

# FEDERAL TAX ACCOUNTING

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## GRADUATE TAX SERIES

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# FEDERAL TAX ACCOUNTING

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Second Edition

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MATTHEW  BENDER

# PREFACE

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The Lexis Graduate Tax Series grew out of the recognition that the goals of a graduate tax program are different than those of J.D. tax courses. J.D. tax courses are introductory in nature. Although many J.D. tax courses provide a good overview of their targeted areas of law, time rarely permits either in-depth analysis of complicated Code or Regulation provisions, or the application of those provisions to real life problems. In essence, J.D. tax courses provide students a foundation in the core statutory and judicial concepts.

LL.M. programs build on, and significantly expand, students' knowledge of the Code, Regulations, and judicial doctrines, and enhance their Code and Regulations reading skills. LL.M. programs require students to concentrate on the primary sources of the law, the Code and Regulations. Students are expected to improve their ability to read, comprehend, and apply the Code and Regulations, and they do so by working on complex fact patterns that raise difficult legal issues.

The different goals of graduate tax programs and J.D. tax courses suggest that the course materials used in those programs should also be different. Students in LL.M. programs need to move away from the standard, J.D., "author tells all," casebooks, which contain extensive quotations from cases and other secondary sources, and toward emphasis on the primary sources of the law. By applying the Code and Regulations to real-life fact patterns, students gain the confidence necessary to rely on the Code and Regulations as their main source of information.

An important, but different, driving force behind the development of specially designed course materials for LL.M. programs is the dramatic expansion of the quantity and complexity of tax law over the past forty or fifty years. The current commercially available versions of the Code and Regulations are roughly four times as large as their 1970 predecessors. Over that period, class time dedicated to tax has grown very little. Covering much more material in the same period of time has led authors to write longer J.D. textbooks, many of which exceed one thousand pages. Such comprehensive coverage leads to extended textbook assignments. This both forces and permits the students to bypass the assigned Code and Regulations provisions and spend their available time answering problems by reference solely to the author's explanation of the law in the textbook. Tax casebooks written primarily for the larger J.D. market that purport to be suitable for both J.D. and LL.M. tax courses, also lean towards comprehensive explanations of the Code and Regulations, which tend to deflect students away from the primary sources.

Books in the Graduate Tax Series are designed to be read with, and complement, the study of the Code and Regulations. Although some chapters of books in the Series provide detailed explanation of the topic, more frequently the chapters provide a general, normally brief, overview of the topic together with more complete explanations of the applicable portions of the Code and Regulations that are particularly difficult to understand. Also, many of the problems are based on situations encountered in practice or found in decided cases. Although some of the questions either state or disclose the issues and even the applicable statutes, many of them require analysis of a given set of facts to first determine and then resolve the critical issues.

## *PREFACE*

Students need to recognize that shifting the emphasis to primary sources and practice-based problems, which is made possible by reducing the time spent reading and analyzing cases and other secondary sources, increases the responsibility of the student for his or her education. It is harder to master a complex statute or regulation by studying it than it is to have someone explain it. It is also harder to identify the issues and applicable law from a group of facts than it is to answer short problems that identify the issue and the applicable law.

Students in an LL.M. program should be able to handle the higher level of personal responsibility. Furthermore, if one accepts the premise that learning a core set of rules and developing Code and Regulations reading skills are equally important goals, it is clear that students must dedicate a significant portion of their study time to the primary sources of the law.

The entire structure of the income tax depends on an annual accounting system that assigns income, deductions and other tax incidents to specific accounting periods. A thorough grounding in this system is essential to understanding the tax law. This book aims to provide students with this thorough grounding through analysis of materials and problems in the context of representing a variety of categories of taxpayers.

