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CHANGES IN TAX ACCOUNTING: ADMINISTRATIVE AND LEGISLATIVE NONSENSE.

WILLIAM A. KELLEY, JR. †
AND
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I.
The Problem.

Let us assume that on January 1 the taxpayer had an opening business inventory which cost $30,000 dollars and that his business records showed accounts receivable due but uncollected, totalling $12,000 dollars. During the year the taxpayer purchased $20,000 dollars worth of additional inventory. He paid $17,000 dollars in cash and carried the balance of $3,000 dollars as an account payable. On December 31 the taxpayer's records reflected gross sales for the calendar year of $45,000 dollars, of which $27,000 dollars were collected before the close of the year. The closing inventory on December 31, cost $34,000 dollars.

If this taxpayer were to report his taxable income under the cash receipts and disbursements method of accounting, the computation of gross profit on sales for the year, before business expense deductions, would be as follows:

Cash Receipts From Sales $27,000.00
Less: Cash Disbursements for Purchases of Inventory $17,000.00

Gross Profit on Sales $10,000.00

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1. The commonly recognized methods of valuing inventory are: (1) cost, and (2) cost or market, whichever is lower. Proposed U.S. Treas. Reg. § 1.471-2(c) (1957).

2. Under the cash receipts and disbursements method in the computation of taxable income, all items which constitute gross income (whether in the form of cash,
If this taxpayer were to report his taxable income under the accrual method of accounting, the computation of gross profit on sales for the year, before business expense deductions, would be as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Sales</td>
<td>$45,000.00</td>
</tr>
<tr>
<td>Less: Inventory, Jan. 1</td>
<td>30,000.00</td>
</tr>
<tr>
<td>Inventory Purchases</td>
<td>20,000.00</td>
</tr>
<tr>
<td>Total</td>
<td>50,000.00</td>
</tr>
<tr>
<td>Less: Inventory, Dec. 31</td>
<td>34,000.00</td>
</tr>
<tr>
<td>Cost of Goods Sold</td>
<td>16,000.00</td>
</tr>
<tr>
<td>Gross Profit on Sales</td>
<td>$29,000.00</td>
</tr>
</tbody>
</table>

The startling difference in gross profit on sales, depending upon the method of accounting employed by the taxpayer, results because the logic of the cash receipts and disbursements method of accounting requires that the taxpayer take current deductions from cash receipts for every dollar he disburses for purchases of inventory, even though that inventory is not sold in the same business year for which his gross profit on sales is computed. The cash method of accounting takes into account only those sales collected during the accounting period while income from uncollected accounts receivable is not reported. During a period of business expansion accompanied by the accumulation of basic inventories and accounts receivable, the cash method of accounting presents a distorted picture of taxable income because deductions from gross income in any taxable year are not necessarily related to the dollars of gross income arising from those deductions.

The internal revenue acts have long required that taxable income be computed under the method of accounting regularly employed by the taxpayer. If no method of accounting is regularly employed by

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3. Under an accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Under such a method, deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy. U.S. Treas. Reg. § 1.446-1(c)(ii) (1957), 1958 INT. REV. BULL. NO. 2, at 28.

the taxpayer, or, if the method employed does not clearly reflect income, the computation of taxable income may be made by the Commissioner under such an accounting method as, in his opinion, does clearly reflect income.⁵

Congress and the Commissioner have declared that in every case in which the production or the purchase and sale of merchandise is an income-producing factor, opening and closing inventories must be employed in determining the net income for the period.⁶ For this reason, taxpayers for whom inventory is an income-producing factor, and who compute taxable income under the cash method, take prohibited expense deductions from gross sales for those cash disbursements representing purchases of inventory. Proper tax accounting would only permit deductions from gross sales for a cost of goods sold determined by the use of opening and closing inventories. It is only the cost of goods sold, thus computed, which gives rise to the gross sales of the taxable year.

In any case in which it is necessary to use inventories, no method of accounting will correctly reflect income except an accrual method.⁷ Therefore, taxpayers for whom inventory is an income-producing factor and who compute taxable income under the cash method, improperly omit current receivables which are not collected during the taxable year.

