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CASH AND ACCRUAL METHODS OF INCOME TAX ACCOUNTING

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That the legal profession muffed the ball in the beginning days of the federal income tax law is so widely recognized that laymen almost invariably refer tax problems to their accountants. The lawyer is consulted, if at all, only after the dispute has reached the litigation stage. This is largely due to the attitude of the profession. Lawyers have shied away from tax matters. They have hesitated to enter a field where the principles of accounting rather than law seemed to be determinative. This reluctance runs counter to our long tradition. The technical language of other fields of learning has not generally deterred the practitioner who needed an understanding of the principles of some other science to win his case. This hesitancy in the tax field is without justification. Every tax dispute involves a legal problem. The lawyer's tools—the rules of evidence, of statutory construction, of governmental power, of *stare decisis;* the techniques of settlement; the skills of presentation and argument; in short, the tools of the legal practitioner are in a large measure the tools of the tax practitioner.

Accounting concepts and principles have long been part of the stock in trade of the trust and estate lawyer, the corporate and business advisor, the family investment counselor.[1] Among the most elementary of these concepts are the cash and accrual methods of accounting. The general practitioner has shown a strange reluctance to grapple with these terms. Yet as a result of the developing case law they have in the field of taxation more of a legal than an accounting flavor in that the policy considerations on which judicial decisions are based have so shaped and altered their traditional meaning that to the non-tax accountant they are, to put it mildly, distorted versions of the original systems.

It is the purpose of this article to introduce the two methods of income tax accounting to the general practitioner who is not a specialist in the field and to the student who is attempting to learn the subject of income taxation. The article simply seeks to express in a clear and orderly fashion the developed law on the topic.

Requirement of Annual Accounting Period

As a practical matter, income taxes must be collected on a periodic basis. "It is obviously not feasible to wait until a man's death, then cast up his entire

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1. They use accounting principles, for example, in dealing with the following: amortization; expense vs. capital expenditures; repairs vs. improvements; income vs. return of capital; depreciation and depletion.

lifetime, and collect an income tax on the net result."[2] Because of our system of progressive rates, the year in which a particular receipt becomes taxable or in which a particular deduction is allowed will vitally affect the amount of the taxes payable. In *Jackson v. Smietanka*,[3] the taxpayer served as railroad receiver from May, 1913, to April, 1918. He had throughout this period been paid for his services, pursuant to court order, $2000 per month. The order fixing this monthly compensation provided that he "shall be at liberty to apply for such further compensation as to the court may appear reasonable and just." In 1918 he was allowed and paid "as final payment for all services rendered by him during the receivorship herein the additional sum of $100,000." Had he been allowed to prorate this sum to the years earned, instead of having it all taxed in the year of receipt, his tax liability would have been reduced by $19,973.[4] In *Burnet v. Sanford & Brooks Co.*,[5] the taxpayer was engaged from 1913 to 1916 in carrying out contracts with the United States for dredging the Delaware River. It included in gross income for each of these years the payments received under the contract and deducted its expenses paid. Expenses exceeded payments by $176,271.88. The corporation's tax returns for 1913, 1915 and 1916 showed net losses. The return for 1914 showed no net income. The company abandoned the work in 1915 and sued the United States for breach of warranty as to the character of the material to be dredged. It obtained in 1920 a recovery of $192,577.59, which included the $176,271.88 by which its expenses exceeded its receipts. The Court of Appeals held that the amount of $176,271.88 represented a return of losses suffered in the earlier years and hence was not taxable as income. The Supreme Court in reversing this decision said:

> "Only by including these items of gross income in the 1920 return would it have been possible to ascertain respondent's net income for the period covered by the return, which is what the statute taxes. The excess of gross income over deductions did not any the less constitute net income for the taxable period because respondent, in an earlier period, suffered net losses in the conduct of its business which were in some measure attributable to expenditures made to produce the net income of the later period. . . . It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals."[6]

