

# MARK-TO-MARKET AND THE WIDENING GAP BETWEEN FINANCIAL AND TAX ACCOUNTING

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## ABSTRACT

*In the wake of the recent financial meltdown, financial reporting under both North American generally accepted accounting principles (GAAP) and international financial reporting standards (IFRS) has involved renewed attention to the structures and constraints of “mark-to-market” and similar expressions of fair value accounting. Despite some significant opposition by banks and other financial institutions (and their political champions), mark-to-market has enjoyed a relatively high level of support by securities regulators and by the accounting profession. Meanwhile, mark-to-market as a tax accounting concept has recently been subjected to a sustained attack by the Internal Revenue Service, courts, and legislators. This paper examines the recent Treasury regulations, revenue rulings, court cases, legislative proposals and other legal regulatory and administrative promulgations and pronouncements that comprise this renewed opposition to mark-to-market, in an effort to identify and articulate this widening gap between financial and tax accounting in the United States. Inductive research methods include legal research and analysis, and case studies.*

**JEL:** M4, M40, M41

**KEYWORDS:** Tax accounting, fair value, mark-to-market, tax administration.

## INTRODUCTION

In the case of *Thor Power Tool Co. vs. Commissioner* (439 U.S. 522, 1979), the United States Supreme Court acknowledged that tax accounting and financial accounting are two different and separate disciplines. In that case, the notion of “lower of cost or market,” an accounting protocol that is widely used in financial accounting for inventories, was effectively abolished for tax accounting purposes. This despite the Internal Revenue Code's premise that businesses and other tax reporting entities use the same accounting principles on their tax returns as they do on their financial statements (26 USC § 446). In some ways, *Thor Power* represents the beginning of a bifurcation of the two accounting systems, and the gap between tax and financial accounting has become more obvious and more pervasive through the decades since that case was decided.

In more recent years, even as financial accounting within the United States and other countries around the world is converging into a globalized system of international financial reporting standards (IFRS), the gap between tax accounting and financial accounting in the United States is has widened even further. This paper examines the recent court cases, administrative pronouncements, and legislative initiatives that have combined to create this larger separation between these two approaches to accounting. After taking into account the history of, and scholarly literature relating to, the tension between tax and financial accounting in regard to fair value accounting, the current status of fair value accounting is considered. In particular, recent legislative, administrative and judicial developments that have combined to halt, and even reverse, the accommodation of fair value accounting within the tax arena. Finally, this paper addresses the significance and the impact of this phenomenon, and the increasing burden that it imposes on business operations as they are required to maintain sufficient books and records so that they can comply with both accounting methods.

## LITERATURE REVIEW AND BACKGROUND

The US Supreme Court was correct. There is a difference between the objectives of tax accounting and those of financial accounting. That difference, and indeed the tension between these two approaches to accounting, has been the subject matter of an ongoing conversation among academics, standard setters, and various stakeholders, for several decades. It is a technical discussion, one that resides at the nexus between two larger debates. Within the financial accounting discipline in the United States and elsewhere, there is a deliberate and gradual shift away from balance sheet reporting of historical costs, to the reporting of current or fair values. Tax accounting within the United States, on the other hand, has retained a greater adherence to the historical cost principle, and has relied upon and "all-even as test" for any determination as to whether income transactions, expenditures, or other types of transactions have been completed to the point where the pertinent gains, expenses, or other accounting consequences have been realized. As academics, professionals, standard setters and others debate these movements and the dynamics, business organizations and other reporting entities are caught in the middle. They are required to comply with both accounting regimes, and so they must continually develop and maintain information systems that properly support both.

Zielinski (1997) summarized this discourse in a law review article that emphasized the need for tax accounting to be pragmatic from the perspective of the collection of revenue. He also highlighted the need for uniform, coherent tax accounting principles: he observed, for example, that a common objection to mark-to-market accounting, for tax purposes, is that if it applies only to a subset of positions, taxpayers will gravitate to substitutes that are taxed only if transactions are completed. He recommended that, for the sake of tax administration, the virtues of consistency, acceptability, enforceability, compliance and fairness would be enhanced if Congress required that only completed transactions would have taxable impact for all taxpayers. He also acknowledged, however, that among academics and tax policy experts, the doctrine of realization has largely fallen out of favor.

If Zielinski was a proponent of uniformity, Morse (1999) has been a proponent of flexibility. For him, heavy-handed adherence to rules, such as the all-events test of the realization principle, can result in inappropriate responses on the part of tax authorities in some circumstances. His preference would be that decision-makers would be authorized to take into account a robust set of variables that would allow them to craft appropriate responses to specific situations. As Carman and Gnazzo (2003) have pointed out, the courts have occasionally done exactly that. The authors observed that in the case of *Bank One Corp. v. Comm'r* (120 T.C. 174, 2003), the Tax Court rejected the taxpayer's method of accounting for securities, but also rejected the method proposed by the IRS. A third method, proposed by the court itself, is neither a pure mark-to-market, current value approach (as favored by the taxpayer), nor a transaction-based method (as favored by the IRS). Instead, the court crafted a series of adjustments that allowed the taxpayer to avoid the severity of the preferred IRS method, while exerting some discipline over a mark-to-market approach.