Chapter 1 introduces the annual accounting system, including annual accounting periods; surveys the subjects covered in the book; provides a historical perspective; and then briefly discusses the relationship between tax accounting and financial accounting. Chapters 2 and 3 detail the cash receipts and disbursements method of accounting, including some material on the new non-qualified deferred compensation rules, and the accrual method of accounting. Inventory accounting and accounting for long-term contracts are also briefly treated in Chapter 3. Chapter 4 covers capitalization, amortization and depreciation. Chapter 5 provides extensive treatment of interest, original issue discount and other time value of money issues, preparing the students for the comprehensive coverage of deferred payment sales in Chapter 6, which includes a special focus on private annuity transactions and self-canceling installment notes. Chapter 7 discusses all of the exceptions to the annual accounting system in one chapter — carryovers, claim of right doctrine, tax benefit rules and the so-called *Arrowsmith* principle — encouraging the student to consider whether these exceptions together derive from one or two coherent general principles. Chapter 8 addresses changes in accounting methods and annual accounting periods. Special issues of pass-through entities, individuals and corporations are raised throughout the book so that the student is prepared to deal with accounting issues in other substantive tax courses.

In this course, students should focus on the assigned provisions of the Internal Revenue Code and Treasury Regulations, as well as the text and materials in the book, in analyzing the problems. The problems are designed to cover all of the core principles. Many of the problems include citations to cases or rulings, sometimes cases or rulings on which the problems are based. Students are encouraged to explore the cited cases and rulings in connection with working out the problems, although it is preferable that students try to work them out first. Also, the authors do not necessarily agree with the results in some of the cited cases or rulings.

There is a vast literature on tax accounting issues, principally in the form of articles in tax journals. A helpful treatise is Stephen F. Gertzman, *FEDERAL TAX ACCOUNTING* (2d ed. 1993, as supplemented). The student who wants to explore the financial accounting treatment of issues discussed in the course in greater depth will find comprehensive

## *PREFACE*

coverage in Barry J. Epstein, et al., WILEY GAAP 2010, or later annual editions.

The second edition of this book reflects the contributions and experience in class of many teachers and students. The authors particularly thank Steven J. Willis, who was an important partner in authoring the first edition, having drafted both Chapters 4 and 8. The current versions of these chapters have benefited greatly from his work on the first edition for which we are most appreciative.

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# TABLE OF CONTENTS

<b>Chapter 1</b>	<b>INTRODUCTION</b> .....	<b>1</b>
§ 1	INTRODUCTION .....	1
§ 1.01	The Annual Accounting System .....	3
(a)	General Principles .....	3
	<i>Burnet v. Sanford &amp; Brooks Co.</i> .....	3
	Problem for Discussion .....	6
	Note .....	6
	Problems for Discussion .....	6
	<i>North American Oil Consolidated v. Burnet</i> .....	7
	Problems for Discussion .....	9
(b)	Taxable Year .....	10
	Problems for Discussion .....	13
§ 1.02	Methods of Accounting .....	14
§ 1.03	Capital Expenditures .....	19
§ 1.04	Deferred Payment Sales .....	20
§ 1.05	Interest .....	21
§ 1.06	Role of Financial Accounting .....	22
§ 2	A BIT OF HISTORY .....	23
§ 3	TAX ACCOUNTING VS. FINANCIAL ACCOUNTING .....	35
<b>Chapter 2</b>	<b>THE CASH RECEIPTS AND DISBURSEMENTS METHOD OF ACCOUNTING</b> .....	<b>43</b>
§ 1	INTRODUCTION .....	43
§ 2	INCLUSION IN INCOME .....	44
§ 2.01	Cash Equivalents .....	45
	<i>Cowden v. Commissioner</i> .....	45
	<i>Warren Jones Co. v. Commissioner</i> .....	49
	Notes and Questions .....	54
	Problems for Discussion .....	56
§ 2.02	The Economic Benefit Doctrine .....	56
	<i>Pulsifer v. Commissioner</i> .....	56
	Problem for Discussion .....	58
§ 2.03	Constructive Receipt .....	58
	<i>Baxter v. Commissioner</i> .....	58
	Notes and Questions .....	59
	Problems for Discussion .....	61
	<i>Amend v. Commissioner</i> .....	62
	Note .....	64