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2. GRISWOLD, CASES ON FEDERAL TAXATION 475 (2d ed. 1946).
3. 272 Fed. 970 (7th. Cir. 1921).
4. This harsh effect has been mitigated by legislative action; see INT. REV. CODE § 107. Similar remedial legislation has eliminated many of the unfortunate consequences resulting from the requirement of an annual accounting period. See *id.* § 122 (net loss carry-over and carry-back); *id.* § 42(b) (pertaining to non-interest bearing obligations issued at a discount and providing an election as to the time of treating certain increment thereon as income); *id.* § 44 (installment sales); U. S. Treas. Reg. 111, § 29.42-4 (completed contract method); INT. REV. CODE §§ 42, 43 (income of decedents); *id.* § 117(e) (1) (capital loss carry-over).
5. 282 U. S. 359, 51 Sup. Ct. 150, 75 L. Ed. 383 (1931).
6. 282 U. S. at 364.

Cash and Accrual Basis

Section 41 of the Internal Revenue Code[7] provides that income shall be computed in accordance with the method of accounting regularly employed by the taxpayer. Section 42[8] requires that cash-basis taxpayers shall report items of gross income in the year actually received, and that accrual taxpayers shall report such items in the year accrued. Section 43[9] provides the correlative rules with respect to deductions. Cash-basis taxpayers are allowed expense deductions in the year actually paid; accrual taxpayers in the year the liabilities are incurred or accrued. There is one very important exception applicable to both types of taxpayers. The above rules apply, "unless in order to clearly reflect income, the deduction should be taken as of a different period."[10]

The cash basis is the in-and-out-of-pocket method. Income actually received and expenses actually paid are reported. This system serves for ordinary non-business citizens and to some extent for professional men and the proprietors of very small enterprises. But to reflect income fairly, a business of any substantial size and complexity will find the accrual method a necessity. Under this method income is reported when earned. Deductions are taken when accrued.[11] Thus, if a lawyer on the accrual basis completes a particular assignment for a client and a fee is agreed upon in December, he reports that item as income even though the fee may not be paid until the following year. Similarly, rent for December and any other operating expenses incurred in December will be deductible for that year even though these items are not

7. "The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer."

8. "The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period."

9. "The deductions . . . shall be taken for the taxable year in which 'paid or accrued' or 'paid or incurred,' dependent upon the method of accounting upon the basis of which the net income is computed."

10. Int. Rev. Code § 43. See also *id.* § 41: "[I]f the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income."

11. "The essential nature of the accrual basis ignores the collection or other receipt of income and payment of deductions, but recognizes in lieu thereof the increase in the taxpayer's net assets through the acquisition of rights to receive cash, accounts receivable and other property of whatever nature, regardless of when collection or other receipt occurs, and similarly recognizes decreases in net assets arising from obligations incurred during the taxable year, whether or not actually paid or payable therein.

"The accrual method is preferable for the determination of income from business, since almost any business must recognize in some form the existence of receivables and payables. Consequently, most businesses of any considerable size determine income on the accrual basis but there are still thousands of small businesses and some larger ones which continue to use the cash basis and are permitted to do so under the terms of the Code." 2 Montgomery, Federal Taxes—Corporations and Partnerships, 1948-49, p. 351.

paid until the following year. Under this system earnings and the expenses related to such earnings are better tied to the same period.

There are a number of departures from the traditional accounting principles. These have been developed by the case law (1) to prevent unfair distortion of income in a particular period, (2) to decrease tax avoiding opportunities, and (3) in response to a very basic practical principle that taxes should be collected at a time when cash is in hand, even though such a rule may violate some of the niceties of accounting science.

