IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-920

THOR POWER TOOL, CO.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

Brief of the Taxation With Representation Fund and the Tax Reform Research Group as *Amici Curiae* in Support of Respondent

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INTEREST OF AMICI CURIAE*

The Taxation With Representation Fund is a non-profit corporation organized under the laws of the District of Columbia to provide legal representation for the public interest in tax cases and to provide news and current analysis of legislative and administrative tax issues for tax

* This Brief on behalf of Amici Curiae is filed with the written consent of the parties pursuant to Supreme Court Rule 42(2). Letters of consent are on file with the Clerk of this Court.

practitioners, journalists and the public. The Fund publishes *Tax Notes: The Journal of Policy Relevant Tax Analysis*, a weekly periodical to make tax information available to the news media and public. Its Special Reports have provided policy analysis by leading tax lawyers and public finance economists of current tax issues since 1970 and its features convey news of Congress, the Internal Revenue Service and the courts. The Fund also conducts a public interest law practice on tax issues within the guidelines established by the Internal Revenue Service for public interest law firms. I.R.S. Technical Information Release 1348 (February 19, 1975). The Fund is a tax exempt charity under section 501(c)(3) of the Internal Revenue Code and has such broad public support that it qualifies as a public charity and not a private foundation under section 509(a) of the Code. The Taxation With Representation Fund was founded (under its former name Tax Analysts and Advocates) in 1970 and draws continuing public support in pursuit of the goals, including the following:

> To ensure that ordinary citizens are represented effectively when important tax decisions are made
>
> To counter the influence and power of special interest lobbies and their domination of important aspects of the tax policy process
>
> To ensure that the tax decision process respects basic canons of rational debate
>
> To present for decision by the courts important tax questions that would not otherwise be litigated. The Taxation With Representation Fund, *Description, Budget and Funding Request 1975-1980.*

The Tax Reform Research Group is a division of Public Citizens, Inc., a nonprofit corporation organized

under the laws of the District of Columbia. Public Citizen is supported by 175,000 members through $15 annual dues and is a tax exempt organization under section 501(c)(4) of the Internal Revenue Code. The Tax Reform Research Group is composed of 4 lawyers and supporting staff whose function is to work for reform of the Federal, state and local tax laws in the interest of the average taxpayer and for the improvement of the administration of existing laws. The staff lawyers of the Group have frequently testified before the House Ways and Means and Senate Finance Committees on tax legislation and have worked with various members of Congress on tax legislation. On state and local tax issues, it serves as a clearing house for information which local groups use in their efforts for tax reform. The Tax Reform Research Group was founded in 1971 by Ralph Nader.

The Taxation With Representation Fund and the Tax Reform Research Group of Public Citizen, Inc. offer this brief as *amici curiae*, within the scope of their articulated goals and within the scope of their long standing activities toward improvement of the Federal tax system and to prevent the shifting of the given Federal tax burden to ordinary citizens like the supporters of The Taxation With Representation Fund and like the members of Public Citizen. Such shifting would occur if some taxpayers avoided paying their fair share of the tax burden through abuses such as the inventory write down which petitioner herein has claimed. *Amici* here support respondent, Commissioner of Internal Revenue, in seeking affirmance of the decision of the Court of Appeals for the Seventh Circuit.

QUESTION DISCUSSED BY AMICI CURIAE

Are undervaluations of intentionally overproduced inventory binding on the Commissioner of Internal Revenue and the Courts for tax purposes merely because the valuations are reported on financial books prepared within the range of generally accepted accounting principles?

ARGUMENT

I. It is the responsibility of the Commissioner of Internal Revenue and the Courts to decide issues concerning the definition of taxable business income, including tax accounting issues. Financial books, including those prepared within the range of generally accepted accounting principles are not binding on the Commissioner or the Courts for tax purposes.

The term "tax accounting" has traditionally been applied to issues dealing with the timing of taxable business income and deductions. Timing is integral to and as important as other aspects of defining taxable income. Deferral of taxable income is as valuable to a taxpayer as are tax exclusions or drastic rate reductions.[1] Thus, it is more accurate to use the term "tax accounting" for all the tax issues in the area in which professional accountants work, that is, the determination of business income. While Congress has specified many details of taxable business income, other tax accounting issues come to the courts under such general tests that the courts have developed and relied on what amounts to a common law of tax accounting.[2] The jurisprudence defining business tax-

1. Good explanations of the importance of tax timing and the value of deferral are found in Surrey, The Tax Reform Act of 1969—Tax Deferral and Tax Shelters, 12 B.C. INC. COMM. L. REV. 307 (1971) and Andrews, A Consumption-Type or Cash Flow Personal Income Tax, 87 HARV. L. REV. 1113, 1123-1128, 1136-1139, 1181-1183 (1974). See also Cohen, Accounting for Taxes, Finance and Regulatory Purposes—Are Variances Necessary? 44 TAXES 780, 782 (1966). (Because business activity is an unending stream, a dollar of tax revenue deferred is a dollar never collected.) It is fair to say that classical analysis—and the common sense opinions based on it—significantly underestimates, the importance of tax deferral. *See e.g.*, Andrews, *supra*, 87 HARV. L. REV. at 1123.

