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MATCHING OF COSTS AND REVENUES AS A GOAL OF TAX ACCOUNTING

Alan Gunn*

The history of tax accounting is a history of divergence between theory and practice. Since 1916, the tax law has authorized only those accounting methods that "clearly reflect income." To financial accountants, clear reflection of income requires the matching of revenues with the costs of producing those revenues by reporting related items in the same accounting period. In practice, major departures from matching often occur in tax cases by specific statutory direction and because the Supreme Court has given the Commissioner wide discretion to impose accounting methods wholly unacceptable for financial accounting purposes. Nevertheless,

*Professor of Law, Cornell University. I am grateful to William C. Gifford, Calvin H. Johnson, and Dale A. Oesterle for comments on drafts of this article and to George A. Hay for help with the appendix. This article was written in 1983. The effect of the Tax Reform Act of 1984 upon the article's examples and conclusions is discussed in an "Afterword." See infra text accompanying notes 151-61 (Part V).

1 See I.R.C. § 446(b). Section 446(b) provides: "If no method of accounting has been regularly used by the taxpayer, or if the method used 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." Id. § 446(b).


3 See, e.g., American Auto. Ass'n v. United States, 367 U.S. 687 (1961). Section 446(b), if read literally, limits the "opinion of the Secretary" standard to the choice of a replacement once the taxpayer's method is found not to reflect income clearly. See I.R.C. § 446(b). However, the Supreme Court has given the Commissioner broad discretion to reject methods used by taxpayers. Treas. Reg. § 1.446-1(a)(2) provides that "no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income." In Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979), the Court cited this regulation with approval. See id. at 531-32.
the idea that tax accounting, particularly in the case of accrual-method taxpayers,⁵ should match revenues and expenses has never lost its hold on the thinking of Congress,⁶ the Treasury Department,⁷ and the courts.⁸

This article will argue that tax accounting should not, and characteristically does not, accept matching as a central principle. Neither the history of accrual accounting nor any consideration of tax policy requires that income be matched with related deductions. After a brief introductory sketch of the accrual method, the article examines the role of matching in connection with the two fundamental concerns of accrual accounting: the "all-events" test and the principle of "clear reflection of income." It concludes that matching is usually irrelevant in principle⁹ and sometimes perverse in practice in light of the overriding goal of tax accounting—the production of administratively feasible and economically sensible rules for timing income and deductions.

I. THE FRAMEWORK OF ACCRUAL ACCOUNTING

Determining the taxable year in which an accrual-method taxpayer reports income and deductions involves two distinct steps.

* See I.R.C. §§ 455 (prepaid subscription income of accrual-method taxpayers), 456 (prepaid dues income of membership organizations).
* See, e.g., Boise Cascade Corp. v. United States, 530 F.2d 1367 (Ct. Cl.), cert. denied, 429 U.S. 867 (1976) (holding that income was properly reported in the tax year in which the services which earned the income were performed, although payment may have actually been received in some other year).
* I do not want to suggest that the "matching" which occurs when the costs of income-producing assets are capitalized and recovered through depreciation is undesirable. In that case, matching is a side effect of a process performed for good tax reasons. See infra text accompanying note 66.

Matching sometimes avoids problems peculiar to taxpayers in unusual situations. If the tax status of a taxpayer changes from year to year, matching may be a practical way of insuring that deductions are not wasted and that credits are properly computed. This is particularly important to taxpayers having international operations. See Dale, Tax Accounting for Foreign Persons, 37 Tax L. Rev. 275, 302-22 (1982). Matching a trust's income and deductions may sometimes make the taxable incomes of various beneficiaries correspond more closely to their relative economic interests in the trust than would a system not requiring matching. The basic rules for tax accounting, however, should not be fashioned primarily for the purpose of avoiding difficulties in these relatively uncommon cases.
The first step is to apply the all-events test, under which income and deductions accrue when "all the events" giving rise to a fixed right to receive or obligation to pay a reasonably ascertainable amount have occurred. Once the all-events test has been satisfied in a particular year, the question becomes whether reporting the income or deductions at that time will "clearly reflect" the taxpayer's income. *Mooney Aircraft, Inc. v. United States,* a rare case in which both steps were disputed, provides a clear example of accrual analysis. Mooney manufactured and sold light airplanes. Whenever it sold a plane, Mooney issued a document called a "Mooney Bond," which entitled the bearer to a $1000 payment upon the retirement of the aircraft from service, an event which might occur twenty or more years after the sale. Mooney, an accrual-method taxpayer, claimed a $1000 deduction in the year of sale for each "bond" issued that year. The Government made two arguments for disallowing the deductions. First, the Government claimed that the deduction was premature because Mooney's obligation to pay had not yet accrued under the all-events test. The court rejected this argument because retirement of the aircraft, the only event upon which Mooney's obligation to pay was contingent, was an event certain to occur. Second, the Government argued that a deduction taken so many years before payment would not "clearly reflect" Mooney's income. Persuaded by this view, the Fifth Circuit found the "attenuation" of the relationship between obligation and payment sufficient to give the Commissioner a "reasonable basis" for exercising his "very broad discre-

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10 420 F.2d 400 (5th Cir. 1969).
11 See id. at 401.
12 See id. at 402.
13 See id.
14 See id. at 405.
15 See id. at 406. In this respect the court's decision is consistent with the great weight of authority, which does not require that payment be due in order to be accrued as an income or deduction item. The one exception to this rule involves prepaid income, where unpaid items are treated as accruing only as they become due. See, e.g., Decision, Inc. v. Commissioner, 47 T.C. 58 (1966), acq. 1967-2 C.B. 2; Rev. Proc. 71-21, 1971-2 C.B. 549.

It was once thought that accrual required a definite time for payment as well as a fixed liability. See Comment, *Accrual: The Uncertain Concept of Certainty—A History of the All Events Test*, 21 U. Chi. L. Rev. 293, 294-95 (1954). The *Mooney Aircraft* court's failure to require a fixed due date is characteristic of modern cases.
16 See 420 F.2d at 409-10.
tion to disallow . . . accounting techniques."\textsuperscript{17}

As \textit{Mooney Aircraft} illustrates, accrual analysis can be easily summarized: a taxpayer accounts for income and expenses according to the all-events test unless special considerations, raised by the notion of "clear reflection of income," require a different result. This summary says nothing about the content of either the all-events test or the clear-reflection principle. Indeed, it conveys no more specific information about timing rules than would a statement that income and deductions are recognized as they accrue unless they are recognized at some other time. But if it fails to predict the outcome of accrual accounting in particular cases, the description provides a useful framework for examining two very different sets of rules. The all-events test, the subject of the next section of this article, generates little controversy in most of its applications. It emphasizes conformity between tax and financial accounting, and courts apply the test with only occasional reference to the Commissioner's discretion. In contrast, the clear-reflection principle, discussed in section III, has been invoked sporadically, with controversial results. It leads more often to differences than to conformity between tax and financial accounting, and in applying the test courts defer to the Commissioner's discretion, sometimes to the point of avoiding analysis. Despite these differences, the all-events test and the clear-reflection principle share an unfortunate similarity: both rules have been justified as means of matching income and expenses.

\section*{II. Matching and the All-Events Test}

The Revenue Act of 1913 required the use of cash-method accounting by all taxpayers.\textsuperscript{18} Most businesses, however, kept their

\textsuperscript{17} See \textit{id.} at 410.

\textsuperscript{18} Section II(A)(1) of the Revenue Act of 1913, Pub. L. No. 16, ch. 16, 38 Stat. 114, 166, imposed a tax "upon the entire net income arising or accruing from all sources." Although the reference to "accruing" appears to authorize accrual accounting, the word was commonly used to mean "deriving from" rather than in its modern technical sense. The deduction provisions of the 1913 Act contemplated the use of today's cash method. Deductions were allowed for business expenses "actually paid" and for interest and taxes "paid within the year." \textit{Id.} at 167. The Senate Finance Committee's substitution of "paid" for the House's "incurred" in the business expense provision shows that these references to payment were not accidental. \textit{See J. Seidman, Legislative History of Federal Income Tax Laws 1938--1861}, at 992 (1938). The Corporation Excise Tax Law of 1909, ch. 6, 36 Stat. 11, 112-
books on an accrual basis, and from the beginning the regulations allowed corporations to report income and deductions in accordance with their books. The Revenue Act of 1916 brought the

117, the source of much of the 1913 Act, imposed a tax on income "received" with deductions for expenses "actually paid." The 1909 Act was adopted in the face of opposition from "twelve of the most prominent firms of accountants of the country," who complained to the Attorney General that large businesses did not keep books on the basis of receipts and payments. The Attorney General replied that the framers of the bill had a different "theory" of income from that of the accountants. See Adams, When Is Income Realized?, The Federal Income Tax 29, 30-31 (R. Haig ed. 1921). The early cases, reflecting a confusion between income and money, tended to hold that taxpayers had no income until they received either cash or property. See United States v. Christine Oil & Gas. Co., 269 F. 458, 459-60 (W.D. La. 1920) ("actual receipt" or "the notes of third persons"); Maryland Casualty Co. v. United States, 52 Ct. Cl. 201, 209 (1917) ("income" under 1913 Act means "the receipt of actual cash as opposed to contemplated revenue due but unpaid"); cf. United States v. Indianapolis & St. L.R. Co., 113 U.S. 711, 712-13 (1885) (bond interest accrued for 1871 and paid in 1872 not income of 1871); United States v. Schillinger, 27 F. Cas. 973 (S.D.N.Y. 1876) (No. 16,228) ("In the absence of any special provision of law to the contrary, income must be taken to mean money, and not the expectation of receiving it, or the right to receive it, at a future time").

The 1913 Act has been read as requiring the use of the cash method by the Supreme Court in United States v. Anderson, 269 U.S. 422 (1926), by R. Magill, Taxable Income 154-55 (1936), and by Hahn, Methods of Accounting: Their Role in the Federal Income Tax Law, 1960 Wash. U.L.Q. 1, 16. Against this background, a statement in the legislative history of the Revenue Act of 1916 to the effect that prior law imposed the tax "on the accrued [sic] basis," H.R. Rep. No. 922, 64th Cong., 1st Sess. 4 (1916), seems to have been a mistake, perhaps inspired by the regulations and forms, which did require a sort of accrual accounting.

In a sense, asking whether the 1913 Act required cash or accrual accounting may be an attempt to impose modern concepts upon a law drafted and applied by people lacking those concepts. Nonetheless it is clear that in many respects the 1913 Act reflected attitudes toward income today considered appropriate for cash-method but not accrual-method taxpayers.

Regulation 33, Art. 158 provides:

It is immaterial whether the deductions except for taxes and losses are evidenced by actual disbursements in cash, or whether evidenced in such other way as to be properly acknowledged by the corporate officers and so entered on the books of the corporation as to constitute a liability against the assets of the corporation. . . . Except as the same may be modified by the provisions of the act, limiting certain deductions and authorizing others, the net income as returned for the purpose of the tax should be the same as that shown by the books or the annual balance sheet.

Reg. 33, art. 158 (1913).