Other scholars have pointed to the importance of theoretical soundness. Even though the principle of realization has historically been central to the jurisprudence of the federal income tax, it has not enjoyed a reputation for theoretical elegance or coherence, at least among academics. Geier (1998) critiqued the realization doctrine and its essential elements (known as the all-events test), and concluded that it did a poor job of matching of expenses to revenue used within a given tax year. She points out that the all-events test as adopted by the Internal Revenue Service is not really equivalent to the matching principle as used in financial accounting, but instead operates as an independent and somewhat arbitrary tax rule. In Dodge's (2006) view, the realization principle, as employed through the use of the all-events test for tax purposes, is a rule that "almost gets it right."

In the midst of this ongoing conversation about tax accounting methods and principles, Root (2000) raised the alarm about the extent to which the Internal Revenue Service has been given the power to arbitrarily require that taxpayers use specific accounting methods. She expressed concern that the anti-abuse provisions of the Internal Revenue Code have been interpreted by the courts as a broad grant of discretion to the IRS, both to determine whether an accounting method used by a taxpayer clearly reflects income, and, if the Service determines that it does not reflect income, to specify and require the Service's preferred accounting method. Her analysis of this yielding of discretion by the courts and by Congress, led her to ask where the rule of law has gone and whether and how we can get it back.

Most of the analysis and scholarship in this area has focused on the propriety and the fairness of the tax accounting methods as prescribed in some cases by Congress, and in other cases by the IRS. Fair value accounting, in particular, has been compared to transaction-based accounting in light of the overall objectives of tax administration. With the exception of a few scholars, such as Zielinski, most academics have applauded the incremental gravitation toward fair value accounting by both tax and financial accounting standard setters. This paper suggests that the graduation toward fair value tax accounting has halted, if not reversed, even as the movement toward current value accounting has continued or accelerated for financial accounting purposes, and considers the implications of the resulting gap.

#### Historical Cost vs. Fair Value Accounting

The art of accounting emphasizes objectivity, relevance, and reliability of the financial information being communicated. To that end, much attention is paid to the way assets and liabilities are measured and reported. According to the Financial Accounting Standards Board (FASB) *Concepts Statement No. 5* (1984), five attributes can be taken into account for this purpose: historical cost, current cost, current market value, net realizable value, and present value of future cash flows. Generally, historical cost refers to the amount paid to acquire an asset, and is commonly adjusted after acquisition for amortization or other allocations. Current cost is the amount that would have to be paid if the same or an equivalent asset were acquired currently. Current market value (often referred to as fair value, or market value) is the amount that could be obtained by selling an asset in orderly liquidation. Net realizable value is the amount, net of direct costs, into which an asset can be expected to be converted in the due course of business. Present value is the discounted value of net future cash inflows into which an asset can be expected to be converted in the due course of business.

The traditional measurement attribute used in financial reporting has been historical cost. The historical cost protocol results in the recording of transactions at their entry price. At the point of exchange, historical cost is equivalent to fair value because it represents the price at which a willing buyer and a willing seller would establish at the time of the transaction. Over time, portions of the historical cost of an asset are "matched" to annual revenues, through a process of depreciation or amortization. As this happens, the net book value (that is, the difference in cost and accrued depreciation or amortization) is reflected on the balance sheet of the organization even though the fair value of the asset may be different. Generally accepted accounting principles (GAAP) have for many years been guided by the historical cost principle. Historical cost has been considered reliable because it exists as a historical event that can be verified by the documentation accompanying the purchase transaction. Market values, in contrast, are often difficult to obtain accurately for many assets, and are usually temporary. Under a fair market accounting, fluctuations in market values trigger unrealized gains and losses until the asset is sold. And yet, in recognition of the shortcomings of historical cost, alternatives and exceptions to the historical cost principle have been developed for purposes of GAAP. For example, under the lower-of-cost-or-market concept, inventory can be reflected on the balance sheet at the lesser of the inventory's historical cost and market value. The reported value of certain marketable securities held by the reporting organization is also maintained at fair value. Similarly, impairments of investments and other assets are

recognized, even though this can result in a recorded value less than the original historical cost. In these specific situations, the FASB has concluded that the continued use of “true” historical cost accounting was inappropriate, because strict adherence to the historical cost principle would result in financial distortions rather than fair representations.

As described in its *Concepts Statement No. 2* (1980), the FASB has pointed to relevance and reliability as the primary qualitative accounting characteristics that distinguish more useful accounting information from less useful accounting information. In financial accounting, information is considered to be relevant when it makes a difference for investors, creditors, or other users of information as they assess future cash flows and attempt to make investment decisions, lending decisions, and other decisions in reliance upon the information. On the other hand, information is considered to be reliable when it captures how well the measure represents what it purports to represent and can be verified.