INCOME—CASH BASIS

(a) *Constructive Receipt.*

It was early recognized that a too strict adherence to the requirement of actual receipt would enable taxpayers on a cash basis to select arbitrarily the year in which particular items would be subjected to tax, and to do so to the detriment of the public revenues. The savings account depositor would fail to draw his interest in a year of high rates or of unusual earnings or returns on his investments. Similarly the owners of corporate bonds would refrain from presenting coupons for collection until a year when off-setting losses or other deductions were available. To prevent this type of avoidance, the cash method was pushed one step back from actual receipt. The courts held that it was enough that the funds were unconditionally available—that the taxpayer could have them for the asking.[12] In the words of Mr. Justice Holmes, "The income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income, whether he sees fit to enjoy it or not." [13] But there must be no obstacles to collection.[14]

(b) *Prepayments.*

Items will be taxable as income in the year of receipt even though the taxpayer may not have yet earned the money and even though he may be under a contingent liability to return a part or all of it. In *Saunders v. Commissioner,*[15] officers of a building and loan association charged and received commissions on the sale of its capital stock. These were later returned on advice of counsel after suit was instituted against the recipients. It was nevertheless held that

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12. Hedrick v. Commissioner, 154 F. 2d 90 (2d Cir. 1946); Loose v. United States, 74 F. 2d 147 (8th Cir. 1934); Edward Mallinckrodt, Jr., 38 B. T. A. 960 (1938); U. S. Treas. Reg. 111, §§ 29.42-2, 29.42-3. But the taxpayer may not blow hot and cold. Where he fails to report such items in the year they become available he will be taxed on them in the year of receipt. He will not be permitted to contend from behind the shelter of the statute of limitations that the items were taxable in the earlier years. Moran v. Commissioner, 67 F. 2d 601 (1st Cir. 1933).

13. Corliss v. Bowers, 281 U. S. 376, 378, 50 Sup. Ct. 336, 74 L. Ed. 916 (1930).

14. A corporation declared a dividend payable on December 31 and checks were mailed to the stockholders on that date; a taxpayer who received his on January 2 was held taxable in the year the check was received. Avery v. Commissioner, 292 U. S. 210, 54 Sup. Ct. 674, 78 L. Ed. 1216 (1934).

15. 101 F. 2d 407 (10th Cir. 1939).

"Revenue thus received under claim of right and without restriction as to use and disposition constitutes taxable income, even though the person receiving it may subsequently be adjudged liable to restore it or its equivalent."[16]

The problem of prepayment of income items arises most frequently in connection with long term leases. If at time of the execution of the lease the tenant pays the rent for both the first and last years, the landlord is required to include both amounts in his gross income for the current year.[17] It should be noted that the harsh effect of this rule may be avoided if the amount attributable to the last year's rent is accepted as a security deposit for the faithful performance of the lease covenants.[18]

INCOME—ACCRUAL BASIS

(a) *Unliquidated Claims.*

Generally an item is income to an accrual-basis taxpayer at the time his right to the money becomes fixed and certain.[19] It is not necessary that the claim be liquidated so long as the existence of the liability is not in dispute. It is enough that the amount of the claim may be estimated with reasonable accuracy. For example, the Treasury has ruled even though the amount of the liability is undetermined at that time, the proceeds to be received under a fire insurance policy accrue as income in the year in which the fire occurs to a taxpayer on the accrual basis, provided the liability is not contested by the insurance company.[20] The taxpayer is required to estimate the value of his unliquidated claims. For this reason items of undeterminative value are not includible in income.[21]

(b) *Dividends.*

The regulations and decisions have created exceptions to the general rule.

16. *Id.* at 409. See also South Dade Farms v. Commissioner, 138 F. 2d 818 (5th Cir. 1943); Griffin v. Smith, 101 F. 2d 348 (7th Cir. 1938) *cert. denied,* 308 U. S. 561 (1939); Baker v. United States, 17 F. Supp. 976 (Ct. Cl. 1937).

17. Astor Holding Co. v. Commissioner, 135 F. 2d 47 (5th Cir. 1943).

18. Clinton Hotel Realty Corporation v. Commissioner, 128 F. 2d 968 (5th Cir. 1942).

19. That collectibility is doubtful will not excuse accrual of an item. See Spring City Foundry Co. v. Commissioner, 292 U. S. 182, 184-85, 54 Sup. Ct. 644, 78 L. Ed. 1200 (1934), where the Court said: "Petitioner first contends that the debt, to the extent that it was ascertained in 1920 to be worthless was not returnable as gross income in that year, that is, apart from any question of deductions, it was not to be regarded as taxable income at all. We see no merit in this contention. Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the *right* to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrues. When a merchandizing concern makes sales, its inventory is reduced and a claim for the purchase price arises. . . . On an accrual basis, the 'total sales,' to which the regulation refers, are manifestly the accounts receivable arising from the sales, and these accounts receivable, less the cost of the goods sold, figure in the statement of gross income. If such accounts receivable become uncollectible, in whole or part, the question is one of the deduction which may be taken according to the applicable statute."