If, in order to correct the improper accounting method employed by such a wrong-method taxpayer, he were merely required to change from the cash method, to the accrual method, without regard to adjustments designed to prevent amounts from being duplicated or omitted, the logical computation of taxable income under the accrual method of accounting would be as follows. Only accounts receivable which accrued during the year of change would be taken into account. Accounts receivable on hand at the beginning of the year of change, having accrued in prior years, would escape tax, even though collected after the change to the accrual method. The cost of the opening inventory, less the cost of the closing inventory on hand at the end of the year

⁵ Revenue Act of 1926, § 212(b), 44 Stat. 23; Int. Rev. Code of 1939, § 41, 53 Stat. 24; Int. Rev. Code of 1954, § 446(a), (b). Since this article is an exposition of a chronological development of the law, statutory references, regulations and cases are cited in chronological order.


of change would be deducted from gross sales in computing the cost of goods sold, even though the opening inventory had been taken as a deduction in prior years, at a time when the taxpayer employed the cash method of accounting.

All of the litigation concerning changes of accounting method has involved disputes concerning adjustments designed by the Commissioner to avoid these omissions from income and duplications of deductions. In each case the Commissioner sought, in the year of change, to add to the income, computed under the accrual method, the cost of the inventory and the value of the receivables on hand at the beginning of the year of change. If the income could not be computed under the accrual method in the year of change (perhaps by reason of improper records maintained by the taxpayer), the Commissioner has contended that the cost of the closing inventory and the value of the receivables on hand at the end of the year must be added to the income computed under the cash method. Only with these adjustments to the income reported in the year of change from the cash method to the accrual method, can the Treasury Department avoid the loss of revenue from the omission of previously unreported accounts receivable and the duplication of previously deducted payments for inventories.

Since the revenue acts and regulations thereunder require tax reporting under the method of accounting regularly employed in keeping the taxpayer’s books, except in cases where the Commissioner considers that such method of accounting does not clearly reflect income, thought must be given to changes of accounting methods in those cases where the method actually employed does not clearly reflect income. The Commissioner has required his prior consent in any case where a change in accounting method is initiated by the taxpayer, and this consent is not given unless the taxpayer and the Commissioner agree to the adjustments to be made.8

By section 446(e) the requirement of the Commissioner’s prior consent has been incorporated into the Internal Revenue Code of 1954. It is extremely doubtful, however, that the Commissioner’s consent is a prerequisite to a change of tax accounting in the case of a cash method taxpayer using inventories.9 Since the revenue acts, the

9. Letter Ruling, January 5, 1945, Deputy Commissioner of Internal Revenue, 4 CCH 1945 Stand. Fed. Tax Rep. ¶ 6129. This argument was relied on in Simon v. Commissioner, 176 F.2d 230 (2d Cir. 1949) but was considered inapplicable by reason of the fact that the taxpayer did not employ inventory as an income-producing factor.
regulations and the cases have declared that the cash method of accounting does not clearly reflect the income of such a taxpayer, the accrual method is made mandatory.\textsuperscript{10} To refuse permission to such a wrong-method taxpayer would be tantamount to forcing the taxpayer to continue under an accounting method which is unlawful for tax purposes.\textsuperscript{11} In any case, the consequences of a change of tax accounting method from cash to accrual should not depend upon the identity of the proponent of the change.

II. THE CASE LAW.

The earlier cases in this field sustained the imposition of the adjustments by the Commissioner in the year of change without regard to whether the taxpayer or the Commissioner initiated the change in accounting method for tax purposes.\textsuperscript{12} It was held, however, that such adjustments might properly be imposed only in the case where the taxpayer had kept his books and reported taxable income improperly under the cash method.\textsuperscript{18} Similar adjustments could not be imposed upon a taxpayer who had always kept his books under a proper accrual method, but had merely reported his taxable income under an improper method.\textsuperscript{14} In the latter case, it was said that a change in accounting method was not involved, but merely a correction in the method of reporting income for tax purposes. The problem was properly characterized as one involving the Commissioner’s attempt to correct the consequences of improper omissions and deductions taken in prior years. In these cases the rule of the Greene Motor Co. case\textsuperscript{15} was applied, namely, that the improper treatment of income or deductions in prior years cannot be corrected by adjustments to returns of subsequent years.