In the selection and establishment of useful accounting standards, trade-offs can occur between relevance and reliability. This tension is brought into sharp focus as the accounting profession, users of financial statements, and society in general, deliberate and debate the various advantages and disadvantages of fair value accounting as opposed to the historical cost principle. To the extent that it is determined that there is a need for greater relevance, fair value accounting is emphasized. On the other hand, to the extent that reliability and verifiability are paramount, the emphasis shifts to the historical cost principle.

## FINANCIAL ACCOUNTING’S RECENT EMPHASIS ON RELEVANCE

Over the last decade, the FASB has moved toward a more comprehensive view of the appropriateness of fair value accounting, especially for financial instruments. This evolution began in 1991 with the issuance of *Statement No. 107, Disclosures about Fair Value of Financial Instruments* (now codified at FASB ASC 825-10-50-1), whereby companies were required to disclose fair market values for financial instruments. This was followed in 1993 by *Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities* (FASB ASC 320-10-25-1), which required debt and equity securities that are available-for-sale or trading to be recorded at fair value rather than, as in the past, lower of cost or market. In 1998, *Statement No. 133, Accounting for Derivative Instruments and Hedging Activities* (FASB ASC 825-10-35-1) was issued, requiring that derivatives be recorded at fair value. Prior to that pronouncement, these activities were not reported on the balance sheet at all.

FASB *Statement No. 115* provides specific guidance for the accounting for investments such as mortgages and mortgage-backed securities. Under that standard, companies holding these types of investments are required to categorize them into three separate groups. “Hold to maturity” investments are those which the owner holds in its portfolio with no intention or compulsion to sell. Because these investments are being held long-term, temporary fluctuations in the market value of these investments are not considered to be relevant and are not taken into account. For these investments, the accounting protocol approximates that of the historical cost principle. “Trading securities” are at the other end of the spectrum. This refers to securities which the owner intends to sell or turn over on a regular basis. These investments are “marked to market” at every balance sheet date, and any gains or losses are recognized currently on the owner’s income statement. “Available for sale” securities fall within an intermediate category, and represent investments that the owner intends to sell at some point, based on operational and financial decision-making. These securities are marked to market in the same manner as trading securities, but the resulting gains and losses are not recognized through the income statement. Instead, unrealized gains and losses on these securities are recognized through a special category of shareholder equity, “Additional Other Comprehensive Income.” The reader of the financial statement can see this AOCI gain or loss on the Statement of Shareholder’s Equity.

The most dramatic fair value accounting pronouncement by the FASB, *Statement No. 157, Fair Value Measurements* (FASB ASC 820-10-35), issued in September 2006, did not actually require fair value accounting *per se*. What it did do, however, was set forth valuation protocols for those situations for which fair market value of accounting was already required via previous promulgations. A three-level hierarchy for measuring fair value is established, based on the availability of market information. For securities for which an exchange price is available, referred to as Level 1, the valuation is established at the fair value for which the security would sell at market. If there is no formal, ongoing, meeting place for exchange, *Statement No. 157* requires the use of market participant assumptions based on credible market data obtained from independent sources (Level 2). If no such credible market data can be found, the reporting entity may use its own assumptions based on the best information available in the circumstances (Level 3). These three “confidence levels,” from which these protocols are derived, have been referred to by cynics as “mark to market; mark to model; or make it up.”

As soon as *Statement No. 157* became effective, many banks and financial institutions were required to value their holdings of financial instruments. This, in turn, caused an uproar, and led to a grand debate about whether the requirements of *Statement No. 157* actually “caused” the financial crisis of 2008 and 2009, or merely “precipitated” the crisis by shedding light on problems that should probably have been disclosed years earlier. In response to this brouhaha, the United States Congress enacted the Emergency Economic Stabilization Act of 2008, which directed the Securities and Exchange Commission to research and report on the impact of *Statement No. 157* on the market. The SEC’s responsive report rejected the proposition that mark-to-market caused economic distress, but called for more clarification of the measurement rules. Despite recurrent calls for revocation of *Statement No. 157* from various corners, including some banks and a number of their supporting politicians, mark-to-market is not only here to stay; it is likely to be expanded in the years ahead.

Part of that likely expansion is related to the convergence between U.S. GAAP and the International Financial Reporting Standards (IFRS). As Fosbre, Kraft and Fosbre (2009) have observed, the movement toward global accounting standards has accelerated in recent years. IFRS also provides for a similar methodology for determining fair value, that is, for arriving at an amount equivalent to the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties, in an arm’s length transaction. Under IAS 39, quoted prices in active markets must be used as fair value when available. In the absence of such prices, the reporting entity is required to use valuation techniques and all available relevant market information so that valuation techniques maximize the use of observable inputs (International Accounting Standards Board, 2004).

