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# PREPAID INCOME — THE ACCRUAL ACCOUNTING SYSTEM AND THE TAX LAW

Scott Morris

## I. INTRODUCTION

Nearly thirty years have passed since the Supreme Court first ruled that a taxpayer could not defer prepaid income over the years in which it was earned.<sup>1</sup> Since that time, increasing complexity in business organization has brought about an increased need for the deferral practice, yet the laws controlling the use of this practice are nearly the same today as they were years ago. Case after case has confirmed the rule against deferral,<sup>2</sup> despite the fact that deferral is, of necessity, an integral part of any accrual accounting system dealing with prepaid income.

The accrual method recognizes items of income only when they are "earned" in an accounting sense, regardless of the period in which they are received by the taxpayer. To correlate items of income with the expenses necessary to earn them, the accrual system dictates that prepaid income be deferred over the period in which these expenses are met.<sup>3</sup> However, the cases say that for taxation purposes such deferral is prohibited.<sup>4</sup> This conflict between the case law and the practical needs of the taxpayer was well illustrated in a recent Supreme Court case, *Schlude v. Commissioner*;<sup>5</sup> however, *Schlude* established no new rules, nor can it be said that it actually extends the rule against deferral of prepaid income into new areas. Unlike the cases preceding it,<sup>6</sup> however, *Schlude*<sup>7</sup> applies not to national organizations or to special-interest groups, but denies the ordinary businessman the deferral privilege, even though his accrual accounting system dictates that he defer prepaid income.

The purpose of this Comment is to explain the rationale behind the rule against deferral, to illustrate why attempts to change the

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<sup>1</sup> *Brown v. Helvering*, 291 U.S. 193 (1934).

<sup>2</sup> *Schlude v. Commissioner*, 372 U.S. 128 (1963); *American Auto. Ass'n v. United States*, 367 U.S. 687 (1961); *Automobile Club v. Commissioner*, 353 U.S. 180 (1957); *Brown v. Helvering*, *supra* note 1; *South Dade Farms, Inc. v. Commissioner*, 138 F.2d 818 (5th Cir. 1943); *Curtis R. Andrews*, 23 T.C. 1026 (1955); *Wallace A. Moritz*, 21 T.C. 622 (1954); *National Airlines, Inc.*, 9 T.C. 159 (1947); *Your Health Club, Inc.*, 4 T.C. 385 (1944); *South Tacoma Motor Co.*, 3 T.C. 411 (1943).

<sup>3</sup> *Miller, Tax Problems in Change of Accounting Methods*, U. So. Cal. 9th Tax Inst. 354 (1957).

<sup>4</sup> See note 2 *supra*.

<sup>5</sup> 372 U.S. 128 (1963).

<sup>6</sup> *American Auto. Ass'n v. United States*, 367 U.S. 687 (1961); *Automobile Club v. Commissioner*, 353 U.S. 180 (1957).

<sup>7</sup> 372 U.S. 128 (1963).

rule have failed, and to suggest methods by which a taxpayer can, in effect, defer prepaid income.

## II. PREPAID INCOME AND THE CLAIM OF RIGHT DOCTRINE

### A. Case History

For some time, accountants have disagreed with the courts over the application of the claim of right doctrine to prepaid income.<sup>8</sup> *North American Oil Consolidated v. Burnet*<sup>9</sup> instituted the so-called claim of right doctrine. In that case, the issue was in which year the revenue from property, title to which was in litigation, would be income for taxation purposes. The Court held that the income was reportable in the year in which a final decree was entered awarding title to the land to the taxpayer.<sup>10</sup> A few years later, in *Brown v. Helvering*,<sup>11</sup> the Court applied the claim of right doctrine to earnings received from insurance policy premiums. Although the general agent had unrestricted use of the money, he tried to deduct the amount he put into a "return commissions" account which was designed to meet contingent liabilities arising under the policies he sold. The Court rejected this system and stated that the agent's right to the money, when received, was absolute. The income was under no restriction, contractual or otherwise, as to disposition, use, or enjoyment.<sup>12</sup> The most interesting aspect of the *Brown* case is the Court's rejection of an alternative plan to defer prepaid income. Petitioner claimed that the overriding commissions, which were subject to the contingency of being refunded to the company if the policy was cancelled, were compensation for services rendered throughout the life of the policy. Thus, petitioner claimed that he should be allowed to prorate the commissions over the life of the policies. The Court dismissed this proposal summarily, ruling that the commissions were to be treated as income for the years in which the policies were written.<sup>13</sup>

*South Dade Farms, Inc. v. Commissioner*<sup>14</sup> is recognized as the first

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<sup>8</sup> Simply stated, the doctrine is: When a taxpayer receives income under a claim of right and without restrictions on the use of the money, this income must be reported even though the money has not been earned in an accounting sense. Contrarily, the basic tenet of accrual accounting is that income is not reported until earned, *i.e.*, until the services necessary to earn it have been rendered.

<sup>9</sup> 286 U.S. 417 (1932).

<sup>10</sup> *Id.* at 424.