The instructions to Form 1040, which can be found in H. Black, Income Taxation 776-78 (2d ed. 1915), went even further. They directed "persons receiving fees or emoluments for professional or other services" to include in income "all unpaid account charges for services, or contingent income due for that year, if good and collectible." Id. The "due for that year" and "collectible" limitations may have been intended to limit the "accrual" required by the instruction to accrual of items due in the taxable year. See Maryland Casualty Co. v. United States, 52 Ct. Cl. 201, 204 (1917), in which the government argued that "according to all
statute into line with administrative practice by permitting taxpayers who kept accounts on any basis other than "actual receipts and disbursements" to make tax returns on the basis on which their books were kept "unless such . . . basis [did] not clearly reflect . . . income." Thus, accrual accounting in tax cases arose from considerations of convenience and not, as is sometimes said, from an assumption that accrual accounting, by matching income and deductions, provides a better measure than the cash method of the taxpayer's "true income." Indeed, the history and structure of the accounting provisions of the 1916 Act imply that the cash method clearly reflected income; the "clear reflection of income" requirement became part of the statute only as a limitation upon methods of accounting other than cash receipts and disbursements.

In an apparent attempt to reduce the rather loose concept of accrual to a rule, the Supreme Court created the all-events test in 1926. In United States v. Anderson, Justice Stone asserted "with no uncertainty" (and, it should be noted, with no citation of authority) that the purpose of the first tax statutes authorizing accrual accounting was "to enable taxpayers to keep their books and make their returns according to scientific accounting principles, by charging against income . . . the expenses properly attributable to the process of earning [that] income." As history, this is wrong. Furthermore, the all-events test announced in Anderson was itself inconsistent with a systematic "matching" principle, for under the all-events test a future cost associated with this year's income will not be deductible this year if the obligation to pay is

definitions the word 'accrued' means 'due and payable.'" The Maryland Casualty court declined to go even that far. See supra note 18.

20 Revenue Act of 1916, ch. 463, §§ 8(g) (individuals), 13(d) (corporations), 39 Stat. 756, 763, 771.


22 Although the "clear reflection" requirement of the 1916 Act qualified only the right of taxpayers to use methods other than the cash method, the legislative history said that all accounting methods had to reflect income clearly. H.R. Rep. No. 9222, 64th Cong., 1st Sess. 4 (1916). The Revenue Act of 1918 adopted language substantially similar to that of § 446(b). See Revenue Act of 1918, § 212(b), 40 Stat. 1064-65 (1919).

23 269 U.S. 422 (1926).

24 See id. at 440.

25 Id.

26 See supra notes 18-22 and accompanying text.
The Supreme Court's accounting decisions in the years following *Anderson* refined the all-events test and completely ignored the matching principle. The Court's last chance to implement matching, by allowing deductions for additions to reserves for estimated future payments, came in 1934. The taxpayer in *Brown v. Helvering* was an insurance agent who had received commissions subject to an obligation to repay some of the money if the policies were cancelled. The Court refused to allow current deductions for estimated repayments because the liabilities, being contingent, had not been "incurred" and could not be taken into account in the absence of specific statutory sanction. Of the two inconsistent themes of *Anderson*, the Court chose to perpetuate the all-events test, not the matching principle.

In describing the all-events test, the regulations say that income is ordinarily reported when "all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." Deductions are allowed when "all the events have occurred which determine the fact of the liability . . . and the amount thereof can be determined with reasonable accuracy." If this test were taken at face value, accrual accounting would be an administrative horror. If a seller of goods, for example, had to include gains on sales in income when all the events making the buyers liable for payment had occurred, reporting of income would require detailed interpretation of contracts under the Uniform Commercial Code. Routine sales income could be properly reported only after investigation of course of dealing, usage of trade, and the buyer's exercise or waiver of its

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29 291 U.S. 193 (1934).
30 See id. at 196.
31 See id. at 200.
35 See id. §§ 2-208(2), 1-205(2).
right to inspect goods. Fortunately, at least in cases of routine business receipts and outlays, the all-events test is not read literally.

The regulations on accrual of income items, after stating the all-events test, provide:

The method used by the taxpayer in determining when income is to be accounted for will be acceptable if it accords with generally accepted accounting principles, is consistently used by the taxpayer from year to year, and is consistent with the Income Tax Regulations. For example, a taxpayer engaged in a manufacturing business may account for sales of his product when the goods are shipped, when the product is delivered or accepted, or when title to the goods passes to the customer, whether or not billed, depending upon the method regularly employed in keeping his books.

These two sentences virtually negate the all-events test. If a seller can report gains from sales when goods are shipped, or when they are delivered, or when they are accepted, or when title passes, or upon billing, only by coincidence will the gain be reported when the seller's "right to payment" becomes "fixed." Although the regulation's example covers only the income of manufacturers, the same principle applies to service income and to routine business deductions. Conventional bookkeeping practices, not determinations of rights, control. Indeed, an accrual-method gambling casino has been required to accrue income when its customers incurred unenforceable gambling debts.

Nevertheless, the all-events test plays a real, albeit minor role in certain accrual accounting situations. In the case of isolated sales of property, the taxpayer lacks a consistent accounting practice and generally accepted accounting principles are too imprecise to offer clear rules; in these situations, the all-events test is used as a last resort. Even in the case of routine transactions, the all-

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36 See id. § 2-513.
37 See 4 B. Bittker, Federal Taxation of Income, Estates and Gifts § 105.3.2 (1981) (taxpayers may choose "among plausible alternative accrual dates") [hereinafter cited as Bittker].
38 Treas. Reg. § 1.446-1(c)(1)(ii).
40 See, e.g., Lucas v. North Texas Lumber Co., 281 U.S. 11 (1930). Although the opinion
events test limits the range of the taxpayer’s choice. For example, the regulations do not allow a manufacturer to defer reporting until the purchase price is collected unless the seller elects to use the installment method.41

The conformity between tax and financial accounting permitted by the regulations simplifies audits, saves the taxpayer money, and in some cases may deter fraud. The objective of conformity is the practical convenience of using the taxpayer’s books for tax reporting. Consistently with this objective, the law of accrual accounting in tax cases tends to depart both from the all-events test and from conformity when a special tax accounting rule provides substantial practical advantages over financial accounting. When a taxpayer’s right to receive an income item is disputed, the taxpayer must report the item upon receipt under the “claim of right” doctrine.42 This rule has nothing to do with the all-events test, under which we would either decide the merits of the dispute or await its resolution, and the result may not conform to the taxpayer’s bookkeeping. Nevertheless, reporting the income upon receipt is very sensible as a practical matter. The date of payment is normally easier to determine than the date of resolution of a controversy, which may linger on for years and then die without formality. Similarly, no deduction is allowed for accrued expenses if the taxpayer contests liability and does not pay.43 Under section 461(f),44 a deduction is allowed once payment is made even though the dispute continues.45 The Senate Finance Committee supported this provision, which overruled a prior Supreme Court decision,46 on the ground that section 461(f) helps match income and deductions.47 While this reasoning may account for the provision, it of-

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41 See Treas. Reg. § 1.446-1(c)(1)(ii), (iii).
44 I.R.C. § 461(f).
45 See id.
fers no justification for it. The year in which a disputed expense is paid may not—indeed, typically will not—be the year in which revenues associated with the expense are accrued. The real merit of section 461(f) is administrative convenience. As in the case of disputed receipts under the claim of right doctrine, the most easily fixed event—payment—determines the time of deduction.48

With one exception,49 the all-events test and its subsidiary rules have evolved to further administrative convenience.50 Sometimes the system achieves this goal by allowing the taxpayer's financial records to be used for tax purposes, thereby avoiding the cost of multiple books. Sometimes, as in the case of the "claim of right" doctrine and the rules concerning contested claims, the tax system has developed rules simpler and less reliant upon estimates than financial accounting practices. Nowhere in this pattern is the matching of costs and revenues discernable as a goal of the all-events test, and never since 1926 has the Supreme Court suggested

48 A further advantage of § 461(f) is that prior law gave taxpayers an incentive to concede non-tax disputes over obligations giving rise to deductions. Section 461(f) eliminates this incentive, by allowing deduction upon payment to a trust pending resolution of the dispute. But see Poirier & McLane Corp. v. Commissioner, 547 F.2d 161 (2d Cir. 1976) (transfer of funds to a trustee for payment of asserted liability sometime in the future was not deductible where the claimants were not parties to the trust agreement), cert. denied, 431 U.S. 967 (1977).

49 The administrative merits of the claim of right doctrine and section 461(f) may be contrasted with the unsatisfactory state of the law concerning the accrual of an income item when the amount, rather than the right, to the item is uncertain. In Continental Tie & Lumber Co. v. United States, 286 U.S. 290, 295 (1932), the Supreme Court required a railroad to estimate and accrue an award under a statute awarding compensation to railroads controlled by the Government during World War I even though the Interstate Commerce Commission had to resolve both legal and factual issues before the amount of the award could be determined. The right to payment, said Justice Roberts, "ripened when the act became law," and the inevitable error in estimating the amount to be received "could readily have been [adjusted] by an amended return, claim for refund, or additional assessment, as the final award of the Commission might warrant." Id. at 295, 298-99. Fortunately, today's courts seem less willing than Justice Roberts to find that the amount of a payment in litigation can be estimated "with reasonable accuracy." Perhaps modern courts recognize that a tax system routinely relying upon amended returns and additional assessments serves only the interests of those who exploit the statute of limitations. Today, amended returns are not required; correction of a reasonably accurate estimate later proved inaccurate is made by taking the difference into account as an income or deduction item in the year of the determination. See Treas. Reg. § 1.461-1(a)(2). A problem not addressed by the regulation is whether a correction must be made when the original estimate was not made "with reasonable accuracy."

that it should be.

III. MATCHING AND "CLEAR REFLECTION OF INCOME"

The clear reflection of income process which is the subject of this discussion can be defined functionally as the process by which a taxpayer takes income or deductions into account at some time other than the time of accrual under the all-events test. This definition hardly exhausts the scope of the statutory phrase "clearly reflect income." See I.R.C. § 446(b). The principle has been invoked to require consistency from year to year; to compel a liquidating corporation to change from the cash to the accrual method to keep items earned but not received from disappearing from the tax base; and to rule out the use of methods based on arbitrary assumptions about costs or receipts rather than actual transactions. Unlike "clear reflection" in the Mooney Aircraft sense, these uses of the clear reflection doctrine involve either the choice between cash and accrual accounting or the proper application of their respective rules; they have little to do with matching.

