the aggregate tax base than in the individual tax base. And so we focus on those matches that are within the taxpayer's history, rather than within the history of enhancement.\textsuperscript{460}

But the consideration of “systemic matching,” as Professor Julie A. Roin calls it, can lead to more informed tax policy choices.

Though the process of matching is no panacea for all of the ills of the tax system, it can advance tax policy goals by isolating problems and the causes of perceived problems. Once isolated, these situations can either be solved or accepted as inevitable side-effects of some other tax policy decisions. Even more important, the failure to match often leads to the mistaken adoption of false solutions to nonproblems, creating undesirable economic distortions.\textsuperscript{461}

These latest insights have been extended to two issues discussed earlier in this Article: the premature accrual of expenses to be paid in the future and the inclusion of prepaid gross receipts. Our understanding of the outcomes argued to be appropriate earlier under an individual taxpayer analysis can be deepened

\textsuperscript{459} See id. at 757.


\textsuperscript{461} Roin, supra note 405, at 814.
by approaching these issues from the perspective of the aggregate system-wide tax base.

2. Premature Accrual of Future Expenses Revisited

Recall our accrual basis florist, who agreed to pay $100,000 in year 16 to settle the tort claims of his victim.462 The all events test with respect to the payment is satisfied in year 1, yet a year-1 accrual of the $100,000 liability, even if consistent with the financial accountant’s matching principle, would allow inappropriate tax arbitrage as well as violate the income-tax value because it fails to account for the time value of money. Section 461(h) thus requires the florist to delay his $100,000 deduction until year 16. An economically equivalent alternative, rejected by Congress in enacting section 461(h), would allow the florist to take his deduction in year 1 but would require the amount of the deduction to be discounted to its present cost using an after-tax rate of return, which was only $31,524 under the assumed facts of the hypothetical.463

Professor Halperin identified an alternative justification for section 461(h) premised on the ideas discussed in subpart 1. above. Section 461(h) “can be viewed as deferring the payor’s deduction not only to eliminate an unwarranted advantage to the payor, but also to tax the payor on investment income when it appears to be the only means of subjecting such income to tax.”464 Consider his example, comparable to our florist example.

In settlement of a lawsuit brought by F, E has agreed to make a payment to F, three years hence, of $1,331 in lieu of a current payment of $1,000. If E is not taxable on investment earnings, it should be able to meet its obligation by setting aside $1,000 today. This result can be achieved if E is permitted a deduction of $1,000 currently (the present value of its $1,331 obligation discounted at the pre-tax interest rate of 10 percent) and additional deductions for each year’s interest. If 10 percent is earned on the accumulated funds, the deduction for interest would be $100 for the first year, $110 the second year, and $121 the third, or a total of $331. An immediate deduction of $1,331 more than offsets the tax on $331 of expected future earnings and

462. See supra note 258 and accompanying text.
463. See id..
reduces E's burden below $1,000. 465

If we focus solely on E, then, a present deduction of $1,331 is inapposite, as it would effectively allow E "not just to avoid tax on investment income which it is receiving but which is accruing to the benefit of the payee, but also to take an up-front deduction to offset investment income to be earned in the future." 466 But he goes on to consider a point not considered earlier: that the proper treatment of E perhaps cannot be considered without considering the treatment of F.

If F were to receive the $1,000 immediately, F would be taxed on the $331 of interest income that would be earned in the following three years. Suppose, however, that F is an accrual basis taxpayer and is required to accrue $1,331 immediately upon the settlement even though the amount is not to be received until year 3. 467 In that case, he is paying tax in year 1 on investment income that will not be earned until the future. Professor Halperin posits that "[i]t may be reasonable to offset this disadvantage by granting a corresponding advantage to E," 468 though he concludes that it would be preferable to discount both the deduction and inclusion.