In 1953, the Court of Appeals for the Second Circuit in Commissioner v. Dwyer discarded the meaningless distinction between tax-

\textsuperscript{10} See note 7 supra.
\textsuperscript{11} See, e.g., William Hardy, Inc. v. Commissioner, 82 F.2d 249 (2d Cir. 1936).
\textsuperscript{12} See, supra.
\textsuperscript{13} William Hardy, Inc. v. Commissioner, 82 F.2d 249 (2d Cir. 1936); Omah MacDonald, 8 CCH T.C. Mem. 212 (1949); Z. W. Koby, 14 T.C. 1103 (1950).
\textsuperscript{14} Estate of Samuel Mnookin, 12 T.C. 744 (1949), aff’d, 184 F.2d 89 (8th Cir. 1950); Robert G. Frame, 16 T.C. 600 (1951), aff’d, 195 F.2d 166 (3d Cir. 1952).
\textsuperscript{15} See, e.g., William Hardy, Inc. v. Commissioner, 82 F.2d 249 (2d Cir. 1936).
payers who report taxable income improperly under the cash method, but who correctly keep their books under the accrual method, and taxpayers who both report taxable income and keep their books under a wrong method.16 It was held that the only method of accounting with which the Commissioner had any concern or control was the method under which the taxpayer computed his taxable income.17 Accordingly, under the case law, the Commissioner has no authority to make the accounting adjustments in the year of change because a subsequent year cannot be assessed for the errors of prior years. Here again is the rule of the Greene Motor Co. case which now bars all adjustments to years of change in accounting method no matter which party initiates the change and no matter how the taxpayer’s books are kept. Then, in 1954 the Tax Court, in three decisions rendered within a period of two months,18 followed the rule of the Dwyer case, and the Commissioner’s attempts to avoid the loss of revenues resulting from omissions of income and duplications of deductions were defeated.

However, the Commissioner still attempts to preserve a distinction between changes in tax accounting method initiated by the taxpayer and those initiated by the Commissioner. When permission for the change is requested consent is withheld unless the adjustments can be amicably determined in accordance with the regulations.19 In William H. Goodrich, decided since 1954, the Tax Court, in an opinion of questionable soundness, sustained this distinction20 only to be reversed by the Court of Appeals for the Eighth Circuit.21 Some relief for the Commissioner was suggested in the appellate court by way of dictum to the effect that the previously omitted accounts receivable might be treated as having been committed to an election by the taxpayer to treat them under a cash method of accounting, thereby continuing the cash method treatment of the opening receivables, while requiring all subsequent transactions to be accounted for under a strict accrual method of accounting. This would require that the taxpayer add to the current accrual income the receipts derived from

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16. 203 F.2d 522 (2d Cir. 1953), overruling William Hardy, Inc. v. Commissioner, 82 F.2d 249 (2d Cir. 1936). The Court of Appeals for the Eighth Circuit three months earlier had rejected this distinction in Welp v. United States, 201 F.2d 128 (8th Cir. 1953).

17. Welp v. United States, 201 F.2d 128, 130 (8th Cir. 1953).


20. 25 T.C. 1235 (1956); see also Clement A. Bauman, 22 T.C. 7, 12 (1954) (dictum).

accounts receivable of prior years. However, this would, in effect, put the taxpayer under a temporary hybrid accounting method and would be inconsistent with the Greene Motor Co. rule applied in the later cases. The Goodrich dictum has not been sanctioned by any other case.\(^{22}\) In addition, the suggestion of the Goodrich case would not make any adjustment for previously expensed inventory which was on hand at the beginning of the year of change, since accurate accrual accounting requires the reflection of opening and closing inventories in the determination of income accrued for the period.

