CHAPTER 10

INCOME MEASUREMENT

Significant strides were made in the Deficit Reduction Act of 1984 toward accruately reflecting the "time value of money" in measuring taxable income. This Chapter discusses proposals that would continue these improvements. Areas addressed in the 1984 legislation were generally not reevaluated.

The Treasury Department proposals would require production costs to be capitalized on a more comprehensive basis, providing a more accurate matching of income and expenses. Accounting methods that mismeasure income, such as the cash method of accounting and the installment method, would be limited. Finally, the deduction for additions to bad debt reserves would be repealed.

REVISE ACCOUNTING RULES FOR MULTIPERIOD PRODUCTION

General Explanation

Chapter 10.01

Current Law

In General

Where a taxpayer produces inventory or property that is not sold during the current year the costs of production generally may not be currently deducted. Rather, these costs must be added to the taxpayer's basis in the property to which they relate. If the product is sold, these capitalized costs are recovered against the selling price. If the product is a durable good that is used in the taxpayer's business, the costs are recoverable as depreciation, amortization, or depletion deductions. The general principle that production costs must be capitalized is not uniformly applied in all contexts. In some cases production costs may be currently deducted. In others, where current tax accounting rules require production costs to be capitalized, the costs included within the definition of "production costs" vary substantially depending on the type of property produced and the method of production.

Production Costs Other than Interest

a. **Inventories**. In accounting for inventories of manufacturers or producers, costs must be collected according to the full absorption method of inventory accounting. All direct costs and certain indirect costs must be capitalized. Indirect costs that are not required to be included in inventoriable costs include, for example: depreciation and amortization reported for Federal income tax purposes in excess of depreciation reported in the taxpayer's financial reports, and general and administrative expenses incident to and necessary for the taxpayer's activities as a whole.

The treatment of certain indirect costs varies depending on how such costs are treated in the taxpayer's financial reports ("financial-conformity indirect costs"). These costs must be capitalized only if the taxpayer capitalizes them in its financial reports. Included in this category of indirect costs are: taxes, depreciation and cost depletion attributable to assets incident to and necessary for production; pension and profit-sharing contributions and other employee benefits; costs attributable to rework labor, scrap and spoilage; factory administrative expenses; salaries paid to officers attributable to services performed incident to and necessary for production; and insurance costs incident to and necessary for production.

Long-term contracts. Long-term contracts are building, installation, construction, or manufacturing contracts that are not completed within the taxable year in which they are entered into. Taxpayers using the completed-contract method of accounting for long-term contracts may not deduct contract costs until the contract is completed and income is reported. The rules for determining which costs must be treated as contract costs differ from the full absorption costing rules applicable to inventory. In addition, different rules apply depending on the duration of the contract.

For many long-term contracts the costs that must be capitalized generally track the full absorption regulations as they apply to a manufacturer that capitalizes in its financial reports the financial-conformity indirect costs. Differences are as follows: pension contributions and other employee benefits need not be capitalized; costs attributable to strikes, rework labor, scrap, and spoilage need not be capitalized; and research and experimental expenses directly attributable to particular contracts must be capitalized.

In the case of "extended-period long-term contracts," proposed regulations provide that taxpayers must capitalize certain additional long-term contract costs. With certain exceptions, extended-period long-term contracts are contracts that take more than two years to complete. The additional costs that must be capitalized include:

- o all depreciation, amortization, and cost recovery allowances on equipment and facilities used in the performance of particular extended-period long-term contracts (tax depreciation in excess of depreciation reported on financial statements need not be capitalized in the case of non-extended-period contracts);
- o depletion (whether or not in excess of cost) incurred in the performance of particular extended-period contracts;
- o pension contributions and other employee benefits;
- o rework labor, scrap, and spoilage incurred in the performance of particular extended-period contracts;
- o expenses of successful bids; and
- o certain direct and indirect costs incurred by any administrative, service, or support function or department to the extent allocable to particular extended-period contracts.

Proposed regulations set forth detailed rules for allocating administrative, service, and support costs to particular extended-period long-term contracts. The general test is whether a particular function or department of the taxpayer benefits the extended-period long-term contracts, or merely benefits the overall management or policy guidance functions of the taxpayer.

