INTRODUCTION

§1.01 OVERVIEW

*Black’s Law Dictionary* (7th ed. 1999) defines accounting as “The act or a system of establishing or settling financial accounts; esp., the process of recording transactions in the financial records of a business and periodically extracting, sorting, and summarizing the recorded transaction to produce a set of financial records. It is also termed financial accounting.

The American Institute of Certified Public Accountants (AICPA) has defined accounting as “the art of recording, classifying, and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character and the results therefrom.”

Understanding financial accounting is important, but financial accounting is not the same as tax accounting.\(^1\) Tax accounting issues often arise in the circumstances of your daily practice. For this reason, a fundamental understanding of the principles of tax accounting is important to your practice.\(^2\)

The tax accounting portion of the Internal Revenue Code (hereafter “Code”) is contained in Subchapter E. The topics of tax accounting regulated by the Code can also be found in many IRS pronouncements, rulings, and tax cases. The materials in this book are designed to introduce the practitioner to the tax accounting issues he will most often face in his daily practice. Accordingly, in addition to various accounting doctrines, the following topics are discussed in this book.

- The Entity’s Tax Year;
- Methods of Accounting;
- The Cash Receipts and Disbursements Method;
- The Accrual Method;
- Change in Accounting Method;
- Inventories;
- Uniform Capitalization Rules;
- Installment Sales;
- Long-Term Contracts; and
- The Domestic Manufacturing Deduction.

§1.02 FINANCIAL ACCOUNTING VS. TAX ACCOUNTING

Financial accounting governs financial reporting. Aspects of financial accounting include the preparation of balance sheets, statements of retained earnings, income statements, and financial

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1 See §1.02, below.
2 See §1.03, below.
The primary function of financial accounting is to provide useful and accurate information to those who need to use it.

Tax accounting and financial accounting are not functionally equivalent. In *Thor Power Tools Co. v. Commissioner*, Justice Blackmun addressed the distinction as follows.

The primary goal of financial accounting is to provide useful information to management, shareholders, creditors and others properly interested; the major responsibility of the accountant is to protect these parties from being misled. The primary goal of the income tax system, in contrast, is the equitable collection of revenue; the major responsibility of the Internal Revenue Service is to protect the public first. Consistently with its goals and responsibilities, financial accounting has as its foundation the principle of conservatism, with its corollary that possible errors in measurement [should] be in the direction of understatement rather than overstatement of net income and net assets. In view of the Treasury’s markedly different goals and responsibilities, understatement of income is not destined to be its guiding light. Given this diversity, even contrariety, of objectives, any presumptive equivalency between tax and financial accounting would not be acceptable.

Nonetheless, tax accounting draws on financial accounting concepts, such as the “Generally Accepted Accounting Principles” (GAAP). These concepts are often used to augment the distinctly different regime of tax accounting.

§1.03 WHY LEARN TAX ACCOUNTING?

Whether you are an attorney, an accountant, or a financial advisor, you will face circumstances in your daily practice involving matters of tax accounting.

- When advising a client as to whether his new business should be a “C” corporation, “S” corporation, partnership, or LLC, is the selection of a tax year or accounting method important to the client?
- If a client were selling property on an installment basis, would it be important to know if the buyer were a related party or if the installment obligation was contingent on future unknown factors?
- If a client’s corporation were going to make an “S” election, would it be important to know if the fiscal year of the corporation could end by a date other than December 31st?
- If your client were to start a service business that has inventory, would it be important to know under what circumstances a taxpayer would be required to “maintain inventories?”

Tax accounting has become more important as the government’s need for revenue has increased; it is largely non-political. As an observation, a change in a tax accounting rule is more likely to go unnoticed by the general public than a tax rate increase.

§1.04 TAX RECORDS MAINTENANCE

Section 6001 of the Code requires that taxpayers maintain accounting records so that they can file a correct return. The implementing regulations provide, in pertinent part:

3 43 AFTR 2d, Paragraph 79-325 (Sup. Ct. 1979).
Except as provided in paragraph (b) of this section, any person subject to tax under subtitle A of the Code...or any person required to file a return of information with respect to income, shall keep such permanent books of account or records, including inventories, as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by such person in any return of such tax or information.4

Notice by district director requiring returns statements of the keeping of records. The district director may require any person, by notice served upon him, to make such returns, render such statements, or keep such specific records as will enable the district director to determine whether or not such person is liable for tax under subtitle A of the Code, including qualified State individual income taxes….5

Sanctions and penalties may be imposed on taxpayers who fail to comply with these mandated record keeping requirements. The absence of records may be evidence of fraud or negligence.

A willful failure to keep records is a misdemeanor under Section 7203 of the Code and could be considered as an attempt to evade or defeat a tax under Section 7201 of the Code. Moreover, a taxpayer who fails to maintain records cannot use a fiscal year end.6

Under Reg. §31.6001-1(e), records must be kept for at least four years after the due date of the return or for as long as their contents may be material.

4 Reg. §1.6001-1(a).
5 Reg. §1.6001-1(d).
6 Section 441(g) & Reg. §1.441(b)(2).