1962

Federal Income Taxation-Accounting Methods-Accounting for Prepayments and Estimated Future Expenses

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Recommended Citation

Jerome M. Salle S.Ed., *Federal Income Taxation-Accounting Methods-Accounting for Prepayments and Estimated Future Expenses*, 61 MICH. L. REV. 148 (1962).

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COMMENTS

FEDERAL INCOME TAXATION—ACCOUNTING METHODS—ACCOUNTING FOR PREPAYMENTS AND ESTIMATED FUTURE EXPENSES—“It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals.”¹ In order to obtain regular periodic revenues from the federal income tax, Congress requires all taxpayers to determine their taxable income annually.²

Income may be defined as “value added” as a result of a given economic activity.³ Logically, the most opportune time to measure income occurs whenever that activity has ended, for at that time the continuous growth or contraction in the attributable value will likewise have ended and the income or loss from the activity will be readily susceptible to measurement. The fragmentation of this period of activity into an annual period, as demanded by Congress, requires an attempt to measure a continuously changing quantum of income. Business activity does not cease and begin anew at the end of each taxable year; thus, some transactions will necessarily span such artificial limits. Consequently, the determination of taxable income requires the implementation of accounting methods which will wholly or partially exclude or include such transactions in the current taxable year.

The need for yearly accounting may also arise apart from tax considerations. Reports of annual business income are required by government agencies,⁴ stock exchanges,⁵ and shareholders.⁶ In ad-

¹ Stone, J., in *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 365 (1931).

² INT. REV. CODE OF 1954, § 441(a).

³ “The net worth method of estimating taxable income is a logical derivation of the net accretion definition of income. . . .” Morag, *Some Economic Aspects of Two Administrative Methods of Estimating Taxable Income*, 10 NAT’L TAX J. 176, 179 (1957). See generally Avakian, *Net Worth Computations as Proof of Tax Evasion*, 10 TAX L. REV. 431 (1955).

⁴ See, e.g., Securities Act of 1933 § 7, Schedule A § 26, 48 Stat. 88, 90, 15 U.S.C. §§ 77g, 77aa(26) (1958); Securities Exchange Act of 1934 § 13(a), 48 Stat. 894, 15 U.S.C. § 78m(a) (1958); Interstate Commerce Act § 20(1)-(3), 54 Stat. 916 (1940), as amended, 49 U.S.C. § 20(1)-(3) (1958); Federal Aviation Act of 1958 § 407(a), 72 Stat. 766, 49 U.S.C. § 1377(a) (1958); OHIO REV. CODE ANN. § 1701.38 (Page Supp. 1961). Many government agencies may promulgate uniform rules of accounting to be used in filing annual reports. See, e.g., Interstate Commerce Act § 20(3), 54 Stat. 916 (1940), 49 U.S.C. § 20(3) (1958).

⁵ NEW YORK STOCK EXCHANGE, COMPANY MANUAL § A4 (1953).

⁶ See generally BALLANTINE, CORPORATIONS §§ 159-61 (1946); 2 HORNSTEIN, CORPORATION LAW AND PRACTICE § 612 (1959).

dition, the level of annual income is the most important influence on the management of business operations⁷ and the determination of financial policies.⁸ In the business community, the responsibility for the formation and application of accounting methods has been generally entrusted to professional accountants. After an unsuccessful attempt to measure business income with accounting methods based on cash receipts and disbursements, Congress expanded the permissible tax accounting methods to allow accrual accounting, the method used by professional accountants.⁹ However, as a control measure Congress gave the Commissioner of Internal Revenue the right to reject any method of accounting which did not clearly reflect income.¹⁰ While a determination of taxable income made according to generally accepted accounting principles has usually been allowed for tax purposes, the Commissioner has consistently rejected such determinations when they have involved prepaid income or estimated future expenses.¹¹

The widely divergent views held by the Internal Revenue Service and professional accountants in regard to the proper accounting treatment for these types of transactions have resulted in a substantial amount of litigation, which began soon after the adoption of the accrual method of accounting for tax purposes. However, this litigation has not clearly defined acceptable methods of tax accounting for prepaid income and estimated future expenses. Instead, it has seemingly rendered the question incapable of resolution in the absence of an articulate redefinition of the applicable accounting provisions of the Internal Revenue Code.¹² Since the fulfillment of this objective apparently requires a choice between the methods advocated by the accounting profession and the Commissioner of Internal Revenue, the initial step toward such a redefinition lies in an investigation of the relative merits of their proposals.

⁷ PATON & PATON, CORPORATION ACCOUNTS AND STATEMENTS 275 (1955).

⁸ 1 DEWING, FINANCIAL POLICY OF CORPORATIONS 509-10, 519-20, 530-34 (5th ed. 1953).