---

**TABLE OF CONTENTS**

	Problems for Discussion . . . . .	64
§ 2.04	Application to Non-Qualified Deferred Compensation . . . . .	65
(a)	Introduction . . . . .	65
(b)	Basic Principles . . . . .	67
	Revenue Ruling 60-31 . . . . .	67
	Notes . . . . .	72
	Problem for Discussion . . . . .	74
(c)	Current Issues . . . . .	74
(1)	When Deferral is Elected . . . . .	74
	Problem for Discussion . . . . .	76
(2)	Significance of Certain Forfeiture Restrictions . . . . .	76
	Problem for Discussion . . . . .	77
(3)	Security Arrangements . . . . .	78
§ 3	DEDUCTION OF PAYMENT . . . . .	79
	Problem for Discussion . . . . .	80
§ 3.01	Cash, Notes, Checks, and Credit Cards . . . . .	81
	<i>Commissioner v. Bradley</i> . . . . .	81
	<i>Don E. Williams Co. v. Commissioner</i> . . . . .	82
	Notes and Questions . . . . .	87
	Revenue Ruling 78-38 . . . . .	88
	Note . . . . .	89
	Problems for Discussion . . . . .	89
§ 3.02	Interest “Paid” With Additional Funds From Lender . . . . .	90
	<i>Davison v. Commissioner</i> . . . . .	90
	Notes . . . . .	98
	Problems for Discussion . . . . .	99
§ 3.03	Prepaid Expenses . . . . .	100
	<i>Commissioner v. Boylston Market Ass’n</i> . . . . .	100
	<i>Zaninovich v. Commissioner</i> . . . . .	102
	Notes . . . . .	105
	Problems for Discussion . . . . .	105
§ 3.04	Prepayment vs. Deposit . . . . .	106
	Revenue Ruling 79-229 . . . . .	106
	Notes . . . . .	108
	Problems for Discussion . . . . .	109
<b>Chapter 3</b>	<b>THE ACCRUAL METHOD AND RELATED MATTERS . . . . .</b>	<b>111</b>
§ 1	ACCRUAL OF INCOME . . . . .	111
§ 1.01	The All-Events Test . . . . .	111
(a)	General Rule . . . . .	112

---

*TABLE OF CONTENTS*

	<i>Lucas v. North Texas Lumber Co.</i> . . . . .	112
	Notes . . . . .	113
	Problems for Discussion . . . . .	114
(b)	Can the Amount be Estimated Accurately? . . . . .	115
	<i>Continental Tie &amp; Lumber Co. v. United States</i> . . . . .	115
	<i>United States v. Harmon</i> . . . . .	118
	Problems for Discussion . . . . .	120
(c)	Collectibility in Doubt . . . . .	120
(1)	In General . . . . .	120
	<i>Spring City Foundry Co. v. Commissioner</i> . . . . .	120
	Problems for Discussion . . . . .	123
(2)	Bad Debts . . . . .	123
(A)	The Specific Charge-Off Method . . . . .	123
	Notes . . . . .	124
	Problem for Discussion . . . . .	125
(B)	Reserves and the Nonaccrual Experience Method of § 448(d)(5) . . . . .	125
	Problems for Discussion . . . . .	127
(d)	Deferred Payment Sales . . . . .	127
	<i>Commissioner v. Hansen</i> . . . . .	127
	Notes . . . . .	134
	Problems for Discussion . . . . .	134
§ 1.02	Income Collected in Advance . . . . .	135
(a)	For Services . . . . .	136
	<i>Schlude v. Commissioner</i> . . . . .	136
	Notes . . . . .	140
	Problems for Discussion . . . . .	142
	Revenue Procedure 2004-34 . . . . .	142
	Notes . . . . .	153
	Problems for Discussion . . . . .	155
(b)	For Goods . . . . .	155
	Problems for Discussion . . . . .	156
(c)	Prepayments vs. Deposits . . . . .	156
	<i>Commissioner v. Indianapolis Power &amp; Light Co.</i> . . . . .	156
	Notes . . . . .	160
	Problems for Discussion . . . . .	160
§ 1.03	Limitations on Use of the Cash Method of Accounting . . . . .	162
(a)	Statutory Limitations . . . . .	162
(b)	Taxpayers Required to Use Inventories . . . . .	163
	<i>Wilkinson-Beane, Inc. v. Commissioner</i> . . . . .	163
	Note . . . . .	166