Proponents of fair value accounting have argued that fair values for assets and liabilities provide more timely and more relevant information, increase transparency, and encourage promptness in the correction of financial reporting information. Despite objections that fair value accounting is not as readily verifiable as historical cost accounting, and despite concerns that current value information could be distorted by market fluctuations and inefficiencies, by overreactions to liquidity problems, and by investors’ irrationality, fair value accounting is here to stay. Both in the United States and globally, accounting standard setters are committed to an evolutionary process that will result in continued graduation from historical cost to fair value accounting for financial reporting purposes.

#### **TAX ACCOUNTING: NO “LOWER OF COST OR MARKET” INVENTORY**

Section 446 of the Internal Revenue Code (26 USC § 446) provides that taxable income “shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.” This section includes the relevant portions of its predecessor § 41 of the 1939 Code relating to methods of accounting, and provides the general rule that the regular method of accounting used in keeping the books of the taxpayer is to be used in the computation of income for tax

purposes. This establishes the premise that taxpayers need not develop an entirely different system of accounting protocols and procedures in order to comply with the income tax laws. Instead, the starting point for tax compliance is the utilization of the books and records, including the accounting methods, used for financial reporting purposes.

In fact, the Internal Revenue Code that are specifically permits the Secretary of the Treasury (and, by delegation Commissioner of Internal Revenue) to require the use of accounting methods that clearly reflect taxable income, even if those methods are not the same it as used for financial reporting purposes. But section 446 of the code also provides that if no established method of accounting has been regularly used by the taxpayer, or, if the method used does not clearly reflect income, the computation of taxable income shall be reconstructed by the Internal Revenue Service in a manner that does properly reflect taxable income. Other parts of the Internal Revenue Code requires specific accounting methods in certain situations area other rules within the code emphasized the role of the IRS in requiring the calculation of taxable income in a manner that is satisfactory to the government. Section 471 of the Internal Revenue Code (26 USC § 471), for example, provides that whenever the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the government may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

This statutory empowerment of the Commissioner of Internal Revenue as the tax accounting standard setter has been largely supported by the courts. This has been especially true since the United States Supreme Court weighed in on the matter in the in the case of *Thor Power*, mentioned above. In that case, the IRS took issue with tool manufacturer Thor Power's calculation of losses stemming from certain items of inventory -- namely, 44,000 pieces of excess merchandise, most of them spare parts and accessories. To value these items, Thor employed the "lower of cost or market" (LCM) method of inventory accounting. Under this method, the taxpayer values inventory at either cost or market value, whichever is lower. Thor put the market value of the items of excess merchandise at approximately their scrap value and thus recognized a loss on those items, which contributed to a net operating loss for the year. Meanwhile, however, Thor continued to offer the "excess" items for sale at their original prices. The Commissioner disallowed the offset on the ground that Thor's valuation of the inventory did not constitute a clear reflection of income as required by the Code. The Court agreed, concluding that the Commissioner acted within the discretion afforded by the statute in deciding that Thor's write-down of 'excess' inventory failed to reflect income clearly. In resolving the matter, the US Supreme Court held that the IRS is clearly vested with wide discretion in determining whether a particular method of inventory accounting should be disallowed as not clearly reflective of income.

In arriving at its decision, the court in the Thor Power case took note of the "vastly different objectives that financial and tax accounting have." It affirmed that notion that an accounting method that may be entirely satisfactory for book purposes may be unsatisfactory for reporting taxable income. The intent and design of § 446 was upheld by the Court: any accounting method used by a taxpayer to calculate income must render a clear reflection of income consistent with the goals of the Internal Revenue Service ... as determined by the Service.

### **MOVING AWAY FROM FAIR VALUE: THE CASE OF MMC CORPORATION**

If there has been any one area where fair value accounting is clearly called for, it has been accounting for dealers in securities, and for holders of financial instruments (for the purpose of eventually selling or liquidating them). As noted above, both IFRS and US GAAP have identified accounting for securities held for sale as one of the most obvious situations for which fair value accounting is appropriate. Indeed, as part of the Omnibus Budget and Reconciliation Act of 1993, the U.S. Congress added § 475, to the Internal Revenue Code (26 USC § 475), specifically allowing mark-to-market accounting method for

dealers in securities. As enacted in 1993, § 475 defined the term “security” to include any “note, bond, debenture, or other evidence of indebtedness.” Treasury regulations interpreting this statute provided that a debt instrument can be considered to be customer paper if (1) a person's principal activity is selling nonfinancial goods or providing nonfinancial services, (2) a debt instrument was issued by a purchaser of goods or services at the time of purchase to finance the purchase and (3) at all times since the debt instrument was issued, it has been held either by the person selling the goods or by a corporation that is a member of the same consolidated group as that person (26 CFR. § 1.475(c)-1(b)(2)).

