31 T.C. 1157 (1959)</p>

When a taxpayer changes from the cash to the accrual method of accounting, the IRS can adjust the income in the year of change to account for items like accounts receivable and inventory that would otherwise be omitted or improperly accounted for, to clearly reflect income.

Summary</p>

In this tax court case, a partnership changed its accounting method from cash to accrual. The IRS adjusted the partnership's income for the year of the change, including collections on accounts receivable from the prior year and excluding from the cost of goods sold inventory previously deducted. The court upheld the IRS's adjustments, reasoning that they were necessary to prevent distortion of income and ensure items of income are properly taxed. The court emphasized that the cash method had previously been accepted by the IRS as properly reflecting income, and the change to the accrual method required adjustments to avoid the omission of income items.

Facts</p>

The Engineering Sales Company, a partnership composed of the petitioners, used the cash receipts and disbursements method of accounting before 1952. The partnership's income tax returns and books were examined by the IRS, which accepted the cash method. In 1952, the partnership changed to the accrual method without the IRS's express permission. The partnership did not include in its 1952 income accounts receivable existing at the beginning of the year, or the collections on such. The partnership also included in its opening inventory the full amount of inventory existing at the beginning of the year, including that which had been paid for and deducted in prior years. The IRS determined deficiencies, adjusting reported income to include collections on the opening accounts receivable and to exclude previously deducted inventory from the cost of goods sold.

Procedural History</p>

The IRS determined deficiencies in income tax against the petitioners for 1950 and 1952, based on the adjustments to the partnership's income after the change in its accounting method. The petitioners contested the IRS's determinations in the U.S. Tax Court. The Tax Court had to decide the correct treatment of accounts receivable and inventory upon a change in accounting methods from cash to accrual.

Issue(s)</p>

1. Whether the IRS properly adjusted the partnership's income for 1952 to include amounts collected on accounts receivable existing at the beginning of that year, representing sales from the prior year.

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2. Whether the IRS properly adjusted the cost of goods sold for 1952 to exclude inventory on hand at the beginning of the year, the cost of which had been paid for and deducted in the prior year.

Holding</p>

1. Yes, because under the cash method of accounting, these items had a tax status and must be considered as items of income when collected, under principles similar to that outlined in the Advance Truck case.

2. Yes, because the partnership was not entitled to effectively deduct the cost of that inventory a second time.

Court’s Reasoning</p>

The court applied Internal Revenue Code of 1939, Section 41, which stated that income shall be computed in accordance with the method of accounting regularly employed. The court found that the partnership voluntarily changed its accounting method from cash to accrual in 1952, without obtaining specific permission. The court cited cases in which courts have held that an accrual method must be used throughout in computing income without any effort to bring into account income of a prior year to prevent it from escaping taxation, and acknowledged that it does not include the authority to add to the income for the year of changeover items which were income of a preceding taxable period.

The court differentiated the instant case from those cited by the petitioners and emphasized that the cash method was adequate for prior years and that the adjustments by the IRS were reasonable. The court cited the Advance Truck Co. case, where the court stated that all items of gross income shall be properly accounted for in gross income for some year. Therefore, the court held that the IRS was correct in making the adjustments to prevent the distortion of income.

The court also considered the regulations, which stated that inventories are necessary when the sale of merchandise is an income-producing factor, and no method of accounting regarding purchases and sales will correctly reflect income except an accrual method. The court recognized that while the nature of the business had changed, the regulations did not necessarily mean that the cash receipts and disbursements method did not correctly reflect income.

Practical Implications</p>

This case highlights the importance of adhering to proper accounting methods and the potential tax implications of changing methods. Practitioners should advise clients to seek permission from the IRS before changing accounting methods, to avoid potential disputes and adjustments. The case clarifies that, when a taxpayer changes accounting methods, the IRS can make adjustments to account for income and expenses to ensure that all items of gross income are properly accounted for.

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Tax professionals should understand the potential for adjustments to opening balances when a client switches between cash and accrual accounting. The court's decision emphasizes the necessity for the accurate reflection of income and the prevention of tax avoidance when accounting methods are altered.

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