---

**TABLE OF CONTENTS**

	Problems for Discussion . . . . .	166
§ 2	ACCRUAL OF EXPENSES . . . . .	167
§ 2.01	The All-Events Test . . . . .	168
	<i>United States v. Hughes Properties, Inc.</i> . . . . .	168
	Notes . . . . .	173
	<i>Mooney Aircraft, Inc. v. United States</i> . . . . .	175
	Problems for Discussion . . . . .	179
§ 2.02	Economic Performance . . . . .	180
(a)	The <i>Ford Motor Co.</i> Case . . . . .	180
	<i>Ford Motor Co. v. Commissioner</i> . . . . .	180
	Problem for Discussion . . . . .	184
(b)	The Economic Performance Rules . . . . .	185
	Notes . . . . .	185
	Problems for Discussion . . . . .	186
§ 2.03	Contested Liabilities . . . . .	187
	<i>Dixie Pine Products Co. v. Commissioner</i> . . . . .	187
	<i>Security Flour Mills Co. v. Commissioner</i> . . . . .	188
	Notes . . . . .	191
	Problems for Discussion . . . . .	192
§ 3	INVENTORIES . . . . .	192
	Problems for Discussion . . . . .	194
	<i>Thor Power Tool Co. v. Commissioner</i> . . . . .	195
	Notes . . . . .	202
	Problems for Discussion . . . . .	203
§ 4	LONG-TERM CONTRACTS . . . . .	204
	Revenue Ruling 82-134 . . . . .	205
	Problem for Discussion . . . . .	206
<b>Chapter 4</b>	<b>CAPITALIZATION, AMORTIZATION, AND DEPRECIATION . . . . .</b>	<b>207</b>
§ 1	REPAIR VS. LONG-TERM ASSETS . . . . .	209
	Problems for Discussion . . . . .	210
§ 1.01	<i>Norwest Corporation</i> . . . . .	211
	<i>Norwest Corporation v. Commissioner</i> . . . . .	211
§ 1.02	Capitalization of Tangibles . . . . .	216
	GUIDANCE REGARDING DEDUCTION AND CAPITALIZATION OF EXPENDITURES RELATED TO TANGIBLE PROPERTY . . . . .	216
	Problems for Discussion . . . . .	226
§ 2	IDAHO POWER AND CAPITALIZATION OF CURRENT EXPENSES . . . . .	226
	<i>Commissioner v. Idaho Power Co.</i> . . . . .	226

---

*TABLE OF CONTENTS*

	Problems for Discussion . . . . .	229
§ 3	IS A SEPARATE ASSET REQUIRED FOR CAPITALIZATION? . . . .	230
	<i>INDOPCO, Inc. v. Commissioner</i> . . . . .	231
§ 3.01	Treasury Regulations in Response to <i>INDOPCO</i> . . . . .	235
	Problems for Discussion . . . . .	236
§ 4	ORIGIN OF THE CLAIM: WHICH CORPORATE ACQUISITION COSTS — ORDINARY OR CAPITAL . . . . .	237
	<i>Woodward v. Commissioner</i> . . . . .	237
	Problems for Discussion . . . . .	239
§ 5	DEPRECIATION . . . . .	240
§ 5.01	Depreciable Items . . . . .	242
(a)	Property Subject to Exhaustion, Wear and Tear, or Obsolescence . . .	242
(1)	Exhaustion, Wear and Tear . . . . .	242
(A)	<i>Simon v. Commissioner</i> . . . . .	243
	<i>Simon v. Commissioner</i> . . . . .	243
(B)	<i>Liddle v. Commissioner</i> . . . . .	248
	Problems for Discussion . . . . .	249
(b)	Obsolescence . . . . .	250
(1)	<i>Selig v. Commissioner</i> . . . . .	250
	<i>Selig v. Commissioner</i> . . . . .	250
(2)	<i>Harrah’s Club v. United States</i> . . . . .	252
	<i>Harrah’s Club v. United States</i> . . . . .	252
	Problems for Discussion . . . . .	256
(c)	Property Used in a Trade or Business or for the Production of Income . . . . .	256
§ 5.02	Depreciable Basis . . . . .	257
(a)	General Basis Rules . . . . .	257
(b)	Section 179 Election to Expense Costs . . . . .	257
	Problems for Discussion . . . . .	258
§ 5.03	Amount of Depreciation . . . . .	259
(a)	General MACRS Depreciation — Tangible Property . . . . .	259
(1)	Determination of Depreciable Lives — The Applicable Recovery Period . . . . .	259
(2)	Determining the Applicable Depreciation Method . . . . .	260
(3)	When to Begin Depreciating — The Applicable Convention . . . . .	261
	Problem for Discussion . . . . .	261
(b)	The Section 280F Limitation . . . . .	261
(c)	Alternative Depreciation System (ADS) . . . . .	262
	Problems for Discussion . . . . .	262
(d)	Depletion — Oil, Natural Gas, and Mines . . . . .	262
(e)	AMT Adjustments . . . . .	263
§ 5.04	Adjustments to Basis . . . . .	263