2. Thus, for instance, the leading depreciation cases were decided under a statutory standard no more definite than that "a reasonable allowance" must be made for obsolescence or wear and tear. *Fribourg Navigation Co. v. Comm.*, 383 U.S. 272 (1966); *Massey Motors Inc. v. United States*, 364 U.S. 92 (1960). See also *United States v. Chicago, Burlington & Quincy R.R.*, 412 U.S. 401 (1973) in which the court determined the depreciable basis under a judicially controlled definition of "contribution to capital." The numerous

able income is extensive and the courts have developed an expertise commensurate with their responsibilities.

Many of the most important presumptions of the federal income tax were adopted from accounting practices. See, *e.g.*, *Jennery v. Olmstead*, 36 Hun. 536 (N.Y. Sup. Ct. 1885), *aff'd* 105 N.Y. 654, 13 N.E. 926 (1887), which is the best judicial explanation found of why unrealized appreciation is not now considered taxable income. On the other hand, some of the clearest judicial rules of tax accounting differ from the procedures which accountants require in reporting business income for financial purposes under generally accepted accounting principles.[3] It has been observed that:

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capitalization cases have been decided under the standard of section 162 allowing an "ordinary and necessary" business expense (*See, e.g., Comm. v. Tellier*, 383 U.S. 687 (1966) (where the court restricted the function of the term "ordinary" to capitalization questions)) or the term "improvement" in section 263(a). See, *e.g., Comm. v. Idaho Power Co.*, 418 U.S. 1 (1974). The leading cases defining what may be deducted under accrual tax accounting were decided under no more definite a standard than the term "accrual." *Dixie Pine Products Co. v. Comm.*, 320 U.S. 516 (1944); *Brown v. Helvering*, 291 U.S. 193 (1934); *United States v. Anderson*, 269 U.S. 422 (1926).

3. A catalogue of the major differences between financial and tax accounting is found in Cannon, Tax Pressures on Accounting Principles and Accountant's Independence, 27 ACCOUNTING REV. 419, 420 (1952); Reimer, Major Differences Between Net Income for Accounting Purposes and for Federal Income Taxes, 23 ACCOUNTING REV. 305 (1948) and the more extensive Smith and Butters, BUSINESS AND TAXABLE INCOME (1949). The Securities Exchange Commission recently adopted rules requiring increased disclosure by reporting companies of their differences between book and tax income. Securities Act of 1933 Release No. 5541 (Nov. 28, 1973). While no comprehensive measurement has been made using the new disclosures of the dollars involved in the difference between financial and tax income, partial analyses indicate that the differences are economically very significant. See 6 TAX NOTES at, *e.g.*, 16, 34, 148, 306 (General Machinery Companies), 393 (1978) (difference between statutory tax rate on financial income and actual tax rate analyzed for some industries).

Tax divergence from financial accounting is not without its critics. Thus, the National Association of Manufacturers, *amicus* here for petitioners, has lobbied before Congress to make financial accounting conclusive for income tax purposes. Statement of National Association of Manufacturers, 1 HEARINGS BEFORE WAYS & MEANS COMM. ON GENERAL REVENUE REVISION, 83 Cong., 1st Sess. at 598 (1953). A more moderate critic is Hahn, Methods of Accounting: Their Role in Federal Income Tax Law, 1960 WASH. U.L. Q. 1 (1960)(concluding that accounting, within accepted limitations, is capable of some greater utility in the administration of the income tax laws).

> "[t]he courts have zealously guarded their own power and that of the Commissioner to determine taxable income without regard to accounting rules prescribed by other . . . federal and state regulatory bodies. . . . [I]n the event of varying criteria, the Supreme Court's decision in *Old Colony R.R. v. Commissioner* left no doubt that taxable income was not to be determined by alien artists:
>
> > 'The rules of accounting enforced upon a carrier by the Interstate Commerce Commissioner are not binding upon the Commissioner, nor may he resort to the rules of that body made for other purposes for the determination of tax liability under the revenue acts.' [284 U.S. at 562]." Hahn, Methods of Accounting: Their Role in Federal Income Tax Law, 1960 WASH. U.L.Q. 1, 38 (1960).

The courts have refused to make generally accepted accounting principles binding for tax purposes because of the need for consistent, equitable and administrable tax rules. "Generally accepted accounting principles" do not provide the enforceable standards needed for the Federal Income Tax.

> "There is some reason to believe that this phrase—'generally accepted accounting principles'—suggests to the ordinary reader the existence of some authoritative code of accounting, which when applied consistently will produce precise and comparable results. The appearance of precision is strengthened by the reporting of net income in exact dollars and cents, instead of rounded approximations.
>
> "Now, we accountants know that 'generally accepted accounting principles' are far from being a clearly defined comprehensive set of rules which will insure identical accounting treatment of the same kind of transaction in every case in which it occurs.