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. This assumption reveals a lack of sophistication about fi-

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51 See I.R.C. § 446(b).
52 See Treas. Reg. § 1.446-1(a)(2) ("consistent application of generally accepted accounting principles . . . will ordinarily be regarded as clearly reflecting income, provided all items . . . are treated consistently from year to year").
53 See, e.g., Idaho First Nat'l Bank v. United States, 265 F.2d 6 (9th Cir. 1959) (bank held notes receivable with interest earned but not yet payable at time of dissolution).
54 See Fruehauf Trailer Co. v. Commissioner, 42 T.C. 83 (1964), acq. 1965-2 C.B. 5, aff'd, 356 F.2d 975 (6th Cir.), cert. denied, 385 U.S. 822 (1966) (Commissioner not estopped from retroactively changing method of valuing inventory of used trailers at $1.00 per trailer on clear reflection grounds despite Service's prior refusal to allow change).
55 See supra text accompanying note 16.
56 Two significant exceptions are W. Andrews, Basic Federal Income Taxation 296-97 (2d ed. 1979) (suggesting that "income" for tax purposes and financial accounting income are "related only by name and analogy"), and Schapiro, Tax Accounting for Prepaid Income and Reserves for Future Expenses, 2 Tax Revision Compendium 1133, 1142 (House Comm. on Ways and Means) (1959) (deferral of prepaid income "may in some cases be further from the mark of the 'intuitively correct' computation of net income than the strict tax rule"). Far more typical is the assumption that tax and financial accounting measure the "same thing," and so both should match revenues and expenses. See, e.g., Malman, Treatment of Prepaid Income—Clear Reflection of Income or Muddied Waters, 37 Tax L. Rev. 103, 146-
nancial accounting principles. Financial accountants devise their rules to achieve matching because the failure to do so would generate financial statements misleading to prospective investors and creditors. Consider, for example, the case of prepaid services income. If payments for services were included in income upon receipt, a business that regularly collected less than its costs could appear profitable by inducing some customers to pay early. The rule requiring deferral of prepaid income makes excellent sense as a matter of financial accounting not because it expresses an ultimate truth about the "nature of income," or defines "income" in some "logical" way, but because it serves the purposes of financial accounting. Those purposes, which derive from the supposition that investors and creditors will use this year's "income" as an estimate of future performance, have virtually nothing to do with the purposes of tax accounting. The tax system need not concern itself with whether this year's income is an accurate measure of the taxpayer's normal profit-generating ability. The willingness of many people to assume, without reflection, that "income" determined by financial accounting principles is or should be "income" for tax purposes demonstrates the continuing relevance of an observation by Lon L. Fuller:

The proposition that legal rules can be understood only with reference to the purposes they serve would today scarcely be regarded as an exciting truth. The notion that law exists as a means to an end has been commonplace for at least a half a century. There is, however, no justification for assuming, because this attitude has now achieved respectability, and even triteness, that it enjoys a pervasive application in practice. . . . We are still all too willing to embrace the conceit that it is possible to manipulate legal concepts


Because they are aware of the specific purposes of matching in financial accounting, some financial accountants seem more willing than many lawyers to recognize that matching is not a goal of tax accounting. See, e.g., 1 D. Alkire, Tax Accounting ¶ 2.02[3][c] (1983) (matching "generally not important in tax accounting"); Raby & Richter, Conformity of Tax and Financial Accounting, 139 J. Acct. 42 (1975) (conformity leads to tax-inspired methods with unfortunate financial accounting consequences and retards development of sound financial accounting principles).
without the orientation which comes from the simple inquiry: toward what end is this activity directed? Nietzsche's observation, that the most common stupidity consists in forgetting what one is trying to do, retains a discomfiting relevance to legal science.\textsuperscript{58}

The attractiveness of "matching" as a tax doctrine may be attributable in part to misapplication of the well-established principle that the costs of earning income must be considered in determining how much a taxpayer has gained. All would agree that someone who has spent fifty dollars to get sixty dollars will be taxed too heavily if the fifty dollars is not allowed as a deduction. It is very tempting to jump from that proposition to the conclusion that the fifty dollars must be deducted in the year in which the sixty dollars is reported as income. Such thinking has occasionally prompted the courts\textsuperscript{59} and Congress\textsuperscript{60} to endorse "transactional" accounting. Upon reflection, however, transactional accounting has usually been rejected as arbitrary and administratively cumbersome.\textsuperscript{61} Except in the curious case of the tax benefit rule,\textsuperscript{62} transactional accounting has yielded to a system of annual accounting with relief for hardship cases.\textsuperscript{63} The two problems


\textsuperscript{59} See, e.g., Bowers v. Kerbaugh-Empire Co., 271 U.S. 170 (1926) (repayment of loan in depreciated foreign currency held not to be income because transaction as a whole produced a loss).

\textsuperscript{60} The pre-1964 income-averaging provisions consisted of rules granting relief from "bunching" in such cases as lump sum payments for work over a long period, income from inventions or artistic efforts, and bunched back pay awards. See Webster & Reed, Income Averaging and the 1964 Revenue Act, 17 U. So. Cal. Tax Inst. 407, 408-11 (1965); Ferguson & Hood, Income Averaging, 24 Tax L. Rev. 53, 54-55 (1968).


\textsuperscript{62} Now codified in I.R.C. § 111. A typical tax benefit rule situation occurs when a taxpayer deducts a non-business bad debt in one year but receives no benefit from the deduction. Recovery of the debt in a later year will be excluded from income because the earlier transaction produced no tax benefit. This treatment seems sensible until one notes that this recovery enriches the taxpayer no less than some unrelated windfall, which the tax benefit rule would not shelter.

\textsuperscript{63} The change in the income-averaging provisions from a set of transactional relief statutes to non-transactional averaging provisions (except for the special exception of § 1303(c)(2)(B)) illustrates progress in this area. See I.R.C. §§ 1301-05. Another illustration is the expansion of net operating loss relief under § 172, which now allows net operating losses to be carried back for three years and forward for fifteen years. See id. § 172(b)(1)(A), (b)(1)(B). Until a net operating loss has expired, business deductions contributing to that loss are not tax benefit rule items. See Treas. Reg. § 1.111-(b)(2)(ii)(b). Thus, the extension of the net operating loss carryover period tends to replace the transactional relief of the tax
which transactional accounting sometimes solves—bunching of income into a high-bracket year and the waste of deductions allowed in a year in which the taxpayer has little or no income—can be dealt with more thoroughly by means of income averaging and loss carryovers and carrybacks than by adopting a tax system that matches related items.\textsuperscript{64}

Another factor encouraging matching may be the familiar practice of capitalizing the costs of depreciable assets and recovering those costs over the assets' useful lives.\textsuperscript{65} But when costs are capitalized, the matching of income and deductions that results is a consequence of capitalization, not a justification for it. The income tax law requires capitalization of the costs of income-producing assets because allowing current deductions for capital expenditures would limit the tax base to personal consumption. The decision to tax savings, as well as consumption, necessarily leads to a capitalization requirement.\textsuperscript{66} While this decision results in some matching, it does not suggest that matching must be a goal of tax accounting generally.

\textit{A. Matching in the Supreme Court}

After endorsing matching in 1926,\textsuperscript{67} the Supreme Court ignored the principle entirely until the prepaid income cases arose in the 1950's and 1960's. The Court's handling of those cases made it

\textsuperscript{64} Consider, for example, someone who spends $10,000 on business expenses in 1983 and receives $20,000 in 1984. Under a strict annual accounting system, the taxpayer would be overtaxed if he had no other income or deductions because the $10,000 deduction would be wasted. This is a real problem, but not one that can be fully solved by "matching" income and deductions, for the problem is no more serious for the taxpayer whose 1984 income results from the 1983 expenses than for someone who has engaged in two entirely separate transactions. The sensible solution for both taxpayers is to allow net operating loss carryovers to preserve the 1983 deductions. Transactional accounting is both too broad and too narrow a relief technique: too broad because it provides relief even when none is needed, too narrow because it applies only in cases in which the income and deductions arise from the same event, a circumstance which is irrelevant as a financial matter.

\textsuperscript{65} See I.R.C. §§ 263, 167 & 168.

\textsuperscript{66} See Kahn, \textit{Accelerated Depreciation—Tax Expenditure or Proper Allowance for Measuring Net Income?}, 78 Mich. L. Rev. 1, 13 (1979) ("[t]he cost of purchasing an asset to be used for more than twelve months is usually not currently deductible. In theory the taxpayer has not actually spent the dollars he paid for such an asset but rather has converted them into a different type of property") (footnote omitted).

\textsuperscript{67} See United States v. Anderson, 269 U.S. 422, 440 (1926).
plain that matching was not a major goal of the clear reflection process; in each case, the Court endorsed a non-matching treatment of an accrual-method taxpayer’s income and expenses. Despite this consistent treatment, the Court failed to face the matching issue squarely, and thus left its status in doubt.

The first of the Supreme Court’s prepaid-income cases was Automobile Club of Michigan v. Commissioner, in which the taxpayer reported prepaid income from membership dues ratably over the period of membership. Consequently, a motorist joining in October 1944 paid for a full year of membership in October but only one-fourth of the dues was reported as 1944 income, with the balance assigned to 1945. Payment entitled members to emergency road service, travel information, and other benefits. The Commissioner rejected this pro rata allocation and the Court agreed, finding the method “purely artificial,” bearing “no relation to the services which petitioner may in fact be called upon to render for the member.” In a footnote, the Court distinguished two appellate court decisions which had allowed deferral of prepaid income by noting that the services involved in those cases were performable on fixed dates and not, as in Automobile Club of Michigan, on demand. Automobile Club of Michigan can be read as a case in which the taxpayer’s only problem was its method of computing deferral. In light of later developments, however, the Court’s failure to endorse the “scientific” principle of matching is significant.

American Automobile Association v. United States involved facts virtually identical to those in Automobile Club of Michigan except that the taxpayer had established at trial that its method of computing deferral did an excellent job of matching costs and revenues. Nevertheless, the Court again held that the Commissioner

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69 See id. at 181.
70 See id. at 181, 188.
71 See id. at 183 n.6.
72 Id. at 189.
73 See id. at 189 n.20. The court expressly declined to comment on the correctness of the results in the circuit court cases. Id.
75 See id. at 692. At first, the taxpayer treated dues as received in the middle of the month of payment and reported one-twenty-fourth of the dues in that month, one-twelfth in the next month, and so forth. Id. at 690 n.3. Later it simply reported half of the dues
could reject the taxpayer's method. A very brief passage in the *American Automobile Association* opinion suggests a dim recognition that good financial accounting need not be good tax accounting. In discussing the trial court's finding that the taxpayer's method was acceptable, the Court said: "This is only to say that in performing the function of business accounting the method employed 'is in accord with generally accepted commercial accounting principles and practices.' It is not to hold that for income tax purposes it so clearly reflects income as to be binding on the Treasury." These words, especially the references to the "function" and "purpose" of financial and tax accounting, suggest that tax accounting may be a different enterprise from financial accounting. Unfortunately, the major reason the Court gave for rejecting the Association's method was that, although it succeeded in matching costs and revenues on an aggregate basis, the method had failed to match a particular member's dues with the costs of performing services for that member. This is not a cogent argument. The Association was not taxable on the dues of one member, it was taxable on all of its income. The same sort of quibbling over the details of how the taxpayer went about matching costs and revenues also characterized the Court's third prepaid income case, *Schlude v. Commissioner*, which allowed the Commissioner to include in the income of a dance studio operator advance payments for lessons to be given in future years.

The Court's failure to furnish adequate justification for its resolution of the prepaid income cases encouraged lower courts to al-

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76 *Id.* at 693 (footnote omitted).
77 *See id.* at 692. The Court found confirmation for its views in Congress's retroactive repeal of former Code sections 452 and 462, which would have authorized the taxpayer's deferral method. *See 367 U.S.* at 695. The dissent's argument that Congress, in repealing sections 452 and 462, was aware of a trend in the cases toward allowing deferral of prepaid income and deductions for estimated future expenses, and intended that "the trend of judicial decisions should be allowed to run its course," seems compelling on this point. *See 367 U.S.* at 703-06.
79 *See id.* at 133-34.
80 *See Willis, The Mad, Mad World of Tax Accounting, 28 U. So. Cal. Tax Inst. 441 (1976). The title seems to refer to the prepaid income cases, though the text is more restrained than the title. While certainly deserving of criticism, the opinions in the prepaid income cases are far from mad. Indeed, they are fairly typical examples of the behavior of
low deferral of prepaid income when future services were scheduled for fixed dates or could otherwise be matched with payments on an individual basis. This continued use of matching was encouraged by the Court’s reliance on financial accounting authority in *Commissioner v. Idaho Power Co.*, which held that depreciation on equipment used in constructing an asset must be capitalized as part of the cost of that asset.