Many taxpayers took the position that their accounts receivable that met this definition of customer paper were securities under the statute. Hence, they elected dealer treatment, and accounted for their customer paper using fair value accounting for tax purposes. Electing taxpayers determined the current value of their nonfinancial customer paper (i.e., trade accounts receivable) on hand at the end of each tax year, and recognized gain or loss equal to the resulting increase or decrease in value.

Five years later, however, Congress passed the Internal Revenue Service Restructuring and Reform Act of 1998, which modified the definition of security under § 475. Under the revised statute, “nonfinancial customer paper” was excluded from the definition of security, effectively prohibiting taxpayers from marking to market their trade accounts receivable. This was a major step backwards for those taxpayers who were using fair value accounting for both financial and tax reporting, and who were now required to essentially maintain two separate accounting systems in order to accommodate the new law.

The recent case of *MMC Corp. v. Comm’r*, 551 F.3d 1218 (10th Cir. 2009) helps to highlight the impact of this change in the tax law. MMC Corporation and its subsidiaries are in the construction services business. MMC elected in 1997 to change its method of accounting for customer paper (i.e., accounts receivable) from the face-value method to the mark-to-market method as permitted at the time by § 475 of the Internal Revenue Code. As a result of using fair value accounting for its accounts receivable, MMC reported a loss and a resulting tax deduction of \$5,349,372 on its customer paper accounts. Had it not used fair value accounting, MMC would not have been entitled to deduct these accounts until they actually became worthless. The deduction offset MMC's taxable income for 1997, thereby reducing MMC's corporate income tax liability.

Unfortunately, one year after their change to the mark-to-market method, Congress amended the tax code to prohibit mark-to-market evaluation of customer paper accounts, and MMC had to revert to their original method because of the change in the tax law. The original method, which was a face-value approach rather than a market-value approach, did not involve write-downs. The IRS was concerned that once MMC changed back to the face-value approach, the taxpayer would expect to claim an additional loss (and resulting deduction) if and when the accounts actually became worthless. To prevent these omissions and duplications, the IRS required MMC to treat the change back to the face-value approach, as a change in accounting method. Thus, in determining its income for tax years 1998 through 2001, MMC was required to account for \$ 1,337,344 in 1998, \$ 1,337,341 in 1999, \$ 1,337,339 in 2000, and \$ 1,337,338 in 2001 through four positive adjustments. These sums would, to use MMC's terminology, “recapture” the \$ 5,349,372 deduction taken in 1997 by adding it back into MMC's taxable income in increments over the four-year period.

In a sense, MMC fared well as a result of this process. The company was able to deduct over \$5 million worth of decline in value on its commercial paper in one year, and recapture that same amount over a period of four years. On the other hand, the deductions reflected the conditions of the marketplace at the time (in 1997), while the recoupment of that same income was imposed on the taxpayer irrespective of the economic conditions of the following four years. In addition, the sheer size of the difference between these two methods of accounting for this taxpayer demonstrates the significance of the change in 1998 which prohibited the use of mark-to-market for companies like MMC. In addition, as noted above, the

1998 change in the law forces companies like MMC to account for its customer paper using fair value accounting (irrespective of whether MMC is using IFRS or US GAAP), and to separately account for its customer paper using the face-value method for tax purposes.

## UNICAP AND THE CASE OF ROBINSON KNIFE MANUFACTURING COMPANY

The *Thor Power* decision by the U.S. Supreme Court permitted the IRS to preclude the use of lower of cost or market for inventories. From a computational perspective, this prohibition of fair value accounting had two effects on the books of *Thor Power*. First, write-downs of inventory, with a corresponding deduction against taxable income, were not allowed. Second, ending inventories are always kept at a higher level than would be the case if write-downs were allowed. When an ending inventory is increased, or kept at a higher level than would otherwise be the case, this reduces the cost of goods sold and serves to increase the gross profit of the taxpayer.

For a manufacturing business, “gross income” for tax purposes means the total sales, less cost of goods sold. The cost of goods sold is determined by subtracting the year-end inventory from the total inventory available during the year, so that the taxpayer excludes goods that have been sold from ending inventory. Reducing the year-end inventory thus increases the cost of goods sold and correspondingly reduces income. Cost of goods sold, or cost of sales, in turn, is the price of buying or making an item that is sold.” Over a given period, it is calculated as the dollar value of beginning inventory, plus purchases, less the dollar value of ending inventory. In short, cost of goods sold is a measure of inventory sales.

The denial of the lower of cost or market method of accounting for ending inventories, with the corresponding increase in taxable gross profits, was the idea of the IRS, and the idea culminated in the US Supreme Court decision of *Thor Power*. But it was Congress who, in 1986, added § 263A to the Internal Revenue Code. That section imposes “uniform capitalization rules,” often referred to as UNICAP, which require manufacturers to bury many of their indirect manufacturing costs into their calculations of ending inventories, or to otherwise write them off over time rather than in the year they are incurred. Under § 263A, costs capitalized under section 263A are recovered through cost of goods sold, depreciation, amortization, or by an adjustment to basis at the time the property is used, sold, placed in service, or otherwise disposed of by the taxpayer.