<sup>11</sup> 291 U.S. 193 (1934).

<sup>12</sup> *Id.* at 199.

<sup>13</sup> *Id.* at 203-04. Apparently, this was the first time that a plan for deferring prepaid income had come before the Court. However, petitioner's plan was not brought up in the lower courts and thus was not really in issue before the Supreme Court.

<sup>14</sup> 138 F.2d 818 (5th Cir. 1943).

case clearly applying the claim of right doctrine to prepaid income. The court held that rental paid in advance on the lease of farm lands was taxable in the year of receipt because "the taxpayer had unfettered dominion and control over the use and disposition of the money."<sup>15</sup> The taxpayer's accrual system, which deferred the rentals by prorating them over the period of the leases, was rejected. Despite the fact that this system supposedly was the best indicator of net earnings, the court decreed that the method of accounting was required to reflect income, not net earnings.<sup>16</sup>

The Tax Court extended the claim of right doctrine to a number of cases in which prepaid cash receipts for services to be rendered at future times were not earned in an accounting sense. One case<sup>17</sup> held that the entire amount received from the sale of coupon books, entitling the purchaser to subsequent automotive services, was reportable income in the year the books were sold. *Your Health Club, Inc.*<sup>18</sup> held that the accrual system taxpayer had to report income in the year received, even though the services earning the income extended beyond the year of receipt. In another case,<sup>19</sup> the court refused to let an airline adopt an accrual system required by the Civil Aeronautics Board because the C.A.B. system dictated deferring prepaid income. Two later Tax Court cases firmly established that court's adherence to the claim of right doctrine. *Wallace A. Moritz*<sup>20</sup> held that an accrual basis taxpayer "is subject to tax liability when the right to receive income becomes fixed."<sup>21</sup> In *Curtis R. Andrews*,<sup>22</sup> an Arthur Murray dance studio case similar to *Schlude*, the court was even more explicit:

Irrespective of the merits of generally accepted commercial accounting treatment of prepaid income, it has been clearly established that, under the 'claim of right' doctrine, prepaid income must be reported as income in the year of receipt. . . . There was no restriction as to the use or disposition of the prepaid receipts. . . . The 'claim of right' doctrine is firmly established and must govern the result herein.<sup>23</sup>

Although these Tax Court cases established the claim of right doctrine as the determinative factor in deciding when income is reportable, the Supreme Court had not spoken on the subject of deferral

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<sup>15</sup> *Id.* at 819.

<sup>16</sup> *Ibid.* The definition of income is money received under a claim of right.

<sup>17</sup> *South Tacoma Motor Co.*, 3 T.C. 411 (1944).

<sup>18</sup> 4 T.C. 385 (1944).

<sup>19</sup> *National Airlines, Inc.*, 9 T.C. 159 (1947).

<sup>20</sup> 21 T.C. 622 (1954).

<sup>21</sup> *Id.* at 624.

<sup>22</sup> 23 T.C. 1026 (1955).

<sup>23</sup> *Id.* at 1033.

since *Brown v. Helvering*.<sup>24</sup> However, in 1957 the Court decided *Automobile Club v. Commissioner*.<sup>25</sup> The club sold one year memberships which were paid in advance. It credited dues to a liability account and allocated one-twelfth of the membership fee as income in each month of the year-long membership period. Applying the claim of right doctrine, the Court held that the dues were income in the year received because the club had unrestricted use of the dues in the year of receipt.<sup>26</sup> As the allocation of the dues over the period of the memberships bore no relation to the time when members called on the club for services, the Court rejected the accrual system employed as not clearly reflecting income.<sup>27</sup>

Four years later, the Court rendered a similar holding in *American Auto. Ass'n*.<sup>28</sup> That decision accentuates the dichotomy between generally accepted principles of commercial accounting and tax accounting. In it, the Court stated, "[T]he method employed by the Association is in accord with generally accepted accounting principles and practice." However, this "is not to hold that for income tax purposes it so clearly reflects income as to be binding on the Treasury."<sup>29</sup>

#### B. Exceptions To The Claim Of Right Doctrine

In cases in which the taxpayer receives prepaid income for goods rather than for services, the Tax Court has departed somewhat from the claim of right doctrine. The exception was set out in *Veenstra & De Haan Coal Co.*<sup>30</sup> There the court held that prepaid receipts (deposits insuring the future delivery of coal) were not taxable in the year of receipt. Again, in *Woodlawn Park Cemetery Co.*,<sup>31</sup> the court ruled that payments received under executory contracts were not completed sales; thus retention of the payments was too contingent for them to be taxed as income in the year of receipt. Although nearly all of the disagreement over the deferral privilege has arisen from "service" contracts, taxpayers who receive prepaid income for goods should note the above cases as establishing a precedent allowing retention of the deferral practice.

Aside from simple deferrals in reporting income, the most popular method of allocating prepaid receipts to subsequent tax periods

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<sup>24</sup> 291 U.S. 193 (1934).

<sup>25</sup> 353 U.S. 180 (1957).