⁹ Revenue Act of 1916, ch. 463 § 13(d), 39 Stat. 756 [now INT. REV. CODE OF 1954, § 446(c)].

¹⁰ Revenue Act of 1916, ch. 463 § 13(d), 39 Stat. 756 [now INT. REV. CODE OF 1954, § 446(b)]. See H.R. REP. NO. 922, 64th Cong., 1st Sess. 4 (1916).

¹¹ See Rev. Rul. 85, 1960-1 CUM. BULL. 181; 1 P-H 1962 FED. TAX SERV. ¶¶ 6282-90, 6453.

¹² Krahmer, *Taxation of Prepaid Receipts—Ambiguity of Supreme Court Decision in American Automobile Association v. United States Expected To Cause Further Confusion*, 47 A.B.A.J. 1218, 1221 (1961).

I. GENERALLY ACCEPTED ACCOUNTING STANDARDS FOR PREPAID INCOME¹³ AND ESTIMATED FUTURE EXPENSES¹⁴

A professional accountant defines "income" as a net or resultant amount determined by matching revenues¹⁵ with related expenses.¹⁶ Income, so defined, does not exist prior to the sale of goods or performance of services.¹⁷ Payments received prior to performance, which have been denominated as "prepaid income," are regarded simply as advance deposits.¹⁸ The advance of cash is treated as creating a debt obligation running from the seller to the advancing purchaser for the full amount received.¹⁹ Normally this obligation will be discharged by the delivery of goods or the rendition of services. When this occurs, the accountant will include the amount of the deposit in the stream of revenues which are included in the current determination of income.²⁰ Such an accounting procedure has the effect of deferring recognition of the monies advanced until they have been actually earned.²¹ Thus,

¹³ The term "prepaid income" is derived from the title of § 452 of the Internal Revenue Code of 1954 repealed by ch. 143 § 1, 69 Stat. 134 (1955). Other terms commonly used to describe such transactions are deferred revenues, deferred credits, and advances from customers. See FINNEY & MILLER, PRINCIPLES OF ACCOUNTING, INTRODUCTORY 367 (5th ed. 1957) [hereinafter cited as FINNEY]; LENHART & DEFLIESE, MONTGOMERY'S AUDITING 327 (8th ed. 1957); PATON, ESSENTIALS OF ACCOUNTING, 313-15 (rev. ed. 1949) [hereinafter cited as PATON].

¹⁴ The term "estimated future expenses" is derived from the title of § 462 of the Internal Revenue Code of 1954 repealed by ch. 143 § 1, 69 Stat. 134 (1955).

¹⁵ Revenue may be defined as the amount of cash, receivables, or other valid assets added to the resources of the business as a result of transferring products to customers. PATON 77.

¹⁶ FINNEY 367. This definition has also been used by the courts. See *United States v. Anderson*, 269 U.S. 422, 440 (1926); *Bressner Radio, Inc. v. Commissioner*, 267 F.2d 520, 523 (2d Cir. 1959), *nonacq.*, Rev. Rul. 85, 1960-1 CUM. BULL. 181; *Beacon Publishing Co. v. Commissioner*, 218 F.2d 697, 699 (10th Cir. 1955). *But cf.* *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931); *Spencer, White & Prentiss, Inc. v. Commissioner*, 144 F.2d 45, 47 (2d Cir.), *cert. denied*, 323 U.S. 780 (1944).

¹⁷ PATON 77-78.

¹⁸ PATON 313-15.

¹⁹ FINNEY 361; PATON 46-47, 312-16. "The term *current liabilities* is used principally to designate obligations whose liquidation is reasonably expected to require the use of existing resources properly classifiable as current assets, or the creation of other current liabilities [T]he classification is intended to include . . . collections received in advance of the delivery of goods or performance of services" COMMITTEE ON ACCOUNTING PROCEDURE, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, ACCOUNTING RESEARCH BULLETIN No. 43, 21-22 (1953). *But see* LENHART & DEFLIESE, *op. cit. supra* note 13, at 327, "Current liabilities should include the *portion* of these deferred credits equal to the estimated cost of realizing such revenues in the following period. The remaining portion of unearned revenues, representing profit, may be *excluded* from current liabilities and designated as *deferred income*." (Emphasis supplied.)

²⁰ FINNEY 367; PATON 312-16.

