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Tax Accounting Myths

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The rules that control the timing of the recognition of items of revenue and expense for federal income-tax purposes—tax accounting—have received little attention in the last two decades. Presumably, this is due in some measure to the time value of money being less interesting in the recent low-interest-rate environment. With so little recent public discussion, many tax lawyers’ understanding of tax accounting rests on historical myths that are no longer true. For example, many tax lawyers think that financial accounting’s Generally Accepted Accounting Principles (“GAAP”) are not relevant to tax accounting because GAAP only applies necessarily to financial statements of public companies. See 15 U.S.C. § 77s(b) (2012). The biggest trade association of accountancy, the American Institute of Certified Public Accountants (“AICPA”), recently proposed its own set of rules for private firms. The Financial Reporting Framework for Small- and Medium-Sized Entities (Am. Inst. of Certified Pub. Accountants 2013), available at http://www.aicpa.org/InterestAreas/FR%20Financial%20Reporting/FRF%20%20Financial%20Reporting/FRF%20%20Small%20-%20Medium%20Entities.pdf. The AICPA sells its proposal as simpler than GAAP, but the AICPA proposal’s real advantage over GAAP is that the proposal provides more flexibility—read, manipulability—to private businesses. FASB’s parent organization, the Financial Accounting Foundation, recently created the Private Company Council, which competes with the AICPA project. Michael Cohn, FAF Ushers in New FASB and GASB Leaders with New Web Site, and Reignites Dispute with AICPA, ACCOUNTING TODAY (July 1, 2013), available at http://www.accountingtoday.com/news/FAF-Ushers-FASB-GASB-Leaders-Site-Reignites-Dispute-AICPA-67297-1.html?ET=webcpa:e7330:405181a&st=email.

1 Professor Stephen Shay provided much appreciated comments—for which he deserves no blame.

2 Over the last two decades—as a consequence of an unfortunate Supreme Court opinion—the rules that control the capitalization of expenditures were given considerable attention. Until 1992, most thought that only asset-related expenditures were subject to capitalization. See George Mundstock, Taxation of Business Intangible Capital, 135 U. PA. L. Rev. 1179, 1228-33 (1987). Then, in INDOPCO, the Supreme Court held that any expenditure associated with a future benefit can be capital, without regard to whether the expenditure relates to an asset. INDOPCO, Inc. v. Comm’r, 503 U.S. 79, 86-88 (1992) (Blackmun, J.). Because it is possible to view any expenditure as having some future benefit, INDOPCO could have disallowed almost all deductions. See Mundstock, supra, at 1229-30. Treasury responded with regulations that (re)adopt the asset-related requirement. Treas. Reg. § 1.263(a)-4(b) (2004). So, basically, the law went full circle.

rests on the principle of "conservatism." This has not been true since 2010. Many tax lawyers think that the only situation where GAAP controls tax accounting is under the LIFO-conformity requirement. In fact, in many important cases, this is just not true. For example, an accrual-basis taxpayer's basic accounting for core items of revenue and expense can be controlled by GAAP. GAAP and tax provided bad accounting for employee stock options because both assumed that most such options were too difficult to value. Since 2006, however, GAAP has rejected the no-value myth and requires valuation of employee stock options. Tax law should follow. This article explores these and other tax-accounting myths.6

I. GAAP: Conservative in Principle No More

One of the most famous quotations in the tax-accounting literature is from Justice Blackmun's opinion in Thor Power:

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."6 [T]he accountant's conservatism cannot bind the Commissioner in his efforts to collect taxes.7

Now this is just wrong—if only as a matter of general principles.

The now-rejected GAAP principle of conservatism, as Justice Blackmun noted, arose out of the auditing process. A business's management keeps the books and prepares the financial statements. The "outside" Certified Public Accountant ("CPA") then audits the financial statements. First, the auditor engages in detective work (the audit process) to satisfy herself that the facts shown on the books are true. Second, the auditor must satisfy herself that management's financial statements present

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4 I.R.C. § 472(c) (2012).
5 The myths addressed in this article are false. It must be noted—however annoyingly pedantically—that a myth is not necessarily false. A myth is something believed based on a common cultural understanding so as to be accepted without regard to whether it is true or false. MERRIAM-WEBSTER DICTIONARY, available at http://www.merriam-webster.com/dictionary/myth.
the information on these books in accordance with GAAP in all material regards. If so, the CPA can certify (attest to) the statements.\textsuperscript{8}

In this process, management has skin in the game. Usually, management wants to look like it is doing the best job possible in running the reporting business. This can create irrational exuberance. Conservatism was intended to put a balancing thumb on the scale. Accountants were supposed to be less optimistic about the business. By such push and pull, it was hoped, financial statements would serve their users best.\textsuperscript{9}

But, conservatism presented its own problems. Managements are not always overly optimistic. For example, they might want to make things look bleak so that they can buy the stock of the reporting business at a low price, say in a management-buyout transaction. More generally, there are many people who stand to be hurt by accounting conservatism. Stock sellers want the highest price possible. Conservatism could encourage low prices. Conservatism also enabled managements to hide profits now and book them later when it would benefit the managements.\textsuperscript{10} For these reasons, in 2010, the Financial Accounting Standards Board ("FASB"), in a Statement of Financial Accounting Concepts, flatly rejected conservatism as a continuing principle of financial accounting:

Deliberately reflecting conservative estimates of assets, liabilities, income, or equity sometimes has been considered desirable to counteract the effects of some management estimates that have been perceived as excessively optimistic. However, even with the prohibitions against deliberate misstatement that appear in the existing frameworks, an admonition to be prudent is likely to lead to a bias. Understating assets or overstating liabilities in one period frequently leads to overstating financial performance in later periods—a result that cannot be described as prudent or neutral.\textsuperscript{11}

This 2010 Concepts Statement, while the highest possible authority on U.S. GAAP concepts, did not, in and of itself, change any of the FASB

\begin{thebibliography}{11}
\bibitem{8} \textit{George Mundstock, A Finance Approach to Accounting for Lawyers} 9-11, 100 (2d ed. 2006).
\bibitem{9} \textit{Id.}
\bibitem{10} The classic way to do this is with a "cookie-jar" reserve (out of which profits can be pulled when management wants a treat). See \textit{Mundstock, supra} note 8, at 234-41.
\bibitem{11} Statement of Financial Accounting Concepts No. 8 § BC3.28 (Fin. Accounting Standards Bd. 2010).
\end{thebibliography}
rules that apply to actual financial statements. All of the old substantive rules that are based on conservatism, such as the generous ability to write down assets that concerned Justice Blackmun in Thor Power, continue in force. But, presumably, as indicated in the just-quoted FASB pronouncement, over time FASB will update its substantive rules that are based on conservatism. For example, the new GAAP rules for sales with multiple deliverables, discussed below, move away from the older, more conservative, regime. As a consequence, the tax law no longer can operate on the assumption that GAAP rules always are conservative. Most interestingly, if GAAP develops as expected, the case against using GAAP books for tax purposes—tax/book conformity—will become considerably weaker.

II. GAAP IS NOT RELEVANT TO TAXES, EXCEPT IN THE REAL WORLD

The quotation from Justice Blackmun above also suggests that, in general, GAAP is not particularly relevant in tax-accounting matters. That is overwhelmingly the opinion of the courts. But, as a practical

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12 A tax lawyer might be interested to know that, in 2009, FASB compiled all of its highest-level rule pronouncements, the Statements of Financial Accounting Standards ("SFAS"), in the new Accounting Standards Codification. Now, FASB's most authoritative new rules are published in Accounting Standard Updates, which amend the Accounting Standards Codification. The old SFASs have no continuing authority. The Emerging Issues Task Force of FASB ("EITF") examines technical matters that need relatively rapid attention. Consensus positions of the EITF were published as EITF Abstracts. EITF consensuses now are reflected in the Accounting Standards Codification and can be found in the Meeting Minutes of the EITF, which are available on FASB's website. FASB Accounting Standards Codification Notice to Constituents (v4.8): About the Codification (Fin. Accounting Found. 2012), available at https://asc.fasb.org/imageRoot/80/34350180.pdf.


14 Infra text accompanying notes 37 to 38.


16 Section 446(a) provides that a taxpayer's tax accounting method must be "the method of accounting on which the taxpayer regularly computes his income in keeping his books." I.R.C. § 446(a) (2012). This has been interpreted, however, to require only that the business's books and records contain all information required to apply the tax accounting method. STEPHEN F. GERTZMAN, FEDERAL TAX ACCOUNTING ¶ 2.02(1) (1994 & 2012 Supp.). Additionally, Section 446(b) requires a tax accounting method to "clearly reflect income." I.R.C. § 446(b) (2012). This also has not been interpreted to require that tax accounting follow GAAP. George Mundstock, The Tax Import of the FASB/IASB Proposal on Lease Accounting, 32 VA. TAX REV. 461, 469-70 (2013).

17 GERTZMAN, supra note 16, ¶ 2.02.
matter, GAAP has been read into tax-accounting rules that control the timing of huge amounts of income, such as those controlling when prepaid income is taxed and when accruals are allowed to be deducted. This idea is explored immediately below.

A. Prepaid Income (Advance Payments)

Along with Thor Power, other particularly well-known tax accounting cases include the “Trilogy” of Supreme Court cases dealing with the timing of the taxation of prepaid income received by an accrual-basis taxpayer: Automobile Club of Michigan,18 AAA,19 and Schlude.20 Collectively, these cases hold that an accrual-basis taxpayer is taxed upon receipt of prepaid income even though, under GAAP, such income cannot be booked upon receipt, and must be deferred, because it has not yet been earned. The results in these cases are so inconsistent with reality—aft all, a prepayment is a loan to be paid off with goods or services21—that the government has been sprinting away from the Trilogy ever since.

As to the sale of goods, a 1971 Treasury regulation22 basically adopts GAAP for tax purposes. The regulation allows the taxation of prepayments to be deferred until the goods are delivered, which is the time at which the revenue is booked under GAAP (and thus when the cost-of-goods-sold expense is booked for tax and financial accounting purposes). Specifically, section 1.451-5(b)(1)(ii)(a) of the regulations allows a taxpayer to defer sale-of-goods revenue until “no later than the time such advance payments are included in gross receipts for purposes of all of his reports (including consolidated financial statements) to shareholders, partners, beneficiaries, other proprietors, and for credit purposes . . . .” With sales of inventory for substantial advance payments, however, which is an important application of the regulation, the