This then is the situation for pre-1954 Code years. The Commissioner cannot require any adjustments in the year of change, if the Commissioner initiates the change. Accordingly, there may be no incentive for the Commissioner to compel changes in cases where taxpayers are reporting income by a method of accounting prohibited by law. Although it is questionable whether the Commissioner can impose the adjustments upon taxpayers who change their tax accounting method without obtaining the Commissioner’s prior consent, this question does not appear to be finally determined by the cases. The Commissioner continues to take the questionable position that his prior consent is necessary, and, when application is made for consent it will not be granted unless the adjustments are agreed to, or, if the change is made without consent or agreement the corrective adjustments will be imposed by the Commissioner. This distinction is no more valid than the discarded distinction between the accounting method under which the taxpayer’s books are kept and the method by which income is reported for tax purposes.

III.

INTERNAL REVENUE CODE OF 1954.

Confronted with the case law and the administrative situation concerning changes in methods of tax accounting, Congress offered, in section 481 of the Internal Revenue Code of 1954, limited relief to the Treasury Department, while preserving the status quo for years not subject to the 1954 Code. Under section 481, regardless of who initiates the change, the adjustments necessary to avoid duplications and omissions are to be made in the year of change, provided, however, no adjustment is to be made with respect to items that were omitted

\(^{22}\) See Advance Truck Company, 29 T.C. No. 74 (1958), where the taxpayer was properly on a cash basis for 1949 and properly on an accrual basis for 1950. It was held that 1949 receivables collected in 1950, since properly omitted from the 1949 return, were properly included when received in 1950 although the taxpayer was then on an accrual basis. This is not an application of the Goodrich dictum and is consistent with the Greene Motor Co. rule.
or deducted in years not governed by the 1954 Code. Accordingly, under section 481 as it now stands, a wrong-method taxpayer need not be deterred from a voluntary change in a 1954 Code year.

It would appear that the wrong-method taxpayer could elect to amend his return for 1954, or for his first fiscal year subject to the 1954 Code, and thereby avoid all change-over adjustments because they would necessarily relate to "taxable years to which [section 481] does not apply." The taxpayer who contemplates the initiation of a change for the calendar year, 1954, will be barred by the statute of limitations which will have run on April 15, 1958. Each year thereafter the benefit to the taxpayer which results from this rule would appear to decrease as an increasing proportion of the adjustments become attributable to years subject to the 1954 Code. The Commissioner, of course, may require that the change be made as of the earliest year still open, thereby correcting the improper omissions and deductions during such open years. However, the prohibition of adjustments related to pre-1954 Code years will frequently deter the Commissioner from requiring the change in 1954 or earlier.

The full impact of the adjustments to be made in years of change subject to the 1954 Code is mitigated by a spread-back provision. The additional tax due for the year of change may not exceed any of the following: (a) the tax due upon the adjusted income computation for the year of change, (b) the aggregate of the taxes which would have

23. § 481. Adjustments Required by Changes in Method of Accounting.
(a) General Rule.
In computing the taxpayer's taxable income for any taxable year (referred to in this section as the "year of the change")—
(1) if such computation is under a method of accounting different from the method under which the taxpayer's taxable income for the preceding taxable year was computed, then
(2) there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted, except there shall not be taken into account any adjustment in respect of any taxable year to which this section does not apply.


25. In some cases the change-over adjustments will represent an omission of more than 25% of the gross income reported, thereby invoking the 6-year limitation upon assessments. Int. Rev. Code of 1954, § 6501(e); Z. W. Koby, 14 T.C. 1103 (1950).

26. There are practical difficulties in determining the precise receivables and inventory amounts improperly treated in the particular years. Consequently, it may be argued that the application of § 481 requires the exclusion from adjustments of the amounts of receivables and inventories on hand, as of January 1, 1954 regardless of how many years have elapsed thereafter but prior to the change in method. Under this view, the benefit to the taxpayer is fixed and does not decrease with passage of time. By reason of the Treasury Department's policy of silence in this area, no official position has been announced.
been payable had the increase been prorated over the year of change and two preceding years, or (c) the aggregate of the taxes which would have been payable had more than two preceding years been properly computed upon the new method. The third computation depends upon the taxpayer's ability to reconstruct an accrual accounting from the records which he maintained during the wrong-method years. In any case, the additional tax liability is for the year of change and no interest or penalties are payable for the earlier years.

27. § 481. Adjustments Required by Changes in Method of Accounting.