The Court’s unanimous opinion in *Thor Power Tool Co. v. Commissioner*, however, may signal an end to unthinking application of financial accounting in tax cases. *Thor* held that a taxpayer could not, over the Commissioner’s objection, write down its inventory of replacement parts to scrap value even though financial accounting principles might have allowed the writedown. Noting that the regulations prohibit the use of accounting methods unacceptable to the Commissioner, the *Thor* Court read the prepaid income cases as supporting the Commissioner’s broad discretion to ignore financial accounting. For the first time, the Court squarely faced the question of whether “generally accepted accounting principles” are presumptively applicable to tax courts unable to articulate good rationales for results they feel to be sound. When the courts of England faced an avalanche of slander actions in the sixteenth and seventeenth centuries they responded by construing supposedly defamatory statements as innocent whenever possible, so that calling someone a “forger” ceased to be actionable—the plaintiff might have been a metal-worker. *See G. Bower, The Law of Actionable Defamation* 302-05 (2d ed. 1923), for a description, with illuminating examples, of the delightful doctrine of “sensus mitior.” When the New York courts became dissatisfied with the doctrine of *Winterbottom v. Wright*, 10 M. & W. 109 (Exch. 1842), which seemed to bar a negligence action against the manufacturer of a defective product unless the victim was in privity of contract with the defendant, the courts created an exception to the privity requirement for “imminently dangerous products” and then held that a coffee urn fell within the exception. *See Statler v. George A. Ray Mfg. Co.*, 195 N.Y. 478 (1909). “Minutely technical” applications of procedural rules have long been used to mitigate the severity of the criminal law. *See T. Plucknett, A Concise History of the Common Law* 398 n.1 (5th ed. 1956). In all of these cases the courts twisted doctrine for the sake of result. This may not be the best method of law reform but it is surely one of the most common.

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81 *See Boise Cascade Corp. v. United States*, 530 F.2d at 1369-70, 1376-78 (engineering and similar service contracts which were “fixed and definite”); *Artnell Co. v. Commissioner*, 400 F.2d 981 (7th Cir. 1968) (advance ticket sales and other service revenue related to baseball games to be played during 1962 Chicago White Sox season).

82 418 U.S. 1, 10 n.7 (1974).

83 *See id.* at 19.


85 *See id.* at 533.

86 *See id.* at 531-32.
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 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.

Although the Thor criticism of financial accounting failed to allude directly to matching in tax cases, the opinion’s reference to the “vastly different objectives” of the two accounting systems led the Second Circuit to hold in *RCA Corp. v. United States* that prepaid income could not be deferred even though the taxpayer’s method “matched . . . revenues and related expenses with reasona-

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87 Id. at 544.
88 Id. at 542-43 (footnotes omitted; brackets in original). Justice Blackmun further distinguished financial and tax accounting:

Financial accounting . . . is hospitable to estimates, probabilities, and reasonable certainties; the tax law, with its mandate to preserve the revenue, can give no quarter to uncertainty. This is as it should be. Reasonable estimates may be useful, even essential, in giving shareholders and creditors an accurate picture of a firm’s overall financial health; but the accountant’s conservatism cannot bind the Commissioner in his efforts to collect taxes . . . .

Finally, a presumptive equivalency between tax and financial accounting would create insurmountable difficulties of tax administration. Accountants long have 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 . . . .

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.

Id. at 543-44.

ble precision. . ." If, as seems likely, Thor and RCA have at last provided a respectable analysis for the prepaid income cases, they have also made the "scientific principle" of matching irrelevant. The demise of matching, however, raises the question of what clear reflection of income should mean. Mindful of Professor Bittker's warning that "attempts to translate the statutory phrase 'clearly reflect income' into another set of generalizations are doomed to fail," an effort will be made to deal with this question in the context of two recurring problems of accrual accounting: prepaid income and deferred-payment deductions.

B. Clear Reflection in Context: Two Problems

This section will examine the merits of two frequently litigated questions about accrual accounting: (1) when prepaid income should be reported, and (2) whether a deduction for accrued expenses should be allowed if a substantial period of time separates accrual of the item under the all-events test from its payment. With deferral of sales income widely available to most taxpayers under the Installment Sales Revision Act of 1980, these are the principal areas in which controversies over "clear reflection of income" are likely to arise.

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90 664 F.2d at 885. The court left open the possibility of deferral in cases in which the services were to be performed on fixed dates and in which the taxpayer could be sure in advance of the profit to be earned. See id. at 889.

91 4 Bittker, supra note 37, at ¶ 105.1.6.

92 Discussions of prepaid income are often lumped together with discussions of deductions for additions to reserves for estimated future expenses. The most serious problem presented by allowing deductions for reserves arises in connection with current deductions for fixed expenses to be paid in the future as well as in the case of reserves. Therefore, both the "reserve" cases and cases of current deductions for future fixed payments will be discussed together under the heading of "deferred-payment deductions."

93 Pub. L. No. 96-471, § 2, 94 Stat. 2247-50. I do not mean to suggest that the installment method provides a sensible solution to the problem of deferred payments of sales proceeds, but only that the matter seems to have been settled. Installment reporting provides substantial tax benefits because the seller who receives cash and invests that cash incurs a taxable event at the time of sale, while the installment seller, who has done much the same thing economically, delays the taxable event. Furthermore, installment treatment of gains is inconsistent with long-term capital gain treatment if the deferral period is substantial, because the standard rationales for favorable treatment of capital gains rest on an assumption that the gains will be "bunched" in the year of sale, and under the installment method they will not be. For a criticism of the installment method on economic grounds, see Cain, Installment Sales by Retailers: A Case for Repeal of Section 453(a) of The Internal Revenue Code, 1978 Wisc. L. Rev. 1.
1. Prepaid Income

Unless specific reasons exist for departing from financial accounting practice, the tax system should accept financial accounting guidelines in regard to prepaid income—not because accountants should be presumed to have discovered the "true" measure of income for all purposes, but because it is more convenient for both taxpayers and the Service if only one set of books is kept. The rejection of matching as a tax principle establishes that immediate taxation of prepayments is an alternative worth considering, but does not show that immediate taxation has any advantages over deferral. The opinions rejecting deferral have avoided serious discussion of its merits by deferring to the Commissioner's discretion, and the Commissioner has been content to exercise that discretion without justifying his choice.

One argument for immediate reporting of prepaid income is based upon administrative convenience. Immediate reporting provides the sort of clear rule required by the tax system, while deferral often involves estimates. As applied to publicly held corporations, this argument is weak. The principal objection to the use of estimates is that taxpayers may estimate unreasonably. But a corporation reporting its income not only to the Service but also to creditors and unsophisticated shareholders has strong nontax incentives to avoid excessive deferral. These incentives are reinforced by professional and legal constraints on accountants. The convenience of using financial statement data for tax returns is obvious. On balance, then, administrative considerations seem to favor deferral for the publicly held corporation. However, if deferral were allowed for publicly held corporations it would probably have to be allowed on "equal treatment" grounds for small

See Schapiro, supra note 56, at 1142-44 (immediate reporting "involves fewer subjective judgments and estimates and produces a more uniform result among different taxpayers").

See id.

See generally 3 American Institute of Certified Public Accountants Professional Standards, Generally Accepted Accounting Principles § 1026 (1970) (pervasive principles) (discussing financial accounting standards regarding deferred income); id. at § 1027 (broad operating principles) (same); id. at § 1220 (1980) (qualitative character of accounting information) (same).

Note, for example, that the Supreme Court's specific criticisms of the deferral methods used in the auto club cases are singularly unconvincing. See supra notes 68-80 and accompanying text.
businesses as well. A dance studio operated by a husband and wife partnership, as in Schlude, faces little serious pressure to avoid deferring income beyond all reasonable limits. Furthermore, review of specific deferral techniques upon audit and during litigation would be time consuming and expensive. Therefore, unless deferred reporting could be limited to taxpayers with reliable financial accounting records, administrative considerations support immediate taxation.

A second argument against deferral rests on a concern that if the tax is not collected fairly soon after the taxpayer receives cash, it may not be collected at all:

The strict tax rule protects the revenues by levying a tax at a time when the taxpayer has the funds with which to pay the tax. This conforms to a general policy of gearing tax collections to dollars in taxpayer's hands. This general policy, of course, at times works in the taxpayer's favor. For example, unrealized appreciation (even in readily marketable securities) is not taxed; and the installment method of reporting in general correlates tax collections with the receipt of money.

Considerations of protecting the revenues do not compel immediate taxation so long as a taxpayer's prepayment receipts remain constant from year to year. The tax due upon performance of services in a particular year can be paid out of revenues received in that year for future services. Should business fall off and customers become reluctant to prepay, however, deferral results in tax liability at the very time that a taxpayer may be most strongly tempted to use cash to revive his business rather than to pay taxes.

Whether economic considerations, which have been ignored in all the reported cases, support taxing prepaid income on receipt is a complex question. If economic effects are measured solely from the taxpayer's perspective, the case for taxation on receipt appears compelling. The taxpayer who receives $1000 now for services performed in five years is better off financially than someone else who

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** This is a prediction, not an endorsement of the "equal treatment" approach. The text demonstrates that the two cases are not "equal."

** Schapiro, supra note 56, at 1142. For a detailed analysis of the problem, see Oberdorfer & Michelman, A Commentary on Tax Administration and Accrual Accounting, 12 Am. U. L. Rev. 135 (1963). Both of these articles have been ignored by most advocates of matching in prepaid income situations.
must await payment until performance. If both are taxed on the same income at the same time, i.e., the time of performance, the tax system will have ignored the substantial economic advantage of the taxpayer who was paid early. This result appears to violate the principle of "vertical equity," under which those with high incomes are taxed more heavily than those with low incomes.\textsuperscript{100} If, however, one considers the fact that both the taxpayer and his customer will adjust their behavior, both because of the tax system\textsuperscript{101} and because a small early payment can be worth as much as a larger but later payment, it ceases to be obvious that immediate taxation of prepaid income is consistent with economically sensible tax policy.

From an economic perspective, the ideal system for taxing prepaid income transactions would tax the parties so that the system neither encourages nor discourages prepayment. Unfortunately, for reasons unrelated to the tax treatment of the recipient, neither immediate taxation of prepaid income nor deferral can achieve this

\textsuperscript{100} See Schapiro, \textit{supra} note 56, at 1142: "To illustrate, suppose a taxpayer leases land on a net basis and receives the fifth year's net cash rent in advance. Why is it more accurate or fairer to postpone the incidence of the tax until the fifth year?" \textit{Id.}

A defense of deferral of prepaid income on the merits is attempted in Mills, \textit{An Evaluation of the Accounting Provisions of the Internal Revenue Code of 1954}, 2 Tax Revision Compendium 1161 (House Comm. on Ways and Means) (1959). Mills says that prepaid income "is really debt capital." \textit{Id.} at 1166. While it is true that paying in advance for goods or services resembles lending in some ways, the treatment of the person advancing the funds differs greatly in the two cases. A lender has taxable interest or discount income, but someone who prepays will not be taxed on the return (in the form of a lower price) received in exchange for prepaying. Mills fails to follow his analogy to the point of advocating taxation of those who prepay. If people making prepayments were taxed, some of the objections, developed below, to allowing deferral would lose their force.