---

**TABLE OF CONTENTS**

	Problems for Discussion . . . . .	263
§ 5.05	Depreciation Recapture . . . . .	264
(a)	Section 1245 Property . . . . .	264
	Problems for Discussion . . . . .	265
(b)	Section 1250 Property . . . . .	266
(c)	Section 179 Property . . . . .	266
	Problems for Discussion . . . . .	267
§ 6	EXCEPTIONS TO CAPITALIZATION RULES . . . . .	268
§ 6.01	Advertising Expenses . . . . .	268
	<i>Mona L. Hymel, Consumerism, Advertising, and the Role of Tax Policy</i> . . . . .	268
	Revenue Ruling 92-80 . . . . .	271
§ 6.02	Employee Training Costs . . . . .	272
	Revenue Ruling 96-62 . . . . .	272
	Problem for Discussion . . . . .	273
§ 6.03	Other Exceptions . . . . .	273
§ 7	HISTORIC CAPITALIZATION RULES GOVERNING <i>INTANGIBLE ASSETS</i> . . . . .	273
§ 7.01	Historic <i>Cash Method</i> Rules . . . . .	273
§ 7.02	Historic <i>Accrual Method</i> Rules . . . . .	276
(a)	True Assets With Long Lives . . . . .	276
(b)	Deferred But Incurred Expenses . . . . .	276
§ 8	AMORTIZATION . . . . .	277
§ 8.01	Start-up Costs . . . . .	278
	Revenue Ruling 99-23 . . . . .	278
§ 8.02	Section 197 Intangibles . . . . .	283
	Problems for Discussion . . . . .	285
§ 9	MISCELLANEOUS DEFERRAL RULES . . . . .	286
<b>Chapter 5</b>	<b>INTEREST, ORIGINAL ISSUE DISCOUNT, AND THE TIME VALUE OF MONEY</b> . . . . .	<b>287</b>
§ 1	INTEREST INCOME AND DEDUCTIONS . . . . .	287
§ 1.01	Stated Interest . . . . .	288
(a)	Definition . . . . .	289
	<i>Gunderson Bros. Engineering Corp. v. Commissioner</i> . . . . .	289
	Problem for Discussion . . . . .	292
(b)	Rule of 78s . . . . .	292
	Revenue Ruling 83-84 . . . . .	293
	Problem for Discussion . . . . .	296
(c)	Prepaid Interest . . . . .	296
	<i>Resale Mobile Homes, Inc. v. Commissioner</i> . . . . .	297