<sup>26</sup> *Id.* at 189.

<sup>27</sup> *Id.* at 189-190.

<sup>28</sup> 367 U.S. 687 (1961).

<sup>29</sup> *Id.* at 693.

<sup>30</sup> 11 T.C. 964 (1948).

<sup>31</sup> 16 T.C. 1067 (1951).

has been the creation of reserve accounts. These reserves are set up to meet expenses incurred in earning the income in subsequent years and are deducted from gross income in the year when the prepaid amount is received. Some courts have allowed deduction of these reserve funds so long as there was a fixed liability on the taxpayer to perform services in future periods.<sup>32</sup> In all of these cases, the Tax Court had invoked the claim of right doctrine and disallowed deduction of the reserve funds. In each case, the courts of appeals overturned the Tax Court on the premise that the taxpayer's method of accounting clearly reflected income.<sup>33</sup>

The Supreme Court spoke on the subject of reserves in 1959<sup>34</sup> and vindicated the claim of right theory somewhat. Several automobile dealers included as income the amounts they received from the finance companies that handled their conditional sales. The dealers did not, however, report the percentage of the price that the finance companies retained in a reserve fund until the automobiles were paid out. The Court held that the amounts placed in these reserves were accrued income to the dealers at the time of the credit.<sup>35</sup> "[I]t is the time of acquisition of the fixed right to receive the reserves and not the time of their actual receipt that determines whether or not the reserves have accrued and are taxable."<sup>36</sup> Even so, this case can be differentiated from those courts of appeals decisions which held the claim of right doctrine inapplicable so long as the accounting system employed "clearly reflects income."<sup>37</sup> It should be noted that *Hansen* concerned a reserve in another party's hands, a sum of money that was to be paid to the taxpayer despite the fact that he had no additional duties to perform to earn the money. The earlier cases concerned reserve funds which the taxpayers themselves set up to meet the expenses necessary to earn their income.<sup>38</sup>

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<sup>32</sup> Deduction of a sales commissions reserve was allowed in *Ohmer Register Co. v. Commissioner*, 131 F.2d 682 (6th Cir. 1942). One taxpayer was allowed to deduct brokerage fees which were to be paid in a later period and to deduct the estimated cost of preparing goods for shipment. *Pacific Grapes Prods., Inc. v. Commissioner*, 219 F.2d 862 (9th Cir. 1955). An appliance dealer was allowed to set up a reserve fund to cover the costs of servicing furnaces purchased by its customers. *Schuessler v. Commissioner*, 230 F.2d 722 (5th Cir. 1956). More recently, deduction of a reserve set up for television service contracts has been allowed. *Bressner Radio, Inc. v. Commissioner*, 267 F.2d 520 (2d Cir. 1959). However, this holding is contradicted by another court's verdict in an identical fact situation. *Streight Radio & Television, Inc. v. Commissioner*, 280 F.2d 883 (7th Cir. 1960).

<sup>33</sup> *Ibid.*

<sup>34</sup> *Commissioner v. Hansen*, 360 U.S. 446 (1959).

<sup>35</sup> *Id.* at 464.

<sup>36</sup> *Ibid.*

<sup>37</sup> See note 32 *supra*.

<sup>38</sup> *Ibid.*

### C. *The Legislative History Of Prepaid Income*

Judicial establishment of the claim of right doctrine as a bar to deferring prepaid income led to the addition of sections 452 and 462 to the Internal Revenue Code. Fundamentally, this was the situation: Accountants and tax lawyers had long wanted to bring tax accounting into harmony with accepted principles of business accounting. Because the courts had ruled that prepaid income received under a claim of right had to be reported in the year of receipt, these accountants and lawyers went to Congress for relief. Representatives of the American Institute of Certified Public Accountants appeared before the House Ways and Means Committee and asked for an amendment to the Code that would permit deferral.<sup>39</sup> In 1953 Congress enacted sections 452 and 462, concerning prepaid receipts and reserves for estimated expenses, respectively. Under section 452, a taxpayer operating on the accrual method could defer reporting prepaid income until the years in which it was earned. This income, however, could not be deferred over a period longer than five years.<sup>40</sup> Section 462 specifically allowed the deduction of reserves for estimated future expenses of fulfilling contracts.<sup>41</sup>

Although these two sections were generally acclaimed as at last bringing about some correlation of tax accounting and commercial accounting, they were repealed retroactively.<sup>42</sup> In its report recommending the repeal, the House Ways and Means Committee stated that it firmly believed in resolving the differences between the two accounting systems, but that an unforeseeably large revenue loss would result from taxpayers' receiving double deductions in the first year they reported under the new system.<sup>43</sup>

From an accounting viewpoint, the repeal was unfortunate, for section 452 had made it possible for the first time for a taxpayer to defer reporting prepaid income. It is obvious that the repeal of section 452 was a return to the previous judicial policy of disallowing de-

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<sup>39</sup> *Hearings Before the House Committee on Ways and Means Regarding General Revenue Revision*, 83d Cong., 1st Sess., pt. 1, at 585 (1953).