Self-constructed assets. The costs of constructing or improving property having a useful life substantially beyond the taxable year must be capitalized and added to the basis of the property constructed. Existing regulations do not spell out which costs are to be capitalized when the construction is undertaken by the taxpayer to construct property for its own use. The Supreme Court has held that depreciation on equipment used in such construction has to be capitalized, and other courts have required certain indirect expenses, such as vacation pay, payroll taxes, certain fringe benefits, and certain overhead costs to be capitalized. Although administrative and judicial interpretations provide some guidelines, it is not clear in many self-construction cases whether particular costs may be deducted or must be capitalized.

Farming. Most farmers are not required to keep inventories for tax purposes, and thus do not capitalize the costs of producing crops. All of these costs may be deducted in the year when paid. The same is generally true of the costs of raising long-lived plants and animals, such as fruit and nut trees or breeding livestock. The costs of acquiring the seedlings or immature animals generally may not be deducted, however. The rule allowing a current deduction for most production costs originated from a concern not to impose an undue recordkeeping burden on farmers.

Some farmers are required to capitalize certain production costs. Under section 447, certain farming corporations must take inventories into account in computing income, and accordingly are effectively denied a current deduction for production costs to the extent reflected in increased inventory. Section 447 does not apply to S corporations, corporations that are 50-percent owned by one family, or corporations with gross receipts of $1,000,000 or less. The provision is also inapplicable to certain corporations that were closely held to a requisite extent on October 4, 1976, and were engaged in farming on that date. In addition to requiring use of the accrual method and inventory accounting for tax purposes, section 447 requires the preproductive period expenses of raising long-lived plants and livestock to be capitalized. Preproductive period expenses are defined as any amount (other than interest and taxes) which is attributable to the preproductive period of crops, animals, or any other property having a crop or yield. In the case of property having a useful life of more than one year that will have more than one crop or yield, the preproductive period is the period before the disposition of the first marketable crop or yield. In the case of any other property having a crop or yield, the preproductive period is the period before the property is disposed of.

Farming syndicates engaged in developing a grove, orchard, or vineyard in which fruit or nuts are grown must capitalize the expenses of these activities under section 278(b). Instead of including the entire period before the disposition of the first marketable crop, the period during which expenses must be capitalized includes only the period before the first taxable year in which the grove, orchard, or vineyard bears a crop or yield in commercial quantities. Under proposed regulations, farming syndicates need not capitalize the following expenses: real estate taxes, interest, soil and water conservation expenditures that are deductible under section 175, and expenditures for clearing land allowable as a deduction under section 182.

Under section 278(a), expenses attributable to the development of any citrus or almond grove incurred before the close of the fourth taxable year beginning with the taxable year in which the trees were planted must be capitalized. This provision is not restricted to farming syndicates. As under section 278(b), interest, taxes, soil and water conservation expenditures, and expenditures for clearing land need not be capitalized.

Timber. Some costs of producing timber are not deductible when paid or incurred, but may be recovered only when the timber is sold. These include planting costs (site preparation, seed or seedlings, labor and tool expenses, and depreciation on equipment) and costs of silvicultural practices incurred before the seedlings are established. All other production costs may be currently deducted, including carrying costs (such as property taxes), costs of silvicultural practices after establishment of the seedlings, costs of disease and pest control, fire protection expenses, insurance, and management costs (including labor and professional costs, costs of materials and supplies, and costs of timber cruises for management purposes, but not timber cruises in connection with the purchase of timber).

Capitalization of Construction-Period Interest

Real property construction-period interest and taxes may not be currently deducted, but must be amortized over ten years. If the property is sold before all the expenses are recovered, the unrecovered expenses are added to basis in determining gain on the sale. The provision does not apply to low-income housing, or to property that cannot reasonably be expected to be held in a trade or business or in an activity conducted for profit. Construction-period interest includes any interest expense that could have been avoided if construction expenditures had been used to repay indebtedness.

Construction-period interest relating to personal property may be deducted currently.

Reasons for Change

Current tax rules do not always match taxable receipts and deductions relating to production activities. This failure to match is particularly egregious in the case of production that extends beyond one taxable year ("multiperiod production"), and becomes more significant with longer production periods. The mismatching of receipts and expenses permits deductions from these activities to offset income from other activities. A large number of tax shelters involve the so-called "natural deferral" industries, such as timber, extractive industries and vineyards. Proposals directed at particular production costs incurred in the extractive industries are discussed in Chapter 11.

Production expenses that relate to income to be produced in future periods should be matched with that income by capitalizing the production costs. Current tax accounting rules do not require comprehensive capitalization of costs. Most importantly, the current rules do not require the capitalization of interest paid with respect to the cost of carrying multiperiod production investments to completion. When these costs are not capitalized, the producer gains tax deferral and the equivalent of an interest-free loan from the Federal government.

