

BOOK REVIEW

The Timing of Income Recognition in Tax Law and the Time Value of Money. By Moshe Shekel. London & New York: Routledge-Cavendish, 2009. Pp. xxxv + 327. \$130.

*Reviewed by Erik M. Jensen**

American income-tax law, it has often been said, boils down to two big questions: character and timing. Do away with capital gains preferences and limitations on the utility of capital losses, and the numbingly complex Internal Revenue Code provisions aimed at preventing manipulation of character rules could disappear. Doing so might not be a good idea for other reasons—even if there were no capital gains preference, it might still be desirable to have rules disfavoring recognition of capital losses¹—but one unquestionable benefit of jettisoning the whole structure would be simplification.

In contrast, it's impossible to imagine how timing issues can ever disappear from an income-tax system. Obviously they should be minimized—all contentious issues should be minimized—but questions about when income should be recognized and when deductions should be permitted will be with us until the end of time.² And here too simplification could come at a cost. The tension between the desire for technical precision in timing rules and the desire for simplification of the tax law can't be eliminated: simpler tax laws almost inevitably mean that more abuses will be tolerated.³ Sometimes trading off simplification for abuse-prevention is

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1. That prevents using the realization rules to cherrypick losses. If capital losses could be used to offset ordinary income without limitation, the assumption is that taxpayers would disproportionately recognize losses while holding on to appreciated assets to defer gain recognition.

2. Or until the end of the income tax, whichever comes first.

3. For example, the original issue discount rules had to be enacted to ensure that what is interest economically would be treated as such for tax purposes, and to make sure that issuers and holders of obligations with OID had symmetrical treatment. *See* I.R.C. §§ 1271–1275, 163(e) (2010). But the rules were simpler before enactment of these provisions. I say that simpler rules “almost inevitably” mean that more abuse will be accepted because there is something to the argument that, if statutes (and regulations) become too detailed, and if, as a result, it becomes excessively costly to try to comply with them, excessive detail can

worth it, sometimes it's not.

Moshe Shekel has produced a prodigious piece of work on timing, the result of a major research project. Shekel is a partner in an Israeli law firm that he founded and is also a lecturer at Tel Aviv University. Few American practitioners, even in down economic times, can afford the time to write a comprehensive, comparative study, systematically pulling together the doctrine and the controversies about doctrine in three sophisticated jurisdictions—the United States, the United Kingdom, and Israel. (It's hard enough for us American lawyers to get a grasp on and critique *American* doctrine.) But that comprehensive, comparative work is exactly what Shekel has given us.

This is not a treatise, if by treatise you mean a systematic exposition of the technical rules in a format that will help a young associate trying to determine what the law of Israel or the U.K. is on a particular question.⁴ Shekel will inform you of the relevant timing rules along the way in his comparative work, but producing a hornbook wasn't his goal. This is a scholarly work about policy issues associated with timing questions—a great thing to have done, but not everyone's cup of tea.

Many American tax professionals might be skeptical about the value of such a work. Why should a practitioner care what Shekel has to say about timing issues in taxation around the globe? In particular, why should a practitioner care about policy discussions in other jurisdictions? Sure, in working on a particular transaction, she might need to know the rules in the U.K., but why should she want to go beyond that?

American practitioners should care for several reasons. For one thing, the time value of money knows no national boundaries. Second, American lawyers, who tend to be provincial (you know who you are), can learn a great deal from the practices of other jurisdictions. As I noted, the real value of Shekel's book isn't in planning transactions that cross national boundaries—we are often told how that is increasingly becoming the norm⁵—but it nevertheless behooves the American practitioner to know as much as she can about transnational taxation.

Most important is that international sensibilities make it possible to improve *American* law. American tax lawyers are engaged in public policy creation and criticism to a greater extent than their colleagues in most other

actually decrease compliance.

4. There are still some associates left, I believe.

5. This point might be overstated. Despite the constant hyping of globalization, I'm regularly struck by how many American tax lawyers have practices that include very little work with transnational implications. Still, understanding other countries' tax rules clearly helps many American lawyers.

legal disciplines in the U.S.—the relative public-spiritedness (and maybe even heroism?⁶) of the American tax bar has often been noted⁷—and learning derived from the experience of other countries can inform policy discussions in the U.S.