> . . . [W]e all know that in some areas there are equally acceptable alternative principles or procedures for the accounting treatment of identical items, one of which might result in an amount of net income reported in any one year widely different from the amount an alternative procedure might produce. . . .
>
> Yet, I suspect it would come as something of a shock to some people to realize that two otherwise identical corporations might report net income differing by millions of dollars simply because they followed different accounting methods and that the financial statements of both companies might still carry a certified public accountant's opinion stating that the reports fairly presented the results in accordance with 'generally accepted accounting principles'." Eaton (former President of AICPA), Financial Reporting in a Changing Society, 104 J. OF ACCOUNTANCY 25, 26-27 (Aug. 1957).[4]

Thus, as one accountant has succinctly put it, "we [accountants] are quite prone to define 'generally accepted' as 'somebody tried it.'" Cannon, Tax Pressures on Accounting Principles and Accountant's Independence, 27 ACCOUNTING REVIEW 419, 421 (1952), *Accord,* Cox, Conflicting Concepts of Income for Managerial and Federal Income Tax Purposes, 33 ACCOUNTING REVIEW 242 (1958); Arnett, Taxable Income v. Financial Income: How Much Uniformity Can We Stand?, 44 ACCOUNTING REVIEW 482, 492 (1969).

While these variances may be acceptable for financial purposes, they are intolerable in the tax system. Two taxpayers who have identical activities in the year and identical ability to pay ought to pay the same amount of tax. Ultimately, the determination of business taxable

4. For a graphic criticism of the variability in accounting for identical companies, see Federal Trade Commission, ECONOMIC REP. ON CORP. MERGERS 120, 127-131 (1969).

income is a determination of the allocation of the given tax burden, and underpayment by one taxpayer will require the relative overpayment of tax by another. Accordingly, uniform treatment of taxpayers and uniform reporting of income is simply more important for federal income tax purposes than uniform treatment apparently is for financial purposes.

A part of the problem of variability is that accountants commonly accept errors in the determination of business income because of longstanding accounting conventions which make little or no sense for tax purposes. Accountants believe in the comparability of income statements over a series of years so that consistency of accounting methods between years has been raised to a fundamental principle. *See, e.g.,* Kieso, Mautz and Mauer, INTERMEDIATE PRINCIPLES OF ACCOUNTING, 52 (1969); Easton & Newton, ACCOUNTING AND THE ANALYSIS OF FINANCIAL DATA 134-135 (1958). Thus, if a company has followed an accounting practice consistently for a number of years, the practice becomes acceptable even though it is a serious departure from normal accounting. By contrast, the Internal Revenue Service accepts tax on non-recurring windfalls [5] that could not possibly be made comparable to a taxpayer's income in any past or future year. For tax purposes consistency between years is less important than consistency between taxpayers. Secondly, under the convention of conservatism, "accountants have generally preferred that possible errors in measurement be in the direction of understatement rather than overstatement of net income." Accounting Principles Board, Statement No. 4 *Basic Concepts and*

5. *See, e.g., Commissioner v. Glenshaw,* 348 U.S. 426 (1955); *Cesarini v. United States,* 296 F. Supp. 3 (N.D. Ohio 1969) (found property). See, Comment, Taxation of Found Property and Other Windfalls, 20 U. CHI. L. REV. 748, 753 (1953) (no policy basis to distinguish salaries and windfalls).

Accounting Principles, paragraph 171 (1970). *See also*, Sterling, Conservatism: The Fundamental Principle of Valuation in Traditional Accounting, ACABUS, No. 2, 109 (Dec. 1967). This convention, however, is questionable for tax purposes:

> "[I]t is probably safe to say that most American businessmen are now 'talking poor' except in the somewhat uncommon cases that involve rigging the statements with the hope of unloading the business on the unwary who do not themselves employ accountants to look into matters. Certainly the sharp rise in income tax burden has, among other things, had the effect of reducing what formerly was often an unbearable braggadocio. Accountants are now well equipped to resist optimism with regard to profits and value increases. Their defenses against wholesale asset write-downs are—to be charitable—spotty, and the pressures are now almost universally beating against these weak defenses. Devine, Loss Recognition, 6 ACCOUNTING RESEARCH 310, 311 (1955).

Finally, the sins of accountants can sometimes be rectified by disclosure in the footnotes to the income statement. See Myers, Footnotes, 34 ACCOUNTING REVIEW 381 (1959). For tax purposes, however, a tax return that allowed taxable income to be reported in footnotes but not in the computation of tax liability would wreak havoc upon the federal system of self-assessment of taxes.

Accounting errors, if binding for tax purposes, would result not just in random variances in tax, but in systematic deferral in the reporting of income and taxes. Underlying all of the authoritative opinions of the American Institute of Certified Public Accountants is the recognition that the financial accounts of a company are primarily the responsibility of management. Accounting Principles Board, Accounting Research Bulletin No. 43, *Introduction*, para-

graph 11 (1953). Tax rules by contrast cannot leave a taxpayer to determine his own taxes by say-so: No self-respecting people could allow their taxes to be collected on the basis of 'willingness to pay.' Moreover, whatever the responsibilities of the accountants to the general public, the accountants themselves recognize that the approval of the accountant is no barrier to the under-reporting of income. "The practicing accountant is duty-bound to assist his client in arriving at the most favorable way of measuring income for tax purposes." Cox, Conflicting Concepts of Income For Managerial and Federal Income Tax Purposes, 33 ACCOUNTING REVIEW 242, 243 (1958). "He, too, is graded at least in part on taxes—the taxes he saves for his client." Cannon, Tax Pressures on Accounting Principles and Accountant's Independence, 27 ACCOUNTING REVIEW 419, 426 (1952).

Blind adoption of financial accounts for purposes of determining tax would have the primary and immediate effect of distorting financial reporting. The possibilities of tax savings would place unbearable pressure on the accountants to change financial practices to step up deductions and defer income.[6] Since tax is usually the most important factor influencing the method of reporting income, businesses would inevitably adopt less than ideal accounting practices in order to gain tax advantage over their competitors. This would be bad for the accounting profession and bad for the tax system.

