Russell K. Osgood

The Story of *Schlude*: The Origins of the Tax/Financial Accounting GA(A)P

Schlude v. Commissioner, 372 U.S. 128 (1963), is the third in a trilogy of cases that established emphatically that tax accounting under the Internal Revenue Code may differ from generally accepted accounting principles ("GAAP"). Unfortunately, the principles to be applied in determining when such a divergence is permissible are not made clear in the *Schlude* trilogy, and indeed still have not been made clear forty years later. The Schlude trilogy thus forms part of a depository of cases embracing a common law approach to the matter.

As this chapter goes to press, the media are full of reports of accounting scofflaws like Enron, Global Crossing, Tyco International, WorldCom, and Xerox. Although the precise nature of the malfeasance differ in these and other conflagrations through the years, the *Schlude* trilogy's sanctioning of departures in tax accounting from GAAP undoubtedly at least planted a seed that may have contributed to the subsequent flowering of accounting irregularities. However, the decoupling of tax accounting from financial accounting clearly makes sense in certain areas in light of the divergent purposes of each: in tax accounting, the pressure is to minimize taxable income (and thus tax liabilities) via decreasing income/increasing deductions; in financial accounting, the pressure is in the opposite direction to maximize book income (and thus stock prices) via increasing revenues/decreasing expenses. Yet one wonders about the cumulative effect as each generation's "masters of the universe" search for new ways to take advantage of the opportunities afforded through the separation of the tax accounting and financial accounting regimes and the decreasing ability of the Internal Revenue Service and Securities and Exchange Commission (and other federal agencies) to reign in these abuses. Indeed, one feature of the savings and loan debacle of the 1980s and early 1990s was the mortgage "swaps" in which S & Ls tried to have their cake (losses for tax purposes) and eat it too (no losses for financial purposes). When the next tax/accounting two-step explodes onto the national scene, consider whether the move can be traced in part to an Arthur Murray dance studio in Omaha, Nebraska.