The current tax accounting rules requiring production expenses to be capitalized differ by type of activity. Long-term contracts, self-constructed assets and inventories all have different rules. Replacement of the several different income tax accounting rules by a uniform rule would make the income tax system more neutral and fairer.

Uniform capitalization rules would also eliminate tax distortions across activities. The current rules encourage businesses to construct their own assets rather than to purchase them even when they are not the most efficient producers. A seller prices goods by reference to all costs, including those deducted for tax purposes, plus a reasonable profit. The tax basis of a purchased asset, therefore, includes all costs of production, both direct and indirect, and these costs are recoverable by the purchaser only when sold or through depreciation, amortization, or depletion allowances. In contrast, the tax basis of a self-constructed asset includes only certain direct costs and perhaps a few indirect costs, while all other costs are deducted currently.

In addition to distorting investment decisions, the present rules cause serious unfairness. The benefits of tax deferral tend to be reflected in the prices of the products produced by multiperiod processes. Because the value of the tax deferral is related to the marginal tax rate of the investor, the attractiveness of these activities as tax shelters crowds out low-bracket individuals, as "shelter investors" bid-up the costs. Low tax rate individuals find they cannot earn a market after-tax rate of return at the price established by "shelter investors."

In sum, present law applies incomplete capitalization rules nonuniformly to different types of multiperiod production and applies rules that vary according to whether the output is sold or used in the producer's own business. These rules violate the principle of tax neutrality and should be modified.

Proposal

Capitalization of production costs other than interest. Uniform rules for capitalizing production costs would apply in all cases where the costs of producing or constructing real or personal property must be capitalized. The following types of production activities would be subject to the uniform capitalization rules:

- the production or manufacture of goods to be held in inventory or for sale to customers in the ordinary course of business;
- production under a long-term contract;
- the construction or other production of real or tangible personal property (including improvements to property) having a useful life beyond the taxable year, whether such property is to be used in the taxpayer's business or held for investment ("self-constructed assets");
- the growing of timber; and
- the development of the productive capacity of oil and gas and other mineral property.

Special rules, described below, would apply to Federal government contracts and to farming. Rules governing the development costs of oil and gas and other mineral property are discussed in detail in Chapter 11.

The expenses of a particular production activity that would have to be capitalized would generally include all direct and indirect costs of production, as set forth in the rules currently applicable to extended-period long-term contracts, described in detail above. Major expenses that would not have to be capitalized as production costs include:

- marketing, selling, and advertising expenses;
- research and development expenses unrelated to particular production activities;
- expenses of unsuccessful bids and proposals; and
- general and administrative expenses other than those properly allocable to particular production activities.

General and administrative expenses attributable to certain Federal government contracts would have to be capitalized. This requirement would apply to all cases where the contractor is required by statute or regulation to submit certified cost data in connection with the award of the contract. Federal statutes generally require certified cost data to be submitted in connection with contracts the price of which is expected to exceed $100,000 (effective March 31, 1985). This rule does not apply where the contract is awarded on the basis of sealed bids; where there is adequate price competition; or where the price is an established catalog or market price or is set by law. In addition, general and administrative expenses would have to be capitalized where the contract price is based in whole or in part on the contractor's costs which include general and administrative expenses, i.e. so-called cost-plus and similar contracts.

This specific requirement to capitalize general and administrative expenses would apply only with respect to contracts with Federal agencies. General and administrative expenses required to be capitalized would not include marketing, selling, and advertising expenses, research and development expenses unrelated to particular contracts, or expenses of unsuccessful bids and proposals.

Special rules would apply to farmers. No farmers would be required to keep inventories for tax purposes if not currently required to do so. With respect to preproductive period expenses, the rules of section 447 would continue to apply to the taxpayers currently covered by that provision (except in the case of property subject to section 278, revised as described below). The principles of section 278(b), which deals with the capitalization of the development costs of fruit and nut orchards and vineyards, would be extended to apply generally to any plant or animal whose preproductive period was two years or longer. The new provision would apply to all taxpayers, not just farming syndicates. The preproductive period would begin with the time the plant or animal was first planted or acquired by the taxpayer, and would end with the time that the plant or animal became productive or was disposed of. For example, in the case of a taxpayer developing an orchard, the preproductive period would begin with the time the seedlings or saplings were purchased by the taxpayer, and would end with the time the tree first bore fruit. If the preproductive period were two or more years long, the preproductive period expenses would have to be capitalized. The types of expenses that must be capitalized would be defined comprehensively as above.