Now suppose that F is a cash basis taxpayer. Then we are suddenly back in the paradigm of sections 83(h), 267(a)(2), and 404(a)(5): We have a deferred payment between an accrual basis payor and a cash basis payee. To ensure taxation of the investment income earned on the deferred payment, we have several choices. We can tax F currently, as cash basis payees are taxed currently under the OID rules, 469 and allow E to avoid tax on the investment income by allowing a year-1 deduction of $1,000 (the $1,331 future payment discounted to present cost using the 10 percent before-tax rate of return) as well as annual deductions for the accrued interest. 470 Or we can tax E on the investment income as a surrogate. That can be accomplished either by requiring two-party matching regarding the deduction and inclu-

465. Id.
466. Id.
467. See supra notes 415-426 and accompanying text (arguing that if we approach this issue on the basis of individual taxpayers, as we have prior to this most recent thinking, then accrual basis taxpayers should be able to reduce to present value their income inclusions if the income is not to be received until the future).
469. See supra notes 126-129 and accompanying text.
470. See Halperin, 1984, supra note 89, at 760.
sion by deferring E's deduction to match the timing of F's inclusion, as in sections 83(h), 267(a)(2), and 404(a)(5), or allowing E an immediate deduction but only for the present value of the future payment discounted at the after-tax rate of return and allowing no further deduction. Even though surrogate taxation clearly is problematic when the two taxpayers are not in the same tax bracket, Congress chose it, and Congress chose to implement it in section 461(h) through the deferral method rather than the discount method—in all cases, even when the payee is an accrual basis taxpayer that must (inappropriately) accrue the $1,331 payment in year 1 without discounting it to present value.

3. Prepaid Gross Receipts Revisited

Recall the treatment of the receipt of gross receipts by an accrual basis taxpayer in a year prior to the corresponding delivery of goods or services. With some exceptions, the recipient must include the receipt in gross income in the year of receipt, even though the receipt is not yet "earned" for financial accounting purposes and thus would not be included in the year of receipt under the matching principal. When viewed from the individualized perspective of the recipient taxpayer, deferral would allow just the kind of time value of money abuse that is inherent in immediate undiscouned deduction of future expenses. The correctness of requiring immediate inclusion can be buttressed by the ideas discussed in this part, which considers the taxation of the other party to the transaction. Failure to tax

471. See supra notes 454-459 and accompanying text.

472. One reason why Congress might have chosen surrogate taxation is that it is not always possible to identify who the payee will be at the time the investment income is earned. There sometimes is no current F that could be taxed, meaning that the investment income would escape taxation if E is not taxed. Examples include the costs associated with nuclear power plant decommissioning or mine reclamation. (On the other hand, perhaps this is the kind of “income” that should not be taxed to anyone. See Halperin, Disguised Interest, supra note 89, at 529.) Professor Halperin gives an additional example of a doctor who self-insures.

Doctor G performs 1,000 operations per year. He knows that one patient is likely to sue successfully for malpractice. Deciding to self-insure, he sets aside $100x out of his current income. Who should be taxed on the income earned on that fund? The doctor, the injured patient who is as yet unknown, all patients, no one? The addition of insurance adds yet another element but no clear answer. Halperin, 1984, supra note 89, at 761. For a discussion of the insurance wrinkle, see Halperin, Disguised Interest, supra note 89, at 527.

473. See supra notes 319-414 and accompanying text.
the recipient immediately can result in investment income slipping through the cracks and being taxed to no one.

Suppose, for example, that C contracts with D for D to perform services in the future, and C prepays for the services to be rendered. Since D can earn an investment return on the prepayment, she should be willing to charge a lower price to C than would be the case without the prepayment. The prepayment by C can thus be reconceptualized as a loan to D coupled with the transfer of the purchase price of the goods or services. C thus earns "interest," which could, if Congress chose, be taxed to C under rules similar to the OID rules.

For example, suppose C transfers $100 to D on December 31, [1996], and D promises to provide a service on December 31, [1997]. [With a 10% rate of return, t]he transaction can be treated as a loan from C to D of $100 with $110 payable at maturity. On the due date, December 31, [1997], the parties can be viewed as making reciprocal payments, D transferring $110 to C in payment of the loan plus interest and C paying $110 to D for services rendered. If the prepayment were for a longer period, then the OID rules could be used to accrue interest annually.474

Current law, however, does not require the taxation of interest to C. And the only way it can be taxed to D as a surrogate, in order to ensure that it does not escape taxation altogether, is to require D to include the prepayment in income upon receipt.

