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Federal Income Taxation - Tax Accounting - Prepaid Income Falling Due but Remaining Unpaid during the Year Included in Gross Income for That Year

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FEDERAL INCOME TAXATION — TAX ACCOUNTING — PREPAID INCOME FALLING DUE BUT REMAINING UNPAID DURING THE YEAR INCLUDED IN GROSS INCOME FOR THAT YEAR.

Schlude v. Commissioner (U.S. 1963)

The taxpayers, operators of dance studios,[1] offered lessons under contracts by which advances in cash payments, notes receivable, and contract installments were received.[2] Under the taxpayers' accrual system of accounting, the total contract price was entered into a "deferred income" account. When each fiscal period ended, income was recognized for the lessons given by deducting that amount from the deferred income account.[3] The Commissioner, however, included in gross income for tax purposes the advance payments, and the amounts of the notes and the contracts. The Tax Court[4] and the Court of Appeals[5] upheld this. The Supreme Court retreated somewhat,[6] but otherwise, by a five to four decision, affirmed, *holding* that the Commissioner properly exercised his discretion under the Internal Revenue Code[7] in rejecting the studio's accounting system as not clearly reflecting income, and in including as income in a particular year advance payments by way of cash, negotiable notes and contract installments falling due but remaining unpaid during the year. *Schlude v. Commissioner,* 372 U.S. 128, 83 S.Ct. 601 (1963).

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1. Pursuant to franchise agreements with Arthur Murray, Inc., the studio was obligated to pay to Arthur Murray, Inc., weekly, 10% of cash receipts from cash payments and discounted negotiable notes, and to hold 5% of receipts in escrow until a $20,000 indemnity fund was accumulated.

2. Under the cash plan contract, the down payment was paid in cash when the contract was executed with the contract price balance due in installments. Under the deferred payment contract, a portion of the down payment was paid in cash, the rest in installments, and the balance of the contract price was paid by a negotiable note signed at the time the contract was executed.

3. 83 S.Ct. 601 (1963).

> [T]he student record cards were analyzed and the total number of taught hours was multiplied by the designated rate per hour of each contract. The resulting sum was deducted from the deferred income account and reported as earned income on the financial statements and the income tax return. In addition, if there had been no activity in a contract for over a year, or if a course were reduced in amount, an entry would be made canceling the untaught portion of the contract, removing that amount from the deferred income account, and recognizing gain to the extent that the deferred income exceeded the balance due on the contract. . . . *Id.* at 603.

4. Mark E. Schlude, 32 T.C. 1271 (1959).

5. Schlude v. Commissioner, 296 F.2d 721 (8th Cir. 1961).

6. 83 S.Ct. 601 (1963). "Amounts for which services had not yet been performed and which were not due and payable during the respective periods," were excluded by the Court from gross income. *Id.* at 606.

7. INT. REV. CODE OF 1954, § 446(b):

> If no method of accounting has been regularly used by the taxpayer, or 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.

Int. Rev. Code of 1939, ch. 1, § 41, 53 Stat. 24:

> . . . if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income.

Although the finding of the Supreme Court in this case is based primarily on two recent decisions,[8] the roots of this holding go back to the early days of the income tax. The case of *United States v. Anderson*[9] first interpreted the Revenue Act of 1916[10] as authorizing the accrual method[11] of accounting as a basis for computing income tax. However, the accrual system has not been completely accepted by the courts, one of the principal areas of difficulty having been the treatment of prepaid income for tax purposes.

Some lower courts have supported the annual accounting concept[12] in order to justify the inclusion of prepaid income in current income for tax purposes. However, such a device has not been followed generally, nor has it been accepted by the Supreme Court, as it can only be applied consistently with regard to cash basis taxpayers. Other courts have applied the "claim of right" doctrine,[13] which has provided even more extensive problems for accrual basis taxpayers than did the annual accounting concept. The doctrine was first enunciated in *North American Oil Consol. v. Burnet*,[14] where income was earned in 1916, but was held by a receiver pending the outcome of litigation with the United States. The government sought the benefit of all income derived from the operation; however, the taxpayer prevailed, received the 1916 income in 1917 and tried to defer the recognition of the income until a later year. Even though at that time there was a possibility that the government might succeed on appeal in recovering the 1916 income, the fact that the taxpayer had full and unrestricted use of the money made it subject to income inclusion in 1917 under the "claim of right" doctrine. Furthermore, *Brown v. Helvering*[15] extended the doctrine to taxpayers employing an accrual basis for their accounting. There, an insurance agent received commissions, but had a contingent liability to return some commissions in later years because of

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8. American Automobile Ass'n v. United States, 367 U.S. 687, 81 S.Ct. 1727 (1961); Automobile Club v. Commissioner, 353 U.S. 180, 77 S.Ct. 707 (1957).