Capitalization of construction-period interest. Construction-period interest would have to be capitalized in the case of self-constructed property with a long useful life, and in the case of any property whose production period was two years or longer. With respect to self-constructed property, construction-period interest would have to be capitalized if it relates to long-lived property (property included in RCRS Class 5, 6, or 7). In determining whether the production period is two years or longer, the period would generally begin with the commencement of construction or production and end with the time when the property is ready to be placed in service or held for sale. In the case of property produced under a long-term contract, the production period would end with contract completion. Interest attributable to the raising of plants or animals whose preproductive period was two years or longer would also have to be capitalized. Interest attributable to self-constructed assets to be used by the taxpayer for personal purposes (such as residential real estate) would not be subject to the capitalization requirement.

Construction-period interest would be defined as any interest expense of the taxpayer that could be avoided if production or construction expenditures were used to repay indebtedness. Production or construction expenditures would be defined as equal to the cumulative production costs required to be capitalized. In effect, as under current-law rules defining construction-period interest, the taxpayer's interest cost is deemed first allocable to production or construction activities. Appropriate related-party rules would be provided.

A customer of a contractor making progress payments or advance payments would be treated as self-constructing the property under construction by the contractor to the extent of such payments. Thus, payments and other advances by a customer would be treated as the customer's construction or production expenditures, and the contractor's construction or production expenditures would be reduced to this extent. The customer would have to capitalize interest attributable to such payments, if the constructed property were in RCRS Class 5, 6, or 7, or if the construction period were two years or longer. To the extent of such advances by the customer, the contractor would not be treated as having incurred construction expenses, and would accordingly not have to capitalize construction-period interest. The contractor would have to capitalize construction-period interest on only the excess, if any, of the accumulated contract costs over the accumulated advances or progress payments.

In cases where interest is required to be capitalized, the amount added to the basis of the property being constructed would be the amount of interest expense, adjusted for inflation by applying the exclusion ratio. See Chapter 9.03. The basis of such property would be eligible for indexing, under the rules set forth in Chapter 9.01, during the production period and thereafter. In the case of a contractor, contract costs up to the amount of advance payments made by the customer would not be eligible for indexing as far as the contractor is concerned, but would be treated as self-construction by the customer.

Effective Date

Except as provided below, the proposed rules concerning production cost accounting and the capitalization of interest would be effective generally for costs and interest expense paid or incurred on or after January 1, 1986. The new rules would not apply to long-term contracts entered into before 1986. Production costs (including interest) attributable to timber that was planted before 1986 that are not required to be capitalized under present law would have to be capitalized under a ten-year phase-in. Thus, 10 percent of such costs paid or incurred in 1986, 20 percent of such costs paid or incurred in 1987, etc., would have to be capitalized. With respect to inventories, the new rules would apply for the taxpayer's first taxable year beginning on or after January 1, 1986. In order to minimize large distortions in taxable income of taxpayers subject to the new inventory cost accounting rules, such taxpayers would be allowed to spread the adjustment that results from the difference between the use of the new and previously used methods of accounting for production costs ratably over a period not to exceed six taxable years in accordance with the usual rules for change in method of accounting initiated by the taxpayer and approved by the Internal Revenue Service.

Analysis

Capitalization of costs means that instead of being allowed to deduct production costs currently, the costs would be recovered when the produced property is sold or through depreciation, amortization or depletion deductions as the property is used in the taxpayer's business. The capitalization of costs incurred in the purchase or construction of a capital asset matches those expenses with the reporting of taxable income.

When capital costs are not capitalized, deductible expenses are not matched with the receipt of the taxable income they serve to produce. The acceleration of expenses allows other taxable income to be sheltered by deductions, and taxable income is deferred until later years. When tax liability can be deferred, the taxpayer benefits from an interest-free loan from the Federal government. Deferral reduces the taxpayer's effective tax rate, and can be passed on to consumers in the form of lower prices.