<sup>40</sup> Int. Rev. Code of 1954, ch. 1, § 452(a), 69 Stat. 134 (1955). Section 452(e)(1) defined prepaid income as:

Any amount (includable in gross income) which is received in connection with, and is directly attributable to, a liability which extends beyond the close of the taxable year in which such amount is received. Such term does not include any income treated as a gain from the sale or other disposition of a capital asset.

<sup>41</sup> Int. Rev. Code of 1954, ch. 1, § 462(a), 69 Stat. 134 (1955).

<sup>42</sup> Act of June 15, 1955, ch. 143, § 1(a), 69 Stat. 134 (1955); *Id.* at § 1(b).

<sup>43</sup> H.R. Rep. No. 293, 84th Cong., 1st Sess. 3, 4 (1955). The Treasury originally estimated the loss at forty-seven million dollars. At the time he asked for the repeal, Secretary of the Treasury Humphrey estimated the impending loss at one billion dollars.

ferrals and that Congress regretted having to make this reversal. The Senate Report, concurring with the House Report in recommending the repeal, expressly stated that the repeal of sections 452 and 462 was not to be considered as either acceptance or rejection of any judicial decisions on the matter. The report further explained that the committee wanted to make the deferral privilege available generally and that they planned to devise proper substitutes for the repealed sections.<sup>44</sup>

Congress has restored in part the advantages of deferral which were eliminated with the repeal of section 452. In 1957 Congress added section 455 to the Code. This section allows publishers to report prepaid subscription income in the years during which the liability exists to deliver newspapers, magazines, and other periodicals.<sup>45</sup> Later, Congress enacted section 456 to nullify the decisions in the automobile club cases. This new section allows membership organizations, such as automobile clubs, to defer reporting membership dues.<sup>46</sup>

Despite its announced intention to reflect accepted commercial accounting principles throughout the tax code,<sup>47</sup> Congress has not yet extended the deferral privilege to taxpayers in general. In fact, bills permitting deferral of prepaid income received under "service" contracts have been introduced but defeated.<sup>48</sup> Consequently, an ordinary taxpayer like Schlude, who cannot benefit from the special provisions of sections 455 and 456, is left with the previous judicial policy, which dictates that he may not defer prepaid income.

#### D. *The Law Before Schlude v. Commissioner, A Summary.*

Clearly, the claim of right doctrine has been firmly established in the courts. That Congress sought to overturn the application of the doctrine to prepaid income by enacting sections 452 and 462 was, in itself, recognition of the doctrine. Despite Congress' tacit recognition of the doctrine and despite the Supreme Court's adoption of the claim of right doctrine, various writers and judges have protested that the application of the doctrine in prepaid income cases is a perversion of its proper use.<sup>49</sup> They argued that the doctrine is relevant only in

<sup>44</sup> S. Rep. No. 372, 84th Cong., 1st Sess. 5, 6 (1955).

<sup>45</sup> Int. Rev. Code of 1954, § 455.

<sup>46</sup> Int. Rev. Code of 1954, § 456.

<sup>47</sup> S. Rep. No. 372, 84th Cong., 1st Sess. 5, 6 (1955). See text accompanying note 44 *supra*.

<sup>48</sup> H.R. 8688, 86th Cong., 1st Sess. (1959); H.R. 2245, 87th Cong., 1st Sess. (1961); H.R. 2440, 87th Cong., 1st Sess. (1961).

<sup>49</sup> *Beacon Pub. Co. v. Commissioner*, 218 F.2d 697, 700 (10th Cir. 1955); Behren, *Schlude: Rationale is Uncertain*, 18 J. Taxation 194-95 (1963); Behren, *Prepaid Income*—

determining whether receipts are reportable income, not in determining in which year it is reportable.<sup>50</sup> This argument can be criticized on the ground that it is a weak distinction to say that, for tax purposes, amounts received under a legal claim of right are earned although there may be some contingency as to their retention because of a conflicting claim,<sup>51</sup> but that prepaid income is not earned in the tax sense if it is subject to a contingency as to its amount, based upon an obligation to furnish future services.

To say that these sums have not been 'earned' in the accounting sense merely begs the question of whether the accrual system of accounting for tax purposes allows the deferral of such amounts. The taxpayer has sold a contract for future services and received the price of that contract. The receipt is not in the form of a deposit or trust fund, but is instead the unfettered property of the taxpayer. Therefore, regardless of accounting considerations it seems appropriate at that time for the government to exact its tax.<sup>52</sup>

Refusing to accept the long line of decisions adopting the claim of right doctrine as establishing the correct rule, the critics of the doctrine hoped for a case in which the Supreme Court might overturn the application of the doctrine to prepaid income cases. The critics thought they had found such a case when *Schlude v. Commissioner*<sup>53</sup> went to the Court.