---

*TABLE OF CONTENTS*

	Problems for Discussion . . . . .	300
§ 1.02	Indebtedness . . . . .	300
	<i>Albertson’s, Inc. v. Commissioner</i> . . . . .	301
	Problems for Discussion . . . . .	307
§ 1.03	Deferred Payment Sales . . . . .	308
	<i>Burnet v. Logan</i> . . . . .	308
	Problem for Discussion . . . . .	310
§ 1.04	Limitations on Interest Deductions . . . . .	310
(a)	Allocation of Interest among Expenditures . . . . .	311
(1)	Interest Related to Tax-Exempt Income . . . . .	312
(A)	Tax-Exempt Obligations . . . . .	312
	Revenue Procedure 72-18 . . . . .	313
	Problems for Discussion . . . . .	319
(B)	Insurance Contracts . . . . .	319
	Problem for Discussion . . . . .	320
(2)	Investment Interest . . . . .	321
(A)	Investment vs. Business . . . . .	321
	Problems for Discussion . . . . .	323
(B)	Tracing . . . . .	324
	Problem for Discussion . . . . .	324
(C)	Pass-Through Entities . . . . .	325
	Notice 89-35 . . . . .	325
	Problem for Discussion . . . . .	328
(D)	Carryover . . . . .	328
	<i>Beyer v. Commissioner</i> . . . . .	328
	Problem for Discussion . . . . .	332
(E)	Market Discount Bonds . . . . .	332
	Problem for Discussion . . . . .	333
(F)	Nonrecourse — At Risk . . . . .	333
	Problem for Discussion . . . . .	334
(G)	Passive Activity Interest . . . . .	334
	Problem for Discussion . . . . .	335
§ 1.05	Personal Interest . . . . .	336
	<i>Redlark v. Commissioner</i> . . . . .	336
	Problem for Discussion . . . . .	340
(a)	Qualified Residence Interest . . . . .	341
	Problem for Discussion . . . . .	342
(b)	Qualified Education Loans . . . . .	342
	Problem for Discussion . . . . .	343
§ 1.06	Coordinating the Limitations . . . . .	343
	Problem for Discussion . . . . .	344

---

**TABLE OF CONTENTS**

§ 1.07	Capitalization of Interest and Borrowing Charges . . . . .	344
(a)	Prepaid Interest, Points vs. Service and Commitment Fees . . . . .	344
(1)	Prepaid Interest . . . . .	345
(2)	Points . . . . .	345
	Problems for Discussion . . . . .	346
(3)	Service and Commitment Fees . . . . .	347
	Problem for Discussion . . . . .	348
(b)	Construction Period Interest . . . . .	349
(1)	The Avoided Cost Method . . . . .	349
	Problem for Discussion . . . . .	350
(2)	Tax-Exempt Financing . . . . .	351
	Revenue Ruling 90-40 . . . . .	351
	Problem for Discussion . . . . .	355
§ 2	DEBT DISCOUNT AND PREMIUM . . . . .	356
	Problem for Discussion . . . . .	357
§ 2.01	Original Issue Discount (“OID”) . . . . .	357
	<i>United States v. Midland-Ross Corp.</i> . . . . .	357
	Problem for Discussion . . . . .	359
(a)	Defining OID . . . . .	360
	Problem for Discussion . . . . .	361
(b)	Determining Issue Price . . . . .	361
	<i>Knetsch v. United States</i> . . . . .	362
	Problems for Discussion . . . . .	367
(c)	Contingent Payment Obligations . . . . .	368
	Problem for Discussion . . . . .	369
(d)	Economic Performance and OID . . . . .	369
	Problems for Discussion . . . . .	370
(e)	Short-Term Obligations . . . . .	371
	<i>Security Bank Minn. v. Commissioner</i> . . . . .	371
	Problem for Discussion . . . . .	377
§ 2.02	Market Discount . . . . .	377
	Problem for Discussion . . . . .	378
§ 2.03	Bond Premium . . . . .	379
	Problem for Discussion . . . . .	380
§ 2.04	Below Market Loans . . . . .	381
	<i>Dickman v. Commissioner</i> . . . . .	381
	Problems for Discussion . . . . .	389
§ 2.05	Stripped Bonds . . . . .	389
	Revenue Ruling 91-46 . . . . .	390
	Problems for Discussion . . . . .	392