Interest is a significant expense of long-term production that generally is not required to be capitalized under current law. Because interest expenses are a fraction of other expenses incurred in short-term production activity, the proposal would generally require capitalization of interest only where the production period occurs over several years. However, interest incurred in relatively short-term production of long-lived self-constructed assets would have to be capitalized, because allowing a current deduction for such costs would excessively accelerate deductions when compared with capitalization. Because of the fungibility of money, it is necessary to make certain assumptions as to the amount of interest attributable to production. Under the proposal, any debt outstanding would be attributed first to construction costs associated with the long-term production activity. The same rule applies in defining construction-period interest under current law.

Uniform rules for the capitalization of production costs would make the tax code less distortionary across activities. Uniform rules would also place all long-term production activities on a consistent tax accounting basis, and reduce tax-induced distortions in constructing and acquiring capital assets.

Special rules would recognize the peculiarities of certain industries. Thus, the current rules that do not require farmers to use inventories in computing income with respect to most crops would be retained, so as not to impose an undue recordkeeping burden. In the case of certain plants and animals that take a long time to mature, however, production costs would have to be capitalized, to avoid a significant deferral of tax liability.

The special rule requiring certain Federal contractors to capitalize general and administrative expenses is appropriate because these contractors are paid for such overhead costs as part of the contract price. While it is generally not an easy matter to determine what portion of the overhead costs of a business are properly allocable to a contract, this determination is not difficult in the case of contractors who directly bill the Federal government for the overhead or rely on the allocated overhead in setting the contract price. The current system allows such contractors to be paid for the overhead costs under the contract, but to currently deduct such costs for tax purposes as current period costs that purportedly have nothing to do with the contract. Allowance of a current deduction for such costs results in tax deferral because the associated payments are not included in income until the contract is completed. The proposal would put Federal tax accounting on a consistent basis with Federal contract cost accounting. The current-law rules effectively subsidize Federal government contracts, thus causing the apparent cost of such contracts on the outlay side of the budget to be understated. Truth in budgeting calls for the subsidy to be removed and the full costs to be reflected in outlays.

TREAT PLEDGES OF INSTALLMENT OBLIGATIONS AS PAYMENTS

General Explanation

Chapter 10.02

Current Law

Income from an installment sale is reported as payments are received, rather than in the year of sale, unless the taxpayer elects otherwise. In general, an installment sale is a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs. The gain recognized for any taxable year is the proportion of the installment payments received in that year which the gross profit to be realized when payment is completed bears to the total contract price. In general, the total contract price is the amount that will be paid to the seller.

Any indebtedness assumed by the buyer which is not "qualifying indebtedness" is treated as a payment in the year of sale or disposition. Qualifying indebtedness is treated as a payment in the year of sale only to the extent that it exceeds the seller's basis in the property. The term qualifying indebtedness means (1) a mortgage or other indebtedness encumbering the property, and (2) indebtedness incurred or assumed by the seller incident to the seller's acquisition, holding, or operation of the property in the ordinary course of business or investment.

If the seller disposes of an installment obligation, the tax that has been deferred on the installment sale generally becomes due. However, if a taxpayer pledges an installment obligation as collateral for a loan, he may, under some circumstances, continue to defer his tax on the sale.

Reasons for Change

The installment method was intended to alleviate liquidity problems that might arise if a taxpayer was required to pay tax on a sale when he had not received all or a portion of the sales proceeds. Under current law, however, a taxpayer generally may defer his tax liability on an installment sale, even if he obtains cash by using the installment note as collateral for a loan. For example, a taxpayer who sells property for $100,000, payable in ten years with market rate interest payable annually, can pledge the note as collateral for a loan of, say, $90,000 from a bank. The interest payments received from the buyer on the installment obligation provide the taxpayer with funds to make interest payments on the $90,000 loan from the bank. Thus, the taxpayer has the use of $90,000 for ten years, but is not required to pay any tax on his gain from the sale until receipt of payment from the buyer in ten years. Under current law, the note from the buyer could be secured by a bank letter of credit, thus making the transaction essentially riskless for the seller. In such a case, the taxpayer obtains the benefit of the profit element on the sale and has sufficient cash to pay the tax liability. There is no reason to permit such a taxpayer to continue to defer tax liability on the sale.

If instead of pledging the installment note after the sale of the property, the taxpayer had pledged the property for a loan prior to the sale and the buyer had assumed the taxpayer's indebtedness, the amount of the indebtedness (in the case of qualifying indebtedness, the excess over basis) would have been treated as a payment in the year of sale. Similar rules should apply regardless of whether the indebtedness is incurred before or after the sale.