Mills' argument is repeated in M. Chirelstein, \textit{Federal Income Taxation} ¶ 12.02 at 220 (3d ed. 1982). Chirelstein adds that including prepayments in income causes "bunching" of income into a single year. It is sufficient to respond that taxpayers who do not ask for prepayments will not get them.

For an accurate comparison of prepaid income and interest-free loans, see Malman, \textit{supra} note 56, at 142. Prepayment is economically equivalent to a transaction in which the buyer makes an interest-free loan of the purchase price until the goods or services are delivered. If the current tax treatment of interest-free loans were sound it would follow that prepaid income should be deferred. For criticisms of the current tax rules for interest-free loans see Keller, \textit{The Tax Treatment of Interest-Free Loans: A Two-Transaction Approach}, 1 Va. Tax Rev. 241 (1981); Note, \textit{The Income Tax Treatment of Interest-Free Loans}, 1 Va. Tax Rev. 137 (1981).

\textsuperscript{101} Common cases in which the amount of a payment will be adjusted to reflect its tax treatment to the recipient and the payor are discussed in the Appendix. \textit{See infra} text accompanying notes 162-69.
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goal. This is because the tax system favors the person making pre-
payments whenever one of two conditions exists: (1) the payor is
unable to deduct the cost of the goods or services, or (2) the
payor's tax rate exceeds the recipient's tax rate.

Consider a prepaid tuition plan of the type adopted in recent
years by several universities. Under the plan, a parent who pays
tuition early is allowed to pay future years' tuition at current rates.
If annual tuition increases equal the return the college can get on
investment income, the cost to the college of selling future years'
instruction at current prices is exactly offset by the benefit of re-
ceiving the tuition early. From the parent's point of view, however,
prepayment provides a tax advantage over investing the money,
paying tax on the return, and subsequently paying higher tui-
ton. Consider, for example, a parent who pays $8000 tuition in
1983 in lieu of $8800 tuition in 1984. If both the parent and the
college can get a ten percent annual return on their investments,
the college is neither better nor worse off than if the parent had
paid $8800 in 1984. Prepayment, however, makes the parent better
off if his investment income is taxed at any rate higher than zero,
because retaining the money would have produced less than $8800
after tax by 1984.

If the person making a prepayment is entitled to deduct the cost
of goods or services when they are received, much of the advantage
of prepayment disappears. However, if the recipient is taxed at a
rate lower than that of the payor, and if the prepayment period
extends over several years, prepayment provides a slight advantage
to the recipient because the money prepaid will grow at a faster
after-tax rate in the recipient's hands than in the hands of the
payor.

Neutrality between prepayment and payment at delivery or per-
formance requires taxing the investment return on prepayments

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102 Or, of course, a student.
103 The only non-tax advantage to parents of a prepaid tuition plan is that the plan pro-
vides parents with a form of insurance against unexpectedly large tuition increases.
104 Because interest is deductible, the parent need not have the cash for several years' tuition on hand in order to take advantage of a prepayment plan; the money can be borrowed.
105 In this case, neutrality seems undoubtedly a desirable objective, as there is no reason for the tax system either to encourage or discourage prepayment. There is, however, a possible "second-best" consideration. The tax advantage a high-income taxpayer gets by prepay-
ing for deductible items resembles one of the tax advantages obtained by buying insurance.
to the payor rather than the recipient. It seems unlikely, however, that Congress would adopt such a plan, given the administrative problems of imputing income on prepayments to the payor.\textsuperscript{106} As a practical matter, the current tax treatment of those who prepay is likely to continue.

An economic analysis of two common prepaid services income situations—one in which the payor cannot deduct the cost of the services and one in which the cost of the services is deductible when the services are performed—is developed in an appendix to this article, both for a system in which prepayments are taxable on receipt and for a system in which prepaid income can be deferred until the services are performed.\textsuperscript{107} The results, taking into account the tax costs and benefits to both parties, are as follows:

(1) In the case of non-deductible services, deferral of prepayments favors those who prepay over those who do not except when the payor’s tax rate is much lower than the recipient’s. A system that taxes prepayments upon receipt is neutral if the payor and recipient pay tax at the same rates. If the recipient’s rate is lower than the payor’s, immediate taxation favors prepayment (though by less than deferral, unless the recipient’s rate is zero). If the recipient’s tax rate exceeds the payor’s, immediate taxation discourages prepayment.

(2) In the case of services whose costs may be deducted at the time of performance, immediate taxation almost always discourages prepayment. Deferred taxation of prepaid income is neutral if the parties’ tax rates are the same, encourages prepayment slightly if the recipient’s tax rate is less than the payor’s, and discourages prepayment somewhat if the recipient’s rate exceeds the payor’s.

On balance, economic considerations favor immediate taxation of prepaid income when the costs of goods or services are not deductible. Although immediate taxation fails to achieve neutrality in most cases, it tends to reduce or eliminate the attractiveness of

\textsuperscript{106} But see I.R.C. § 7872 (imputing interest on interest-free loans to lenders).
\textsuperscript{107} See infra notes 162-69 and accompanying text.
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prepaid income transactions, and therefore should result in fewer cases in which costly prepayment arrangements are made solely for tax reasons. In the case of deductible payments, deferred taxation of receipts comes much closer to neutrality than current taxation, which almost always discourages prepayment.

If the only choice is encouraging or discouraging prepayment, the tax system should select the latter. Most non-tax advantages of prepayment can be obtained by other means, such as escrow arrangements, which do not raise economic neutrality problems. Favoring prepayment encourages expensive and often wasteful tax-motivated transactions and raises an “equity” problem by allowing windfalls to some prepayers. Discouraging prepayment helps to solve the “equity” problem indirectly, though at the cost of penalizing some useful business arrangements. With administrative as well as economic considerations taken into account, the case for immediate taxation of prepaid income is quite strong.

The Government’s current position regarding prepaid income allows deferral in accordance with the taxpayer’s financial accounting practice in the case of prepaid sales and services income, provided the deferral period is short. This limited exception is a reasonable concession to the practical advantage of conformity for cases in which the tax loss on deferral should be small.

2. Deferred-Payment Deductions

It is inherent in present accrual accounting practices that some deductions may be taken before payments are actually made or even due. But what if the time period between deduction and pay-

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108 Tax considerations aside, prepayment should be a relatively rare phenomenon. Fewer tax-motivated payment schemes would result from discouraging such out-of-the ordinary arrangements than would result if ordinary arrangements were disfavored. Thus, discouraging rather than encouraging prepayment seems the better policy choice.

109 See Treas. Reg. § 1.451-5 (discussing rules for prepaid income from sales of goods and long-term contracts); Rev. Proc. 71-21, 1971-2 C.B. 549 (prepaid services income). But cf. I.R.C. § 455(c) and (e) which allow deferral of prepaid subscription income without the limitations of the administrative deferral provisions. Readers have undoubtedly noticed how regularly magazine publishers offer substantial discounts for prepaid subscriptions.

110 See generally Calvin H. Johnson, The Deduction of Liabilities: Silk Purses From a Sow’s Ear (Aug. 30, 1980) (unpublished draft) (explaining the tax advantages of deducting “long deferred expenses at the time the liability . . . arises”; id. at 5.); Johnson, Stock Compensation under Section 83: A Reassessment, 1980 S. Cal. Tax Inst. ¶ 803.4 at 8-59 to -63 (deferred payment deductions examined in the context of compensation for services).
ment is several years, or even decades? Consider, for example, Revenue Ruling 69-429, in which an accrual-method partnership was a self-insurer under a workers' compensation system. The partnership had become liable to pay an injured employee in weekly installments "extending over a period of several years." Because liability was "fixed" and the amount to be paid certain, the ruling allowed the partnership a current deduction for the full amount of the award. If Revenue Ruling 69-429 is an accurate reflection of the law, accrual accounting may be used by high-income taxpayers to yield bizarre results.

Consider this hypothetical case presented in a recent article by an accountant. An accrual-method corporation subject to a forty percent income tax is the defendant in a personal-injury case. The plaintiff will settle for an immediate payment of $1 million or for a payment of $3 million in ten years, the latter sum having a slightly larger present value than the former. If the defendant can get a before-tax return of eighteen percent on its investments and can deduct $3 million in the year of settlement, as allowed in Revenue Ruling 69-429, the corporation is better off, after taxes, by agreeing to pay $3 million in ten years than if it had never been sued. 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.

While people may reasonably differ about the goals and features of a good income tax system, one feature of any income tax system with rates less than 100 percent is beyond dispute: if Smith has done better than Jones before tax, Smith should be better off than Jones after-tax. The tax may reduce the pre-tax difference, a result

112 See id.
113 See id.
115 But see infra text accompanying notes 151-61 (Part V, "Afterword" section) (effect of the Tax Reform Act of 1984 on this hypothetical). Considered as a unit, the payor and payee will receive tax benefits from deferred payments whenever the payor has a higher tax rate than the payee or when the payee's income is deferred, as in the case of a cash-method payee, or when the payee's income is tax exempt, as in the case of the recipient of personal-injury damages. The exemption from tax of personal-injury damages, including the "interest" element of structured settlements, is criticized in Frolik, The Convergence of I.R.C. § 104(a)(2), Norfolk & Western Railway Co. v. Liepelt and Structured Tort Settlements: Tax Policy "Derailed," 51 Fordham L. Rev. 565 (1983).
specifically intended by a progressive tax, but it should not make Jones better off after-tax than Smith. If Jones's activities are identical to Smith's except that Jones has incurred an expense that Smith has avoided, Smith has done better before tax than Jones even if Jones's payment of the expense can be deferred. Yet if Jones can defer payment long enough, allowing him an immediate deduction for the full amount of the expense can make him better off after-tax than Smith—solely because he has incurred an extra cost. Noting that an immediate deduction “matches” costs and related revenues does not make this result respectable.\footnote{Few settlements will actually produce tax benefits in excess of non-tax costs. But the criticism is equally sound, if less dramatic, when early deductions substantially reduce rather than eliminate a non-tax cost.}

Whether current law allows the Commissioner to deny current deductions for payments to be made in the distant future is uncertain. The only cases giving the Commissioner that power are Mooney Aircraft, Inc. v. United States\footnote{420 F.2d 400 (6th Cir. 1969).} and Hodge v. Commissioner,\footnote{32 T.C.M. (CCH) 277 (1973).} a Tax Court memorandum decision also involving “Mooney Bonds.” The Mooney Aircraft court endorsed the Commissioner's denial of current deductions for payments to be made twenty or more years in the future in part because of economic factors, and in part because the taxpayer might never pay the liabilities.\footnote{See 410 F.2d at 409-10.} Hodge discussed only the possibility of non-payment.\footnote{See 32 T.C.M. (CCH) at 282.}

Most cases involving non-contingent obligations to make future payments have allowed deductions.\footnote{See infra note 122 and accompanying text.} Economic considerations have been ignored, apparently because the Government has made technical arguments concerning the all-events test without calling the courts' attention to the consequences of allowing the deductions. Typical of these cases is Lukens Steel Co. v. Commissioner,\footnote{"442 F.2d 1131 (3d Cir. 1971). See also Franklin County Distilling Co. v. Commissioner, 125 F.2d 800 (6th Cir. 1942) (current deduction allowed even though the identity of the ultimate obligee was unknown; key factor was that the obligation to pay was fixed in the year the court allowed the deduction); Cyclops Corp. v. United States, 408 F. Supp. 1287 (W.D. Pa. 1976) (deductions allowed for accrued liabilities under an unemployment benefit plan; amounts became sufficiently absolute and irrevocable during the tax years in dispute);} where the taxpayer had become bound to make future payments.
payments to a fund providing supplemental unemployment benefits to laid-off workers. Although the time of the payments depended upon future events, the total amount to be paid was fixed. The litigants, the Tax Court, and the Third Circuit agreed that the only issue was whether "sufficient events" had occurred to "fix" the taxpayer's obligation. The courts held that the requisite events had occurred and allowed the deductions. Chief Judge Hastie's concurring opinion would have limited the Third Circuit's holding to cases in which payment would occur "within a relatively short time that could be estimated approximately," reserving judgment about cases in which payment might be called for "decades hence."