9. 269 U.S. 422, 46 S.Ct. 131 (1926).

10. Ch. 463, § 12(a), 39 Stat. 767; ch. 463, § 13(d), 39 Stat. 771.

11. Under the accrual method income is recognized when earned, and expenses are deducted when incurred, whether or not collected or paid in the same period.

12. See, *e.g.*, Automobile Club, 32 T.C. 906 (1959).

> Moreover, the amounts received do not cease to be "income" under the statute merely because all the expenses allocable to the earning of such income have not yet been incurred. Wholly apart from the question whether pertinent expenses generally affect the quality of receipts as income, the point here is that net income under the statute is computed on an annual basis, and, as pointed out above, there is no necessary correlation in any given year between receipts and expenses. Expenses with respect to income not yet earned are deductible when paid or accrued; and conversely, income is reportable when received or accrued, notwithstanding that some, or even all expenses allocable thereto have not yet been incurred. *Id.* at 914.

13. The "claim of right" doctrine provides for the inclusion in taxable income of money which the taxpayer has without restriction as to use, although there may be a claim on the money later or even though the expenses which should be matched with the money received will not occur until a later tax year. The implementation of "claim of right" is at odds with financial accounting accrual principles which match revenue and expense in their respective periods.

14. 286 U.S. 417, 52 S.Ct. 613 (1932).

15. 291 U.S. 193, 54 S.Ct. 356 (1934).

cancellations and reinsurance. The taxpayer proposed either to accrue the estimated expense of cancellations or to defer a portion of the commissions as income in the following years. The Court disallowed the deferral of income, using the "claim of right" rationale, stating that since there were no restrictions on the use of the money, it did not matter that a contingent liability in future years existed as to that income.

The "claim of right" tenet was later applied to situations where the income was unearned. Thus, in the case of *Your Health Club, Inc.*,[16] both cash and accounts receivable representing contracts obligating the taxpayer to perform services beyond the end of the taxable year were disallowed as deferrals. It is suggested that such an extension is totally unjustified. Taxation is an assessment against income; under the accrual system, an accepted accounting basis under section 446 of the Internal Revenue Code,[17] cash, accounts receivable, and notes receivable received for services to be performed in later periods are not current income. Recognizing such a defect, several circuit courts[18] have rejected the doctrine, reversing decisions of the Tax Court. In *Bressner Radio, Inc. v. Commissioner*,[19] a retail television dealer on an accrual basis was allowed to defer prepaid income on a twelve-month television servicing contract over the period of twelve months. The court rejected the "claim of right" doctrine for unearned income, holding that the accounting method of the taxpayer truly reflected income. The Supreme Court has also refused to apply the "claim of right" doctrine to the unearned income of accrual taxpayers. The Court apparently has used a different rationale for inclusion of unearned income. Thus, in *Automobile Club v. Commissioner*,[20] the Court, relying on section 41,[21] held that "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."[22] However, there may have been some justification for the holding in this case, as the company recognized $\frac{1}{12}$ of the membership dues per month over the contract year, when, in reality, the services rendered had not been evenly distributed over the months. Because the club was located in a northern climate and the services required were demanded more frequently in the winter months, the Court's decision may not have been unreasonable considering that the taxpayer's system did not properly match revenue and expense according to the principles of accrual accounting.

16. 4 T.C. 385 (1944); *accord*, New Capital Hotel, Inc., 28 T.C. 706 (1957); Curtis R. Andrews, 23 T.C. 1026 (1955).

17. This section provides that income is to be computed by the taxpayer's regular method of accounting, and unless the method of accounting does not clearly reflect income that the accrual method is an acceptable one.

18. See Schuessler v. Commissioner, 230 F.2d 722 (5th Cir. 1956); Pacific Grape Products Co. v. Commissioner, 219 F.2d 862 (9th Cir. 1955); Beacon Publishing Co. v. Commissioner, 218 F.2d 697 (10th Cir. 1955).

19. 267 F.2d 520 (2d Cir. 1959).

20. 353 U.S. 180, 77 S.Ct. 707 (1957).

