Schuster's Express, Inc. v. Commissioner, 66 T. C. 588 (1976)

A change in the manner of computing expenses does not constitute a 'change in method of accounting' under section 481 if it does not affect the timing of income or deductions.

Summary

Schuster's Express, Inc. , an accrual basis taxpayer, claimed insurance expense deductions based on estimates rather than actual expenditures. The Commissioner disallowed these deductions for the years 1968-1970 and attempted to adjust the 1968 income to include the 1967 reserve balance under section 481, arguing a change in method of accounting. The Tax Court held that the change was not a 'change in method of accounting' as it did not involve the timing of income or deductions but rather an erroneous practice of deducting estimated expenses. The court also noted that even if it were a change, the duplication was not solely caused by it, thus section 481 was inapplicable.

Facts

Schuster's Express, Inc. , a Connecticut-based common carrier, used the accrual method of accounting for its federal income tax returns. For monthly reporting, certain expenses, including insurance, were calculated using a percentage of gross receipts rather than actual costs. The difference between these estimates and actual expenditures was credited to a reserve account. The Commissioner disallowed deductions claimed in excess of actual expenditures for the taxable years ending June 30, 1968, through June 30, 1970, and sought to include the reserve balance from June 30, 1967, in the 1968 taxable income under section 481.

Procedural History

The Commissioner issued a notice of deficiency for the tax years 1967-1969, asserting deficiencies and adjustments. Schuster's conceded the disallowance of deductions for 1968-1970 but contested the applicability of section 481. The Tax Court held a trial, with the burden of proof on the Commissioner regarding section 481's applicability, and ruled in favor of Schuster's, finding no 'change in method of accounting' had occurred.

Issue(s)

1. Whether the Commissioner's adjustment of Schuster's insurance expense deductions constituted a 'change in method of accounting' under section 481?
2. If so, whether the Commissioner correctly adjusted Schuster's taxable income for the year ended June 30, 1968, by including the balance of the reserve account from the previous year?

Holding

1. No, because the change in the treatment of insurance expenses did not involve the proper timing of the deduction but rather an erroneous practice of deducting estimated expenses.
2. No, because even if there were a change in method of accounting, the duplication was not caused solely by the change, as required by section 481.

Court’s Reasoning

The court applied the definition of a ‘change in method of accounting’ from the regulations, which requires a change in the treatment of a material item that involves the proper time for the inclusion of income or the taking of a deduction. The court distinguished this case from others where the timing of the deduction was at issue, noting that Schuster’s practice did not relate to the timing but rather to the improper deduction of estimated expenses. The court also emphasized that section 481 is intended to prevent omissions or duplications solely due to a change in method of accounting, not to correct all errors of past years. The court quoted from the Fifth Circuit’s decision in W. A. Holt Co. v. United States, which supported the view that the practice was not a method of accounting but rather a method of distorting income. The court also considered the policy behind section 481, which is to prevent the permanent avoidance of income reporting, not to reach errors that distort lifetime income.

Practical Implications

This decision clarifies that a mere change in the computation of expenses, without affecting the timing of income or deductions, does not constitute a ‘change in method of accounting’ under section 481. Taxpayers and practitioners should carefully distinguish between changes that affect timing and those that involve erroneous practices. The decision limits the Commissioner’s ability to adjust income under section 481 for changes that do not solely cause duplications or omissions. Practitioners should be aware that other remedies, such as sections 1311-1314, may be available to the Commissioner to correct errors in barred years. This case may influence how similar cases are analyzed, particularly in distinguishing between timing issues and erroneous accounting practices.