In many deferred-payment cases the exact amount to be paid is uncertain, either because the taxpayer's obligation to pay is subject to a contingency or because the taxpayer's obligation is to perform some service. In Brown v. Helvering, for example, the taxpayer, a general insurance agent, received overriding commissions on policies written by other agents, but was required to return commissions earned on cancelled policies. Based on his cancellation experience rate for a five-year period, the taxpayer sought to take deductions for additions to a "Return Commission" reserve account. The Supreme Court denied a deduction, ruling that no obligation had been "incurred" so long as the obligation remained contingent. In recent years, however, the Ninth Circuit and the Tax Court have allowed deductions for future workers' com-
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Pension payments contingent upon the recipients' remaining alive.133 The Tax Court has justified this departure from Brown by invoking the purely formal distinction between conditions "precedent" and "subsequent."133

Taxpayers who are bound to perform future services, rather than simply to pay money, have usually been unsuccessful in obtaining current deductions for the costs of the services.134 The repeal of former Code section 462, which would have allowed deductions for additions to reserves, can, but probably should not, be seen as a congressional rejection of the use of reserves,135 and the administrative problems of estimating future costs are even more serious than those involved in allocating prepaid income to future periods. For a number of years after the Supreme Court's prepaid income "trilogy"136 most of the "reserve" cases were decided against the taxpayer.137 However, in Ohio River Collieries Co. v. Commis-

date of payment arrives. The taxpayer will be liable to make any particular payment only if the recipient remains alive. If, however, one applies the test to the taxpayer's entire obligation to the injured worker the test is satisfied. The taxpayer has become liable to pay something and the amount of the liability can be estimated accurately with the use of actuarial tables.

133 But see I.R.C. § 461(h)(2)(C), added by the Deficit Reduction Act of 1984, Division A, Pub. L. No. 98-369, § 91(a), 98 Stat. 494, 599 [hereinafter cited as the Tax Reform Act of 1984], which provides that liabilities arising under any workers' compensation act are deductible only when paid. This provision is generally effective for amounts incurred after July 18, 1984. See Tax Reform Act of 1984, § 91(g); see also infra text accompanying notes 151-55, 160-61 (Part V, "Afterword" section) (discussion of new I.R.C. § 461(h) as it applies to this article).


137 See supra text accompanying notes 68-79.

138 See cases cited in Bittker, supra note 37, at ¶ 105.3.6; see also supra note 134.
sioner, the Tax Court unanimously allowed a strip mining company to deduct the estimated cost of reclamation work it was required to perform upon completion of mining. Ohio River's precedential value is unclear because of the Commissioner's unusual concession that the costs had been estimated "with reasonable accuracy" and the court's cryptic statement that the all-events test must be "strictly construed" in the future.

The courts and the Service have been almost exclusively concerned in the deferred-payment cases with applying the all-events test and with other issues not involving clear reflection of income. As a result, they have failed to confront the astonishing economic implications of a rule allowing immediate deductions for payments deferred for a substantial period of time. Even

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138 77 T.C. 1369 (1981); see also Denise Coal Co. v. Commissioner, 271 F.2d 930 (3d Cir. 1959).
139 77 T.C. at 1375-76.
140 See id.
141 See 77 T.C. at 1373, 1377-78. But see Tax Reform Act of 1984, §§ 91(a) & (b), which added I.R.C. §§ 461(h) & 468, respectively. The new laws allow taxpayers to deduct additions to reserves for qualified reclamation and closing costs, on an elective basis. Id. at §§ 468(a), 461(h)(1)-(h)(2). See also infra notes 152-55 and accompanying text (Part V, "Afterword" section).
142 In Champion Spark Plug Co. v. Commissioner, 30 T.C. 295 (1958), nonacq. 1958-2 C.B. 9, aff'd per curiam, 266 F.2d 347 (6th Cir. 1959), the Commissioner's principal, if not sole, argument was that accrued payments to be made to a disabled employee were nondeductible because of § 23(p) of the 1939 Code, the predecessor of § 404(a)(5). In Consumers Power Co. v. United States, 299 F. Supp. 1180, 1189-91 (E.D. Mich. 1969), the Government coupled a § 404(a)(5) argument with a contention that the all-events test had not been satisfied. The basis of the Commissioner's argument against a current deduction for future payments to be made in settlement of a discharged employee's claims in Peninsular Metal Prod. Corp. v. Commissioner, 37 T.C. 172 (1961), acq. 1966-1 C.B. 3, is not clear. The court rejected an argument that the settlement agreement was a "modification" of the former employee's contract of employment, suggesting that the Commissioner had advanced a § 404(a)(5) argument. See 37 T.C. at 178-79 (case was on "all fours in principle with Champion Spark Plug Co.").
143 The Treasury Department is now aware of the distortions caused by allowing current deductions for future payments without regard for the time-value of money. See Hearings on Misc. Energy Tax Bills (II) Before the Subcomm. on Energy and Agricultural Tax'n of the Senate Comm. on Finance, 97th Cong., 1st Sess. 74-82 (1982) (statement of John E. Chapoton, Assistant Secretary of the Treasury for Tax Policy). Mr. Chapoton explains the Treasury's opposition, on grounds similar to those discussed in the text, to bills which would codify the result of Ohio River Collieries Co. v. Commissioner. See supra text accompanying notes 138-40.
144 See also Committee on Taxation, Association of the Bar of the City of New York, Transactions Involving Deferred Payment of Accrued Liabilities: Federal Income Tax and the Time Value of Money (1983). Noting the time-value problem in various contexts including
Mooney Aircraft and Hodge, the only cases holding that too long a delay can be fatal to current deductions, failed to base their results explicitly on economics, though the Mooney Aircraft court did observe that the taxpayer would be able to use the funds in question to expand its business. These cases, one a fourteen-year-old court of appeals case and the other a Tax Court memorandum decision, do not constitute an impressive amount of authority. Yet the absurdity of a rule that can make the tax benefit of a deduction exceed its cost is so clear, once it has been noted, that the Government should have a fair chance of winning future deferred-payment cases if it makes the right argument: that an immediate deduction for expenses paid in the distant future distorts in-

the workers' compensation and strip-mining cases, the report concludes that immediate deductions are allowable under current law and that any attempt to deny current deductions on clear-reflection grounds would "provide . . . too drastic a change in the current tax system to be sustained in litigation absent corresponding changes in the applicable regulations or statute." Id. at 45. It recommends a study aimed at the promulgation of new regulations or, preferably, legislation. See id.

See 420 F.2d at 410. The Mooney Aircraft court said: "for all practical purposes the revenue taxpayer received from the sale of the planes is his to use as he pleases". Id. A numerical example might have made the court's point more forcefully. Had Mooney been allowed to deduct the face amount of its "bonds" in the year of issuance, the availability of high interest rates (largely attributable to inflation) could have given Mooney tax savings of greater value than the cost of satisfying the bonds. To illustrate, assume that Mooney's tax rate is 50%, that it can obtain a secure after-tax return of 8%, and that it can expect to pay $1000 to the holder of each bond twenty years after that bond is issued. The issuance of each bond would have saved Mooney an immediate $500 in taxes, and this amount, invested for twenty years at 8% (after tax) would have grown to $2325. Mooney then could have paid the holder of the bond $1000 and kept $1325. This curious result would be equivalent to the Government's not only paying off Mooney's bonds in full but also paying Mooney a substantial commission for its trouble in issuing them. The Fifth Circuit's holding that an immediate deduction would not clearly reflect Mooney's income prevents this bonanza.

Mooney Aircraft is criticized in Aidinoff & Lopata, supra note 56, at 800-06, on the grounds that the "overwhelming weight of authority" holds that time of payment is immaterial, that concern about default was misplaced because Mooney sought to deduct only the face amount of bonds likely to be redeemed, and that default on any particular bond was never shown. Aidinoff and Lopata appreciate the bizarre economic consequences of allowing immediate deductions for significantly deferred payments; their proposed remedy is to allow immediate deductions for only the present value of the obligation. Id. at 811-18. If the discount rate were chosen appropriately, this technique might yield roughly the same economic consequences as postponing the deduction until payment. Discounting would, however, be significantly more cumbersome than simply delaying the deduction.

Although Aidinoff and Lopata stress matching in arguing for current deductions for fixed future expenses, they do not seem to be concerned about the departures from matching that occur when contingent future outlays are nondeductible because of failure to satisfy the all-events test.
come.\textsuperscript{145} That the law should not be "a ass, a idiot" is a principle of some persuasive force.

C. "Clear Reflection" and the Differences between Cash and Accrual Accounting

One effect of the assumption that accrual accounting requires matching has been that major differences in tax treatment between cash-method and accrual-method taxpayers are usually accepted. Yet the Code requires that \textit{any} accounting method "clearly reflect income" in the opinion of the Secretary, a requirement originally meant to insure that the results of the several accounting methods not differ dramatically from each other.\textsuperscript{146} This provision tends to be slighted by those who see "matching" as a goal of accrual accounting but not of the cash method. Apart from convenience of reporting and recordkeeping, which may be even more important for the supposedly unsophisticated users of the cash method than for large corporations, the commonly accepted goals of the tax system—taxation according to ability to pay and subsidization of nearly everything—apply with equal force to cash-method and accrual-method taxpayers. The tendency of matching to generate major differences between cash accounting and accrual accounting shows that a matching principle for accrual-method taxpayers does not further these tax goals.

A tax system that allows a choice of accounting methods necessarily leads to some differences in the tax burdens of people who are "similarly situated" in economic terms.\textsuperscript{147} In everyday cases, however, the difference between cash and accrual accounting is likely to be small. The income of a lawyer who deducts expenses as incurred and reports income when clients are billed will be, on average, close to that of another lawyer similarly situated but reporting on the cash method. Furthermore, some differences in tax burdens which may appear to be side effects of accounting method differences are more accurately seen as the result of the annual

\textsuperscript{145} Just how long is too long is the kind of question best left to the Commissioner's supposed "discretion". Presumably, if the Service should decide to follow this line it would issue guidelines, as it has in the case of prepaid income.

\textsuperscript{146} See supra notes 18-22 and accompanying text.

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accounting requirement.