---

**TABLE OF CONTENTS**

<b>Chapter 6</b>	<b>DEFERRED PAYMENT SALES</b>	<b>395</b>
§ 1	INSTALLMENT METHOD	395
§ 1.01	In General	396
(a)	What is Payment?	397
	<i>Estate of Silverman v. Commissioner</i>	397
	Problem for Discussion	401
(b)	Electing Out	401
	Problem for Discussion	403
(c)	Interest on Deferred Tax	403
	Problem for Discussion	404
§ 1.02	Security and Escrow	404
	<i>Porterfield v. Commissioner</i>	404
	Problem for Discussion	407
§ 1.03	Liabilities	407
	Revenue Ruling 79-326	408
	Problem for Discussion	409
(a)	Qualifying Indebtedness	409
	Problems for Discussion	410
(b)	Liabilities Transferred in Excess of Basis	411
	<i>Professional Equities, Inc. v. Commissioner</i>	411
	Problems for Discussion	420
§ 1.04	Related Parties	421
	<i>Rushing v. Commissioner</i>	421
	Problems for Discussion	425
§ 1.05	Qualifying Property	425
(a)	Exclusions	425
	Problem for Discussion	427
(b)	Multiple Assets	427
	Revenue Ruling 68-13	427
	Problem for Discussion	430
§ 1.06	Receipt of Nonrecognition Property	431
	Installment Sales Revision Act of 1980	431
	Problem for Discussion	434
§ 1.07	Dispositions	434
	Problems for Discussion	437
§ 1.08	Shareholders in Corporate Liquidations	437
	Problem for Discussion	438
§ 2	TIME VALUE OF MONEY	439
§ 2.01	Nontraded Property and the AFR	439
	Problems for Discussion	443
§ 2.02	Contingencies	443

---

**TABLE OF CONTENTS**

(a)	Contingent Payment Installment Sales . . . . .	444
	Problem for Discussion . . . . .	447
(b)	Contingent Payments and OID . . . . .	447
	Problem for Discussion . . . . .	447
§ 3	<b>PRIVATE ANNUITIES AND SELF-CANCELING INSTALLMENT NOTES</b> . . . . .	448
§ 3.01	Private Annuities . . . . .	448
(a)	The Seller-Annuitant . . . . .	449
	<i>Bell v. Commissioner</i> . . . . .	450
	Problem for Discussion . . . . .	454
(b)	The Purchaser in a Private Annuity Transaction . . . . .	455
	Revenue Ruling 55-119 . . . . .	455
	Problem for Discussion . . . . .	459
§ 3.02	Self Canceling Installment Notes (SCINs) . . . . .	460
(a)	Death of the SCIN Seller . . . . .	460
	<i>Frane v. Commissioner</i> . . . . .	460
	Problem for Discussion . . . . .	463
(b)	Distinguishing Private Annuity Sales from SCIN Sales . . . . .	463
	G.C.M. 39503 . . . . .	464
	Problem for Discussion . . . . .	480
<b>Chapter 7</b>	<b>EXCEPTIONS TO THE ANNUAL ACCOUNTING SYSTEM — TRANSACTIONAL PROBLEMS: CARRYOVERS, CLAIM OF RIGHT, AND TAX BENEFIT</b> . . . . .	<b>489</b>
§ 1	<b>CARRYOVERS</b> . . . . .	490
	Revenue Ruling 81-88 . . . . .	492
	Problems for Discussion . . . . .	494
§ 2	<b>CLAIM OF RIGHT</b> . . . . .	496
§ 2.01	Basic Claim of Right Deduction . . . . .	496
(a)	Net Effect . . . . .	496
	<i>United States v. Lewis</i> . . . . .	497
	Problem for Discussion . . . . .	498
(b)	Rescission of Sale of Property . . . . .	498
	Revenue Ruling 80-58 . . . . .	499
	Problem for Discussion . . . . .	500
§ 2.02	Section 1341 . . . . .	500
	Problem for Discussion . . . . .	502
(a)	Restored . . . . .	502
	Problem for Discussion . . . . .	504
(b)	“Appeared” . . . . .	504
(1)	Too Good for § 1341(a)(5) Relief . . . . .	505