### III. THE IMPORTANCE OF *Schlude v. Commissioner*

In *Schlude v. Commissioner*,<sup>54</sup> the taxpayers operated a chain of dancing studios which offered dancing lessons under two basic contracts: a cash plan which required the entire down payment in cash and a deferred payment plan which required only a portion of the down payment to be paid in cash. In the latter plan, the student gave the studio a negotiable note and paid it in installments. Both contracts provided that: (1) the student was to pay a certain amount of tuition, (2) he would not be relieved of his contract to pay tuition, (3) no refunds would be made, and (4) the contract was non-cancellable. Although the contracts designated the period during which the lessons had to be taken, there was no schedule of specific

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*Accounting Concepts and the Tax Law*, 15 Tax L. Rev. 343, 349 (1960); Horwich, *Deferred Income and Claim of Right*, 5 Tax Counselor's Q. 1 (1961).

<sup>50</sup> *Ibid.*

<sup>51</sup> *North American Oil Consol. v. Burnet*, 286 U.S. 417, 464 (1932).

<sup>52</sup> *Loeb, Cash Receipts and Accrual Method Taxpayers, the A.A.A. Case*, U. So. Cal. 14th Tax Inst. 737, 757 (1962).

<sup>53</sup> 372 U.S. 128 (1963).

<sup>54</sup> *Ibid.*

dates, and appointments were arranged from time to time as lessons were given.<sup>55</sup>

Cash payments and amounts received from discounting the negotiable notes were deposited in the taxpayers' general bank account without segregation from other funds.<sup>56</sup> The studio kept its books and reported income on an accrual system. It maintained a system of individual record cards showing the number of hours taught each student and the number of lessons remaining under the contract. At the end of each fiscal year, the cards were analyzed and the income earned from lessons given during the year was transferred from the deferred income account and reported as earned income. Additionally, if a contract lay idle for a year or more or a course was reduced in amount, any gains were transferred to the earned income account. After these transfers from the deferred income account were made, the balance was carried over into the next fiscal year to be handled as before. Expenses were reported on the accrual basis except that royalty payments to Arthur Murray, Inc. and sales commissions were deducted when paid without regard to the period in which the related receipts were taken into income.<sup>57</sup>

The Commissioner rejected the accounting system as not clearly reflecting income.<sup>58</sup> He included as gross income not only advance payments received in cash, but also the full face amounts of notes and contracts executed during the years in question. The Tax Court upheld the Commissioner,<sup>59</sup> but the Eighth Circuit reversed.<sup>60</sup> Following *American Auto. Ass'n*,<sup>61</sup> the Supreme Court granted certiorari,<sup>62</sup> vacated the judgment, and remanded the case for reconsideration. On remand, the court of appeals held that, in view of *American Auto. Ass'n*,<sup>63</sup> the taxpayers' accounting system did not, for income tax purposes, clearly reflect income.<sup>64</sup>

On final review by the Supreme Court, the issue was: Should the taxpayer be required to include advance payments in cash, the face value of negotiable notes, and the value of contract installments falling due but remaining unpaid as income in a particular year? The

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<sup>55</sup> Brief for Petitioner, pp. 3, 4, *Schlude v. Commissioner*, *ibid.*

<sup>56</sup> 372 U.S. at 131.

<sup>57</sup> Brief for Petitioner, pp. 5-6; Brief for Respondent, p. 6, *Schlude v. Commissioner*, 372 U.S. 128 (1963).

<sup>58</sup> 372 U.S. at 133-34.

<sup>59</sup> 32 T.C. 1271 (1959).

<sup>60</sup> 283 F.2d 234 (8th Cir. 1960).

<sup>61</sup> 367 U.S. 687 (1961).

<sup>62</sup> 367 U.S. 911 (1961).

<sup>63</sup> 367 U.S. 687 (1961).

<sup>64</sup> 296 F.2d 721 (8th Cir. 1961).

Court, stating that the problem was squarely controlled by *American Auto. Ass'n*,<sup>65</sup> held that the Commissioner acted properly.<sup>66</sup>

The majority opinion states: (1) that the retroactive repeal of section 452 of the 1954 Code reinstated longstanding administrative and lower court rulings that the Commissioner could reject accounting systems deferring prepaid income;<sup>67</sup> (2) that the taxpayers' accounting system did not clearly reflect income for taxation purposes as required by section 41 of the 1939 Code and section 446(b) of the 1954 Code;<sup>68</sup> and (3) that for an accrual basis taxpayer, "it is the right to receive not the actual receipt that determines the inclusion of the amount in gross income."<sup>69</sup> The minority makes its strongest arguments on the first two bases—the repeal of section 452 and the "clear reflection of income" arguments<sup>70</sup>—and dismisses as inapplicable the claim of right doctrine, which is the third basis of the majority opinion.<sup>71</sup>

In taking up the "clear reflection of income" argument, the dissent debated the implications of the enactment and repeal of sections 452 and 462 of the Code.<sup>72</sup> Mr. Justice Stewart reiterated the argument he used in the dissent in *American Auto. Ass'n*.<sup>73</sup> He refused to divorce the deferral privilege from the other aspects of accrual accounting, insisting "no inference of disapproval of accrual accounting principles was to be drawn from the repeal of the sections."<sup>74</sup> The majority, however, did not infer any disapproval of accrual accounting from the repeal of sections 452 and 462 save for Congress' mandate that the deferral privilege no longer is allowed.<sup>75</sup> The majority opinion is, of course, substantiated by the reports of the various Congressional committees.<sup>76</sup> The majority decision is strengthened by Congress' cautious, step-by-step approach in restoring the deferral privilege to limited groups of taxpayers while denying it, for the time being at least, to taxpayers generally.<sup>77</sup> Two new sections, sec-

<sup>65</sup> 367 U.S. 687 (1961).