(b) Limitations on Tax Where Adjustments Are Substantial.

(1) Three Year Allocation.

If—

(A) the method of accounting from which the change is made was used by the taxpayer in computing his taxable income for the 2 taxable years preceding the year of the change, and

(B) the increase in taxable income for the year of the change which results solely by reason of the adjustments required by subsection (a) (2) exceeds $3,000, then the tax under this chapter attributable to such increase in taxable income shall not be greater than the aggregate of the taxes under this chapter (or under the corresponding provisions of prior revenue laws) which would result if one-third of such increase were included in taxable income for the year of the change and one-third of such increase were included for each of the 2 preceding taxable years.

(2) Allocation Under New Method of Accounting.

If—

(A) the increase in taxable income for the year of the change which results solely by reason of the adjustments required by subsection (a) (2) exceeds $3,000, and

(B) the taxpayer establishes his taxable income (under the new method of accounting) for one or more taxable years consecutively preceding the taxable year of the change for which the taxpayer in computing taxable income used the method of accounting from which the change is made, then the tax under this chapter attributable to such increase in taxable income shall not be greater than the net increase in the taxes under this chapter which would result if the adjustments required by subsection (a) (2) were allocated to the taxable year or years specified in subparagraph (B) to which they are properly allocable under the new method of accounting and the balance of the adjustments required by subsection (a) (2) was allocated to the taxable year of the change.

(3) Special Rules for Computations Under Paragraphs (1) And (2).

For purposes of this subsection—

(A) There shall be taken into account the increase or decrease in tax for any taxable year preceding the year of the change to which no adjustment is allocated under paragraph (2) but which is affected by a net operating loss (as defined in section 172) or by a capital loss carryover (as defined in section 1212), determined with reference to taxable years with respect to which adjustments under paragraph (2) are allocated.

(B) The increase or decrease in the tax for any taxable year for which an assessment of any deficiency, or a credit or refund of any overpayment, is prevented by any law or rule of law, shall be determined by reference to the tax previously determined (within the meaning of section 1314(a)) for such year.

(C) In applying section 7807(b)(1), the provisions of chapter 1 (other than subchapter E, relating to self-employment income) and chapter 2 of the Internal Revenue Code of 1939 shall be treated as the corresponding provisions of the Internal Revenue Code of 1939.

28. Note that should a wrong-method partnership or proprietor incorporate in a § 351 organization, the corporation would be a new entity in receipt of receivables
The application of section 481 is complex and the details of its administration are left to the Secretary, or his delegate. This section is intended to empower the administrator to work out, under promulgated standards, alternative methods of providing for change-over adjustments.

It is more than three and one-half years since the enactment of the Code, and the Commissioner has published no regulations to aid in the solution of the intricate problems with which section 481 is concerned. On February 15, 1957 the Treasury Department announced that, in view of contemplated amending legislation, no proposed regulations would be issued at that time. In addition, the Commissioner has refused to grant permission to change accounting methods for 1954 Code years, or to issue revenue rulings in this field. As a consequence of this administrative inaction, a taxpayer who voluntarily changes his method of tax accounting for a 1954 Code year is assured of a contest with the Commissioner who apparently is relying upon benefits from retroactive amendment of section 481.

The proposed amendment relied upon by the Treasury Department is section 24 of the Technical Amendments Act of 1958. This act, which is now before the Senate Finance Committee, would amend section 481 to give statutory sanction to the Commissioner's distinction between voluntary and involuntary changes in accounting method. Changes initiated by the taxpayer would no longer escape adjustments attributable to taxable years prior to the 1954 Code.

and inventory with a zero basis. The result would be to require the accrual method corporation to add to its first-year income the receivables acquired from its transferor and the corporation would be denied an allowance for its opening inventory in the computation of the cost of goods sold. See P. A. Birren & Son, Inc. v. Commissioner, 116 F.2d 718 (7th Cir. 1940). In such a case the entity planning to incorporate should consider the possible benefits of a change in method in a year preceding incorporation.

29. § 481. Adjustments Required by Changes in Method of Accounting.

(c) Adjustments Under Regulations.

