The Timing of Income Recognition in Tax Law and the Time Value of Money

Moshe Shekel
Contents

Table of Cases xiii
Table of Legislation xxvi
Table of Secondary Legislation xxx
Abstract xxxiv
Dedication xxxvii
Acknowledgments xxxviii

1 Introduction 1

2 Accounting background 4

2.1 The purpose of financial accounting and the concept of prudence 5
2.2 The distinction between income, revenue and gains 5
2.3 Revenue recognition 5
   2.3.1 The accrual basis 5
   2.3.2 The realization principle and the earned requirement 6
   2.3.3 Revenue recognition from real estate sale contracts 8
   2.3.4 Future development of an alternative conceptual framework 8
2.4 Expense recognition 9
   2.4.1 Provisions 10
   2.4.2 Contingent liabilities 10
   2.4.3 The difference between provisions and contingencies 11
   2.4.4 The methods for measuring liabilities 11
2.5 Advances and deposits 11
   2.5.1 GAAP treatment of deposits 11
   2.5.2 GAAP treatment of advances 14
2.6 Accounting background – summary and comments 15
3 Tax values

3.1 General tax values 17
   3.1.1 Principle of non-erosion of capital 17
   3.1.2 Principle of equity 18
   3.1.3 Principle of neutrality 18
   3.1.4 Principle of certainty 18
   3.1.5 Principle of efficiency 19
   3.1.6 Principle of preventing unjust tax advantages 19
3.2 The time value of money theory 19
3.3 Tax values relevant to the question of timing – summary and comments 20

4 Between GAAP and fiscal accounting

4.1 The Dualistic Doctrine and the Singular Doctrine 23
   4.1.1 The Dualistic Doctrine 23
   4.1.2 The Singular Doctrine 24
   4.1.3 The practicable approaches 25
   4.1.4 The practicable approaches – advantages and disadvantages 26
4.2 The reporting methods 26
   4.2.1 The accrual basis method 27
   4.2.2 The cash basis method 27
   4.2.3 Hybrid methods 28
   4.2.4 The various methodologies and the Singular and Dualistic Doctrines 28
4.3 Between GAAP and fiscal accounting – UK tax law 29
   4.3.1 Legislation 30
      4.3.1.1 The “true and fair view” criteria 31
      4.3.1.2 “Subject to any adjustment by law” deviation 32
   4.3.2 The case law 32
   4.3.3 Administrative directives 36
   4.3.4 Comments 38
4.4 Between GAAP and fiscal accounting – US tax law 38
   4.4.1 Legislation 39
      4.4.1.1 Flexibility relating to reporting methods 39
      4.4.1.2 The “safety regulator” – the exception of “clearly reflect income” 40
      4.4.1.3 Statutory stipulations regarding the cash basis method 41
4.4.1.4 Statutory stipulations regarding the accrual basis method 42

4.4.1.5 Statutory provisions regarding reporting of special transactions 44
   4.4.1.5.1 Installment sales 44
   4.4.1.5.2 Recognition of income deriving from long-term contracts 47
   4.4.1.5.3 Short-term obligations issued at a discount 50

4.4.1.6 Hybrid methods 50

4.4.1.7 Tax legislation as a tool for applying the Dualistic Doctrine 51

4.4.2 The case law 52
   4.4.2.1 Stipulations imposed on the cash basis method 53
   4.4.2.2 Stipulations imposed on the accrual basis method 55
   4.4.2.3 The "exception" of IRC§446(b) 58
      4.4.2.3.1 Support for the Singular Doctrine 58
      4.4.2.3.2 Support for the Dualistic Doctrine 59
      4.4.2.3.3 The broad interpretation of IRS powers 60
      4.4.2.3.4 Adopting the Consistent Selective Approach 62
   4.4.2.4 The "divorce" of tax accounting from GAAP 62