Suppose that Wynken and Blynken are subject to a maximum tax rate of fifty percent for 1983 and twenty-five percent for 1984. In December, 1983, each earns $1000, which is received in January, 1984. Wynken, an accrual-method taxpayer, must pay half of this $1000 in taxes while Blynken, on the cash method, pays only one-fourth. At first glance, this looks like a case in which the accidents of accounting methods have discriminated against Wynken. But if blame for the discrimination is to be assigned, it should be assigned to the necessity of computing income on an annual basis, not to the difference between the cash and accrual methods. For if Wynken and Blynken are "similarly situated" to each other, they are also situated quite similarly to Nod, who earned and received $1000 in January of 1983, a low-bracket year. Requiring both Wynken and Blynken to use accrual accounting would eliminate the difference between their tax burdens, but would create an identical and no less arbitrary difference between Blynken and Nod. Under any system in which tax rates vary from year to year, minor differences in timing will create arbitrary differences in tax burdens. The accidents of cash and accrual accounting will change the pattern of those burdens but will not make that pattern more (or less) capricious than it would have been if everyone used the same accounting method.148

Only when time differences between accrual and payment become substantial will the choice of accounting method generate substantial and systematic tax advantages, often in favor of the accrual-method taxpayer.149 By abandoning matching we will

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148 A rather far-fetched, but appropriate, analogy may clarify the argument. Suppose that a whimsical despot, in need of funds, were to impose a poll tax on people born in February. Later he reduces taxes by exempting from tax those born on odd-numbered days in February. The basic tax could be fairly criticized as capricious, but the amendment could not be.

149 Cash-method taxpayers have been allowed deductions for some prepaid expenses that accrual-method taxpayers are required to capitalize. See, e.g., Waldheim Realty & Inv. Co. v. Commissioner, 245 F.2d 823 (8th Cir. 1957), rev'd 25 T.C. 1216 (1956) (prepaid insurance premiums); Morton v. United States, 258 F. Supp. 922 (W.D. Mo. 1966), aff'd in part with no discussion on this point, 387 F.2d 441 (8th Cir. 1969) (same). Contra Commissioner v. Boylston Mkt. Ass'n, 131 F.2d 966 (1st Cir. 1942) (cash basis corporation may deduct only prorata portion of prepaid fire insurance premium). This undesirable aspect of the law seems gradually to be giving way to a requirement that all substantial prepayments be capitalized. See, e.g., Smith v. Commissioner, 51 T.C. 429 (1968) (advance rental payment to be applied to last year's rental under a five-year lease, not deductible); Herter v. Commissioner, 30 T.C.M. (P-H) 83 (1950) (premiums on three-year fire insurance policy required to
abandon the only apparent justification for those advantages. The lack of any general tax reason for treating accrual-method and cash-method taxpayers in fundamentally different ways shows that the "scientific" principle of matching is not only irrelevant but positively hostile to the goals of tax accounting.

IV. CONCLUSION

The Code requires that accounting methods clearly reflect income. Thor and the prepaid income cases make it clear that this does not mean that tax accounting must follow financial accounting. What, then, is "clear reflection of income"? The answer is found not in "another set of generalizations," but in recognizing that the "clear reflection" provision authorizes a process. Once an income or deduction item has been received, paid, or accrued, someone must decide whether to give it tax effect at that time. Sensible decisions require asking questions about administrative convenience and economics. The Commissioner's power to determine clear reflection of income matters is a power to ask—and answer—those questions. I have argued that administrative and economic considerations favor matching income and deductions with cash flow, rather than with each other, in cases of prepaid income and deferred-payment deductions. But these specific conclusions are of secondary importance to my principal contention, which is simply that "clear reflection" problems should be resolved by con-

be prorated); Rev. Rul. 70-413, 1970-2 C.B. 103 (cash basis corporation may deduct only prorata portion of three-year prepaid fire insurance premium) (citing Boylston). The requirement that accrual-method taxpayers take into account the face amount, rather than the value, of obligations received in income-producing transactions unjustifiably treats accrual-method taxpayers less favorably than cash-method taxpayers. In the case of income from sales, the installment method relieves much of the pressure. The use of bad-debt reserves can adjust for the possibility of non-payment, but fails to account for time-value-of-money considerations.

Cash-method taxpayers receiving non-qualified deferred compensation for services are favored over accrual-method recipients. In this case, neither the deferral allowed cash-method recipients nor the immediate inclusion of the face amount in the income of accrual-method recipients makes economic sense. The cash-method taxpayer ignores a wealth-enhancing event and the accrual-method taxpayer is overtaxed. The deferral allowed cash-method service performers is of particular concern when those taxpayers work for tax-exempt organizations. Their employers are not affected by delay of deductions under sections 83(h) or 404(a)(5). Section 457 offers a partial solution by limiting the amount of compensation deferred by payees of state and local governments.

150 See supra note 91 and accompanying text.
sidering the merits of the available alternatives.

Although the Supreme Court has routinely upheld the Commissioner's demand for non-matching methods of accounting, although the financial accounting reasons for insisting on matching have no weight in tax cases, and although no one has ever advanced a reason for believing that matching should play a role in tax cases, tacit and express assumptions that tax accounting should match revenues and expenses persist. As a result, little attention has been paid to the merits of accounting cases. The grounds for the Commissioner's exercise of his "discretion" and the standards the courts should use in reviewing that exercise remain not only unclear, but almost undiscussed. We must free ourselves from our obsession with matching if these issues are to be faced squarely and resolved sensibly.

V. AFTERWORD: THE TAX REFORM ACT OF 1984

Several provisions of the Tax Reform Act of 1984 affect some of the problems discussed in this article. The most general of the new provisions, Code section 461(h), modifies the all-events test by prohibiting the accrual of deduction items before the year in which "economic performance with respect to such items occurs." The "economic performance" limitation will curb some abuses of accrual accounting, but postponing deductions until "performance" is not a complete solution to the problem of deferred-payment deductions. That problem arises whenever a substantial interval separates accrual and payment, and payment may well take place long after performance. The new act does, however, solve the particular problem of accrued deductions for tort damages and workers' compensation payments by providing that "economic performance" in those cases occurs when payments are made.

182 Added by § 91 of the Tax Reform Act of 1984. Special rules are provided for mining reclamation costs and nuclear power plant decommissioning costs by new I.R.C. §§ 468 & 468A. Section 461 itself contains special rules for some recurring items, tax shelters, and farming. See I.R.C. § 461(h)(3), (i).
183 I.R.C. § 461(h)(1).
184 See supra text accompanying notes 111-15.
185 I.R.C. § 461(h)(2)(C).
New Code section 7872\textsuperscript{156} provides for taxing the makers of substantial interest-free or low-interest loans as if they had received interest at the market rate. Whether this section applies to people who prepay the costs of goods or services is unclear. As noted below,\textsuperscript{157} prepayment transactions are in substance equivalent to interest-free loans, but the many references in section 7872 to “loans,” “borrowers,” and “lenders” may lead to the new provision’s being limited to transactions creating formal debtor-creditor relations.\textsuperscript{158} If the new interest-free loan rules do apply to prepaid-income transactions, the economic case for taxing prepayments upon receipt is weakened considerably, though administrative considerations still support immediate taxation.\textsuperscript{159}

Where does the new legislation leave the matching principle? At first glance, it seems to solidify it. The “premature accrual” rules of new section 461(h), with their goal of allowing deductions at the time of “economic performance,” seem to be based rather loosely on matching; indeed, one of the exceptions to the “economic performance” limitation expressly adopts a “matching” test.\textsuperscript{160} Furthermore, by solving the tort liability problem legislatively, Congress has reduced the pressures on the courts to abandon matching in order to avoid absurdity in one important area. In the long run, however, the new law should weaken the attachment of tax lawyers to the matching concept. The Tax Reform Act, despite its flaws, reflects a serious congressional concern with the time value of money. Once time-value issues come to be regarded

\textsuperscript{156} Added by § 172 of the Tax Reform Act of 1984.

\textsuperscript{157} See infra note 165 and accompanying text.

\textsuperscript{158} It may be significant that the Conference Committee Report on the 1984 Act, in giving an example of a case in which a deposit may be treated as an interest-free loan, refers specifically to a “refundable” deposit. H.R. Rep. No. 98-861, 98th Cong., 2d Sess. 1019-20 (1984). There is no difference in principle between refundable and non-refundable deposits, but refundable deposits “look” more like loans.

\textsuperscript{159} New I.R.C. § 467, added by § 92(a) of the Tax Reform Act of 1984 and directed primarily at “stepped” rental payments, may apply to some forms of prepayment. See H.R. Rep. No. 98-861, 98th Cong., 2d Sess. 895 (1984) (conference agreement provides that the Treasury Department is to issue regulations to deal with the treatment of front-loaded (prepaid) rental agreements).

\textsuperscript{160} I.R.C. § 461(h)(3)(A)(iv)(II) (stating that an exception to the economic performance requirement described in I.R.C. § 461(h)(2) is made for certain recurring items generally paid within 8 ½ months of year end or a reasonable period if the exception will “result[] in a more proper match against income than accruing such item in the taxable year in which economic performance occurs”).
as important matters, matching must give way, because the matching principle ignores time-value questions and is in practice inconsistent with systematic solutions to time-value problems. By raising these issues and forcing the tax bar to think seriously about them, Congress has begun a process that should lead eventually to the demise of the matching principle in the tax law.¹⁶¹

¹⁶¹ Consider, again, the prepaid income problem. Many articles—at least a dozen—have criticized the cases requiring taxation on receipt with no reference to any principles other than those of financial accounting. See generally, e.g., Malman, supra note 56; Stanger, Vander Kam & Polifka, supra note 56; Dubroff, Cahill & Norris, Tax Accounting: The Relationship of Clear Reflection of Income to Generally Accepted Accounting Principles, 47 Alb. L. Rev. 354, 359 n.20 (1983) (citing ten articles criticizing the no-deferral cases). Now that time-value concerns have received serious legislative attention, it should no longer be possible for a scholar to write that kind of article. In effect, the Tax Reform Act of 1984 has been an elementary course in economics for tax lawyers. The course may not have been well taught, but it has raised issues we can no longer ignore.
APPENDIX

The Economics of Prepaid Income

A complete analysis of the tax costs and benefits of a transaction must take into account the tax consequences to all parties involved. When the parties have a choice as to the character of income, such an analysis is widely recognized and routinely applied. For example, a divorced couple often has a choice between the husband’s making alimony payments includible in the wife’s income under section 71, or making payments that are tax-free “child support.” An analysis of the recipient’s side of the transaction alone would suggest that the payments be made tax-exempt. But once it is recognized that taxable “alimony” payments can be deducted by the payor, while tax-free “child support” payments cannot, it becomes apparent that making taxable rather than tax-free payments benefits both husband and wife if the husband’s tax rate is higher than the wife’s. The husband can, at a cost lower than the benefit of his alimony deduction, compensate the wife for her increased tax burden attributable to alimony. When the tax effect of a payment turns on timing rather than characterization, however, the need for examining the tax treatment of the entire transaction is sometimes overlooked because of the rather formidable mathematics involved. This appendix will examine some standard prepaid income situations with regard to the total tax costs and benefits.