<sup>66</sup> 372 U.S. 128, 134 (1963).

<sup>67</sup> *Id.* at 134-35.

<sup>68</sup> *Id.* at 136.

<sup>69</sup> *Id.* at 137. At this point, note the concession the Government made on a point it had won in the lower courts. The Government conceded that a bare contractual promise to pay is not includable in income unless the sum is due or the lessons contracted for are given.

<sup>70</sup> *Id.* at 139, 141.

<sup>71</sup> *Id.* at 137-38.

<sup>72</sup> *Id.* at 139-40.

<sup>73</sup> 367 U.S. at 703-11.

<sup>74</sup> 372 U.S. 128, 139-40 (1963).

<sup>75</sup> *Id.* at 134.

<sup>76</sup> See text accompanying notes 42, 44 *supra*.

<sup>77</sup> See notes 46-49 *supra* and accompanying text.

tions 455 and 456, have granted the deferral privilege to publishers and membership organizations, respectively. Yet, omnibus bills that would have granted the privilege to all service industries have been defeated.<sup>78</sup>

Despite the minority's dismissal of the claim of right doctrine, this principle is as basic to *Schlude v. Commissioner* as it is to all prepaid income cases. In the face of overwhelming evidence that the claim of right doctrine determines when receipts are reportable income,<sup>79</sup> the minority retreats into a battle of semantics. Admitting, in a footnote, that the claim of right doctrine has "sometimes" been a bar to deferrals, the minority cites two "more recent" cases as proof that the doctrine is irrelevant to the deferral issue.<sup>80</sup> The fallacy in the argument is that these cases, *Bressner Radio, Inc. v. Commissioner*<sup>81</sup> and *Schuessler v. Commissioner*,<sup>82</sup> are reserves cases, not simple deferral cases. As has been pointed out, the courts have, with one exception, been almost as lenient in allowing deductions of reserves as they have been strict in disallowing simple deferrals.<sup>83</sup>

Stating that the Code "explicitly authorizes income tax returns to be based upon sound accrual methods,"<sup>84</sup> the dissent does not consider the command that *all* accounting systems must clearly reflect income.<sup>85</sup> The whole point is that, by the dictates of the claim of right doctrine, prepaid receipts taken under a claim of right are income. They must be reported in the year of their receipt if the taxpayer's system clearly reflects income.<sup>86</sup> Therefore, the decision in *Schlude* ultimately turns upon whether the taxpayer's accounting system "clearly reflects income."<sup>87</sup>

<sup>78</sup> See text accompanying note 48 *supra*.

<sup>79</sup> *Brown v. Helvering*, 291 U.S. 193 (1934), held that money received under a claim of right without restriction as to its use is reportable income. *South Dade Farms, Inc. v. Commissioner*, 138 F.2d 818 (5th Cir. 1943), applied the doctrine to prepaid income, and this precedent has been followed consistently by the Tax Court. See text accompanying notes 17-23 *supra*. A Supreme Court case cited by the majority, *Commissioner v. Hansen*, 360 U.S. 446 (1959), clearly states that for an accrual system taxpayer "it is the right to receive not the actual receipt that determines the inclusion of the amount in gross income." *Id.* at 464.

<sup>80</sup> *Schlude v. Commissioner*, 372 U.S. 128, 138 n.1 (1963).

<sup>81</sup> 267 F.2d 520 (2d Cir. 1959).

<sup>82</sup> 230 F.2d 722 (5th Cir. 1956).

<sup>83</sup> See note 32 *supra* and accompanying text. Further, the validity of the exception, *Bressner Radio, Inc. v. Commissioner*, 267 F.2d 520 (2d Cir. 1959), is challenged by *Streight Radio and Television, Inc. v. Commissioner*, 280 F.2d 883 (7th Cir. 1960). The fact situations in the two cases are identical; in *Bressner, supra* at 525, the Second Circuit held the claim of right doctrine inapplicable and in *Streight, supra* at 887, the Seventh Circuit held the doctrine applicable. Note also that the Supreme Court denied certiorari in *Streight*, 366 U.S. 965 (1961), but no appeal was taken in *Bressner*.

<sup>84</sup> 372 U.S. at 139.

<sup>85</sup> Int. Rev. Code of 1954, § 446(b).

<sup>86</sup> *American Auto. Ass'n v. United States*, 367 U.S. 687, 689 (1961).

<sup>87</sup> 372 U.S. at 136, 139-40.