Proposal

Any amount borrowed that is secured by an installment obligation would be treated as a payment on the installment note. In the case of an amount borrowed in the ordinary course of the taxpayer's business and secured by an installment note received for the sale of goods in the ordinary course of business, only the excess of the borrowed amount over the taxpayer's basis in the installment note (i.e., the profit element) would be treated as a payment. Exceptions would be provided for short-term borrowings and certain bank borrowings secured by a general lien on all of the borrower's assets.

Effective Date

The proposal generally would be effective for installment notes pledged as security on or after January 1, 1986. As of January 1, 1991, the proposal would apply to installment notes that were pledged prior to January 1, 1986.

Analysis

As shown in Table 1, the deferral of tax liability under the installment method can substantially reduce a taxpayer's effective tax rate. For example, when interest rates are eight percent, the deferral of tax for ten years by a taxpayer with a marginal tax rate of 50 percent reduces the effective tax rate to 23 percent. In effect, under the installment method, the Federal government makes an interest-free loan to the taxpayer of the tax that otherwise would be due in the year of sale. The benefit of tax deferral under the installment method would be denied to taxpayers who have obtained cash by pledging an installment obligation.

In recent years many homebuilders have issued bonds secured by mortgage loans received upon the sale of houses. The use of so-called "builder bonds" has risen rapidly and is expected to exceed $5 billion in 1984. The proposal would somewhat reduce the tax benefits of such transactions. To the extent that the bond proceeds exceed the homebuilder's basis in the mortgage loans securing the bonds, the homebuilder would be treated as having received a payment on the

459-813 O - 84 - 8

mortgage loans. In such cases, the borrowing represents enjoyment of the profit element from the sale of the houses and should be taxed as income. Data concerning the extent to which similar transactions are used in other industries and by individual taxpayers is not available.

Table 1

Effective Tax Rate Per Dollar of Income Deferred by a
50 Percent Taxpayer
for Different Deferral Periods and Interest Rates

Interest rate	Deferral period (in years)					
	1	3	5	10	20	30
4 percent	48.1	44.4	41.1	33.8	22.8	15.4
6 percent	47.2	41.0	37.4	27.9	15.6	8.7
8 percent	46.3	39.7	34.0	23.2	10.7	5.0
10 percent	45.4	37.6	31.0	19.3	7.4	2.9
12 percent	44.6	35.6	28.4	16.1	5.2	1.7

Office of the Secretary of the Treasury
Office of Tax Analysis

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LIMIT USE OF CASH METHOD OF ACCOUNTING

General Explanation

Chapter 10.03

Current Law

The Internal Revenue Code provides for the following permissible methods of accounting: (1) the cash receipts and disbursements method ("cash method"), (2) an accrual method, or (3) any other method or combination of methods permitted under Treasury regulations. A taxpayer is entitled to adopt any one of the permissible methods for each separate trade or business of the taxpayer, provided that the method selected clearly reflects the taxpayer's income from such trade or business. A method of accounting that reflects the consistent application of generally accepted accounting principles ordinarily is considered to clearly reflect income.

The cash method of accounting generally requires an item to be included in income when actually or constructively received and permits a deduction for an expense when paid. In contrast, the principles of the accrual method of accounting generally require that an item be included in income when all the events have occurred which fix the right to its receipt and its amount can be determined with reasonable accuracy. Similarly, a deduction is allowed to an accrual basis taxpayer when all events have occurred which determine the fact of liability for payment, the amount of the liability can be determined with reasonable accuracy, and the economic performance that establishes the liability has occurred.

In general, taxpayers (other than farmers) that are required to use inventories for a particular trade or business must use an accrual method of accounting for their purchases and sales. A taxpayer is required to use inventories in all cases in which the production, purchase, or sale of merchandise is an income-producing factor. Any other permissible method of accounting (including the cash method) may be used for other purposes in that trade or business or for other trades or businesses of the taxpayer.

A farmer generally may use the cash method of accounting even though the farmer is engaged in the production and sale of goods. Use of the accrual method is required, however, for a corporation engaged in the trade or business of farming (or a partnership engaged in the trade or business of farming that has a corporation as a partner) that has gross receipts of more than $1 million in any taxable year beginning after December 31, 1975.

Reason for Change

The cash method of accounting frequently fails to reflect the economic results of a taxpayer's business over a taxable year. The cash method simply reflects actual cash receipts and disbursements, which need not be related to economic income. Obligations to pay and rights to receive payment are disregarded under the cash method, even though they directly bear on whether the business has generated an economic profit or a loss. Because of its inadequacies, the cash method of accounting is not considered to be in accord with generally accepted accounting principles and, therefore, is not permissible for financial accounting purposes.