The courts have rejected financial practices for tax purposes in part in order to achieve or improve objective and administrable standards to determine business income. A mass national tax requires that the amount of taxable

6. Kurtz, Can the Accounting Profession Lead the Tax System, 126 J. ACCOUNTANCY 66, 69 (September 1968); Lent, Accounting Principles and Taxable Income, 27 ACCOUNTING REV. 479, 485 (1962).

income be defined with enough certainty to avoid endless disputes as to the amount which is owed. Thus, for instance, this Court in *Brown v. Helvering*, 291 U.S. 193 at 201 (1934) denied a deduction for an estimated expense, which an accountant would be required to accrue, because "[e]xperience taught that there is a strong probability [that the contingencies giving rise to the liability will occur]. But experience taught also that we are not dealing with certainties." The tax accounting rule avoids protracted controversy over the real likelihood of the contingency or the accuracy of the estimates. Here as elsewhere, tax accounting "is easier to administer because it involves fewer subjective judgments and estimates." Schapiro, Tax Accounting for Prepaid Income and Reserves for Future Expenses, 2 *Compendium of Papers on Broadening the Tax Base Submitted to the Ways & Means Committee*, 86th Congress, 1st Session 1133, 1142 (1959).

In sum, the Commissioner and the courts must review a taxpayer's books to determine whether the taxpayer's determination of taxable income is correct, even where the taxpayer reports the same income for financial purposes and under methods within the range of generally accepted accounting principles. Tax accounting is too important to be left to the accountants.

II. While the lower of cost or market method is an acceptable method of accounting for inventories for tax purposes, the Commissioner is not therefore bound to accept every undervaluation of inventory claimed by management.

Inventory accounting is a kind of capitalization. Inventory accounting allows a deduction for the basis of goods sold, but not for the basis of goods retained. The

rule is like the rule that a taxpayer gets tax recognition for the cost of corporate shares he sells during the year, but not for the cost of shares or other nondepreciable assets he keeps. Since it is far easier to keep track of inventory goods held at the end of the year than to identify the cost of each good as it leaves inventory, the inventory deduction—cost of goods sold—is computed by the process of elimination: Cost of goods sold equals the cost of all goods (including goods acquired and inventoried in prior years) minus the costs in inventory on hand at the close of the accounting period. Closing inventory is capitalized and everything else is deducted. For tax purposes a taxpayer wants a low value or a write down for closing inventory because that means less of his expenditures are capitalized and that more of his expenditures reduce taxable income immediately.

Capitalized costs are carried as asset accounts on the balance sheet to future years when they become an expense charged against future income. Accountants, however, are reluctant to carry costs on the balance sheet across to future income statements unless the "asset" has a value equal to the amount of the account—even if the costs relate most plausibly to future periods. Thus under the lower of cost or market method for accounting for inventory, which is the method petitioner herein used, closing inventory is written down to its net realizable value if such value is lower than original cost. As explained by the AICPA,

> "[h]istorically, managers, investors, and accountants have generally preferred that possible errors in measurement be in the direction of understatement rather than overstatement of net income and net assets. This has led to the convention of conservatism, which is expressed in rules adopted by the profession as a whole such as the [rule] that inventory should be measured

> at the lower of cost and market . . . [This rule] may result in stating net income and net assets at amounts lower than would otherwise result from applying the pervasive measurement principles [such as matching of expenses with income]. Accounting Principles Board, Statement 4, Basic Concepts and Accounting Principles at paragraph 171 (1970).

Writing down inventory assets to lower value has been criticized, especially by more academically inclined accountants, as inconsistent with the rule that unrealized gains are not taken into account,[7] and as producing undue fluctuation in income between the year of write down and the later year of sale.[8] However, as indicated by petitioner's five expert accounting witnesses at trial, the lower of cost or market is a fully acceptable method. It has the "almost unanimous support" of accounting practitioners.[9] In any event, the lower of cost or market method has been an authorized method for tax purposes since 1917 when the first inventory regulations were adopted[10] and the controversy in this case does not involve the theory of the method or its general validity for tax purposes.

However, while the lower of cost or market method is valid in theory, application of the method has been subject to tremendous abuse. The method requires determinations of the market value of inventory. Consequently, without being inconsistent with the theory of method,

7. Hoffman and Gunders, INVENTORIES: CONTROL, COSTING AND EFFECT UPON INCOME TAXES at 162 (2d Ed. 1970); Paton, dissenting from the original ARB No. 29 at point 4 (doubting that value is significant when prices are falling but deserves no notice when prices are advancing); Gilman, ACCOUNTING CONCEPTS OF PROFIT (1939) (a "heads I win, tails you lose" rule).

8. Hoffman and Gunders, *supra* note 7, at 162-163; Smith and Butters, BUSINESS AND TAXABLE INCOME at 101 (1949); Sterling, Conservatism: The Fundamental Principle of Valuation in Traditional Accounting, 3 ABACUS, No. 2, 109, 110-111 (December 1967).