20. G. C. M. 14666, XIV-1 CUM. BULL. 181.

21. 2 MONTGOMERY, FEDERAL TAXES—CORPORATIONS AND PARTNERSHIPS, 1948-49, p. 360.

The accrual-basis taxpayer becomes entitled to a dividend on stock owned by him not later than the "record date" and conceivably as early as the "declaration date." Yet actual receipt of the dividend is the event which incurs tax liability. Any other rule would have unfortunate consequences in the administration of the income tax statute. Assume the record date to be December, 1949, and the payment date January, 1950. If an accrual-basis taxpayer sells in 1950 after the record date to a cash-basis buyer, a contrary rule, while logically correct, would impose two taxes on the same dividend.[22] Also if a company which had no accumulated earnings and profits, had a deficit in 1949, but had earnings in 1950, the distribution would be taxable as income to cash-basis recipients but would be treated as return of capital rather than income for accrual-basis recipients.[23] A further difficulty is presented in cases where the distribution is of property of fluctuating value. There the amount of the taxable dividend might be substantially different depending on the method of accounting used by particular stockholders. These considerations led the courts with the aid of the statutory definition of a divided as a corporate "distribution" [24] to hold that the actual receipt of the dividend constitutes the taxable event, even in the cases of those using the accrual method.[25]

(c) *Prepayment.*

Another and more important exception is found in the prepayment cases, of which *Brown v. Helvering* [26] is a typical example. The taxpayer was a general agent for fire insurance companies and was entitled to receive overriding commissions on policies written by local agents. Many of these policies were for periods of longer than one year, and if one was cancelled, the policy holder became entitled to a refund. The taxpayer in turn was required to refund to the insurer the corresponding portion of the commission he had received. He had set up on his books an account entitled "Return commission." In it was recorded his estimate, based on experience, of his liability to refund commissions with respect to policies written during the year. The Supreme Court, sustaining the Commissioner, held the entire amount received was net income, even though the taxpayer would very probably have to refund a portion of it in a later year. Thus under the accrual method, the year of actual receipt may be determinative. Sound accrual accounting would treat such items as in suspense until earned, but practical problems of tax collection dictate the wisdom of imposing the tax when the funds are in hand.[27]

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22. The accrual taxpayer would include the dividend in his gross income for 1949; the cash-basis buyer would have to report it as part of his gross income in 1950.

23. Tyler, *When Does a Dividend Become Income?* 80 J. ACCOUNTING 353 (1945).

24. INT. REV. CODE § 115.

25. Commissioner v. American Light and Traction Co., 156 F. 2d 398 (7th Cir. 1946).

26. 291 U. S. 193, 54 Sup. Ct. 356, 78 L. Ed. 725 (1934).

27. An automobile club on an accrual basis was held taxable for the entire amount of membership fees received although they covered services for a period of three years after payment. Automobile Underwriters, Inc., 19 B. T. A. 1160 (1930). Similarly the