Whichever method is used, cash or accrual, the accounting system must, if it clearly reflects income, compute taxable net income on an annual basis. Neither income nor deductions may be accelerated or postponed from one taxable year to another in an attempt to reflect the long-term economic result of a particular transaction.<sup>88</sup> Ordinary accrual systems do not conflict with this principle, but the deferral of prepaid income conflicts directly.

Failure clearly to reflect income *for tax purposes* was the basis for rejecting the accounting systems in both *Automobile Club*<sup>89</sup> and *American Auto. Ass'n.*<sup>90</sup> In the *Automobile Club* case, the Court said: "The pro rata allocation of the membership dues in monthly amounts is purely artificial and bears no relation to the services which petitioner may in fact be called upon to render for the member."<sup>91</sup> In *American Auto. Ass'n.*, the Court found that the A.A.A.'s system might be in accord with generally accepted accounting principles and practice, but for *income tax purposes* it did not so clearly reflect income as to be binding on the Treasury.<sup>92</sup>

Applying the two automobile cases to *Schlude*, the Court held that the taxpayers' accounting system was artificial because the prepaid receipts related to services to be performed at an unfixed time.<sup>93</sup> Even if a student let his rights lapse by not demanding the lessons, the studio still could demand that he make his payments.<sup>94</sup> Under the contracts, the studio had a right to retain both prepayments and installment payments without any restriction as to their use and without any obligation to refund.<sup>95</sup> Although the studio could determine at the end of the year from the card system how many lessons it had given during the year, still it could not determine how many, if any, lessons it would have to give in the future. The studio could compute income earned during the current and previous years, but could not accurately anticipate earnings for future years.<sup>96</sup> This was true despite the fact that the taxpayers were paid in advance for possible future services.<sup>97</sup>

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<sup>88</sup> *Security Flour Mills Co. v. Commissioner*, 321 U.S. 281, 285-86 (1944); *Dixie Pine Prods. Co. v. Commissioner*, 320 U.S. 516, 519 (1944); *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182, 190 (1934); *Burnet v. Sanford & Brooks*, 282 U.S. 359, 364 (1930).

<sup>89</sup> 353 U.S. 180 (1957).

<sup>90</sup> 367 U.S. 687 (1961).

<sup>91</sup> 353 U.S. at 189.

<sup>92</sup> 367 U.S. at 693.

<sup>93</sup> 372 U.S. at 135, 136.

<sup>94</sup> *Ibid.*

<sup>95</sup> *Ibid.*

<sup>96</sup> *Ibid.*

<sup>97</sup> 372 U.S. at 130, 131-32.

The Schludes' accounting system did not clearly reflect income because income and expenses were not correlated within the taxable year. Instead, their system postponed income to subsequent years without any relation to the expenses incurred in those years. Such postponements are in violation of the annual accounting rule.<sup>98</sup> Mr. Justice Stewart's objection to the majority opinion is that it strikes down an accrual system that accurately reflects the taxpayers' earned income. He is, however, forced to admit that the accounting system does not correlate deferred, unearned income with the expenses that would be necessary to earn it in later tax periods.<sup>99</sup>

#### IV. CONCLUSION

*Schlude* exemplifies the distinction that courts must make between ordinary commercial accounting and tax accounting. The requirements of tax accounting are designed for maintenance of government revenue; commercial accounting practices are not so designed. The two accounting systems must, therefore, conflict at some point.

Two of the basic theories of commercial accounting are (1) to match income with the expenditures necessary to produce it and (2) to defer recognition of income until such expenditures are made. By delaying the recognition of income until it is earned, the accounting system minimizes excessive and/or speculative income.

Taxing authorities are concerned with protecting the revenues, not with the technicalities of when income is earned. Consequently, the Treasury is interested in the fact that a citizen holds money under a legal claim and that the money is taxable. The Treasury has little concern that the money is not earned in a commercial accounting sense.<sup>100</sup> In taxation problems, therefore, the claim of right doctrine often is the focal point because it defines reportable income.

That the Schludes had unrestricted use of their prepaid income is undisputed; they held the money under a claim of right. Their right to receive the money was not conditioned upon the giving of a service or the delivery of goods; rather, it was fixed by the contract. The accounting system they used did not correlate receipts with expenditures,<sup>101</sup> so it could not "clearly reflect" the income received under the contracts. Section 446 of the Code provides both that taxable income is to be computed under the accounting system by which the taxpayer regularly computes his income in keeping his books and

<sup>98</sup> See note 91 *supra* and accompanying text.

<sup>99</sup> *Schlude v. Commissioner*, 372 U.S. 128, 141 (1963).

<sup>100</sup> Loeb, *supra* note 52, at 756.

<sup>101</sup> *Schlude v. Commissioner*, 372 U.S. 128, 135-36 (1963).

that "if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income."<sup>102</sup> So, actually the Code does not allow a taxpayer to use any method that reflects income in a commercial accounting sense; it only specifies that a method may not be used that does not clearly reflect income for tax purposes.