Indeed, the United States would be crazy not to look at what other countries are doing with timing issues. Very smart folks elsewhere are thinking about very difficult topics that are conceptually similar, and sometimes identical, to their American counterparts. Even those who are skeptical about importing ideas from other countries to interpret legal documents like the Constitution and the Internal Revenue Code should see nothing wrong with Congress's looking at the way other countries handle specific tax issues. If Congress enacts into law a principle derived from the U.K., the most Americentric among us has to treat that enactment as *the law*. Or if Congress uses policy discussions from Israel to inform its own understanding of issues, even if it ultimately rejects the learning from abroad, what is there to complain about?

To be sure, in looking to the laws of other nations, we need to be sensitive to political differences that might make importation of certain doctrines unworkable. For example, U.K. tax law is much more formalistic than its U.S. counterpart—styles of dress similarly differ—and American lawyers brandishing their substance-over-form knowledge are inclined to look down on formalism. (How, I've often heard it said, can a reasonable person not give primacy to the substance of a transaction?⁸) But formalism, as British academic John Tiley has taught us in his critical review of U.S. substance-over-form doctrine, actually has a lot to be said for it.⁹ And,

6. See Erik M. Jensen, *Aside, The Heroic Nature of Tax Lawyers*, 140 U. PA. L. REV. 367 (1991) (discussing JOHN GRISHAM, *THE FIRM*), reprinted in 54 TAX NOTES 1557 (1992). I have it on good authority, however, that the title of this piece might not have been intended to be taken literally.

7. See, e.g., Robert W. Gordon, *The Independence of Lawyers*, 68 B.U. L. REV. 1, 48, 58–59 (1988) (noting role of tax bar in fighting to create a clean Internal Revenue Code); Robert W. Gordon, *Corporate Law Practice as a Public Calling*, 49 MD. L. REV. 258, 274 (1990) (noting that the “tax bar . . . often has pushed for reforms of the tax code against the interests of many of its corporate clients”). But see David M. Schizer, *Enlisting the Tax Bar*, 59 TAX L. REV. 331, 369–70 (2006) (arguing that tax advisors have an incentive to do no more than the minimum to avoid penalties, and, indeed, “the tax bar is highly motivated to undermine the effectiveness of [the disclosure] effort” through, for example, interpreting “reportable transaction” hypertechnically and burying the government in paper).

8. The controlling doctrine in U.S. tax law, however, is not that substance always controls over form. It is that substance controls unless form does. See BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* ¶ 4.3.3 (3d ed. 1999).

9. See John Tiley, *Judicial Anti-avoidance Doctrines: The US Alternatives*, 1987 BRIT. TAX REV. 180; John Tiley, *Judicial Anti-avoidance Doctrines: Some Problem Areas*, 1988 BRIT. TAX REV. 63; John Tiley, *Judicial Anti-avoidance Doctrines: Corporations and*

even if we ultimately come out on the side of a relatively substance-driven system, we should know the benefits of a more formalistic one.¹⁰

Timing issues, the subject of Shekel's book, might initially seem to have little potential for chauvinistic exhibitions, but they can creep in. Although he understands quite well that financial accounting and tax accounting serve different purposes,¹¹ one of Shekel's ultimate arguments is that tax systems should adhere, as much as possible, to generally accepted accounting principles (GAAP):

[A]lthough following GAAP with regard to the timing recognition of income and liabilities for tax purposes may result in some untaxed economic advantages in contradiction of tax values, attempts to prevent such untaxed economic advantages by deviating from GAAP and transforming "liabilities" into "income" using tax accounting (created in ad hoc rulings of the courts) might violate other tax values.¹²

Conclusions, 1988 BRIT. TAX REV. 108.