(d) *Disputed Claims.*

The same result has been reached in the prepayment cases where there was a substantial dispute as to the right to the funds. In the *Brooklyn Union Gas* case,[28] the New York Public Service Commission issued orders in 1916 directing gas companies to reduce their rates. The companies attacked this action in the courts and secured an interlocutory injunction staying execution of the Commissioner's order and directing that moneys collected in excess of the reduced rates be impounded subject to the order of the court. In 1919 the court permitted the withdrawal of the impounded moneys by the companies upon the giving of security for repayment if the reduced rates were sustained. In 1922 the commission abrogated its original order reducing the rates. Thus the first time that the right of the companies to the excess collected became fixed and certain was in 1922. Prior to that date proper accounting would preclude the accrual of a purely contingent asset. But the companies received the money in 1919 without restriction on its use, and the court held it was taxable in that year. The leading Supreme Court case is *North American Oil Consolidated v. Burnet.*[29] There a receiver was appointed to operate certain property pending the outcome of a suit brought to contest the taxpayer's title thereto. Net income produced from the receiver's operations of the property in 1916 was turned over to the taxpayer in 1917, upon entry of a decree dismissing the bill. The decree was appealed and the litigation determined finally in 1922. The taxpayer contended that the profit should be allocated either to 1916 or 1922. But the court said it was income in the year received, 1917. It was not income in 1916, because the right was not then fixed or certain. It was not income in 1922 because it had been received without restriction in 1917. Thus the rule is well established that such items are income in the year of accrual or receipt, whichever is earlier.[30]

The *North American Oil* and the *Brooklyn Union* cases, in so far as they hold no accrual is permissible so long as the claim is disputed, are to be contrasted with the rule that mere uncertainty as to the amount of an admitted claim does not delay accrual. Under the latter rule, income accrues as soon as the claim is conceded. The taxpayer is required to make an estimate of the value of the claim, subject to later correction. While these classifications may at times shade into each other, the distinction between an unliquidated claim and a

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Bureau has ruled that magazine subscriptions paid in advance are income when received, though the magazines are to be furnished in future years. G. C. M. 20021, 1938-1 Cum. Bull. 157.

28. Commissioner v. Brooklyn Union Gas Co., 62 F. 2d 505 (2d Cir. 1933).

29. 286 U. S. 417, 52 Sup. Ct. 613, 76 L. Ed. 1197 (1932).

30. There seems to be one exception to this prepayment rule. The regulations with respect to the sale and purchase by a corporation of its bonds provide, "if subsequent to February 21, 1913 bonds are issued by a corporation at a premium, the net amount of such premium shall be prorated or amortized over the life of the bonds." U. S. Treas. Reg. 111, § 29.22(a)-17.

disputed claim is common throughout the law and its application to tax accounting well settled.

DEDUCTIONS—CASH BASIS

(a) *Constructive Payment.*

The doctrine of constructive receipt under which the cash-basis method was broadened to include items which though not actually received were unqualifiedly subject to the taxpayer's control has never been carried over to the deduction side of the tax ledger. Should wages be deducted by a cash-basis taxpayer if in December cash is withdrawn from his bank account and placed in the hands of a disbursing officer, but some employees fail to call for their pay until the following year?[31] In *Vander Poel, Francis & Company v. Commissioner,*[32] a corporation on a cash basis credited to the account of its officers salaries earned. The funds were unconditionally available to the individuals and on the theory of constructive receipt were included in their tax returns. The corporation took a deduction on the theory of constructive payment. But the Commissioner disallowed the item and his decision was sustained by the Tax Court.

There is no correlative doctrine of constructive payment. The constructive-receipt rule was developed to prevent taxpayers from exercising an unfettered choice of the year in which they would actually collect (and hence incur the tax) on income items. No such arbitrary power exists with respect to choosing the year of a deduction. While creditors can readily persuade debtors to delay payment until next year, the debtor is rarely successful in inducing his creditor to permit him, the debtor, to select the year for payment.

The courts have been strict. Deductions are thought of as a matter of legislative grace [33] and hence a rigid adherence to the letter of the statute has been insisted upon. While this strictness may cause an occasional hardship, the policy considerations behind the doctrine of constructive receipt are absent. And the common sense and practical attitude of examining agents in avoiding a too technical application of the rule requiring actual payment in cases where the debtor inadvertently fails to cash the creditor's check, have made it workable. On the other hand, a recognition of a correlative rule of constructive payment would in some cases enable the debtor to eat his cake and have it too. Situations may readily be suggested where employers and other responsible debtors would suggest to executive employees or friendly creditors that the funds were available and credited on the books, but that a year-end delay in withdrawal would be helpful for credit or other reasons.