21 A closely-related case is Indianapolis Power. Comm’r v. Indianapolis Power & Light Co., 493 U.S. 203 (1990) (tax years 1974-77). It tried to distinguish between “advance payments,” which are taxable as received, and “deposits,” which are not so taxable, since viewed as loans ab initio. Justice Blackmun noted that the parties expect deposits to be returned in cash, while advance payments are expected to be paid in services or non-cash property. The amounts in controversy were deposits—based on the Court’s assumptions as to the expectations of the parties—even though the Court acknowledged that this was inconsistent with the actual practice. Id. at 211-14.
maximum deferral is two tax years.\textsuperscript{23}

Thus the Trilogy cases do not apply to the principal type of revenue for many businesses, sale-of-goods revenue, albeit, for just two years. For example, in fiscal year 2012, 66\% of General Electric's (including GE Capital Services) book revenue was from the sale of goods.\textsuperscript{24}

Beyond this regulation, the IRS administratively permits accrual-basis taxpayers to use GAAP deferral for most other types of prepaid revenue for one year. Revenue Procedure 71-21\textsuperscript{25} announced a practice of allowing taxpayers to defer the taxation of prepaid income that is deferred under GAAP for one year. In the practice's current implementation, Revenue Procedure 2004-34,\textsuperscript{26} the IRS allows one year of deferral with respect to advance payments for a wide variety of items, including prepayments for the following categories:

(a) services;
(b) the sale of goods (other than for the sale of goods for which the taxpayer uses a method of deferral provided in §1.451-5(b)(1)(ii));
(c) the use (including by license or lease) of intellectual property . . . ;
(d) the occupancy or use of property if the occupancy or use is ancillary to the provision of services. . . ;
(e) the sale, lease, or license of computer software; . . . and
(j) any combination of items described [above].\textsuperscript{27}

Basically, for almost every conceivable type of prepaid income (that does not involve finance or the rental of tangible property), if GAAP allows deferral, one year of deferral is allowed for tax purposes.\textsuperscript{28}

\textsuperscript{23} Id. at § 1.451-5(c)(1). A cost-of-goods-sold deduction is then allowed. Id.
\textsuperscript{24} General Electric Co., Annual Report (Form 10-K), 92 (Feb. 26, 2013).
\textsuperscript{25} 1971-2 C.B. 549.
\textsuperscript{27} Id. ¶ 4.01(3).
\textsuperscript{28} Id. ¶ 4.02. In Indianapolis Power, supra note 21, at 204, the taxpayer wanted many years of deferral. Presumably one year of deferral would have been available under Revenue Procedure 71-21, the predecessor of Revenue Procedure 2004-34. See supra notes 26 to 27.
B. Multiple Deliverables

The rules for deferral of prepaid income apply interestingly to an accounting issue that has received considerable attention in the financial-accounting context during the last decade: revenue from a sale with multiple deliverables. FASB relaxed conservatism, which had interesting tax consequences.

The classic example of a sale with multiple deliverables is Apple selling an iPhone. When a customer buys an iPhone, the customer is buying from Apple (usually through a wireless carrier) multiple items (the phone, the software thereon, the right to software updates, and the right to customer service). The obvious question is when the associated revenue is recognized for GAAP and tax purposes. Before the 2009 changes to GAAP, revenue from a sale with multiple deliverables was recognized pro rata over the longest possible period unless the seller had "objective evidence" to support breaking the sale into the component, separately deliverable, pieces—most importantly, so as to recognize the allocated sale-of-goods revenue earlier than otherwise, upon delivery of the goods. Objective evidence consisted of sales of the pieces separately by the reporting business or sales of very similar items separately by third parties. Apple does not sell any part of the iPhone package separately and views nothing sold by others as similar to any deliverable involved in the sale of an iPhone. Under pre-2009 GAAP, this meant that Apple recognized revenue from iPhone sales pro rata over two years. In contrast, for example, under the pre-2009 rules, Microsoft was able to book much of the revenue on its sales with multiple deliverables early by using objective evidence to break a sale in the separate deliverables.

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30 Id.
31 Id. This article dodges the dicey issue of whether the "sale" of software is treated as a sale or license for tax purposes. But, an iPhone sale involves a tangible iPhone, so that the transaction clearly involves, inter alia, a sale of a good.
34 Id.
Then, FASB moved away from conservatively requiring objective evidence to divide up a sale with multiple deliverables. Now, a seller such as Apple can use best estimates to break a sale down into pieces. This change alone gave Apple, for fiscal year 2009, a 31% increase in total gross margin (total net revenues less total cost of sales)—from $13.1 billion to $17.2 billion—and a 44% increase in profit—a $2.5 billion increase. This move away from GAAP conservatism involved serious money!

This change in GAAP had some interesting tax ramifications. In many cases, such as with Apple, most or all of the consideration with respect to a sale with multiple deliverables is received before it may be recognized under GAAP. Thus all revenue would be taxed up front under the Trilogy cases, even for accrual-basis taxpayers. But for sales involving bundled software and services, Revenue Procedure 2004-34 makes deferral available. The revenue procedure contains examples in

37 FASB Accounting Standards Codification, supra note 13, Subtopic 605-25.
38 Apple Inc., Amended Annual Report (Form 10-K/A), 34-37 (Jan. 25, 2010). The higher percentage increase in profits than in gross margin was due to the additional revenue bearing no additional expenses other than taxes.