10. We should also understand how differences between political systems might make formalism more workable in one system than another. A parliamentary majority can act relatively quickly to change formal rules to deal with newly discovered abuses. One reason that extra-statutory, anti-abuse doctrines developed in the U.S. is that Congress can be slow to react. When a new form of abusive tax behavior is discovered, judges are forced to wonder, in effect, whether Congress would have blessed particular behavior that seems to comport with statutory requirements, but that gives rise to results that are too good to be true. For the last decade or so, Congress had considered codifying an economic substance doctrine, to give one judicially created anti-avoidance doctrine a statutory boost, and codification finally occurred in the recent healthcare legislation. See Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409, 124 Stat. 152 (replacing the former I.R.C. § 7701(o), now appearing as I.R.C. § 7701(p) (as amended in 2010), with a new provision entitled "Clarification of Economic Substance Doctrine," generally effective for transactions entered into after the date of enactment). Resistance to codification had come in part from those fearful that codification might limit the flexibility, and therefore the utility, of the doctrine. See Erik M. Jensen, *The US Legislative and Regulatory Approach to Tax Avoidance*, in *COMPARATIVE PERSPECTIVES ON REVENUE LAW: ESSAYS IN HONOUR OF JOHN TILEY* 99, 114 (John Avery Jones et al. eds., 2008). As it is, Congress defined "economic substance doctrine" by reference to the common law, see I.R.C. § 7701(o)(5)(A) (as amended in 2010), but "clarified" the doctrine by requiring that both a meaningful change in the taxpayer's economic position and a substantial non-tax purpose exist for "any transaction to which the . . . doctrine is relevant." I.R.C. § 7701(o)(1) (as amended in 2010).

11. See *Thor Power Tool Co. v. Comm'r*, 439 U.S. 522 (1979) (describing the different purposes of financial and tax accounting in concluding that, just because a write-down in the value of inventory might be appropriate for financial accounting purposes, it is not permissible under the income-tax system until a realization event has occurred).

12. SHEKEL at xxxiv.

But—here’s the chauvinism—GAAP rules are not the same throughout the world. Shekel has to distinguish (as must we) between US-GAAP and IAS (International Accounting Standard) GAAP. Although the United States is fighting a rearguard action on this one—the international market will inevitably force U.S. accounting principles to follow international norms—the U.S. has been resistant. We don’t generally accept the generally acceptable, as proponents of the metric system know.

You’ve waited long enough and here—finally!—are some examples of the substantive issues Shekel addresses: such things as the timing of recognition of income from deposits and advances—an accrual-basis taxpayer gets something but might not be permitted to keep it—and the timing of deduction for future expenses.¹³ How and when should a taxpayer take into account an obligation that will be satisfied only in the future?

On these timing issues, Shekel focuses on what he calls the Collection Question and the Quantification Question—that is, questions of when and how much.¹⁴ Assume accrual-basis taxpayer *A* with a calendar-year taxable year has earned income according to GAAP rules on April 1, 2010, but is not actually to receive payment until April 1 of the following year—and then with no provision for interest to take account of the passage of time. *A* clearly has income at some point. But when and in what amount?

Requiring *A* to recognize the entire amount yet to be received on April 1, 2010, would overstate his income in real terms: the present value on April 1, 2010, of \$1000 to be received in a year is less than \$1000. Furthermore, because the two times straddle the end of a taxable year, the tax liability on the amount earned, if it has to be reflected in taxable income, might even have to be paid before the amount is actually collected. Should we instead discount the amount of income in 2010 and, if so, how—and when—do we treat the additional amount that will eventually be received? Or should *A* not be treated as having income at all until 2011, even though that result would clearly be inconsistent with financial accounting? Those are serious issues, addressed differently by different tax regimes, and with no clearly right answers. (There are, however, clearly wrong ones. For example, no one could reasonably conclude that income should be recognized only in 2011 in the amount of the present value

13. I have written on some of these issues, and Shekel kindly cited my work. See, e.g., Erik M. Jensen, *The Deduction of Future Liabilities by Accrual-Basis Taxpayers: Premature Accruals, the All Events Test, and Economic Performance*, 37 U. FLA. L. REV. 443 (1985); Erik M. Jensen, *The Supreme Court and the Timing of Deductions for Accrual-Basis Taxpayers*, 22 GA. L. REV. 229 (1988).

14. SHEKEL at 1.

discounted to 2010.)

The shorter the time between the two events, the less serious the problem, of course. And if the time is sufficiently short, everyone would agree, I think, that we can safely ignore the issues altogether (except, perhaps, for the end-of-year straddling). With longer time periods involved, however, a simple answer may make things, well, simpler, but at a technical cost.