---

**TABLE OF CONTENTS**

	Revenue Ruling 68-153 . . . . .	505
	Problem for Discussion . . . . .	507
(2)	Too Bad for § 1341(a)(5) Relief . . . . .	507
	<i>Zadoff v. United States</i> . . . . .	508
	Problem for Discussion . . . . .	510
(c)	“Established” . . . . .	510
	<i>Barrett v. Commissioner</i> . . . . .	511
	Problem for Discussion . . . . .	514
(d)	Inventory . . . . .	515
	Problem for Discussion . . . . .	516
§ 3	TAX BENEFIT . . . . .	517
§ 3.01	Inclusionary Aspect . . . . .	518
	<i>Hillsboro National Bank v. Commissioner</i> . . . . .	518
	Problems for Discussion . . . . .	535
(a)	Net Effect . . . . .	536
	<i>Alice Phelan Sullivan Corp. v. United States</i> . . . . .	536
	Problem for Discussion . . . . .	540
(b)	Tax Benefit vs. Amount Realized . . . . .	540
	<i>Allan v. Commissioner</i> . . . . .	541
	Problem for Discussion . . . . .	543
§ 3.02	Exclusionary Aspect . . . . .	543
(a)	Basic Application of Exclusion . . . . .	543
	Revenue Ruling 93-75 . . . . .	545
	Problem for Discussion . . . . .	549
(b)	Malpractice . . . . .	549
	<i>Clark v. Commissioner</i> . . . . .	550
	Problem for Discussion . . . . .	553
§ 3.03	Estoppel and Equitable Recoupment . . . . .	553
	Problem for Consideration . . . . .	555
§ 4	CHARACTERIZATION . . . . .	556
§ 4.01	The <i>Arrowsmith</i> Principle . . . . .	556
	<i>Arrowsmith v. Commissioner</i> . . . . .	557
	Problem for Discussion . . . . .	560
§ 4.02	Net Effect . . . . .	561
	<i>United States v. Skelly Oil Co.</i> . . . . .	561
	Problem for Discussion . . . . .	568
§ 5	SUMMARY . . . . .	568
<b>Chapter 8 ACCOUNTING PERIODS AND METHODS . . . . .</b>		<b>571</b>
§ 1	CHANGES OF ACCOUNTING METHOD . . . . .	571
§ 1.01	General Rules Governing Changes . . . . .	572

---

**TABLE OF CONTENTS**

(a)	Permission . . . . .	572
(b)	Adjustments . . . . .	575
(c)	Methods of Computation . . . . .	575
(1)	Traditional Method . . . . .	575
(2)	Cut-Off Method . . . . .	576
(d)	Voluntary vs. Involuntary Compliance . . . . .	577
	Problems for Discussion . . . . .	578
§ 1.02	Interrelationship Between Changes of Accounting Method Rules and Error Correction . . . . .	580
(a)	Government Positions . . . . .	580
(1)	Treasury Regulations . . . . .	580
(b)	Revenue Procedure 2002-9 . . . . .	581
(c)	Revenue Ruling 90-38 . . . . .	581
	Revenue Ruling 90-38 . . . . .	582
	Note . . . . .	582
(d)	Private Letter Ruling 94-21003 . . . . .	583
	Private Letter Ruling 94-21003 . . . . .	583
(e)	Analysis . . . . .	584
§ 1.03	Case Law Regarding Whether Erroneous Treatment Constitutes an Accounting Method . . . . .	585
	<i>Diebold v. United States</i> . . . . .	587
§ 1.04	Relationship of Change of Accounting Method Issues to Statutory Mitigation . . . . .	590
(a)	Hypothetical Application of § 481 to <i>American Can</i> . . . . .	592
(b)	Hypothetical Application of Mitigation to <i>American Can</i> . . . . .	593
(c)	Mitigation vs. the Tax Benefit Rule vs. § 481 . . . . .	594
	Problems for Discussion . . . . .	596
§ 2	BUSINESS PURPOSE YEAR AND CHANGES OF TAXABLE YEAR . . . . .	597
§ 2.01	Revenue Procedure 2002-39 . . . . .	597
	Revenue Procedure 2002-39 . . . . .	597
§ 2.02	Business Purpose . . . . .	606
	<b>TABLE OF CASES . . . . .</b>	<b>TC-1</b>
	<b>TABLE OF STATUTES . . . . .</b>	<b>TS-1</b>
	<b>TABLE OF SECONDARY AUTHORITIES . . . . .</b>	<b>TSA-1</b>
	<b>INDEX . . . . .</b>	<b>I-1</b>