Goodrich v. Commissioner, 20 T.C. 303 (1953)

When a taxpayer voluntarily changes their method of accounting without the Commissioner's consent, the Commissioner may make adjustments to prevent income from escaping taxation, including the inclusion of previously unreported income from prior years.

Summary

William H. Goodrich, an implement dealer, changed his accounting method from a hybrid cash/accrual basis to a strict accrual method without the Commissioner's permission. The Commissioner, upon accepting the change, included in Goodrich's 1949 income the accounts receivable accrued in 1948 but unreported. The Tax Court held that the Commissioner's adjustment was proper to prevent the escape of income from taxation, as the taxpayer failed to obtain the required consent for the accounting method change. The court emphasized that a voluntary change without consent subjects the taxpayer to the same adjustments as if consent had been obtained. The court also addressed the deductibility of bad debts, finding them deductible because the accounts receivable were included in taxable income.

Facts

Goodrich operated two agencies for the sale of farm implements. Prior to 1949, he used a hybrid accounting method. He reported cash sales and collections from accounts receivable, but did not report accounts receivable at the end of the year. On December 31, 1948, Goodrich had $13,812.86 in unreported accounts receivable. In 1949, without the Commissioner's consent, he switched to a strict accrual method. The Commissioner included the 1948 accounts receivable in his 1949 income. Goodrich also deducted bad debts for both 1949 and 1950, some of which related to pre-1949 accounts receivable.

Procedural History

The Commissioner determined income tax deficiencies for Goodrich for 1949 and 1950, which led to the case being brought before the Tax Court. The Tax Court ruled in favor of the Commissioner, upholding the inclusion of the previously unreported accounts receivable as income in 1949, while allowing certain bad debt deductions.

Issue(s)

1. Whether the Commissioner properly included the 1948 accounts receivable in the petitioner's 1949 income, given the unauthorized change in accounting method?

2. Whether the petitioner was entitled to deduct the bad debts in 1949 and 1950?

Holding

1. Yes, because the Commissioner’s adjustment was necessary to prevent the escape of taxable income, as the change in accounting method was made without the Commissioner’s consent.

2. Yes, because, given the court’s decision to include the 1948 accounts receivable in the petitioner’s 1949 income, the related bad debt deductions were proper.

Court's Reasoning

The court emphasized the importance of obtaining the Commissioner’s consent before changing accounting methods, as per Regulations 111, Section 29.41-2. The court held that the Commissioner could make adjustments to prevent income from escaping taxation, or to avoid the duplication of deductions. The court referenced "Gus Blass Co., 9 T. C. 15," to explain the Commissioner’s acceptance of the changed method of reporting income, and the court determined that the Commissioner could make adjustments to that year’s income, by including the amount of the $13,812.86, which represented accounts receivable accrued in 1948. The adjustment was necessary because the item was not reported by the petitioner in income for 1948. Because the taxpayer voluntarily changed the accounting method without consent, the court found that the taxpayer should be subject to the same adjustment order as one who does. The court noted that if the change resulted in a significant distortion of income, such adjustments were a common consequence. The court also found the bad debt deductions allowable because the underlying income (accounts receivable) was now subject to taxation.

Practical Implications

This case reinforces the strict requirement of obtaining the Commissioner’s consent before altering an accounting method. Taxpayers must understand that failing to do so exposes them to significant adjustments by the IRS, including the inclusion of previously untaxed income. Tax advisors need to stress the importance of following proper procedures when changing accounting methods. Furthermore, the case demonstrates that changes made without the Commissioner’s consent will be treated similarly as though consent were requested, including any adjustments related to prior periods to ensure proper taxation of income. Practitioners should carefully analyze the tax implications of any change in accounting methods to ensure that the taxpayer is not penalized for a failure to follow the proper procedures.