31. Hulse, *Can the Cash Basis of Reporting Be Justified Now?* 24 TAXES 139 (1946).
32. 8 T. C. 407 (1947).
33. Inter State Transit Lines v. Commissioner, 319 U. S. 590, 63 Sup. Ct. 1279, 87 L. Ed. 1607 (1943).

(b) *Form of Transaction.*

The form of the transaction will often be determinative of its tax consequence. Had the officers in the *Vander Poel* case drawn their salaries and loaned comparable amounts to the corporation, the deduction would undoubtedly have been allowed. Formal elements are frequently important in tax matters, especially for the cash-basis man. A person borrowing $1,000 from his bank at 5% interest for two years may sign a note for $1,000, while his account will be credited with only $900. The bank deducts the interest in advance. This is traditional banking practice, and the mercantile understanding of this transaction is that the debtor has prepaid $100 of interest. Similarly where a borrower renews a loan on his life insurance policy, the normal procedure is for him to execute a new note to the company in an amount which includes interest to the renewal date. Thus if he borrows $500 in January, 1949, and wants to borrow an additional $300 in January, 1950, the company will have him sign a new note for $800, cancel the $500 note and give him a check for $275—the remaining $25 discharging his interest obligation on the $500 loan from January, 1949, to January, 1950. Are these borrowers entitled to deductions for interest paid? An analysis of these situations demonstrates that in neither case has the borrower actually paid any interest. He has promised to pay but he has not paid. He may never pay. Indeed, he has no obligation to pay until maturity of the note. Factually, in the bank case, the bank loaned him $900 in return for his promise to pay $1,000 at the end of the two-year period, the additional $100 being the charge for the use of the money. The insurance loan transaction is identical.[34] Had the bank actually credited the borrower's account with $1,000 and received his check for $100, a deduction by the borrower for interest paid would have been proper.[35]

(c) *Prepayment.*

While the cash-basis taxpayer has been allowed to deduct prepaid interest,[36] there is a definite trend toward requiring him to amortize all prepaid items whenever the life of the asset or service purchased extends for a measurable period beyond the year of prepayment.[37] Here again the objective is to limit the taxpayer's uncontrolled power of selecting the year when the deduction will be most profitable to him rather than putting it in the year where it will fairly reflect his income. The most common example is the three-year prepayment of fire insurance policies on business or rental property by cash-basis taxpayers. Since the benefits of the contract are exactly equal in each of the years, a deduction of the expense attributable to future years in the current year brings about a distortion of income. Even more important than the requirement that

34. Cleaver v. Commissioner, 158 F. 2d 342 (7th Cir. 1946), *cert. denied*, 330 U. S. 849 (1947); Keith v. Commissioner, 139 F. 2d 596 (2d Cir. 1944).
35. *Cf.* Newton A. Burgess, 8 T. C. 47 (1947).
36. John D. Fackler, 39 B. T. A. 395 (1939).
37. Commissioner v. Boylston Market Ass'n, 131 F. 2d 966 (1st Cir. 1942).

taxes be computed in accordance with the system of accounting regularly employed by the taxpayer is the statutory command that a deduction be taken during the period when it will most fairly reflect his income. This rule has been applied to prepayment of rentals,[38] bonuses for the acquisition of leases,[39] bonuses for the cancellation of leases [40] and commissions for negotiating leases.[41] All of these expenses are required to be amortized over the life of the lease. Query if the cases permitting full deduction in the year paid of prepaid interest will long survive.

(d) *Accounts Receivable and the Bad Debts Deduction.*

One other problem should be noted before leaving the cash-basis taxpayer. He may not deduct as a bad debt an uncollectible receivable. The accrual-basis taxpayer on the other hand, deducts his loss in the year in which such debt becomes worthless. This is permissible because he has included it in gross income in the year of the sale or rendition of service and paid a tax thereon. It thus becomes a capital asset. On the other hand, the cash-basis taxpayer has never included it in taxable income; hence it has no cost basis to him and its non-payment does not result in a recognized tax loss.