21. If taxpayer's system doesn't "clearly reflect income" then this section provides that the Commissioner may recompute the income by a method which does "clearly reflect income."

22. 353 U.S. 180, 189, 77 S.Ct. 707, 712 (1957).

However, the subsequent Supreme Court decision of *American Automobile Ass'n v. United States*[23] is not so easily reconciled. There, membership dues were also accounted for on the accrual basis, being treated as income received ratably over the twelve month membership period. The Court, relying on the *Automobile Club* case, held that under section 41 the taxpayer's system was "purely artificial" and that "substantially all services are performed only upon a member's demand and the taxpayer's performance was not related to fixed dates of the tax year."[24] The dissent, however, carefully shows that the system used by petitioner did clearly reflect income, and that since the accrual method is provided for by statute in section 446, the Commissioner had no discretionary power under that statute to deny the use of the accrual method as to petitioner's prepaid income.[25] Moreover, the majority suggested that Congress had repealed sections 452[26] and 462,[27] as it preferred not to allow deferral of prepaid income.[28] The dissent points out the invalidity of this reasoning. In reality, Congress repealed those sections to prevent a great loss of revenue from taxpayers who could claim a double deduction in the transitional year of change from one accounting method to another.[29] The accrual method of accounting was not meant to be disapproved by the repeal of the foregoing statutes.[30]

The Supreme Court applied the rationale of *American Automobile Ass'n* in deciding the instant case.[31] Even though the Court reversed the lower courts in part (by not including in income amounts not paid or due for services yet to be performed) still the case seems to extend the scope of inclusion of prepaid income in gross income for tax purposes beyond that of *American Automobile*. Although there the income included was

23. 367 U.S. 687, 81 S.Ct. 1727 (1961).
24. *Id.* at 691, 81 S.Ct. at 1729.
25. *Ibid.*
26. Int. Rev. Code of 1954, ch. 1, § 452, 68A Stat. 152. This section specifically provided for the deferral of prepaid income by accrual basis taxpayers.
27. Int. Rev. Code of 1954, ch. 1, § 462, 68A Stat. 158. This section specifically provided for reserves for estimated expenses to be taken into account in computing taxable income by accrual basis taxpayers.
28. Since this decision was rendered a statute has been passed allowing deferral of prepaid income in a limited number of cases. Organizations without capital stock of any kind, and in which there is no distribution of net earnings to any member, may so defer prepaid income. The instant case deals with a profit making organization, and so does not fall within the provisions of the statute. INT. REV. CODE OF 1954, § 456.
29. 367 U.S. 687, 708-09, 81 S.Ct. 1727, 1738 (1961). Such a change had been allowed without the Commissioner's consent by sections 452 and 462.
30. See, H.R. REP. No. 293, 84th Cong., 1st Sess. 2-5 (1955); S. REP. No. 372, 84th Cong., 1st Sess. 4-5 (1955).
31. In the Tax Court, Mark E. Schlude, 32 T.C. 1271 (1959), the decision went against petitioner on the "claim of right" basis. The court relied on two Tax Court cases which are without higher court approval that also dealt with unearned income, (Curtis R. Andrews, 23 T.C. 1026 (1955), and Your Health Club, Inc., 4 T.C. 385 (1944)) and on a Supreme Court case (Commissioner v. Hansen, 360 U.S. 446, 79 S.Ct. 1270 (1959)) which dealt with earned income. In the Court of Appeals (Schlude v. Commissioner, 283 F.2d 234 (8th Cir. 1960)) the judgment was reversed in favor of the petitioners. The court rejected "claim of right" with regard to unearned income and held that the system clearly reflected income. However, the court later vacated its own judgment in Schlude v. Commissioner, 296 F.2d 721 (8th Cir. 1961), after the decision in American Automobile Ass'n, 353 U.S. 180, 77 S.Ct. 707 (1957).