At the time (in 1986), Congress was acting to address what it perceived as two significant problems concerning the expense/capital expenditure boundary with respect to inventory: First, the legislature was concerned that the more flexible financial accounting rules were allowing costs that were in reality costs of producing, acquiring, or carrying property, to be deducted currently, rather than capitalized into the basis of the property and recovered when the property is sold or as it is used by the taxpayer. This produced, in the view of Congress, a deferral of taxes. Second, Congress was concerned that different capitalization rules were being applied in different circumstances, depending on the nature of the property and its intended use. Those differences could arguably create distortions in the allocation of economic resources and the manner in which certain economic activity is organized. To fix these possible problems, Congress enacted § 263A, which was an attempt to impose a single, comprehensive set of rules would govern the capitalization of costs of producing, acquiring, and holding property

The mandate to capitalize costs, such as by increasing ending inventories by absorbing a comprehensive list of overhead costs (rather than writing those costs off directly against taxable income), not only runs counter to the fair value accounting notion of lower of cost or market, but it moves tax accounting even further away from financial accounting than would otherwise be the case. These rules are designed to achieve a result that is as similar as possible to what would happen if it were administratively feasible to keep track of each individual inventory item, so that whenever an item were sold its cost basis would be known, and the taxpayer would pay income tax on the gain (or deduct the loss) from the sale of that



inventory item. Some capitalization of costs is consistent in principle with US GAAP and financial reporting generally, but not to the extent of the UNICAP rules of § 263A.

The recent case of *Robinson Knife Mfg. Co. v. Comm'r*, 2010 U.S. App. LEXIS 5693, 2010 WL 986532, 94 U.S.P.Q.2d 1045 (2d Cir. Mar. 19, 2010), serves as an example of the reach and application of § 263A. Robinson is a corporation whose business is the design, manufacture and marketing of kitchen tools such as spoons, soup ladles, spatulas, potato peelers, and cooking thermometers. In the process by which Robinson typically turns an idea into a saleable finished product, someone at Robinson comes up with an idea for a product. Robinson then decides which brand name would be best for that product, and if Robinson does not already have a licensing agreement that would permit it to use that trademark on the proposed product, it tries to negotiate one. Once Robinson has a licensing agreement in hand, it hires an industrial designer to design the product, and the trademark licensor is consulted to make sure that they agree that the designer's plans are appropriate for the brand that's involved. Robinson next contracts out the manufacturing, usually to firms in China or Taiwan, and the products are shipped to Robinson in the United States. With the products in hand, Robinson markets them under the previously selected brand name to customers, who are generally large retailers such as Wal-Mart or Target.

As part of their business, Robinson entered into trademark licensing agreements with Corning, Inc. (for the use of the Pyrex name) and Oneida Ltd. (for the use of the Oneida name). The agreements gave Robinson the exclusive right to manufacture, distribute, and sell certain types of kitchen tools using the licensed brand names. In return, Robinson agreed to pay each trademark owner a percentage of the net wholesale billing price of the kitchen tools sold under that owner's trademark. These royalty payments were calculated as a percentage of sales revenue from the licensed inventory, and were incurred only upon sale of such inventory. Robinson deducted these royalty payments to Corning and Oneida as ordinary and necessary sales-related business expenses under § 162 of the Internal Revenue Code.

The IRS had other ideas. Based on § 263A, the IRS determined that the royalty payments made by Robinson to Corning and Oneida should be added to Robinson's capital and deducted only over time, either as a separate asset, or, as part of ending inventories. As a result, the IRS denied the deduction and issued a notice of deficiency to Robinson. Robinson petitioned the Tax Court for a redetermination of the deficiency, but the Tax Court rejected Robinson's arguments. It held that, within the meaning of § 263A, the royalties directly benefitted Robinson's production activities or were incurred by reason of those activities. It also held that the royalties were not marketing costs exempt from capitalization or absorption into ending inventories.

On appeal, the Second Circuit disagreed. It noted that royalties like Robinson's in this case do not directly benefit production activities, and are not incurred by reason of the performance of production activities. It observed that Robinson could have manufactured the products, and did, without paying the royalty costs. None of the product approval terms of the license agreements referenced by the Tax Court relates to Robinson's obligation to pay the royalty costs. Robinson could have manufactured exactly the same quantity and type of kitchen tools – that is, it could have performed its production activities in exactly the same way it did – and, so long as none of this inventory was ever sold bearing the licensed trademarks, Robinson would have owed no royalties whatever. Robinson's royalties, therefore, were not, in the view of the Second Circuit court, factory overhead that was some incurred by reason of production activities, and did not directly benefit such activities. It concluded that Robinson's royalty payments were, in economic substance, nothing other than true sales-based royalties that were properly deducted currently in the same manner as advertising and other sales-related expenses. This allowed Robinson to maintain consistent accounting treatment of the royalties for both tax accounting and financial reporting.