9. Barden, THE ACCOUNTING BASIS OF INVENTORIES, AICPA ACCOUNTING RESEARCH STUDY No. 13 at 102. (1973).

10. T.D. 2069 (Dec. 19, 1917).

management can cheat if it wishes. Accountants themselves have recognized that determinations of value are manipulable in computing the financial income for which they are responsible.[11] It is, however, for tax purposes that the manipulations of value have become truly scandalous. These manipulations are so severe that it has been said that "if the federal government wanted to pay off the national debt and balance the budget all it needed to do was audit inventories for federal income tax purposes." Skinner, Inventory Valuation Problems, 50 TAXES 748 (1972). While this statement is undoubtedly an exaggeration, the comments of other knowledgeable observers confirm the abuse. See, B. Bittker and L. Stone, FEDERAL INCOME ESTATE AND GIFT TAXATION 843 (4th edition 1972) (income is sometimes systematically understated by deliberately low estimates of closing inventories, a practice that may become a form of fraud); Schwaigart, Increasing IRS Emphasis on Inventories Stresses Need for Proper Practices, 19 J. TAXATION 66, 69 (1963). (Note also the title of Swan & Marcus, Current Developments in Tax Accounting: Inventories (Now You See Them, Now You Don't), 28 S. CAL. TAX INST. 493 (1976).) The practice of inventory write downs in an endeavor to avoid tax liability apparently has been a practice since bookkeeping was developed in Renaissance Italy. Hoffman and Gunders, INVENTORIES: CONTROL, COSTING AND EFFECT UPON INCOME AND TAXES 146 (2d ed. 1970). In 1961 the Secretary of the Treasury testified that the President had directed the Internal Revenue Service to give increasing attention to inventory reporting as an area of tax avoidance, noting especially that closing enventory could be

11. Paton, The Cost Approach to Inventories, 72 J. OF ACCOUNTANCY 300, 303 (1941) (lower of cost or market allows management to fudge costs and doctor accounts to protect the showing of future profits by understating inventories); Husband, Another Look at Cost or Market, Whichever Is Lower, 21 ACCOUNTING REV. 115, 120 (1946) (lower of cost or market results in profit manipulation.)

manipulated by undervaluation under the lower of cost or market method. The Secretary, however, did not recommend legislation for the reason that abuses could be reached by administrative action under current law. Statement of Secretary Dillon, Hearings on President's Tax Message of Aprol 20, 1961, before the House Ways and Means Committee, 87th Congress, 1st Session, 295-96 (1961).

It is because of the history of manipulation that the inventory statute and the regulations based on it necessarily commit such a high degree of discretion to the Commissioner to approve and even prescribe closing inventory accounts and, further, require a strict standard of evidence to justify closing inventory write downs. As a general rule the taxpayer has the burden of proof in tax cases—necessarily so since the taxpayer has control of all evidence and could, in the absence of such a rule, defeat the Internal Revenue Service by withholding that evidence. Section 471, the inventory statute, goes beyond this general burden and requires that reporting of inventories must be on such basis "as the Secretary may prescribe." Internal Revenue Code of 1954, §471. As one court has observed, "The determination of the valuation of inventories, including therein all items entering into the basis, . . . is expressly confided to the Commissioner." *Montreal Mining Co.*, 2 T.C. 688, 694 (1943).

While the regulations under section 471 have not used the full statutory authority to prescribe specific closing inventory accounts for a taxpayer, they do require objective evidence of value to justify a write down below cost. Treasury Regs. §1.471-2(c) required that inventory carried at a lower than cost "market" be valued from "bona fide selling prices." "Bona fide selling price means actual offering of goods during a period ending later than 30 days

after inventory date." Treasury Regulations §1.471-2(c). The courts have routinely upheld the evidentiary requirements of the regulations. *Pierce Arrow Motor Car Co. v. United States,* 11 F. Supp. 60, 63 (Ct. Cl. 1935) (marked down sales were after close of inventory period); *Elder Manufacturing Co. v. United States,* 10 F. Supp. 125, 129 (Ct. Cl. 1925) (failure to meet evidential burden); *Melvin Goodman,* T.C. Memo 1971-226 (insufficient proof that market value was accurately reflected through annual reductions of cost price by a fixed percentage); *National Fireworks, Inc.,* T.C. Memo 1956–1 (insufficient evidence as to how inventory was valued to permit a writedown).

Certainly no case has allowed a write down of inventory on a mere opinion of management, no matter how "careful" or "experienced" management has tried to appear. Even *Space Control, Inc. v. Commission,* 322 F.2d 144 (5th Cir. 1963) and *E.W. Bliss Co. v. United States,* 224 F. Supp. 374 (N.D. Ohio 1963), *aff'd* 351 F.2d 449 (6th Cir. 1965), on which petitioner relies, while erroneously sloughing aside the requirement of showing of bona fide selling prices required by Treasury Regs. §1.471-2, still maintained a controllable standard. These cases allowed write downs only for goods identified to contracts for a fixed price; items not so identified were not allowed to generate a deductible write down.

The courts early came to the conclusion that tax write downs under estimates or conventions such as the petitioner used in this case could not be allowed for tax purposes. See T.B.R. 48, 1 Cum. Bul. 47 (1919), where in a carefully reasoned opinion the Board of Tax Advisors recommend disallowing an inventory write down using a convention for estimating and averaging value.[12] Since

12. The Board of Tax Advisers was a quasi-judicial authority which was the precedessor to the Board of Tax Appeals. See Dubroff, The United States Tax Court: An Historical Analysis, 40 ALBANY L. REV. 7, 44-45 (1975).