A tax lawyer might ask whether Apple's restated 2009 earnings reflected not only 2009 sales but also profit on prior-year sales that had been deferred under the old accounting method. That would be the tax result. I.R.C. § 481 (2012). Under GAAP, however, when an accounting method is changed, rather than a current adjustment so that all income is booked once and only once (the tax rule), a reasonable number of prior-year financial statements are restated. FASB Accounting Standards Codification, supra note 13, ¶ 250-10-50-1. Before and after a change in GAAP methods, each year stands on its own. Under these circumstances, the increase in Apple's 2009 GAAP earnings as a consequence of the change seems shockingly large. After all, the pre-change 2009 earnings included large amounts with respect to earlier year sales of iPhones (albeit relatively little for 2009 sales), while the post-change 2009 earnings mostly reflected 2009 sales (albeit almost the entire amount thereof). For the change to be so large, 2009 iPhone sales would have had to have been considerably larger than prior years' sales. In fact, they had increased 93%. Apple Amended Report, supra, at 10.

This illustrates a general point about accounting rules: Averaging and consistency reduce the impact of accounting rules. In comparing the results of two, different, accounting rules for the same item, if the two rules both are applied consistently from year to year, their internal year-to-year differences offset, so that the difference between the two in a given year is an average (across the years) difference. See Mundstock, supra note 8, at 118-20. Under these circumstances, the details of the applicable accounting rules have the most impact with respect to businesses that change from year to year, such as growing and contracting businesses. Id. Apple's iPhone business was growing, so that the accounting rules applicable thereto made a big difference. The tax flip-side of averaging is that unwarranted deferral allowed a growing business will not be recaptured until the business starts shrinking.

which the tax accounting follows GAAP on the issue of breaking the sale into pieces.\textsuperscript{40} And the revenue procedure allows taxpayers to divide a transaction into a piece for which deferral is allowed and a piece for which it is not, so as not to disqualify the entire transaction—so long as this division can be done on the basis of "objective criteria."\textsuperscript{41} Separate sales of the pieces satisfy the "objective criteria" requirement.\textsuperscript{42} So, for example, Microsoft can defer services and software licensing revenue associated with the sale of an Xbox.\textsuperscript{43}

This leaves open the treatment of Apple and other beneficiaries of the 2009 GAAP change. If, unlike Apple, only software and services were involved and the business was applying the revenue procedure to the transaction as a whole, the GAAP acceleration also would have sped up the taxation.\textsuperscript{44} This is tremendously interesting, because it illustrates how the tax law can benefit as GAAP becomes less conservative.

Some businesses, like Apple, however, sell goods along with deliverables covered by the revenue procedure. Lacking "objective criteria," these sales presumably were not covered by the revenue procedure (because goods are involved) or section 1.451-5 (because services are involved). All revenue was thus taxed up front under the Trilogy cases. Now, however, GAAP has increasingly relaxed rules regarding the evidence required to separately account for multiple deliverables. Arguably, this new GAAP now contains "objective criteria." If so, the acceleration of GAAP revenue could paradoxically defer the taxation of the transactions. Regardless, this is not troubling, because the results of applying the Trilogy cases here are so harsh. It does border on the use of estimates, however, which so troubled Justice Blackmun in \textit{Thor Power}.

Accounting for sales with multiple deliverables illustrates how things have changed in tax accounting. Rules are needed for new transactions, and GAAP adapts by becoming less conservative. The tax law then benefits by following GAAP.

\textsuperscript{40} Rev. Proc. 2004-34, \textit{supra} note 26, § 5.03 (Examples 18 through 22).
\textsuperscript{41} Rev. Proc. 2004-34, \textit{supra} note 26, § 5.02(4)(A).
\textsuperscript{42} Rev. Proc. 2004-34, \textit{supra} note 26, § 5.02(4)(C).
\textsuperscript{43} See Microsoft, \textit{supra} note 36, at 8, 49.
\textsuperscript{44} Section 446(e), generally, and Revenue Procedure 2004-34, specifically, provide rules for a change in a tax accounting method. I.R.C. § 446(e) (2012); Rev. Proc. 2004-34, \textit{supra} note 26, § 8.
C. Accrued Expenses

GAAP also controls many real-world deductions of accrual-basis taxpayers. The “economic-performance” test of section 461(h), enacted in 1984, was supposed to prevent this. In fact, due to the recurring-item exception of section 461(h)(3), the 1984 legislation expanded GAAP’s tax role.

Before 1984, most tax experts thought that a tax deduction was not allowed for estimated amounts to be paid in the future, particularly such an amount as to which the identity of the actual payee was not yet known. For example, in the above quotation from Thor Power, Justice Blackmun rejected tax deductions based on estimates. Only completed transactions justify a tax deduction. Notwithstanding this near consensus, in 1984, a few judicial opinions (and presumably-then-well-known, pending controversies) had shaken this faith. Also, in that time of high interest rates, there was a concern for overstated current deductions with respect to future amounts that were not discounted to reflect the time value of money. In response, Congress enacted section 461(h) in 1984, which prevents taxpayers from deducting an amount until “economic performance.” Under the 1984 limit, before a deduction is allowed, there must be a real (e.g., not executory) transaction, such as the payment