Similar questions arise from the payor's standpoint in the above transaction. Let's assume payor *B* is an accrual-basis taxpayer, and the expense is ordinary and necessary in character. When should the deduction be taken and in what amount? For a time in the United States, it was thought that the controlling rule (a liability could be deducted when all events had occurred that fixed the obligation, and the amount could be determined with reasonable certainty) permitted an accrual-basis taxpayer to deduct the full face amount of a future obligation, regardless of when the obligation would be satisfied.¹⁵ An obligation to pay \$1000 in twenty years could have generated a \$1000 deduction at the time the obligation was incurred, a nonsensical result. That led Professor Alan Gunn famously to remark that, if that in fact were the law, "well-advised accrual-method businesses should cancel their liability insurance and run down pedestrians at the rate of at least one a year."¹⁶ Run a guy down today, deduct the full amount of the tort liability that might not have to be satisfied for years, and use the tax savings to cover the liability and a lot more.¹⁷

Another example reflects similar questions of when and how much: *C* receives an advance or deposit that, under financial accounting standards, is not required to be included in income currently because it might have to be returned. Income, if it is to be recognized at all, occurs when the recipient's right to keep the funds becomes sufficiently clear. *C* nevertheless has the dollars in hand and can make use of them (always subject to the risk of repayment, however). U.S. doctrine generally requires recognition of income before GAAP would treat the amounts as financial income.¹⁸ That has some sense to it because of the taxpayer's control over

15. *E.g.*, *Ohio River Collieries Co. v. Comm'r*, 77 T.C. 1369 (1981) (permitting current deduction for undiscounted amount of future reclamation obligation).

16. Alan Gunn, *Matching of Costs and Revenues as a Goal of Tax Accounting*, 4 VA. TAX REV. 1, 26 (1984).

17. The now generally applicable rules require that, in addition to satisfying the all-events test, the taxpayer may take a deduction no earlier than the occurrence of "economic performance." See I.R.C. § 461(h) (2010). Those rules often defer deductions (and can never accelerate them). And economic performance for a tort liability would occur only as payments are made, thus deferring the deduction (and destroying Gunn's tongue-in-cheek business strategy). See I.R.C. § 461(h)(2)(C) (2010).

18. See *Auto. Club of Michigan v. Comm'r*, 353 U.S. 180 (1957); *Am. Auto. Ass'n v.*

the funds. In that case, deferring the time of recognition would have the effect of *understating* the amount of income.

With common fact patterns like those, a lot of dollars can be at stake. Shekel concludes that none of the three countries adequately deals with the Collection and Quantification Questions, and he presents his own theoretically sophisticated proposal, the Saving of Financing Costs (SFC) model. I'm not going to print it here, in part because I'd have to use a formula, and Greek letters make me nervous.¹⁹ Nevertheless, although I've been told that reviews aren't supposed to tell how a book ends,²⁰ a brief summary of the underpinnings of the SFC model is appropriate.

The SFC model seeks to measure the benefits associated with the difference between the time of "cash flows" and the time that income or expense is recognized. For example, to the extent a taxpayer is not required to recognize income on receipt of a deposit, but is required to return the deposit with adequate interest, the taxpayer has received no economic benefit from the arrangement. In contrast, if the taxpayer has use of the deposited funds and the deposit must be returned without interest, the taxpayer has received a clear economic benefit, which can be measured by looking to comparable financing mechanisms. A similar analysis would apply on the liability side: compare the time the liability is taken into account with the time it must be satisfied.²¹ If the taxpayer benefits from the timing gap—again the analysis would take into account interest in comparable financing transactions—that benefit should be relevant for tax purposes. I wouldn't like having to explain all of this in a basic federal income tax class, but the model is grounded in good sense.

In his analysis, Shekel has striven to take into account not only technical issues, but how the result comports with other tax values like equity, neutrality, certainty, efficiency, and so on. Getting one issue "right" in a way that undermines other tax values is hardly a victory. One value of the SFC model is that it would preserve GAAP;²² we wouldn't have to start from scratch in implementing the SFC model.

Shekel devotes substantial time to describing debates in the

United States, 367 U.S. 687 (1961); *Schlude v. Comm'r*, 372 U.S. 128 (1963); *see also* Rev. Proc. 2004-34, 2004-1 C.B. 991 (permitting limited deferral for advance payments in some circumstances). *But see* *Comm'r v. Indianapolis Power & Light Co.*, 493 U.S. 203 (1990) (not requiring utility company to treat security deposits as income).