DEDUCTIONS—ACCRUAL BASIS

(a) *Ability to Pay.*

The accrual-basis taxpayer becomes entitled to a deduction in the year when the liability is incurred [42] or accrued.[43] It is immaterial that he has not discharged his obligation. Indeed, it has been held immaterial that there is no reasonable prospect of his ever paying. In the *Zimmerman Steel Company* case,[44] the Commissioner refused to allow the taxpayer deductions which it claimed on account of interest accrued upon its debts. The Commissioner's position was based on a finding that "there was no reasonable probability that

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38. Baton Coal Co. v. Commissioner, 51 F. 2d 469 (3d Cir. 1931), *cert. denied*, 284 U. S. 674 (1931); Galatoire Bros. v. Lines, 23 F. 2d 676 (5th Cir. 1928).

39. Home Trust Co. v. Commissioner, 65 F. 2d 532 (8th Cir. 1933); J. Alland & Bro., Inc. v. United States, 28 F. 2d 792 (D. Mass. 1928).

40. Steele-Wedeles Co., 30 B. T. A. 841 (1934); Harriet B. Borland, 27 B. T. A. 538 (1933).

41. Bonwit Teller v. Commissioner, 53 F. 2d 381 (2d Cir. 1931), *cert. denied*, 284 U. S. 690 (1932).

42. Section 24(c) of the Internal Revenue Code is a provision intended to prevent tax avoidance. Under it expenses deductible under section 23(a) and interest deductible under section 23(b) may not be deducted by an accrual-basis taxpayer, if all three of the following conditions exist: (1) the expenses or interest are not actually paid in the taxable year or within two and one-half months after the end of the year, (2) the payee is on a cash basis, and (3) the payor and the payee are closely related persons between whom losses would be disallowed under section 24(b).

43. Where he prepays expenses attributable to later years, he must amortize the expense over the life of the asset. This is in accordance with sound accounting principles. Indeed, as has been noted, this accrual principle has been generally required of cash-basis taxpayers.

44. Zimmerman Steel Co. v. Commissioner, 130 F. 2d 1011 (8th Cir. 1942).

such interest would ever be paid." The Court of Appeals in reversing the Commissioner, said:

"Though it is earnestly insisted for the government that the conclusion of the Board was without error, it is admitted in the brief that 'there are no court decisions directly holding that an accrued item of expense may not be deducted when there is no reasonable expectancy that it will be paid.' Our own search has confirmed the admission. The law is that if a method of bookkeeping employed by a taxpayer 'does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income' (Section 41), and the real facts, not forms of entry, must measure the tax. But where interest actually accrues on a debt of a taxpayer in a tax year the statute plainly says he may deduct it. That he has no intention or expectation of paying it, but must go into bankruptcy as this taxpayer was obliged to do, can not of itself justify denial of deduction in computing the taxpayer's net income. It is true that if a man's gains at the end of the year consist of bad debts he can have no net income to tax. But neither does he have such net income if the interest on what he owes amounts to more than his gains." [45]

(b) *Unliquidated Obligations.*

A deduction accrues when all of the events which go to fix the liability have occurred, even though the amount of the obligation may not have been ascertained. In *United States v. Anderson,*[46] the taxpayer was engaged in the manufacture of munitions in 1916. The munitions tax on the profits from 1916 sales became due and was paid in 1917. The taxpayer deducted this amount from its 1917 income. The Supreme Court held that the taxpayer's books were kept on the accrual basis, and that the tax was deductible in 1916, not in 1917. The Court said: "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." [47]

(c) *Disputed Liability.*

Here again on the deduction side of the ledger we have the distinction between an unliquidated claim and a disputed liability. In a leading case, Cahn owned a jewelry business in California. In 1944 he sustained a loss from burglary amounting to $34,000. He carried burglary insurance with Lloyd's of London, but his insurers denied liability on the grounds that it was an "inside job." In 1945 suit was brought against Lloyd's and a settlement made for $27,500. The court held the entire loss was deductible in 1944.[48] Because of the disputed liability, and therefore the non-accruability of his claim against his insurers, Cahn's loss was not "compensated for by insurance." [49] The usual disputed liability case is the one in which the accrual taxpayer contests the