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45 Supra text accompanying note 7.
46 Ford Motor famously settled personal injury lawsuits by agreeing to “structured settlements”: promising defendants annuity payments over time. Ford immediately deducted the total amount thereof (with no discounting to reflect the time value of money or hidden interest). This caused the current tax savings to exceed the present value of the promised future payment. See Ford Motor Co. v. Comm’r, 71 F.3d 209 (6th Cir. 1995) (rejecting such deduction for tax year 1980). In Hughes Properties, the Supreme Court allowed the taxpayer, a casino, a current tax deduction for estimated future payoffs to be made on “progressive” slot machines attributable to play on the machines during the current year. (The more that a progressive slot machine is played during a year without a winner, the bigger the payoff in the later year when there ultimately is a winner.) Hughes Props., Inc. v. United States, 5 Cl. Ct. 641 (1984), aff’d, 760 F.2d 1292 (Fed. Cir. 1985), aff’d, 476 U.S. 593 (1986) (Blackmun, J.).
of cash.\textsuperscript{50}

To prevent undue disruption in taxpayers’ tax-accounting practices, however, the 1984 Act’s Conference Committee added a “recurring item” exception\textsuperscript{51} to the economic-performance requirement.\textsuperscript{52} To be “recurring,” an item need only repeat periodically.\textsuperscript{53} Additionally, to qualify for the exception, an item must be either (i) “immaterial” or (ii) such that the early deduction effects better “matching.”\textsuperscript{54} The regulations indicate that GAAP is vital in applying the materiality and matching requirements, but does not always control.\textsuperscript{55}

Under the recurring-item exception, for example, a manufacturer can deduct year-end additions to GAAP allowances (reserves) (i) with respect to payments expected on discount coupons and (ii) with respect to returns expected. These can be large amounts. John Wiley & Sons reported total fiscal year 2012 (net) revenue of $218 million, while the total amount of the allowance for returns at the end of the year was $36 million.\textsuperscript{56} So,
basically, for many normal business deductions, GAAP trumps economic performance.

1. (Nonqualified) Compensatory Stock Options: What’s Old Is New Again

A corporation’s compensation amount (expense or capital item) when it rewards employees with (call) options on its stock has caused problems for both GAAP and the tax system—and for the same reason: Non-traded options can be hard to value. Historically, the different approaches taken by the two accounting regimes gave businesses the best possible outcome under both (no GAAP expense, ever, and the largest conceivable tax deduction). FASB, in response to abuse during the tech bubble, finally adopted reasonable GAAP. FASB recognized that, due to developments in finance modeling, it is possible to approximately value options. Tax law should follow GAAP and eliminate current law’s unjustifiable loophole. In this highly public context, for the tax law to respect GAAP estimates—and thereby reject the myth that such options cannot be valued—would be an unconditional win.

In a typical compensatory-stock-option transaction, a corporate employer grants (awards) an employee an option to buy the employer’s stock at the current market price (sometimes adjusted over time by some market index). The option cannot be exercised for some (vesting) period, say three years. All of the option might vest at the end of the vesting period (cliff vesting) or the amount of stock covered by the option might vest proportionately over the vesting period. If the employee’s employment terminates before the end of the vesting period, all unvested rights lapse. The option may lapse after the first possible exercise day or may continue for some period thereafter. Usually, any stock acquired by exercise is transferable (to the extent that other shares of the employer are).

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57 Intra text accompanying notes 62 to 63 and 67 to 69.
58 Intra text accompanying notes 64 to 66.
It is important to distinguish between two separate aspects of a compensatory-stock-option transaction. First, the employee invests in the employer corporation. By accepting the option instead of cash, the employee gets a long position in the corporation. That investment increases in value when the company’s stock goes up in (forward) value. Second, the transaction involves compensation. The receipt of the option is intended as payment for services. Also, to the extent that the employee’s good work increases the value of the company, the associated increase in the value of the option also is compensatory. The key to good accounting here is to carefully distinguish and separately account for the two aspects.

An example illustrates these points: A company grants a call option to an employee. The option vests five years after the day it is granted. After the five years, the employee can buy 1,000 shares of the company’s stock for $100 a share, the market value on the day of the grant. The employee stays with the company for the five years and exercises the option at a time when the stock is trading at $225 a share. The employee buys $225,000 worth of stock for $100,000, so as to be in a position to make an immediate $125,000 profit.

Economically, the employee earned the option over the five-year vesting period. The option had value at the time of grant, say $10,000. (Even though the stock was then trading at the exercise price ($100 a share), the right to lock in that price for five years has real value, although that value can be hard to determine without a market for the option (or similar options).) By taking the option instead of cash, the employee is investing in the company. The $120,000 increase in the value of the option is in most cases just a return on the investment in the option. Of course, a particularly effective employee may be able to increase the value of the company’s stock so that some of the $120,000 increase in the value of the option is attributable to her services.

Under GAAP as in effect prior to 2006, the transaction was viewed as involving only investment. As a consequence, no expense of any kind was booked. At the time of grant, the real cost of the compensation was hard to value and contingent and so not booked. Later, the exercise of the

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61 Id. at ¶ 3.
62 Accounting for Stock-Based Compensation, Statement of Financial Accounting Standards No. 123, ¶
option to buy stock for less than its market value at such time was a capital transaction. There is no cash expense, just the dilution of the other shareholders. Future earnings per share would be reduced, but there was no expense, per se.

The tech bubble changed things. The public realized that most of the earnings of tech companies would have been eliminated had stock compensation been reflected on their income statements. First, the International Accounting Standards Board required that options be valued at the time of grant and that such amount treated as compensation pro rata over the vesting period (with appropriate adjustments if the employee leaves and the option rights forfeit). Then, under this political cover, FASB adopted the same basic regime, effective in 2006. So, now, compensation treatment for the initial value of the option is booked (although any compensatory aspect of the increase in value of the option over the vesting period still is not treated as compensation). In the example above, the employer is treated as incurring $10,000 of wages over the five-year vesting period. Exercise has no impact on the income statement.