Consider the purchase of services by P from R. R’s cost of performing the services is assumed to be zero.\(^{162}\) If P can purchase the services by paying amount A when the services are performed he should be able to purchase the same services by paying a smaller amount at an earlier time. One factor in determining this smaller amount is whether R must include the prepayment in income upon receipt. Let X be the amount P must prepay to give R the same after-tax benefit (measured as of the time of performance of services) as a time-of-performance payment of A if prepaid income can be deferred. X is the prepayment needed to give R the same after-tax benefit as a time-of-performance payment of A if prepaid income cannot be deferred.

If R can invest prepayments safely at a rate of return (for the

\(^{162}\) This assumption is not so unrealistic as it appears, for it means only that the cost of providing services is the same whether or not the buyer prepays.
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entire prepayment period) of i, with tax on the investment return to be paid at the time of performance of the services, a prepayment of X will grow to X(1 + i) by the time of performance. If the tax on the prepayment, as well as the tax on the return from investing the prepayment, can be deferred until services are performed, the prepayment X which leaves R in the same position as a time-of-services payment of A is given by the formula:

\[ X = \frac{A}{1 + i}. \]

If a tax on a prepayment of X is collected from R at the time of prepayment, R will be able to invest kX at that time, where k is the fraction of R's income that is left after tax. By the time of performance and after the tax on the investment return is paid, this amount will grow to kX (1 + ki). If this amount equals kA, then:

\[ \frac{X}{1 + ki}. \]

The calculations in this appendix are based on an assumption that R always receives X or X, depending on the rule for taxing prepayments, so that R's after-tax position is not affected by whether he receives payment early or late. The costs or benefits of prepayment are therefore treated as being borne or enjoyed by P. This assumption has been made because it simplifies calculations, not because it is realistic. The objective is to show how prepayment generates costs and benefits, not to answer the unanswerable question of how those costs and benefits will be divided between particular P's and R's. All costs and benefits are measured as of the time of performance of services.

The cost of the services purchased may or may not be deductible by P; if the cost is deductible it will be assumed that the deduction

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19th This assumption eliminates from the computations the very minor but difficult calculation of benefits or burdens arising from compounded interest. If R is subject to a lower tax than P, an investment yielding a return taxed annually will grow somewhat faster if made by R rather than P. Figures A-3 and A-4 in the Appendix were derived on an assumption that investment return is compounded and taxed annually. For an indication of the magnitude of the error introduced by ignoring compounding, compare Figures A-3 and A-4 with Figures A-1 and A-2, respectively.
is allowed when the services are performed. Taking into account both non-deductible and deductible costs under tax systems which do and do not permit deferral of prepaid income, four cases result.

Case 1: P's cost is non-deductible; prepaid income can be deferred.

P has a choice between prepaying X or paying A at the time of performance of services. If P does not prepay, he can invest X, which will grow to X(1 + \lambda i) by the time of performance, where \lambda is the fraction of P's income left after tax (i is assumed to be the same for P as for R, and the tax on investment returns is treated as payable at the time of performance). P's benefit (B_1) from early payment, measured as of the time of performance, is therefore:

\[
B_1 = A - X (1 + \lambda i) = A \lambda \left( \frac{1 - \lambda}{1 + i} \right)
\]

The advantage to P of prepayment can be explained in this way: If P does not prepay, the money not used for prepayment can be invested by P and the investment return will be subject to tax (at R's rate) again as part of the purchase price of the services. If P prepays, the gain from investing the prepayment will still be taxed at R's rate, as interest rather than as part of the purchase price, but it will not have been taxed to P.  

164 Except in the case of farmers' prepaid expenses, prepaid expenses have generally but not uniformly been regarded as non-deductible capital expenditures, even when made by cash-method taxpayers. For a recent example, see Bonaire Dev. Co. v. Commissioner, 679 F.2d 159 (9th Cir. 1982) (prepaid management fees). See also supra note 149 (citing earlier authorities for this proposition).

165 This analysis applies as well to interest-free loans whenever lenders cannot deduct direct payments. Indeed, prepaid income transactions are in substance interest-free loans from buyers to sellers for the prepayment period. See Rev. Rul. 82-135, 1982-2 C.B. 104 (interest is imputed under section 482 on prepayment to a commonly-controlled taxpayer where the prepayment did not arise in the "ordinary course of business"). Some of the analyses of interest-free loans in reported opinions and commentaries fail to take into account the tax effects of interest-free loans to lenders as well as borrowers. See, e.g., Dean v. Commissioner, 35 T.C. 1083, 1090 (1961) (corporation which makes an interest-free loan to a shareholder has no imputed interest income) (although originally dictum, the foregoing statement developed into a generally accepted rule of law), nonacq. 1973-2 C.B. 4; see also Martin v. Commissioner, 649 F.2d 1133 (5th Cir. 1981); Suttle v. Commissioner, 625 F.2d 1127 (4th Cir. 1980); Baker v. Commissioner, 75 T.C. 166 (1980), aff'd, 677 F.2d 11 (2d Cir. 1982); Greenspun v. Commissioner, 72 T.C. 931 (1979) (low-interest loan), aff'd, 670 F.2d
Case 2: *P’s cost is non-deductible; prepaid income cannot be deferred.*

This case differs from Case 1 because *P* must prepay $\bar{X}$ rather than $X$. *P*’s benefit from prepayment ($B_2$) is therefore:

$$B_2 = A - \bar{X} (1 + \lambda i)$$

$$= A i \left( \frac{k - \lambda}{1 + ki} \right)$$

Therefore, prepayment benefits the parties if *P*’s tax rate exceeds *R*’s (i.e., if $\lambda < k$), and imposes an additional cost if *P*’s rate is less than *R*’s.

Case 3: *P’s cost is deductible; prepaid income can be deferred.*

Prepayment in this case confers no benefit and imposes no cost. The “extra” income *P* recognized in Case 1 by investing the prepayment is exactly offset by the “extra” deduction *P* gets by not prepaying. (If compounding had not been ignored, prepayment in this case would have provided a slight benefit if *P*’s tax rate exceeded *R*’s and a slight detriment if *R*’s rate exceeded *P*’s because the money in question would have grown faster in the hands of whichever party is subject to the lower tax.) So the benefit of prepayment here, $B_3$, is zero.

Case 4: *P’s cost is deductible; prepaid income cannot be deferred.*

In Case 2, the benefit of prepayment was: $Ai \left( \frac{k - \lambda}{1 + ki} \right)$. But if the cost ($\bar{X}$ or $A$) is deductible, *P* incurs an extra cost of $(1 - \lambda)(A - \bar{X})$ by prepaying because his deduction is $\bar{X}$ rather than $A$. Therefore, the benefit of prepayment in this case ($B_4$) is:

123 (9th Cir. 1982); Crown v. Commissioner, 67 T.C. 1060 (1977), aff’d, 585 F.2d 234, 240 (7th Cir. 1978) (although this case involved a gift tax issue, the appellate court’s rejection of the Commissioner’s attempt to make the granting of interest-free loans a taxable event to the lender absent an express statute or regulation relies heavily upon precedent in income tax cases); articles cited and discussed in Keller, *The Tax Treatment of Interest Free Loans: A Two-Transaction Approach*, 1 Va. Tax Rev. 241 n.170 (1981).
Because $k < 1$, $B_4$ is always zero or negative. Therefore, prepayment in this situation always imposes an extra cost upon the parties if $R$'s income is subject to tax.\footnote{If $P$'s tax rate exceeds $R$'s by a significant amount and investment returns are taxed annually, prepayment will provide a very small advantage even in this situation because the money prepaid will grow much more rapidly in $R$'s hands than in $P$'s.}

Figures A-1 and A-2 illustrate the results of cases 1, 2, 3 and 4 graphically for a case in which $R$'s tax rate is thirty percent ($k = .7$),\footnote{Because $X$ is not a function of $k$, the graphs showing the benefit of prepayment where prepaid income can be deferred are valid for any $k$.} $P$'s rate varies from zero to fifty percent, $A = $1000, and $i =$ fifty percent. Except for the assumption that the tax on investment return is not imposed until the services are performed, this situation is the equivalent of one in which the cost of a time-of-service payment is $1000$, the annual rate of return is ten percent simple interest, and payment is made five years before the services are performed. Figures A-3 and A-4 show the costs and benefits of prepayment to a thirty percent payee as a function of $P$'s tax rate when the pre-tax rate of return is ten percent per year compounded annually and tax on the investment return is collected annually, rather than at the time of performance.\footnote{The cumbersome equations reflected in the graphs are not reproduced here. With certain exceptions, their derivation is the same as those in the text. A prepayment of $X$, for example, would grow in five years to $X(1 + ki)^5$ in $R$'s hands or $X(1 + ki)^5$ in $P$'s hands, before taking into account the tax on $X$, where $i$ is the \textit{annual} pre-tax rate of return (here, 10%). It is assumed that interest is paid and reinvested and tax on that interest is collected at the end of each full year after the prepayment.} All other assumptions are the same as those used in deriving Figures A-1 and A-2.

**Discussion**

Neither a system that taxes prepaid income on receipt nor one that allows deferral is neutral between prepayment and time-of-service payment. In the case of payments deductible by the payor at the time of performance, a deferral rule is neutral if compounding and current taxation of investment return are ignored; it
is close to neutral even if they are not. On the other hand, a rule of immediate taxation discourages prepayment unless the recipient’s tax rate is very low. For non-deductible payments, both rules encourage prepayment if the payor is subject to tax at a higher rate than the recipient, but the distortion is smaller under immediate taxation than under deferral. In the case of non-deductible payments by a payor subject to a lower tax than the recipient, immediate taxation discourages prepayment while deferred taxation usually encourages it.

These results show that the tax system encourages prepayment in the case of goods or services furnished by tax-exempt organizations, particularly if the purchasers cannot deduct the costs of the goods or services. This is true whether prepaid income is taxable on receipt or deferred because the choice between immediate and deferred inclusion does not affect a tax-exempt recipient. With respect to transactions between those subject to significant income taxation, deferral comes much closer to neutrality in the case of goods or services whose costs are deductible by the purchaser, while immediate taxation is preferable for non-deductible items. Unfortunately, a rule conditioning the recipient’s right to deferral upon the payor’s right to a deduction at the time of performance would be almost impossible to administer.169

169 A second-best solution is possible. Immediate taxation of prepaid income could be coupled with deductibility upon payment rather than performance. This approaches neutrality for deductible payments in the case of parties subject to tax at approximately the same rate, but at the cost of increasing the incentive for deductible prepayments to low-rate recipients.
FIGURE A-1
NON-DEDUCTIBLE EXPENSES

B₁ (DEFERRED TAXATION)

B₂ (IMMEDIATE TAXATION)

PAYOR'S TAX RATE

BENEFIT OF PREPAYMENT ($)
FIGURE A-2
DEDUCTIBLE EXPENSES

B₃ (DEFERRED TAXATION)

B₄ (IMMEDIATE TAXATION)

PAYOR'S TAX RATE

BENEFIT OF PREPAYMENT ($)
FIGURE A-3
NON-DEDUCTIBLE EXPENSES
INVESTMENT RETURN TAXED ANNUALLY

Payor's Tax Rate

Benefit of Prepayment ($)

$0

B₁ (Deferred Taxation)

B₂ (Immediate Taxation)

0 10 20 30 40 50

Payor's Tax Rate

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FIGURE A-4
DEDUCTIBLE EXPENSES
INVESTMENT RETURN TAXED ANNUALLY

B₃ (DEFERRED TAXATION)
B₄ (IMMEDIATE TAXATION)