4.4.3 Administrative directives 63

4.4.4 Comments 63

4.5 Between GAAP and fiscal accounting – Israeli tax law 65
   4.5.1 Legislation 66
      4.5.1.1 Flexibility relating to reporting methods 66
      4.5.1.2 Statutory provisions regarding reporting of special transactions 67
         4.5.1.2.1 Recognition of income in the case of cessation of business 67
         4.5.1.2.2 Recognition of non-recurring and exceptional income 68
         4.5.1.2.3 Recognition of contractors' income 68
         4.5.1.2.4 Recognition of income from rental 71
         4.5.1.2.5 Recognition of income from premiums by insurance companies 72
         4.5.1.2.6 Recognition of income from exchange rate differentials 72
         4.5.1.2.7 Recognition of capital gains 73
      4.5.1.3 Silence on the part of the legislature 73
4.5.2 The case law 73
4.5.3 Administrative directives 74
4.5.4 Comments 75
4.6 Between GAAP and fiscal accounting – summary and comments 75
   4.6.1 The effect of the Proportionality Principle 78
   4.6.2 Criticism of the Singular Doctrine 79
      4.6.2.1 Limitations of GAAP 79
      4.6.2.2 Possible erosion of tax values 80
   4.6.3 Criticism of the Dualistic Doctrine 80
      4.6.3.1 The ethical consideration 81
      4.6.3.2 The practical consideration 82
   4.6.4 The proper balance 84
      4.6.4.1 As to form (the means) 85
      4.6.4.2 As to content (the Proportionality Principle) 85

5 Timing of recognition of income from deposits 87
   5.1 The Loan Approach and the Income Approach 87
      5.1.1 The Loan Approach 87
      5.1.2 The Income Approach 88
   5.2 Timing of recognition of deposits as "income" – UK tax law 88
      5.2.1 The case law 89
      5.2.2 Administrative directives 90
   5.3 Timing of recognition of deposits as "income" – US tax law 91
      5.3.1 The case law 91
         5.3.1.1 The timing question of income from a deposit 92
         5.3.1.2 The deposit classification question – former case law 93
         5.3.1.3 The deposit classification question – the City Gas case 97
         5.3.1.4 The deposit classification question – the IPL case 98
         5.3.1.5 The deposit classification question – later cases 99
      5.3.2 Administrative directives 105
      5.3.3 Comments 106
Contents

5.4 Timing of recognition of deposits as "income" – Israeli tax law 108
   5.4.1 The case law 109
   5.4.2 Administrative directives 110
   5.4.3 Comments 110

5.5 Timing of recognition of income from deposits – summary and comments 110
   5.5.1 Criticism of the Loan Approach 111
   5.5.2 Criticism of the Income Approach 112

6 Timing of recognition of income from advances 114

   6.1 The Deferral Approach and the Advance Approach 114
      6.1.1 The Deferral Approach 114
      6.1.2 The Advance Approach 114
   6.2 Timing of recognition of income from advances – UK tax law 115
      6.2.1 The case law 115
      6.2.2 Administrative directives 120
      6.2.3 Comments 120
   6.3 Timing of recognition of income from advances – US tax law 120
      6.3.1 Legislation 121
      6.3.2 The case law 122
         6.3.2.1 The Claim of Right Doctrine 123
         6.3.2.2 Other early case law (prior to the trilogy) 126
         6.3.2.3 The trilogy 128
         6.3.2.4 Post trilogy cases 129
      6.3.3 Administrative directives 132
      6.3.4 Comments 135
   6.4 Timing of recognition of income from advances – Israeli tax law 143
      6.4.1 The case law 143
      6.4.2 Administrative directives 144
      6.4.3 Comments 144
   6.5 Timing of recognition of income from advances – summary and comments 145
      6.5.1 Criticism of the Deferral Approach 145
      6.5.2 Criticism of the Advance Approach 146
7 Timing of the deduction of future expenses