An equivalent extra burden on the payee would occur if D were subject to tax at the same rate as C and D were taxed on the investment income accrued to C. If this were true, then D would give C credit only for an after-tax rate of return indirectly exposing C to tax. D is, in form, taxable on the earnings it receives when it invests a prepayment. Thus, in the above example, D would earn $10 of interest on the $100 it received on December 31, [1996]. However, if D is performing services worth $110 on December 31, [1997], taxation at that point on the original $100, plus $10 of interest, merely reflects the correct treatment of D. In order to place the burden of the tax on investment income on D, it must be taxed on the original $100 at the point of receipt.475

Recall from the discussion of capital expenditures that if D is not taxed on the $100 on receipt, then even though the interest received on the investment is nominally taxed to D it is effec-

475. Id. (footnoted omitted).
tively exempt from tax, contrary to the income-tax value. 476

4. Final Thoughts

The two-party analysis discussed in this part is the latest and most sophisticated example of how tax values are independent of financial accounting values, particularly the matching principle. The two-party matching analysis has no counterpart in financial accounting, yet it is merely a more refined application of tax principles pioneered earlier in the context of one-party analysis. The analysis described here evolved out of the increasing appreciation of time value of money principles, and those principles revealed the inappropriateness of the financial accountant's matching principle in the world of tax. That is, tax values seek to protect the tax base of "income," which is a construct independent of financial accounting but, unfortunately, shares a nomenclature with financial accounting. As this part exemplifies most tellingly, tax values are different not just in degree but in kind from financial accounting values.

Some commentators have argued for extension of the analysis described in this part to other contexts. 477 In the meantime, however, courts should strive to further understanding of the tax values discussed here by openly focusing on them and being informed by them when deciding cases under Code sections already implementing them. An example is the controversial case of Albertson's, Inc. v. Commissioner, which the Ninth Circuit

476. See supra notes 81-125 and accompanying text. An alternative method of ensuring taxation of the investment income would be available if C's payment is of a deductible expense. "If C is prepaying for a deductible item, he should be allowed a deduction of $110 in [1997] and be charged with $10 of interest income at that time. If, despite payment in [1996], C's deduction were delayed until [1997], when the services are performed, and limited to the amount paid, $100, the net result would be correct." Halperin, 1984, supra note 89, at 758. Cash basis taxpayers, however, are allowed to deduct expenses when paid, and not all prepayments are of deductible expenses in any event. Nevertheless, if D includes the prepayment in income upon receipt and C's payment is a deductible expense that may not be deducted until economic performance under section 461(h), the investment income will be taxed twice to each party under this analysis. See Halperin, Disguised Interest, supra note 89, at 518.

477. See, e.g., Yin, supra note 89, at 480-90 (encouraging Treasury to issue regulations under section 7872 to cover the fact situation encountered in Indianapolis Power & Light); Halperin, Disguised Interest, supra note 89 at 539-50 (proposing a special tax on the investment income of nonqualified deferred compensation since surrogate taxation fails when the employer is tax exempt or has net operating losses); Fellows, supra note 452, at 1539-41 (advocating an alternative to section 461(h) to take account of the limitations in surrogate taxation).
first decided in favor of the taxpayer. Because of the ensuing uproar over its decision, however, it vacated that decision and granted a rehearing, subsequently deciding the case against the taxpayer.

Albertson's had nonqualified deferred compensation agreements with some of its executives and directors that were subject to the deferred deduction rule in section 404(a)(5). The agreements provided that an interest-like component would be added to the deferred compensation to compensate the recipients for the time value of the deferral. Albertson's argued that, although the compensation itself was not deductible until paid to the cash basis recipients, the interest-like component was not subject to the deduction deferral rule of section 404(a)(5) but rather was deductible as it accrued. The interest-like component was not included in the recipient's income until received. Thus, unless deduction of the interest-like component was deferred, that investment return would escape taxation entirely, a result anathema to the income-tax value.

As I argued elsewhere:

One can envision three approaches to this issue of statutory interpretation. Under an ultimate purpose approach, the interpreter would first try to identify the ultimate purpose of delayed deduction in section 404(a)(5) for nonqualified plans and would then ask whether deductions for accruals of the interest-like component would be inconsistent with that purpose. This was the approach taken by the Ninth Circuit in its final decision, which held the accruals nondeductible until paid. The court believed that the ultimate purpose of delaying the employer deduction under nonqualified plans, while allowing immediate deductions for contributions to qualified plans, was to encourage the use of qualified plans, which must satisfy complex minimum funding, participation, and vesting requirements and avoid discrimination in favor of highly compensated individuals. If substantial amounts could be deducted before inclusion by the employees in the case of a nonqualified plan, the court reasoned, the ultimate purpose of section 404(a)(5) would be frustrated. Thus, the deduction was denied.