The relative simplicity of the cash method justifies its use for tax purposes by smaller, less sophisticated businesses, for which accrual accounting may be burdensome. Current law, however, permits many taxpayers that already use an accrual method for financial accounting purposes to use the cash method for tax purposes.

The cash method also produces a mismatching of income and deductions where the taxpayer engages in transactions with parties that employ a different method of accounting. For example, an accrual method taxpayer may deduct certain liabilities as incurred, such as liabilities for certain services rendered, even though the service provider on the cash method may defer reporting income until cash payment is made.

Proposal

In addition to the current law limitation on use of the cash method with respect to a trade or business in which inventory accounting is required, a taxpayer would not be permitted to use the cash method of accounting for a trade or business unless it satisfied both of the following conditions: (1) the business has average (determined on a 3-year moving average basis) annual gross receipts of $5 million or less (taking into account appropriate aggregation rules); and (2) no other method of accounting regularly has been used to ascertain the income, profit, or loss of the business for the purpose of reports or statements to shareholders, partners, or other proprietors, or to beneficiaries or for credit purposes.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986. In order to minimize large distortions in the taxable income of taxpayers who are required to change from the cash to the accrual method, the administrative rules generally applicable to changes in methods of accounting initiated by the taxpayer and approved by the Internal Revenue Service would be applied. Accordingly, taxpayers affected by the proposal would be allowed to spread the adjustment that results from the difference between the use of the cash and accrual methods of accounting ratably over a period not to exceed six taxable years.

Analysis

The proposed restriction on the use of the cash method of accounting would affect only a small percentage of firms. In 1981, approximately eight percent of corporations, one percent of partnerships, and less than one percent of non-farm sole proprietorships, had receipts greater than the proposed $5 million limitation. Some of these businesses already use the accrual method of accounting for tax purposes. Accurate measurement of the income of these large firms is important to the integrity of the tax system, since they account for a significant share of business receipts.

The proposal would affect only businesses that are already using an accrual method of accounting in some part of their business or are sufficiently large to have professional accounting expertise. The primary industries that would be affected by the proposal would be banks that use an accrual method of accounting for financial reporting and large service organizations, such as accounting, law and advertising firms.

The virtue of the cash method's simplicity would be retained for those businesses that might be unduly burdened by a requirement that they use accrual accounting.

REPEAL RESERVE METHOD FOR BAD DEBT DEDUCTIONS

General Explanation

Chapter 10.04

Current Law

Taxpayers other than depository institutions may deduct a business bad debt in the year in which it becomes wholly or partially worthless. In lieu of deducting specific bad debts, a taxpayer may create a bad debt reserve for the obligations created or acquired in the course of a trade or business and held by the taxpayer at the close of the taxable year. In any year, the taxpayer may deduct an addition to the reserve sufficient to bring it to a reasonable level. The purpose of the reasonable reserve is to estimate the portion of the obligations held by the taxpayer at year-end that will become uncollectible in the future. Debts that become worthless during the year are charged against the reserve. This charge reduces the reserve and hence increases the amount that must be added to the reserve to restore it to an appropriate level. The deduction for additions to a bad debt reserve effectively allows a deduction for debts that become worthless during the year plus a deduction for future bad debts (attributable to the increase in the amount of receivables held at year-end.)

A dealer in property may deduct a reasonable addition to a reserve for bad debts relating to its liability as a guarantor of debt obligations arising out of the sale by the taxpayer of property in the ordinary course of its trade or business. In the case of certain taxpayers who were in existence in 1965, a suspense account arrangement prevents allowance of a double deduction by reason of a change in law which took place at that time.

Special rules govern the tax treatment of bad debts of depository institutions; these rules are dealt with in Chapter 12.01.

Reasons for Change

The reserve method for bad debt deductions of non-financial businesses allows taxpayers to deduct the bad debt losses in the current year and to deduct any net increase in the reserve. The deduction for the increase in the reserve represents a deduction for estimated future loan losses arising from an increase in the level of receivables on hand, without any discount for the present value of such losses. Moreover, the formula used to estimate such losses bears no necessary relationship to the future losses. The accelerated deduction for future losses defers taxable income and thereby reduces the effective tax rate of a business which experiences an increasing bad debt reserve.