7.1 The certainty level question and the time gap question 151
   7.1.1 The certainty level question 151
   7.1.2 The time gap question 152
   7.1.3 Compatibility to the timing recognition of income 152
7.2 Timing of deduction of future expenses – UK tax law 153
   7.2.1 The case law 154
      7.2.1.1 The required degree of certainty 154
      7.2.1.2 The time gap question 156
   7.2.2 Administrative directives 157
   7.2.3 Comments 157
7.3 Timing of deduction of future expenses – US tax law 158
   7.3.1 Legislation 158
   7.3.2 The case law 160
      7.3.2.1 The required degree of certainty 160
         7.3.2.1.1 Rejection of the Accounting Certainty Degree 160
         7.3.2.1.2 The distinction between cash liabilities and other liabilities 161
         7.3.2.1.3 Adopting the High or the Absolute Certainty Degree 162
      7.3.2.2 The time gap question 165
         7.3.2.2.1 Support for the Full and Immediate Deduction Approach 166
         7.3.2.2.2 Support for the Deferred Deduction Date Approach 166
         7.3.2.2.3 Support for the Partial Deduction Approach 167
   7.3.3 Administrative directives 169
   7.3.4 Comments 170
7.4 Timing of deduction of future expenses – Israeli tax law 173
   7.4.1 The case law 173
      7.4.1.1 The required degree of certainty 174
      7.4.1.2 The time gap question 175
   7.4.2 Comments 175
7.5 Timing of deduction of future expenses – summary and comments 175
   7.5.1 Criticism of relying on the Accounting Certainty Degree 177
7.5.2 Criticism of the Full and Immediate Deduction Approach 178
7.5.3 Criticism of the requirement of the High or the Absolute Certainty Degree 180
7.5.4 Criticism of the certainty requirement in correlation with the Income Approach and the Advance Approach 184

8 Alternative models

8.1 The Comparative Value Taxation model ("The CVT model") 188
8.1.1 The CVT formula 190
8.1.2 The base transaction (BT) 192
8.1.3 The finance transaction (FT) 193
8.1.4 Date of taxation under the model 194
8.1.5 Waiver of the certainty requirement 195
8.2 The Saving of Financing Costs Taxation model ("The SFC model") 196
8.2.1 The SFC ("multipart") formula 198
8.2.2 The SFC ("simple") formula 200
8.2.3 The benefit according to the SFC formula 200
8.2.3.1 The benefit according to the "multipart" SFC formula 201
8.2.3.2 The benefit according to the "simple" SFC formula 202
8.2.4 The model and the irrelevance of taxation on the "uses" 203
8.2.5 The model ignores the "losses" in deferring receipt of earned income 204
8.2.6 The SFC model and erosion of tax 206
8.2.7 Date of taxation under the SFC model 207
8.2.8 The model compared to the Loan and the Income Approaches 208
8.2.9 The model compared to the Deferral and the Advance Approaches 209
8.2.10 The model compared to the timing requirements for recognition of expenses 210
8.3 Selecting one of the two models 212
8.3.1 The targets of the two models 213
8.3.2 Identifying the benefit component and the solution 214
8.3.3 Date of taxation 214
Contents

8.3.4 Disadvantages 215
  8.3.4.1 Disadvantages of the SFC model 215
    8.3.4.1.1 The need for assessments 215
    8.3.4.1.2 Difficulties in application 215
    8.3.4.1.3 Tax erosion 216
    8.3.4.1.4 Absence of symmetry 217
  8.3.4.2 Disadvantages of the CVT model 218
    8.3.4.2.1 The need for assessments and speculations 218
    8.3.4.2.2 Unfair preference of the state treasury as a creditor 218
    8.3.4.2.3 Unnecessary deviation from GAAP 218

8.4 Impact on tax revenues 219
  8.4.1 The limitations of the strict approaches 220
  8.4.2 Collection in the short and long terms 220
  8.4.3 The value consideration 221

9 Conclusions 222

Notes 230
Bibliography 305
Index 317