1919 this lead has often been followed. *See, Harry P. True,* 6 B.T.A. 1042 (1927) (inventory write-down disapproved where evidence of lower market value consisted entirely of testimony of three witnesses, two of which were associated with the firm involved); *Appeal of Otto Altschul,* 5 B.T.A. 53 (1926) (write-down disallowed where taxpayer attempted to deduct arbitrary amount from cost price); *Appeal of Kleeman Dry Goods Co.,* 2 B.T.A. 369 (1925) (write-down disallowed where market value as computed by taxpayer consisted of arbitrary percentage of cost); *Ralph Ellstrom* T.C. Memo 1955-91 (application of flat rate to finished and unfinished products did not accurately reflect market value of closing inventory).

It is because of this great potential for abuse that this Court must affirm the Commissioner's power to require as high a standard of evidence as he feels necessary, regardless of the standard which a taxpayer may feel is sufficient for bookkeeping purposes. Since inventory valuation operates in a system which generally does not allow recognition of unrealized losses, even those taxpayers who are unable to prove declines in value which have in fact occurred are not treated unjustly; they are just brought in to line with the more general rule that unrealized gains and losses are not taken into account for tax purposes until sale or abandonment.

Since the tax accounting rules are so strict, it is not surprising that inventories are commonly reported differently for tax and financial purposes. Thus, Treasury Regulations §1.471-2(f) prohibits deducting from inventory a reserve for price changes or estimates in value.

> "The restriction against the deduction of an inventory reserve is merely one specified example of the general

> policy not to allow reserves to be deducted from income.... In an early case, ... the Board [of Tax Appeals] stated . . . : 'In this instance good accounting and the statute may not be in strict accord, since Congress may with entire fairness tax what a conservative prudent businessman may wish to hold in reserve." Smith and Butters, BUSINESS AND TAXABLE INCOME, 99 (1949) quoting *Appeal of Consolidated Asphalt Co.*, 1 B.T.A. 82 (1924).

Treasury Regs. §1.471-11(c)(2)(i) specifies indirect production costs which must be included in inventory regardless of their treatment by the taxpayers in his financial report, whereas generally accepted accounting principles allow many of these costs to be expensed directly.[13]

Such differences are to be expected under the statute. Section 471 requires that the taxpayer's method "most clearly reflect income," according to the prescription of the Secretary, as well as be in accordance with "the best accounting practice." The requirement of "clearly reflect income" is neither redundant nor, given the extensive case law upholding the Commissioner's application of the standard, is it trivial. *See, e.g., Burck v. Commissioner,* 533 F.2d 768 (2d Cir. 1976); *Commissioner v. Kuckenberg,* 309 F.2d 202 (9th Cir. 1962); *Williamson v. United States,* 292 F.2d 524 (Ct. Cl. 1961); *Cole v. Commissioner,* 64 T.C. 1091 (1975) on appeal to Ninth Circuit.

In sum, "[e]ven if the accounting method used by the taxpayer is consistent with generally accepted accounting principles, it may not so clearly reflect income as to be binding upon the Commissioner." *Cole v. Commissioner,* 64 T.C. 1091, 1103 (1975), on appeal to Ninth Circuit. *See also, e.g., Mooney Aircraft, Inc. v. United States,* 420

13. Thus, for instance, Hoffman & Gunders, *supra* 7 note at 137, support direct expensing of maintenance and of vacation pay, whereas Treas. Regs. §1.47-11(c)(2)(i) requires inventorying, regardless of financial reporting.

F.2d 400 (5th Cir. 1969). To hold, as petitioner urges, that inventory accounts prepared under generally accepted accounting practices were conclusive for tax purposes would tear open the fabric of existing law for the benefit only of abuse and manipulation.

III. Petitioner's claimed write down is a special abuse case because management offered no proof to support its opinion and apparently did not itself know the value of its inventory, because the accounting convention which management adopted is self-refuting and because deduction of excess production is erroneous in theory.

Whatever the impact of this Court's decision on the law of inventory valuation, petitioner's write down of inventory in the instant case was clearly a special abuse because petitioner offered no evidence in support of management's opinion of inventory value and because petitioner's method of accounting was erroneous in result and in theory.

A. *The evidence petitioner presented to support its accounts did not go toward proof of value of its inventory and is not sufficient to protect against manipulative undervaluation*

Petitioner offered no evidentiary support for its inventory write down—or for that matter for its claimed addition to its bad debt reserve in excess of that demonstrated by historical experience [13a] —other than the testimony of man-

13a. While amici here have not briefed the bad debt issue, they take the position that a taxpayer's experience is a better guide as to the necessary bad debt reserves than its management's claims and that the Black Motor Car formula is the best administrable test, absent the most extraordinary circumstances.

agement that in its opinion the write down was justified. Petitioner did not attempt to demonstrate that the value of any parts was less than cost. In fact, any of petitioner's inventory actually sold must have been sold for a price considerably in excess of cost. These are very valuable repair parts. Petitioner holds an absolute monopoly on unique parts and each part holds the underlying power tool as a hostage.