The case of *Robinson Knife Mfg. Co.* serves as an indication that there are limits to the extent to which the IRS may recharacterize the accounting treatment of items to suit its purposes. Despite *Thor Power*, and despite broad statutory language giving the IRS the authority to require accounting methods that do not,

in its view, distort income, this case stands for the proposition that the IRS must stay within the parameters of some level of reasonableness. Nevertheless, this case also serves as an indication of the cost that must be incurred by a taxpayer if the taxpayer wishes to challenge IRS attempts to require accounting methods that run contrary to those normally used in financial accounting. In this case, Robinson had to endure an IRS audit, the assessment of an IRS deficiency, an administrative appeal within the IRS, a petition to the Tax Court, a full Tax Court proceeding, and, finally, an appeal to the US Court of Appeals for the Second Circuit. And while future taxpayers may benefit from these efforts and expenses on the part of Robinson, there is no indication that the IRS will be dissuaded from continuing its aggressive stance toward tax administration by way of accounting recharacterization.

## UNICAP FOR AUTO DEALERS

Battles over technical accounting protocols are not being waged solely within the courts. The IRS has maintained a number of administrative initiatives that comprise a comprehensive effort to avoid being drawn into the financial accounting discipline's movement toward fair value accounting. A prominent example of this effort has been the agency's stance toward auto dealers, and whether auto dealers "produce" final products in the same manner as auto manufacturers.

Typically, auto dealers sell new and used vehicles, and also sell vehicle parts. In addition, auto dealer service departments repair and install parts on vehicles owned by customers (as well as on and new and used vehicles owned by the auto dealers themselves). An auto dealership usually has both "regular" sales automobiles to retail customers, as well as "lease sales." If a retail customer prefers to lease a vehicle, the auto dealer usually leases the vehicle to the customer and simultaneously or immediately thereafter sells the vehicle, subject to the lease, to a credit financing company. To facilitate sales of new and used vehicles, an auto dealership will allow its customers to trade in their used vehicles in exchange for a reduction in the price of a new or used vehicle that the customer is purchasing from Taxpayer. If the dealership determines that a particular trade-in is not suitable for retail sale, it will sell the trade-in on a wholesale basis. The dealership will also sell, on a wholesale basis, some trade-in vehicles that it originally intended to sell on a retail basis and some vehicles that it has purchased at auction. If a customer wants to purchase a vehicle that the dealership does not have in stock (e.g., a specific model in a particular color), the dealership will arrange to acquire the vehicle from another dealership. Usually, dealers accommodate each other and sell such vehicles at the dealer's cost. Likewise, when a dealership sells new vehicles to other automobile dealers, it does so at its cost. Dealerships also sell multiple new vehicles in fleet sales.

An automobile dealership also typically has a "service" department that "repairs" automobiles, most of which involves installation of new or replacement automobile parts. Under tax accounting principles, the activities of an automobile dealership's service department would qualify as providing services to customers as well as sales of goods to customers and production of goods for sale to customers. Similarly, the law of tax accounting distinguishes between repairs and improvements and provides different treatment for each. Besides working on customer-owned vehicles, the service department also installs certain options such as air running boards, alarm systems, plow packages, towing packages, air conditioning, stereo equipment, and entertainment systems on new vehicles. Some of these options are installed prior to the sale of the new vehicle being consummated, and some are installed subsequent to the sale transaction being completed. Whether the option is installed before or after the sales transaction is completed often depends on the dollar value of the option being installed. For example, if the cost of any option is above, say, \$200, an auto dealership often will not install the option until the customer completes the sales transaction.

An auto dealership's service department also normally installs parts on used vehicles to correct defects or to make them more suitable for sale. Auto dealerships often obtain most of their used vehicles from

auction or trade-ins, and sometimes install new or replacement parts, if needed, prior to reselling the vehicles. The extent of the work done on a vehicle depends on the retail merit of the vehicle in the auto dealership's judgment. "Retail merit" in the auto industry refers to the following characteristics of the vehicle: mileage, condition, year of vehicle and amount of work required to ready for resale. Auto dealerships also sell automobile parts to automobile repair shops that install the parts in retail customers' vehicles. Other part sales are made to end users. Auto dealerships generally account for new vehicle inventory under the last-in, first-out (LIFO) method, and for used vehicles and parts inventory under the first-in, first-out (FIFO) method. Auto dealerships whose average annual gross receipts are over \$10,000,000 are subject to the uniform capitalization rules under § 263A of the Internal Revenue Code and the corresponding Treasury Regulations.