478. 38 F.3d 1046 (9th Cir. 1993).
479. 12 F.3d 1259 (9th Cir. 1994). For a listing of the exhaustive commentary on the case, see Geier, Purpose, supra note 17, at 527 n.81.
480. 42 F.3d 537 (9th Cir. 1994).
Since section 404(a)(5) disallows immediate deduction only of "compensation," a literal textualist, such as Justice Scalia, would look up the word "compensation" in the dictionary, finding that it means payments for services rendered. An adherent of this approach would likely conclude that accruals of the interest-like component were deductible because this component compensates for the time value of the deferral in payment of compensation, not for the services rendered. This approach was, essentially, the one taken by the Ninth Circuit in its first decision in the case.

There is yet a third approach. In my world . . . , the court would have disallowed the deduction by using what I call a structural analysis. The statute's immediate implementive purpose . . . is to defer the employer deduction for amounts paid to employees under a nonqualified plan until the employees are taxed on these amounts. That is, it creates a matching regime [in order to protect the taxation of the interest-like component.] That structural aspect . . . would be frustrated by allowing a deduction for an interest-like component before those amounts were paid to the employees and included in their income . . . .

IV. CONCLUSION

We tax professors have a hard enough time trying to convince our beginning tax students that tax law is not about financial accounting. It is time we made a more concerted effort toward spreading that message to the bench and bar by fully debunking the myth that "matching" income and related deductions in the same accounting period is as much a value in the income tax as it is in financial accounting. While the Internal Revenue Code does indeed seem on the surface to require matching—and requires a departure from matching—in numerous contexts, each of these provisions can be better explained by the true tax value that underlies it. Matching has no independent tax value, even though it is central to financial accounting. It is at best merely descriptive in those contexts that require matching in order to implement tax values, but the tax values themselves are what is important. At its worst, continued reliance on the rhetoric of matching—rather than the anti-tax arbitrage value and the income-tax value—leads to weak and hap-

481. Geier, Purpose, supra note 17, at 518-19.
482. See Dodge et al., supra note 20, at 1-2 (discussing "common myths regarding tax law and the study of tax law"). See also supra text accompanying note 1.
hazard decisionmaking that often focuses on factors that should be irrelevant if the issue were properly understood.

Only relatively recently—about the last fifteen to twenty years—have the tax values described here become widely understood in academia and generated statutory amendment. The rhetoric in judicial opinions, built on prior case language decided in eras with little understanding of these values, has often failed to keep pace. Even administrative guidance from the Internal Revenue Service often fails to spread popular understanding of these values, as it tends to announce results without much discussion of them or, at the least, to restrict the discussion to beside the point constraints of earlier guidance and decisions. One is extremely hard pressed to find a single judicial opinion or piece of administrative guidance that forthrightly relies on the intellectual history recounted here and explicitly talks about the real tax values at stake beneath the various “tests” developed in various contexts. Very few indeed are willing to jettison the rhetoric of time worn “tests” created generations earlier. We are often reduced, through the perpetuation of such rhetoric, to fashioning our arguments to the decisionmakers in what should be recognized as truly irrelevant terms, helping to solidify these red herrings ever more stubbornly in the legal landscape. We have to dance around what actually should be front and center in the analysis simply because the constructs of the “acceptable” arguments were fashioned in times in which the tax values that are truly at stake were poorly understood. We sometimes—perhaps even often—reach the right results in these situations, but we miss chance after chance of developing widespread understanding and coherence in the development of the law through explicit examination of the real tax values. As Professor William A. Klein strongly put it:

What is there about the legal system that leads judges at the highest level, with the finest support from the smartest and best-trained of clerks and the elite players in the adversary system, to demonstrate such ignorance of, or disdain for, sound tax principles—principles that, once recognized, should be non-controversial?

---

483. I am thinking of such tests as the all events test in accrual accounting and the repair vs. permanent improvement test in the capital expenditure area.

484. William A. Klein, Tailor to the Emperor With No Clothes: The Supreme Court's
The concept of *stare decisis* should not be construed as one of stagnating reliance on the well-intended but poorly informed superficialities of prior opinions.

My hope in this Article is to trace the historical development of thought in this area in a single, easily accessible piece and, in so doing, to articulate explicitly how the matching principle is diametrically opposed to fundamental tax values in some contexts and provides no independent tax value in any other. Simply put, matching has nothing to do with the values sought to be protected in an income tax. My ultimate hope is that this Article will encourage explicit recognition by judges (and justices) and practitioners of the true tax values that underlie the provisions and doctrines discussed here and that should be center stage in modern day tax analysis.