In spite of the honorific descriptions which petitioner in its brief applied to management's opinion, still petitioner presented none of the facts from which a reasonable person could reach the determination that management's opinion was correct or even that it was well founded. Management did not even take the trouble to apply its "best estimate" (Petitioner's Brief at 11) or "careful and detailed analysis" (Petitioner's Brief at 7) or "long manufacturing experience" (Petitioner's Brief at 7) to individual items or narrow lines. Instead there was a blanket estimate of salability which was applied to every item in petitioner's inventory.[14] Management's opinion for tax purposes had no correlation to business reality since petitioner did not at any time sell or offer to sell its repair parts at the allocable market value asserted for tax purposes.[15]

Even the testimony of petitioner's President is weak support for petitioner's claims. Mr. Collins was unwilling to say anything more helpful to his position than that potential technological and market changes made it unreasonable to keep at cost as much as two year's supply of repair parts. (Petitioner's Brief at 11). He did not testify as to actual value. Since petitioner admitted that

14. See a criticism of such blanket estimates in Devine, Loss Recognition, 6 ACCOUNTING RESEARCH 310, 316 (1955). See also cases cited pp. 17-18 *supra*.

15. See *Gregory v. Helvering*, 293 U.S. 465, 469 (1935) (transactions without business purpose need not be respected for federal tax law).

it was unaware of the amount of its inventory which was sold in a year's time from its Cincinnati and LaGrange Park plants (64 T.C. at 159), it appears that petitioner simply does not know the value of much, if not all, of its inventory.

If petitioner had presented five experts in the valuation of parts or even five dealers in spare parts, instead of five expert accountants this case would have come to this Court in a different posture. Although appraisals are not conclusive nor sufficient under Treasury Regulations §1.471-2 nonetheless, the taxpayer could have at least shown a good faith effort at valuation, instead of the arbitrary procedure that it used. Petitioner's accountants have no special expertise in appraisals. Moreover, the Tax Court opinion was rendered eleven years after the taxable year in question and had taxpayer's estimates been vindicated by later experience that experience would surely have been offered in evidence.[16]

The Court is not dealing in this case with *de minimis* figures for which rough justice must be sufficient to keep the system running. Petitioner's claim is for almost a million dollars of write downs. If there was better evidence to support its opinion, then it should have been produced.

B. *Petitioner's convention for writing down inventory did not attempt to measure the value of any parts in its inventory and is self-refuting for parts sold more than a year after the write down*

Rather than attempt to determine the market value for the parts in its inventory, petitioner in its write downs under the lower of cost or market method arbitrarily labelled

16. "While subsequent events are not determinative of a fact on a given date . . . that which occurred . . . confirms what would have been reasonable at that time." *Space Controls, Inc. v. Comm.*, 322 F.2d 144, 155 (5th Cir. 1963).

some of its inventory as salable at full cost, some salable at 25 or 50 percent of cost, and some as not salable at all. Under the convention which petitioner used to generate the write down, one year's supply of parts was retained in final inventory at cost; a second year's supply was written down, half by 75 percent and half by 50 percent; anything over two year's supply was written off. The actual sales of repairs for the year of the write down defined one year's supply under the convention. Where Petitioner had two year's supply or more, the procedure had the same effect as simply keeping 1.375 year's supply worth of parts at cost and writing everything else off. Petitioner made no empirical study of salability; for every product the same 1.375 year's supply was kept at cost and the rest written off. This, despite wide variations in salability.

Under petitioner's own assumptions the convention is self-refuting for any part sold more than a year after the write down. Assuming the definition of one year's supply proved accurate, any inventory to be sold more than two years after the write down had a zero basis: when sold, its cost would have already been deducted two years before. Thus, a sale of such parts for any price would generate a gain—a gain not arising from any increase in value but solely because of the artificial deductions taken two years earlier. For parts sold within a year after the write-down, the convention would leave the parts with an average basis equal to 37.5 percent of the cost (62.5 percent average write-down) but since the taxpayer offered no evidence of any sales below costs, it would appear that even those sales would generate the gains that identify the prior artificial deductions.

Of course, most conventions can produce a correct result by accident.[17] Under the petitioner's method of

17. Even a broken watch has the correct time twice a day.

computation, if the total amount of repair parts (for any given part) ever sold were sold for an aggregate net equal to 137.5 percent of the sales of that part in 1964, then where the petitioner started with two or more year's supply the convention would, by accident, have given a value equal to the fair market value of the supply. Petitioner presented no evidence from which one can ascertain whether the convention coincidentally came out in such a fashion, but one would intuitively conclude that is extremely unlikely that annual sales would drop off fast enough to make the convention come out right.

Most importantly, however, it is apparent that petitioner's accounting convention contradicts itself because even if the sales dropped off as quickly as needed to justify the 1.375 value, petitioner would make further write offs in the following years by using the new, lower sales figure to define one year's supply. (Petitioner's Brief at 9, footnote). Thus, even when the convention could be correct, it refutes itself by redefining one year's supply.

In addition to the inventory convention for excess inventory that generated $744,000 worth of write-downs, taxpayer took "supplementary" write downs of 50 percent, 10 percent or 5 percent of inventory where it didn't even have enough information to apply the convention (64 T.C. at 159). Consequently, petitioner attempted to claim yet another $160,000 in deductions. Percentage write downs do have the advantage for taxpayer here in that they are not self-refuting as is the primary convention, but are merely arbitrary and unsupported.