In September 2007, the IRS issued *Technical Advice Memorandum 200736026*. In that case, an auto dealership under IRS audit had been capitalizing § 263A costs to ending inventory using a self-developed method. Under this method, the dealership computed two absorption ratios, one applied to new vehicle inventory, and the other to parts inventory. The dealership capitalized additional § 263A costs to new vehicles by dividing additional § 263A costs attributable to new vehicles by current year purchases and then multiplying the result by the LIFO increment. The dealership capitalized additional § 263A costs to parts by dividing additional § 263A costs attributable to parts by current year purchases of parts and then multiplying the result by § 471 parts costs in ending inventory. The dealership included a limited amount of mixed service costs in the calculation. The dealership did not capitalize any additional § 263A costs to the used vehicle inventory.

When the dealership's service department repaired or improved dealership-owned vehicles, the costs of parts and labor are accumulated on documents called "internal repair orders." The dealership capitalized the total on the internal repair order to the inventoriable basis of the new and used vehicles. However, other than a limited amount of mixed service costs, the dealership did not capitalize any other indirect costs to new vehicles or to parts. In its TAM, the IRS concluded that when a taxpayer or a subcontractor installs parts to new and used vehicles owned by the dealership, the activities may constitute "production activities" under IRC § 263A(g)(1) and the corresponding regulations (26 CFR 1.263A-2(a)(1)(I)). The IRS also concluded that costs attributable to repair/installation activities with respect to customer-owned vehicles may constitute "handling costs" under a related regulation (26 CFR § 1.263A-3(c)(4)). Additionally, vehicles sold at wholesale, vehicles sold to another dealership at cost, leased vehicles, and some parts sales generally are not on-site sales to retail customers.

The IRS on September 15, 2009, directed its agents to suspend examination of section 263A issues for auto dealerships to encourage compliance and to allow taxpayers in the auto dealership industry an opportunity to voluntarily change their methods of accounting. The directive was issued by the heavy manufacturing and transportation industry director for the IRS Large and Mid-Size Business ("LMSB") Division. The directive is effective through December 31, 2010. The decision to suspend examination of section 263A issues was intended to allow auto dealers an opportunity to voluntarily change their methods of accounting to comply with the legal reasoning outlined in the 2007 TAM.

Taken together, these cases and administrative actions on the part of the IRS provide a clear and strong signal that the Service, and, for that matter, Congress, have no plans to join the financial accounting trend in the direction of fair value accounting. The one statutory exception, § 475 of the Code, has been trimmed to include only dealers in securities, irrespective of other types of taxpayers who rely of fair value accounting for financial accounting purposes. Manufacturers, retailers, wholesalers and many other types of taxpayers are effectively required to maintain two sets of books to account for their inventories. And whenever there is doubt about whether to rely on historical cost information, or more current fair value information, the default protocol for tax purposes is nearly always the historical cost principle.

## CONCLUSION: THE WIDENING GAP BETWEEN TAX AND GAAP

The case studies here do not constitute an exhaustive aggregation or compilation of the various initiatives by the IRS, the Congress, or the courts, as they act to widen the gap between the historical cost emphasis of tax accounting and the increasing use of fair value accounting for financial reporting purposes. But it is safe to say that these cases are representative and instructive, especially in light of other indicators of this same trend. A recent analysis by Lee A. Sheppard, published in *Tax Notes Today* (2009), provides additional evidence (derived from the remarks of IRS officials at a Tax Executives Institute meeting) of the IRS' acknowledged hesitation to embrace mark to market accounting, especially in regard to investment accounts and hedge funds. A recent Treasury Department proposal to eliminate the last-in-first-out (LIFO) inventory method, which approximates current values more closely than other inventory methods, is also indicative.

There are macroeconomic implications and microeconomic implications of this widening gap between the fair value emphasis of financial accounting and the historical cost/realization principle of tax accounting. At the macroeconomic level, standard setters for tax accounting (that is, Congress, the IRS, and of course) are insistent upon the notion that tax accounting should result in a clear reflection of income. At the same time, financial accounting standard setters (such as the FASB and the IASB) are dedicated to the continual improvement of financial accounting so that it ensures a fair representation of the economic activities of reporting entities.

These objectives are very close, even if the methodologies advocated by the respective standard setters are not. They cannot both be right, if the accounting regimes developed by each result in significantly different measures of income. A limitation of this paper is that it does not attempt to measure, at the macroeconomic level, the differing results of these two approaches to accounting. If the macroeconomic differences are very large, the theoretical underpinnings relied upon by one set of standard setters or the other, may need to be revisited. But at the macroeconomic differences are small, questions about the costs of requiring separate accounting systems, especially for tax purposes, ought to be asked and addressed. At the microeconomic level, this widening gap places an increasing burden on taxpayers, who are required to develop and maintain separate accounting information systems that will yield differing results and reports in regard to the same accounts on their books. Another limitation of this paper is that it points to, but does not attempt to measure, that burden. Although the cost of maintaining historical information, and then providing that information as needed for purposes of tax compliance, might not be severe, it has not been measured here (or, from a review of the literature, by any other researchers to date). The extraction and calculation of these costs are likely within the reach of empirical researchers, and appears to be a research opportunity for accounting scholars who would be willing to measure them.

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