unearned, the cash had been received from the members of the club. In *Schlude,* however, much of the unearned income included had not been received in cash.[32] Moreover, in *Schlude* the accounting system was a better one than that in *American Automobile;* revenue and expense were better matched according to accrual accounting principles. In *American Automobile* each member's account was not analyzed with the detail that customer accounts in *Schlude* were. Furthermore, the type of services offered in *Schlude* was better suited for accounting control than those in *American Automobile.* In *Schlude* a definite number of lessons was contracted for at a set rate per lesson.[33] In *American Automobile* the services provided[34] were more on a demand basis, whereby the revenue received from each member could not be matched with the expense applicable to the services performed for him, as could be done in *Schlude.* In addition, the total amount of service to be performed and the expense thereby incurred in *American Automobile,* because service was on a demand basis, could not be matched as accurately with revenue as could be done in *Schlude.* Although it is true that in *Schlude* the accounting system could not perfectly reflect income, it has been pointed out that the deduction of percentage royalties and sales commissions without accrual in the year paid is a "minor 'defect' in the system [and] should not be the basis of a complete rejection."[35] The dissent strengthens this point by observing that the Treasury Regulations[36] provide: "However, in a going business there are certain overlapping deductions. If these overlapping items do not materially distort income, they may be included in the years in which the taxpayer consistently takes them into account."[37] The dissent further points out that if they "do 'materially distort income,' then the case should be remanded for recomputation as to these items."[38] In such a case there would be no wholesale rejection of taxpayers' system; deferred income could be properly recognized, and the related expenses matched with them.

The main difficulty with taxpayers' system was its recognition of income from cancellations of lessons. The Court's objection to the nonrecognition of cancellation income is unsound. It would be impossible for taxpayer to know, as the dissent points out, when "services are not rendered simultaneously with payment . . . the number and amount of cancellations which will occur at the time the advances are received."[39] And the fact is "that a contract which specified the times at which lessons were to be given

32. The notes receivable were discounted at 50% and no cash had been received on the accounts receivable included.

33. Here, there were cancellations from which income was realized, a subject treated *infra.*

34. 367 U.S. 687, 689 n.2, 81 S.Ct. 1727, 1728 n.2 (1961).

35. Behren, *Schlude Holds Prepaid Income Taxable on "Receipt"; Rationale Is Uncertain,* 18 J. TAXATION 194, 198-99 (1963).

36. § 1.461-1(3) (1957).

37. 83 S.Ct. 601, 608 n.12 (1963).

38. *Ibid.*

39. 83 S.Ct. 601, 608-09 (1963).

would [not] make any more certain how many of the remaining lessons students would in fact demand."[40]

It seems unfair to replace taxpayers' system which does satisfactorily reflect income with a hybrid system that puts taxpayers on a cash basis for prepaid income, and which requires an accrual system for other items of revenue and expense. It is too burdensome to require the taxpayer to prepare two sets of financial statements at additional expense—one for financial purposes and another for tax purposes.

The Court's suggestion that an estimate of cancellation income be used by taxpayers for tax purposes is refuted by the dissent. The dissent admits that an estimation procedure might more clearly reflect income but recognizes that such estimates must be based on the same type of statistical evaluations that the Court struck down in the *American Automobile Ass'n* case.

> Whatever other artificialities the exigencies of revenue collection may require in the field of tax accounting, it has never before today been suggested that a consistent method of accrual accounting, valid for purposes of recognizing income, is not equally valid for purposes of deferring income.[41]

The Court's final proposal is that "it is the *right* to receive not the actual receipt that determines the inclusion of the amount in gross income."[42] This statement totally disregards the fact situation in *Schlude*. The Court cited two cases[43] for the proposition, but both cases dealt with earned income rather than unearned income.[44]

Although the instant decision appears to be legally unsound, the policy consideration in its favor is the major interest of the Treasury in providing adequate revenue for an enormously expensive government. However, it is unfortunate that in order to maintain the supply of revenue the Supreme Court has approved a practice of income inclusion which defies a statutory command that accounting systems which clearly reflect income are to be recognized for tax purposes.

It has been suggested in defense of the Court's position that the purposes of financial accounting and tax accounting are different and that therefore the systems need not be identical.[45] Although it is true that the purposes of the two are not the same, Congress under section 446 has made provision for the identity of the two. It would seem that the Supreme Court is fearful of tampering with the needs of the Treasury and that there will

40. 83 S.Ct. 601, 609 (1963).

41. *Ibid.*

42. 83 S.Ct. 601, 606 (1963).

43. Commissioner v. Hansen, 360 U.S. 446, 79 S.Ct. 1270 (1959); Spring City Foundry Co. v. Commissioner, 292 U.S. 182, 184-85, 54 S.Ct. 644-45 (1954).

44. For example, in the *Hansen* case, *supra* note 43, amounts were withheld by finance companies to cover possible losses on notes given by purchasers to dealers for automobiles sold. Such amounts, although not received by the taxpayer, were earned income according to accrual principles at the time of income inclusion.

45. 42 MARQ. L. REV. 131, 136 (1958).