In contrast, the tax rules for (non-qualified) compensatory stock options have been stable for a very long time. The tax law takes the opposite approach as pre-2006 GAAP and treats the transaction as entirely compensatory. Unless the option is transferable and of a type that is readily valuable (i.e., publicly traded), there is no compensation income or expense at the time of grant. At exercise (assuming that the stock

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67 For a complete analysis of current law and its development, see Boris I. Bittker & Lawrence Lokken, Federal Taxation of Income, Estates and Gifts ¶ 60.5 (2012). As to qualified options, which are not discussed in this article, see I.R.C. § 422 (2012). A qualified option provides tax benefits to the employee at the cost of the employer’s deduction. Id.
acquired is transferable), the entire purchase discount afforded by the option is compensation income and expense (provided that the compensation otherwise would be deductible). Lapse has no tax effect. The tax law conservatively waits to the last instant to value the option, thereby effectively ignoring the investment aspect of the transaction. In the example, at exercise, the employer has a $125,000 deduction and the employee has $125,000 of income.

This tax regime is, at best, objectionable. On the deduction side, the employer is allowed to treat the entire value of the option as compensation at the time of exercise. Most of that value should not be viewed as compensation because it is in fact a return on the very real investment by the employee in the employer. A deduction is deferred until exercise (or later if the compensation is capitalized), but it seems unlikely that such deferral exactly reduces the present value of the deduction to equal that of a deduction for only the compensatory portion of the transaction. In the stylized example, a $125,000 deduction in the fifth year is considerably more valuable than $10,000 spread over five years. The employee is taxed on the entire value of the option at exercise as ordinary income (rather than capital gain), even though some of the profit represents a return on an investment. In the example, $115,000 of the $125,000 profit can be viewed as capital gain.

As to employers, the tax law should follow the lead of the new GAAP rules. Since 2007, Senator Carl Levin has periodically introduced a bill that would require that the tax deduction of an employer (accrual or cash-basis) conform to that on the employer’s “report or statement” of “income, profit, or loss.” Under the bill, in the example above, the employer would be limited to a deduction of $10,000 spread over five years. The bill has garnered support from, among others, the AFL-CIO and Citizens for Tax Justice.

The Levin bill’s new deduction limit seems poorly targeted. Many

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70 For a general critique of the defects in current law, see Daniel Halperin, A Fairer and More Effective Approach to Deferred Compensation, 103 TAX NOTES 1187, 1187-90 (2004).
71 Exercise would have no tax impact. The GAAP rules also would improve the taxation of restricted stock, but there has been no change in GAAP here for some time, so that restricted stock is not considered in this article.
72 See, e.g., S. 1375, 112th Cong. § 2 (2011); S. 2116, 110th Cong. § 2 (2007). These bills would not change the tax treatment of the employee.
public companies have statements in addition to GAAP financials. Which control? Private companies have the luxury of keeping the current overstated deduction, with little business impact, simply by using the current tax accounting on their non-GAAP financials.\textsuperscript{74} A better first pass would apply the new limit to accrual-basis corporate employers and not to cash-basis employers. As a general matter, accrual-basis corporations already deal with the complexities of accrual accounting and so are best situated to deal with the burden of proper accounting for stock-option compensation. Today, most corporations are required to use an accrual method.\textsuperscript{75} Thus, under the suggested rule, very few employers would be subject to GAAP-like accounting. If there is concern that this would be an unfair additional relative preference for the corporations already allowed to use the cash method, a possible rule for these employers might be for the IRS to provide tables for valuing the options so as to apply the general rule. The tables could be based on the total exercise price and the term of the option.\textsuperscript{76} Conversely, given how broadly the accrual method applies today, exceptions may once again be needed for accrual-basis corporations for which valuing an option might be too burdensome. Again, IRS tables could be provided as a substitute for real valuations.

Virtually all employees use the cash method of accounting for tax purposes with respect to their employment.\textsuperscript{77} The economics of option compensation suggest that the compensatory aspect should be taxed using the new GAAP accounting. Employees would be taxed under their employers’ method of accounting, which means accrual of compensation for all involved. This regime would tax employees prior to the receipt of the cash with which to pay the tax, which generally does not happen with cash-basis taxpayers.\textsuperscript{78} But current law taxes exercise, at which time the

\textsuperscript{74} The AICPA proposal for a financial accounting regime for smaller firms, discussed \textit{supra} note 3, expressly adopts the old GAAP rule—no expense ever—for stock option compensation. Am. Inst. of Certified Pub. Accountants, \textit{supra} note 3, ¶ 18.15. This presumably reflects a judgment that valuing options is too burdensome for such firms.

\textsuperscript{75} A corporation must use an accrual method of accounting for tax purposes unless either (i) it is a personal service corporation, (ii) it has less than $5 million in annual gross receipts, or (iii) it is a qualified farming business. I.R.C. § 448 (2012).

\textsuperscript{76} The key missing input to this valuation is the riskiness of the stock, which is the heart of the valuation problem that led to old GAAP and the current tax law. Section 1.83-7(b)(3) of the regulations identifies that the three key inputs required to value an option are (i) the value of the underlying property, (ii) the duration of the option, and (iii) the riskiness of the underlying property. Treas. Reg. § 1.83-7(b)(3) (as amended in 2004).