In the case of any change described in subsection (a), the taxpayer may, in such manner and subject to such conditions as the Secretary or his delegate may by regulations prescribe, take the adjustment required by subsection (a)(2) into account in computing the tax imposed by this chapter for the taxable year or years permitted under such regulations.

32. H.R. 8381, 85th Cong., 1st Sess. passed by the House of Representatives January 29, 1958. During its consideration in the House, the Bill was popularly known as the Mills Bill.
33. H.R. Rep. No. 775, 85th Cong., 1st Sess., accompanying H.R. 8381 explains at page 20: "Changes in methods of accounting initiated by the taxpayer include a change in method of accounting which he originates, by requesting permission of the Commissioner to change, and also cases where taxpayer shifts from one method
That portion of the net adjustments attributable to 1954 Code years would, under the act, continue to be limited by the provision for two or more years of spread-back now contained in section 481. The pre-1954 Code adjustments, taken into account in cases involving a voluntary change in method, will (if such adjustments increase taxable income by 3,000 dollars or more) be taxed under a spread-forward provision. These adjustments will be prorated over the year of voluntary change and nine succeeding years, or as many succeeding years as the taxpayer was engaged in the same business prior to the year of change, whichever is less.\textsuperscript{34}

\textbf{IV. Conclusion.}

There are no doubt countless taxpayers who have been filing tax returns under a cash receipts and disbursements method of accounting, although their inventory is an income-producing factor. Any allowance of change-over adjustments is a departure from the rule of the \textit{Greene Motor Co.} line of cases and from an accurate accrual method of accounting. The full force of such adjustments, in the usual case, could constitute a real hardship. In many cases it could be disastrous.

The present effect of section 481 is to provide a reasonable solution in this difficult area of federal tax law. Adjustments attributable to pre-1954 Code years are barred. This is a codification of the case law as it stands apart from section 481. The resulting benefit to taxpayers may be a gradually declining one as the adjustments for years of change become increasingly attributable to 1954 Code years. In any event, the meaningless distinctions between proper accounting methods for bookkeeping and tax reporting purposes, and between voluntary and involuntary changes of accounting methods, killed by the cases, were buried by the 1954 Code.

Due to the Treasury Department's inaction respecting section 481, the law as enacted by Congress has been practically nullified. The taxpayer necessarily invites litigation by unilaterally taking a position under section 481. Such action by a taxpayer would be abortive in the

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\textsuperscript{34} Additional limitations on the spread-forward rule apply to cases of termination of the business during the spread-forward period. As to years of change after December 31, 1963, the spread-forward provisions are inapplicable and all adjustments thereafter will be governed by the limitation spread-back rules of § 481.
event that the presently contemplated retroactive amendment to section 481, which penalizes voluntary changes, becomes law.\textsuperscript{35}

It is a strange principle of law which denies benefits to the taxpayer who voluntarily offers to set things aright, while those benefits continue available to the taxpayer who ignores the requirements of law until he is compelled by the Commissioner to change. This is the case with section 24 of the Technical Amendments Act of 1958. The law requires taxpayers for whom inventory is an income-producing factor to compute taxable income under an accrual method of accounting. But, such a taxpayer who has improperly computed taxable income under a cash method will be penalized if he initiates a change to the proper method, by having pre-1954 Code year items included in the adjustments made in the year of change. Such a taxpayer who continues to file improperly until compelled by the Commissioner to change is given the benefit of the exclusion of items relating to years not subject to the 1954 Code. Contrary to the report of the House Committee on Ways and Means, which "sees no reason why the pre-1954 Code year adjustments should not be imposed upon taxpayers who voluntarily change their method of accounting," it is more difficult to perceive reason in the proposition that a voluntary offer to discontinue an unlawful practice should be penalized.

\textsuperscript{35} § 24 of The Technical Amendments Act of 1958 excepts from its provisions taxpayers (a) who have applied for a change of accounting method in the manner provided by regulations and (b) who have reached agreement with the Secretary or his delegate concerning the terms of the change. However, this relieves no one since the Commissioner has refused to issue regulations concerning applications for change and probably will not enter into any agreements omitting or waiving adjustments relating to pre-1954 Code years.