

CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 077

June 16, 1958

PERSONAL INCOME ACCOUNTING METHODS: CHANGE-OVER FROM CASH TO ACCRUAL BASIS-TREATMENT OF OPENING INVENTORY & ACCOUNTS RECEIVABLE

Syllabus:

In the case of taxable years beginning before December 31, 1954, in determining income for the year of change-over from a cash to accrual basis it was proper to deduct the opening inventory and accounts receivable.

Taxpayer operated a farm and pickle factory. Although they maintained records of inventories, accounts receivable and accounts payable, they reported their income on a cash basis until 1951 when the Bureau of Internal Revenue required them to change over to an accrual basis for 1946 and subsequent years. Advice is requested whether in determining income for the year 1946, allowance must be made for the deduction of opening inventory and accounts receivable.

Although the opening inventory in the year of change-over does reflect amounts previously deducted as purchases, disregarding the opening inventory in computing income in that year conflicts with the basic rule that income is to be computed on an annual basis. The courts have held that neither erroneous exclusion of income nor erroneous allowance of deductions in past years may be corrected by increasing the income of subsequent years. The only legitimate manner of making the correction is to reopen the returns of past years to correct the reporting errors caused by the use of the cash basis, provided those years are not barred. Therefore, in the absence of a showing that there was fraudulent intent in the adherence to cash basis reporting, the opening inventory in the change-over year cannot be disregarded in order to catch up income which should have been reported in previous years.

The treatment of accounts receivable is the same and opening accounts receivable must be deducted, for they do not represent income actually accruing in the change-over year.

The adjustments required in the case of a change of accounting method for taxable years beginning after December 31, 1954, is governed by sections 17611 through 17614 which were added to the Revenue and Taxation Code in 1955.