45. *Id.* at 1011-12.
46. 269 U. S. 422, 46 Sup. Ct. 131, 70 L. Ed. 347 (1926).
47. 269 U. S. at 441. See also Fawcus Machine Co. v. United States, 282 U. S. 375, 51 Sup. Ct. 144, 75 L. Ed. 397 (1931).
48. Cahn v. Commissioner, 92 F. 2d 674 (9th Cir. 1937).
49. Of course the $27,500 would be taxable as "recovery" income in 1945.

existence of the obligation. He may not accrue an expense and at the same time dispute its validity.

The Mississippi Taxing Authorities declared that a solvent used by the Dixie Pine Products Company in its business was gasoline, within the meaning of the state law defining gasoline and laying a tax on its receipt and use. Dixie refused to pay and brought a suit to enjoin collection. At the same time it attempted to accrue its liability for the tax. The deduction was disallowed on the ground that the liability was "contingent" and "contested." [50] Had Dixie paid the tax and sued for refund, the deduction would have been allowed.[51]

CONCLUSION

The cash-basis taxpayer is chargeable only with actual receipts, plus items which are unconditionally available to him. Prepayments received for future services are taxable in the year of receipt, even though there may be a contingent liability to refund some or all of the money. Similarly payments received under a claim of right, even though a liability to repay may later be judicially enforced, constitute income in the year of receipt. He may deduct expenses actually paid, subject to the limitation that prepayments for items whose lives extend beyond the year prepaid may have to be amortized. There is no doctrine of constructive payment corresponding to the doctrine of constructive receipt. Actual payment is necessary. Nothing short of this will satisfy the statutory requirement. The form of the transaction may be decisive. This is particularly true in the bank, insurance and brokerage loan cases, where the tax requirement that an interest check or cash be given is completely out of line with business practice.

The accrual-basis taxpayer reports items in gross income in the year in which the right arises, or in the year in which payment is received, whichever is earlier. He must accrue a claim even though the amount be in dispute; he may not accrue it if his right is contested. His right to a deduction arises as soon as all the events have occurred which determine his obligation. That the amount is uncertain is immaterial. He may deduct it even though there is little likelihood of his being able actually to make payment. Where the liability is contested and therefore the item is not properly accruable, he may nevertheless take a deduction if he actually makes the payment, even though he proposes to sue to get his money back.

The harsh effect upon the recipient, either on a cash or accrual basis, of the prepayment rule may be avoided by tying strings to the receipts until the fund is earned or the right to it established. The taxpayer may arrange to hold

50. Dixie Pine Products Co. v. Commissioner, 320 U. S. 516, 64 Sup. Ct. 364, 88 L. Ed. 270 (1944).

51. Chestnut Securities Co. v. United States, 62 F. Supp. 574 (Ct. Cl. 1945); Western Cartridge Co. 11 T. C. No. 37 (1948); G. C. M. 25298, 1947-2 CUM. BULL. 39.

the money as a trust fund, as security for the contingent claim pending determination of his right, or as security for the payment of the services or property when earned.

The cash-basis system serves ideally for the average citizen (wage earner or investor), who spends as he receives. The accrual method alone assures a fair picture of the activities of substantial business enterprise. But like the distinctions between day and night or youth and age, individual cases will frequently fail to fall clearly on one side of the dividing line or the other. In part this explains the departures from traditional accounting concepts, but more important in shaping the rules has been the need under our system of progressive rates and annual accounting periods to place limitations on the power of individual taxpayers to control the time when a receipt shall be included in gross income and when a deduction shall be taken. It should not be forgotten that it is important that each citizen should bear his fair share of the tax burden. To the extent that any substantial number of persons arrange their affairs so as to reduce their burdens, the load on all other taxpayers is correspondingly increased.