19. I don't like fraternities.

20. *C.f.* YOGI BERRA, *THE YOGI BOOK: "I REALLY DIDN'T SAY EVERYTHING I SAID!"* 97 (Workman Publishing Company 1998) (the comic-book reading Yogi Berra asking his roommate, Bobby Brown—later *Dr. Bobby Brown*—how the medical text Brown was studying came out).

21. *See* SHEKEL at 196–97.

22. *See id.* at 196. As noted, however, GAAP isn't universally accepted.

academic and professional literature, such as the debate about the matching principle (or the lack thereof) in American tax law.²³ Some think the matching principle is fundamental. Others think no “principle” is involved at all. I was astonished at how familiar Shekel is with the American literature on timing issues, and how useful the book therefore is as a research resource. (I cannot claim the same familiarity with U.K. and Israeli sources, but I have no reason to think he has not been equally punctilious in his research there.) Those of us who feed on controversy, even on mundane subjects like matching, like to read about controversy.

The Timing of Income Recognition is competently written, but at times the sledding is heavy. That isn’t really a criticism. Shekel deals with issues that can be made simpler, but not simple. The reader needs to concentrate. (That’s probably the case with articles elsewhere in this journal as well.) And I have to admit that I did not understand all of the nuances of Shekel’s argument on first reading. That’s not a criticism either.²⁴ I intend to refer to the book regularly, and I expect to learn something each time.

Shekel does provide more than I wanted to know about some accounting practices. In most respects, that’s my problem, not his. I admire those who do want to know so much. And we certainly cannot ignore accounting issues in tax law. But we do need to remember that tax law is not only about accounting, nor is it the province only of accountants. Whatever the rules are, tax advisors need to act appropriately.

Some recent scholarship has emphasized the critical role tax lawyers should play as *lawyers* in curbing abusive behavior—not because anything in Circular 230, which sets out the standards professionals have to meet to practice before the Internal Revenue Service,²⁵ or any other set of professional-responsibility rules applies, but because behaving responsibly and exercising good judgment are part of being a lawyer. Professor Linda Beale, for example, has argued that “the basic opinion practices [of Circular 230] (e.g., thorough consideration of law and facts, rejection of unrealistic assumptions) are not substantially different from that which has traditionally been considered good lawyering.”²⁶ In particular, Tanina

23. *See id.* at 63–65.

24. Here’s a real criticism: I wish Shekel, his editors, and the proofreaders had been more careful in avoiding typos and transcription errors. For example, Shekel gets some names horribly wrong. Michael Graetz comes out as Michael Grates in a place or two (although it is right elsewhere in the book). Professor Graetz is great, of course, but he does *not* grate.

25. 31 C.F.R. § 10. Rules governing practice before the IRS effectively become rules of tax practice more generally.

26. Linda M. Beale, *Tax Advice Before the Return: The Case for Raising Standards and Denying Evidentiary Privileges*, 25 VA. TAX REV. 583, 619 (2006).

Rostain has argued that tax lawyers who have moved to accounting firms, which are technically not permitted to practice law,²⁷ might be less inclined to view themselves in a professionally appropriate way.²⁸

That scares me. I'm not sure it's true, but it's a troublesome point. Get too immersed in the details, get too hypertechnical in your reading of authority, get too focused on accounting doctrines, and you might forget the larger picture.

So let's not overdo the reliance on accounting and accountants. But that's a highfalutin point that hardly is central to what is really a fine book, worth dipping into again and again. Besides, if you buy it for professional purposes, you should get a large deduction.²⁹ To determine when you can take the deduction, however, and for what amount, you'll need to study *The Timing of Income Recognition* first.

27. What they do, however, often looks a lot like law practice.

28. See Tanina Rostain, *Sheltering Lawyers: The Organized Bar and the Tax Shelter Industry*, 23 YALE J. ON REG. 77, 120 (2006). On a related point, Peter Canellos has contended that, although many shelter "professionals" have been lawyers, they have not adhered to standards that guide lawyers generally: "The tax shelter professional is a different breed, by experience, temperament, reputation, and calling. . . . Tax shelter practitioners tend to be specialists rather than generalists and often suffer from the specialist's lack of judgment." Peter C. Canellos, *Tax Practitioner's Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and in Tax Shelters*, 54 SMU L. REV. 47, 56 (2001); see also Schizer, *supra* note 7 (discussing lawyerly failings).

29. I'm assuming authority exists for currently deducting a capital expenditure.