Is there any accounting system that will defer income and still meet the test of clear reflection of income?<sup>103</sup> What the Court will hold if confronted with a system that accurately matches prepaid receipts with subsequent expenses, thereby clearly reflecting income, may very well be a moot question. Most service contracts obligate the taxpayer to perform on the customer's demand, as in *Schlude*;<sup>104</sup> few of these contracts obligate their sellers to perform only at fixed times in the future. The most notable exception, the publishing houses, is covered by section 455. Additionally, even if a taxpayer could correlate income and expenses, the Court probably would not allow deferral because of the claim of right doctrine.<sup>105</sup> As stated in *Schlude*, it is the contract, not the giving of the service, that fixes the taxpayer's right to the prepaid receipts.<sup>106</sup>

Further, any system deferring income on a basis of statistical estimates has been explicitly struck down by *American Auto. Ass'n*.<sup>107</sup> Hybrid systems—using a cash basis for prepaid income and an accrual basis for all other items—probably will not be allowed. Section 446(c) (4) allows combinations of cash and accrual methods, but all accounting systems are subject to the "clear reflection of income" requirement of section 446(b). For some time, there has been a general rule that taxpayers cannot report income on one accounting system and adjustments of that income on another system because such computations distort income.<sup>108</sup> If, for example, a taxpayer like *Schlude* were allowed a cash system for income and an accrual system for deductions, his first year's return would reflect an unrealistically

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<sup>102</sup> Int. Rev. Code of 1954, § 446(b).

<sup>103</sup> It is interesting to note that the Court's emphasis in the three recent cases, *Automobile Club v. Commissioner*, 353 U.S. 180 (1957), *American Auto. Ass'n v. United States*, 367 U.S. 687 (1961), and *Schlude v. Commissioner*, 372 U.S. 128 (1963), was on the artificiality of the accounting systems.

<sup>104</sup> 372 U.S. at 135-36.

<sup>105</sup> See note 79 *supra* and accompanying text.

<sup>106</sup> 372 U.S. at 130.

<sup>107</sup> 367 U.S. at 693. Reserve funds based on statistical estimates are also forbidden. In *Milwaukee & Suburban Transp. Corp. v. Commissioner*, 293 F.2d 628 (7th Cir. 1961), the court held that, in light of *American Auto. Ass'n v. United States*, the taxpayer could not deduct its estimated liability for unsettled torts claims.

<sup>108</sup> *United States v. Andrews*, 269 U.S. 422, 440 (1926).

high income because unearned receipts would be reported without any deductions for the future costs of earning those receipts. In a year in which current expenditures were low because relatively fewer advances were received in the preceding year, the result would be an inflated gross income for the current year. Further, if the taxpayer decided to go out of business, he would have an unrealistic loss to report in his final year of doing business. He would have no advances to report and still would have to incur expenses in fulfilling the contracts executed in previous years. Because of the obvious distortions in net income that would result, it is doubtful that the Commissioner would allow such a hybrid accounting system.<sup>109</sup>

Two alternatives seem to remain open to the taxpayer. He can abandon the accrual system altogether—hardly an acceptable solution—or he can, in effect, defer prepaid income by using a reserve fund. Even though section 462, which specifically allowed the deduction of such reserves, was repealed, the repeal carried no inference of disapproval of prior court decisions.<sup>110</sup> As was pointed out above, some of the appellate courts have been amenable to the use of reserve funds.<sup>111</sup>

Aside from using reserves to allocate prepaid income over subsequent tax periods, there is nothing the taxpayer can do unless there is new legislation. The entire weight of judicial precedent is, of course, against allowing deferrals.<sup>112</sup> The courts will not, and should not, make whatever changes need to be made. For nine years, Congress has been struggling with this problem, and it still refuses to make the deferral privilege available generally.<sup>113</sup> Allowing deferrals and reserves once produced a great potential loss to the Treasury.<sup>114</sup> Congress must weigh this impending loss of revenue against the fact that many taxpayers employ the deferral practice as an integral part of their accrual systems. If the deferral privilege were abolished, a taxpayer would be denied his accrual system altogether.<sup>115</sup>

Ultimately, the decision to allow or to deny millions of taxpayers the use of the accrual method should be a policy decision, not a matter of judicial decision. The financial power of the nation is, after all, vested in Congress.<sup>116</sup> Rather than leaving the courts to

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<sup>109</sup> *American Auto. Ass'n v. United States*, 367 U.S. 687, 714 (1961).

<sup>110</sup> See note 44 *supra* and accompanying text.

<sup>111</sup> See note 32 *supra*.

<sup>112</sup> See note 2 *supra*.

<sup>113</sup> See notes 39-48 *supra* and accompanying text.

<sup>114</sup> See note 43 *supra* and accompanying text.

<sup>115</sup> See notes 108, 109 *supra* and accompanying text.

<sup>116</sup> U.S. Const. art. I, § 8.

decide prepaid income cases on the basis of concepts founded years ago, when accrual accounting and prepaid receipts were not so vital a part of the nation's business as they are today, Congress should establish some new rules. Until it does so, the courts can decide cases like *Schlude* in only one way—against deferral.