C. *Petitioner intentionally produced more inventory than it thought it could sell and allowing it to deduct the overhead costs allocated to such excess inventory would be to allow petitioner a manipulable tax loss in excess of any economic loss petitioner has suffered*

Even if petitioner's management were totally accurate in its valuation and even if Thor Power's convention were not self-refuting, it would nonetheless be inappropriate to allow petitioner's write offs for overproduction of inventory. There was not necessarily any change in 1964 in the circumstances affecting the value of petitioner's inventory, other than a change in management. Whatever loss petitioner claimed in 1964 was apparently built into the inventory under petitioner's method the moment that inventory was produced, since petitioner deliberately produced the excess which it is writing off.

If writing off excess inventory were deemed legitimate for tax purposes any company could, as soon as it completed its production run of inventory parts, conclude that most were unsalable under its best estimate. The company, by allocating its production cost (including overhead) to the excess, could deduct most of its production cost while retaining its full supply of inventory for profitable sale.

To illustrate, assume that a product could be sold for $100x but that most of its cost is for overhead costs such as design, tooling, and employee training. The costs of setting up the assembly line are prohibitive if the line is closed down but once the assembly line is running then the marginal costs (supplies and labor) of the product are only $1x. Using its best estimate, the company may conclude that it can only sell 50 bushels—"a year's supply"—

of its product, but it believes that there is a 100-1 chance of selling 1250 bushels—25 years' supply within a reasonable time. Without any tax planning, the company would rationally produce 25 times more inventory than it honestly thinks it will sell in order to take advantage of the most favorable possibilities, since the cost of $1x per item is worth the 100-1 chance of recovering $100x on the sale of the last product in inventory. If writing off excess inventory were legitimate for tax purposes, then as soon at it completed its production run, the company would reasonably determine that only 1/25 of its supply was "salable" under its best estimate. The company would allocate 24/25 or 96 percent of its total cost of the product (including over head) to the excess product and write off the 96 percent. Its "method" then, would be to deduct 96 percent of its cost of the product as soon as it makes them, even though the company retains its full supply of product in inventory and expects to make money on every unit it sells. Since the company was rational in making the "excess" 24 years supply—the cost was justified by the possible but less than most likely prospects—it is improper for it to claim that the excess production is an economic loss. If such non-economic losses were recognized for tax purposes, management of many companies would inevitably always produce such excesses just to deduct the lion's share of their production costs. In any event, absent a showing here that petitioner's originally rational decision to produce the excess proved to be irrational, petitioner is not entitled to any loss deduction here.[18]

18. Treas. Reg. §1.471-2(c) authorizes a write-down to value for under the lower of cost or market for "any goods in inventory which are unsalable at normal prices . . . because of damage, imperfections, shop wear, changes of style, off or broken lots or other similar causes." Petitioner's claimed loss is not within the enumerated cases nor from "other similar causes" since the phrase refers to changes in the value of the inventory since production and not to losses such as this one inherent in the petitioner's accounting method as soon as normal inventory leaves the production line.

Carrying large entirely unsalable inventory on the balance sheet at its average cost may indeed be troublesome accounting. Perhaps most of the extra overhead costs of production could, under some future accounting practice, be assigned to the inventory reasonably expected to be sold—except that inventory is fungible and estimates of the probability of selling various quantities are a continuous function.[19] In any event, even if the salable supply—whatever that means—were to carry a higher share of the total cost, petitioner here would not be helped. Petitioner still held its salable supply that it said it needed in its closing inventory and writing off the excess supply would justify only writing off the trivial marginal costs of the excess. The overhead costs would be allocated to parts petitioner admits should not be written down and such costs would not be deducted.

In any event, as indicated by the paucity of analysis in the accounting literature, the problem of accounting for intentional overproduction of inventory is simply a problem which the accounting profession has not analyzed. Certainly it has reached no consensus on the matter. If the court were to defer to the accounting profession to solve the problem, it would be deferring to a vacuum.[20]

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19. Of course, it might be difficult to determine whether to assign the higher share of overhead costs to the first 100 units, the first 10,000 units or the first one million units.

20. *See,* Gunn, The Requirement that a Capital Expenditure Create or Enhance an Asset, 15 B.C. IND. AND COMM. L. REV. 443, 464 (1974) (criticizing the Tax Court's reliance on expert accounting testimony and accounting literature, in *Fort Howard Paper Co.,* 49 T.C. 275 at 285-86 (1967), whereas the accountants have in fact left the question open); Arnett, Taxable Income vs. Financial Income: How Much Uniformity Can We Stand? 44 ACCOUNTING REV. 482, 493 (1969) (criticizing accountants who ask for legislative changes to conform tax rules to nonexistent standards of generally accepted accounting principles).

CONCLUSION

To prevent abuse by which undervaluations of inventory relieve certain taxpayers of their fair share of the burden of tax, thus shifting their burden to others, amici respectfully urge this Court to affirm the decision below in its disallowance of a deduction for a writedown of inventory.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that on July 24, 1978, I served three copies of this Amicus Curiae Brief for the Taxation With Representation Fund and for the Tax Reform Research Group, upon each of the parties to this proceeding by depositing the same, enclosed in a sealed envelope with first class postage thereon fully prepaid, in a United States mail box at Newark, New Jersey, addressed to the attorneys for the parties as follows:

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