In addition to distorting the timing of taxable income, the reserve method of accounting for bad debt deductions discriminates in favor of firms with growing accounts receivable or worsening loss experiences. In contrast, firms that have improved loss experiences or declining loan portfolios will be taxed on the deferred taxable income.

Finally, the preferential tax treatment of bad debt reserves reduces the effective tax rate on the compensation earned by lenders for bearing the risk of loan default and enables lenders to lower the risk premium charged. Thus, the tax system encourages lenders to make risky loans. By lowering the interest rate charged on risky loans, the preferential tax treatment also distorts the choice between debt and equity financing for projects involving some risk of default.

Proposal

The deduction for a reasonable addition to a reserve for bad debts would be repealed, although taxpayers would continue to be entitled to a deduction for debts that become worthless or are partially charged off. This proposal would also apply to the bad debts of financial institutions governed by Subchapter H.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986. In order to prevent a double deduction for debts that become partially or wholly worthless after the effective date, a taxpayer's outstanding bad debt reserve at the close of the taxable year prior to the effective date would be includible in income ratably over a 10-year period.

Analysis

Taxpayers are generally not allowed to deduct future liabilities or losses until they occur. If reserves for future losses are allowed, a neutral tax reserve system would limit the deduction to the estimated present value of the future loss. Such a system would also require any divergences from the assumptions used in the present value calculation to be corrected. An accurate reserve system is not proposed because of the extreme administrative complexity that would follow.

To illustrate the deferral allowed by the current reserve system, suppose a new firm, shown in Table 1, begins with $1,000 of accounts receivable and in the first year has $10 of bad debts (an experience rate of one percent). Under a reserve system where the allowable reserve equals the current year losses, the firm establishes a year-end reserve of $10. The allowable first year bad debt deduction is $20 -- $10 of actual losses plus $10 for the increase in the allowable reserve. As long as the firm's loss experience does not improve and its level of receivables does not decrease, the excess deduction is deferred indefinitely. If the firm prospers and accounts receivable increase in year two to $1,500 with the same loss experience rate of one percent, the allowable reserve increases to $15 and the company deducts $20 -- $5 more than the actual loan losses. In year three, if loans remain the same but the loss experience worsens to two percent, the company can deduct $45. Finally, if in the fourth year the company experiences a decrease in accounts receivable, its bad debt deduction is less than the loan losses that actually occurred. A net decrease in the bad debt reserve effectively brings excess deductions back into taxable income, thereby ending tax deferral on that amount. Table 1 in Chapter 10.02 shows the reduction in effective tax rate due to tax deferral for given deferral periods and interest rates.

Table 2 shows the discrepency between bad debt deductions and actual loan losses due to the reserve method. The overstatement of losses and the amount of tax deferral depends on the growth rate of loans and the change in the loss experience rate. Credit growth over the past 10 years for domestic non-finiancial corporations was in excess of 20 percent annually. The change in the loss experience rate is not known, and is probably cyclical. Yet even with a constant loss rate, bad debt deductions overstated aggregate actual loan losses by 10 percent annually.

Table 1

Hypothetical Example of Excess Deductions with Reserve Method

	Year 1	2	3	4
Loss experience rate	1.0	1.0	2.0	2.0
Total loans	$1,000	$1,500	$1,500	$1,000
Actual losses	10	15	30	20
Beginning reserve	0	10	15	30
End reserve	10	15	30	20
Change in reserve	10	5	15	-10
Bad debt deduction [Losses plus change in reserve]	20	20	45	10
Excess deduction [Deduction minus actual losses]	10	5	15	-10
Accumulated excess deductions	10	15	30	20

Office of the Secretary of the Treasury
Office of Tax Analysis

November 29, 1984

Table 2

Discrepancy Between Reserve Deductions 1/ and Actual Bad Debt Losses By Change in Total Loans and Loss Experience
(In percent)

Annual Percentage Change in Loss Experience	Annual Percentage Change in Total Loans					
	-5	0	+5	+10	+15	+20
-5	-11.2	-4.9	-0.2	3.3	6.0	8.0
0	- 4.9	0	3.6	6.3	8.4	10.0
+ 5	- 0.2	3.6	6.4	8.6	10.2	11.4
+10	3.3	6.3	8.6	10.2	11.5	12.5
+15	6.0	8.4	10.2	11.5	12.5	13.3

Office of the Secretary of the Treasury
Office of Tax Analysis

November 29, 1984

1/ Assumes a six-year moving average experience method reserve. Shorter periods would increase the discrepency.