\textsuperscript{77} \textit{Gertzman}, \textit{supra} note 16, ¶¶ 3.01, 3.02.

\textsuperscript{78} \textit{Id.} at ¶ 3.02[2].
employee still has no cash with which to pay the tax, so the proposal would create no new hardship. For example, SPRINT (the communications company) famously got bad press when its CEO used a questionable tax shelter in an attempt to defer his tax on the exercise of his stock options.\footnote{David Cay Johnston & Jonathan Glater, Tax Shelter Is Worrying Sprint's Chief, N.Y. Times (Feb. 6, 2003), available at http://www.nytimes.com/2003/02/06/business/06SHEL.html.} Permitting employees to pay the tax (plus interest) at a later time, say at exercise, can mitigate any hardship arising out of the early taxation.\footnote{For example, Section 444 allows taxpayers to defer the taxation of income by using certain otherwise not allowable tax years, but requires an interest charge determined under Section 7519. I.R.C. § 444 (2012). There would be no need for a mechanism like current Section 83(b), which, in the case of most property compensation, but not options (that are not of a type that is publicly traded), allows taxpayers to choose early taxation in exchange for being able to put a low value on the property.}

The amount treated as investment profit under GAAP could be taxed as capital gain on exercise as under current law. But, the current tax at exercise is based on the view that this is compensation income. If viewed as investment profit, exercise should not be taxable, per se, because call-option exercise generally is not taxable.\footnote{JAMES EUSTICE & THOMAS BRANTLEY, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 3.12 (2013).} The acquired stock would have a basis equal to the already-taxed compensation income (plus any further amount paid for the stock).\footnote{Id.} All investment profit would be taxed as capital gain when the stock itself is sold. If the option lapses, a capital loss would be allowed for the amount previously taxed as compensation income.\footnote{Id.}

But, arguably, current GAAP still does not provide for perfect accounting. If the employee is in a position to increase the price of the employer's stock, some of the amount treated as investment profit under GAAP (in the example above, some portion of the $115,000 profit on the option) can be viewed as compensation—alogously to, say, cash-incentive compensation based on profits. After all, a classic justification for stock-based compensation is to reward employees for performance. How best to determine the compensation portion of option profit is not, however, obvious. Consequently, at this juncture, it seems best to adopt the view of accountancy that any profit on the option itself is not compensation.
III. What Condition Conditions Are In

Changes in how state law and GAAP view conditions upon obligations that are provided for in private contracts also should change how an accrual-basis taxpayer accounts for revenue. An accrual-basis taxpayer reports income when "all events" that are required to fix the taxpayer's right to the income have occurred.84 "All events" does not mean absolutely all events, however. A contractual condition upon completion of a revenue-generating transaction may be viewed as an event. The courts and the IRS, however, have limited the circumstances in which contractual conditions justify deferral of income. Under their analysis, only "conditions precedent" must have occurred for income to be recognized. "Conditions subsequent" do not prevent income recognition.85

As a matter of contract-law theory, the 1981 Restatement (Second) of Contracts eliminated the distinction between a "condition precedent" and a "condition subsequent."86 The Reporter's Notes to the Restatement indicate that this change was based on analysis originally presented by Justice Holmes in The Common Law,87 which was first published in 1881. There, Justice Holmes observed as follows:

84 Treas. Reg. § 1.451-1(a) (as amended in 1999). The "all events" test also applies for purposes of determining the proper time to accrue a liability with respect to an expense. Treas. Reg. § 1.461-1(a)(2) (1960). For that liability to result in a deduction, however, the expense also must satisfy the "economic performance" and other requirements, so that the "all events" test is less interesting in the deduction context. Id. For this reason, this article focuses on the income side.

85 See generally BITTKE & LORKEN, supra note 66, 105.5.1; GERTZMAN, supra note 16, ¶ 4.03[1][a][i]; George L. White, BNA Tax Management Portfolios U.S. Income Series: Income Tax Accounting §70-3rd: Accounting Methods — General Principles ¶ IV.C.1.a.3 (2009); discussion infra notes 89 to 91 and accompanying text.

86 Restatement (Second) of Contracts §§ 224, 230 (1981) [hereinafter Restatement]. As a matter of contract law, the practical effect of the old distinction was that a party suing on a contract was required to plead and prove that "conditions precedent" were satisfied, while a defendant raised "conditions subsequent." Restatement, supra, § 224 (Reporter's Notes); OLIVER WENDELL HOLMES, JR., THE COMMON LAW 316-18 (1881), reprinted in OLIVER WENDELL HOLMES, JR., THE COMMON LAW AND OTHER WRITINGS (1982). There is a formal distinction between events that must occur for a liability to arise (roughly the old "condition precedent," now just a "condition") and events that can discharge a liability (roughly the old "condition subsequent," now with no special name). Restatement, supra, §§ 224, 230; HOLMES, supra, at 318. Using the distinction can help understand the meaning of a contract. Id. But, the distinction is irrelevant in actually deciding contract cases: If either type of event happens (or does not happen, depending upon how the requirement is drafted), there is no contract liability, period. Restatement, supra, §§ 224, 230; HOLMES, supra, at 316-318.

87 Restatement, supra note 86, § 224 (Reporter's Notes).
But all conditions are precedent . . . to the existence of the plaintiff's cause of action. . . . When a man sues, the question is not whether he has had a cause of action in the past, but whether he has one then.\textsuperscript{88}

An example illustrates the tax stakes: A high-end loudspeaker manufacturer sells only online. Consumers will not buy expensive loudspeakers without first listening to them. The manufacturer could deal with this very real problem by using either of two different contractual arrangements. In the first, the manufacturer would sell a pair of speakers to a retail customer, shipping new speakers on the day after receiving the order. Title to the speakers would pass upon delivery. The manufacturer would take the customer's credit-card information, but promise not to bill for thirty days. The customer would have thirty days to return the speakers in good condition to get full credit.

The second contractual arrangement, which involves "loaning" speakers, is slightly different: New speakers would be shipped on the day after an order is received. But in this second case, title would stay with the manufacturer. The customer would be required to return the speakers in good condition within thirty days, unless, before the end of the thirty days, it notifies the manufacturer that it wants to buy the speakers. As a consequence, the buyer would bear the practical benefits and burdens with respect to the speakers upon delivery even though legal title stays with the manufacturer. The manufacturer would keep the customer's credit-card information as security. If the customer exercises its option to buy the speakers, title would at that time pass and the credit card would be charged.

Obviously, these two arrangements are very similar. Yet, under current law, they are subject to different tax treatment. In the first, the manufacturer has gross income upon delivery (or shipment)\textsuperscript{89} of the speakers. The unconditional right of return is merely a "condition subsequent," which is not relevant to the determination of gross

\textsuperscript{88} HOLMES, supra note 86, at 317.

\textsuperscript{89} The current tax regulations give manufacturers some flexibility between reporting revenue from a sale of a good (when there is no "condition precedent" to getting paid) upon (i) delivery or (ii) shipment, so long as the method used for tax purposes also is used on the taxpayer's books and is acceptable under generally accepted accounting principles. Treas. Reg. § 1.446-1(c)(1)(ii)(C) (1960). In 1999, the SEC made clear that revenue is to be booked for financial accounting purposes upon "delivery" (when "the seller has substantially accomplished what it must do pursuant to the terms of the arrangement. . ."), Revenue Recognition in Financial Statements, SEC Staff Accounting Bulletin No. 101, 64 Fed. Reg. 68936, 17 C.F.R Part 211 (Dec. 9, 1999). This should have reduced taxpayers' tax-accounting flexibility under the regulation.
income.\textsuperscript{90} In contrast, in the second case, the manufacturer can defer the gross income. The customer's decision whether it really wants the speakers is a "condition precedent" to "all events" that fix the manufacturer's right to the income having occurred.\textsuperscript{91}

Since a 1999 S.E.C. Staff Accounting Bulletin, GAAP has treated the two contractual arrangements in this example the same: Revenue is booked only after the thirty days, when it is clear that the customer really wants the loudspeakers.\textsuperscript{92} The SEC accounting staff's view is that such transactions so closely resemble a consignment that they should have the same accounting treatment as a consignment.\textsuperscript{93}

Here, the tax law should adopt the basic approach of the SEC but take a less conservative tack: When an accrual-basis taxpayer has done what it is required to do to earn income (transferred possession of a good, performed services), a contractual "condition precedent" should not defer the income earned.\textsuperscript{94} This new rule could be adopted by Congress, although the Treasury should be able to do the same by way of regulation.\textsuperscript{95} Pending such change, the courts and the IRS should be mindful not to further expand the consequences of the merely formal distinction between a "condition precedent" and a "condition subsequent."


\textsuperscript{91} See Perry Funeral Home, Inc. v. Comm'r, 86 T.C.M.(CCH) 713, 719 (2003); Yapp Corp. v. Comm'r, 63 T.C.M.(CCH) 3155, 3156-57 (1992); Hallmark Cards, Inc. v. Comm'r, 90 T.C. 26, 32-33 (1988); Ringmaster, Inc. v. Comm'r, 21 T.C.M.(CCH) 1024, 1029-30 (1962), dismissed per curiam, 319 F.2d 860, 860 (8th Cir. 1963); Florence Mills, Inc. v. Comm'r, 9 B.T.A. 579, 583 (1927), aq. VII-1 C.B. 11 (1928); Webb Press Co. v. Comm'r, 9 B.T.A. 238, 242 (1927); Webb Press Co. v. Comm'r, 3 B.T.A. 247, 253 (1923), aq. VI-1 C.B. 6 (1927); Rev. Rul. 2003-3, 2003-1 C.B. 252. Note that "conditions precedent" can be involved in the sale of services as well as in the sale of goods. For example, an engineering services contract can provide that the work product must be satisfactory to the customer. Frequently title has not passed with respect to goods in the "condition subsequent" cases, but title passage actually represents a distinct tax issue.

\textsuperscript{92} Staff Accounting Bulletin No. 101, supra note 89.

\textsuperscript{93} Id.

\textsuperscript{94} In a sale of goods, this time also would be when the cost of goods sold is deducted, of course.

\textsuperscript{95} See generally Mayo Found. for Educ. & Med. Research v. United States, 131 S. Ct. 704, 711-14 (2011); Littriello v. Comm'r, 484 F.3d 372, 376-78 (7th Cir. 2007).
IV. Conclusion

Tax accounting frequently is arcane. But, given the amount of money involved, tax's timing rules merit real and immediate attention. Recent changes in GAAP and contract law should motivate revisiting a number of important tax-accounting rules.