²¹ *Ibid.*

the accountant recognizes the revenues as earned in the year in which the seller has performed, regardless of the time when payment was actually received. This accounting treatment acknowledges income as being earned only after the risk of performing the obligation required by the pertinent sales contract has been terminated and the cost of performance accurately ascertained. On the other hand, it prevents the recognition as income of advances from customers which may have to be returned because of the seller's inability to perform as required by the sales contract.²²

The professional accountant recognizes estimated future expenses when the current performance of a contract to deliver goods or render services creates an *incidental* obligation in the seller which may require him to incur additional expenses at some future time. Instead of deferring the recognition of a portion of the revenue from the sale transaction until such time as the future expenses are incurred, accepted accounting procedures require inclusion of the total revenue in the current determination of income when the contract has been substantially performed, and the simultaneous deduction of all the related expenses, including a reasonable estimate for future expenses.²³ The obligation to incur future expense is then treated as a current liability which will be discharged when the expense is incurred.²⁴ Unlike other current liabilities, obligations to incur estimated future expenses may be accrued although there may be no certain sums owed to specific persons.²⁵ Common examples of estimated future expenses involve obligations arising under agreements to provide free services on the seller's products and agreements to install goods on the buyer's premises. However, it is essential that the expenses accrued be related to the current production of revenues.²⁶ Accordingly, deductions from current revenues normally are not allowed for the estimated cost of future

²² FINNEY 309; PATON 315.

²³ FINNEY 309, 367; PATON 352; LENHART & DEFLIESE, *op. cit. supra* note 13, at 329.

²⁴ FINNEY 309; PATON & PATON, *op. cit. supra* note 7, at 414.

²⁵ FINNEY & OLDBERG, *LAWYER'S GUIDE TO ACCOUNTING* 165 (1955). "This concept of current liabilities would include estimated or accrued amounts which are expected to be required to cover expenditures within the year for known obligations (a) the amount of which can be determined only approximately (as in the case of provisions for accruing bonus payments) or (b) where the specific person or persons to whom payment will be made cannot as yet be designated (as in the case of estimated costs to be incurred in connection with guaranteed servicing or repair of products already sold)."

COMMITTEE ON ACCOUNTING PROCEDURE, *op. cit. supra* note 19, at 22.

²⁶ FINNEY 367.

fire losses, or future strikes.²⁷ Generally accepted accounting principles also make no allowance for the deduction of future expenses which cannot be estimated with reasonable accuracy, even if related to current production of revenues.²⁸ As an example, prospective losses arising due to injuries sustained by the purchaser of a defective product normally may not be deducted in the year the article was produced.

An alternative to deducting estimated future expenses would be to defer recognition of that portion of current receipts which corresponds to the cost of providing the future services.²⁹ Thus, when a product is sold under an agreement to provide free maintenance services for a given period, the portion of the current receipts from the sale which represents the amount the seller would charge for such service would be excluded from the determination of income until the service is rendered.³⁰ In short, this alternative procedure would treat a portion of the current revenue from such sales as "prepaid income."

While it is often said that the same result can be achieved using either method,³¹ this statement is only a half-truth. Although it is true that either procedure will result in matching revenues with related expenses, the matching, and therefore the recognition of income, will often take place in different taxable years. For example, where future services are required in a sales contract, if estimated future expenses are deducted, all income from the sale is recognized in the year the product is sold. If the alternative procedure of deferring a portion of the receipts is adopted, a portion of the income will be deferred to the year or years in which the services are rendered.

Thus, deferring a portion of current revenues is an alternative to deducting estimated future expenses where the future obliga-

²⁷ COMMITTEE ON ACCOUNTING PROCEDURE, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, ACCOUNTING RESEARCH BULLETIN No. 53 § 7(a) (1958); PATON 746.

²⁸ See COMMITTEE ON ACCOUNTING PROCEDURE, *op. cit. supra* note 27, § 7(c): "The Committee is therefore of the opinion that reserves such as those created . . . in amounts not determined on the basis of any reasonable estimates of costs or losses are of such a nature that charges or credits relating to such reserves should not enter into the determination of net income."

²⁹ PATON & PATON, *op. cit. supra* note 7, at 340-45. See, e.g., *Bressner Radio, Inc. v. Commissioner*, 267 F.2d 520 (2d Cir. 1959), *nonacq.*, Rev. Rul. 85, 1960-1 CUM. BULL. 181.

³⁰ *Ibid.*

³¹ See, e.g., Olincy, *Taxability and Deductibility of Prepaid Income and Expense*, U. So. CAL. 1961 TAX INST. 415, 434.

tions are incidental to the contract for goods or services. On the other hand, generally accepted accounting principles require the deferring of advance payments absent the current performance of such contract.³² In such a case, the obligation to incur future expenses would not be incidental to current operations. For this reason, attempts to manipulate the periodic determination of income by deducting the estimated cost of the goods sold or services rendered from payments made in advance in order to recognize the income from the transaction before it has been earned by the performance of the contract are disfavored by professional accountants.

II. TAX ACCOUNTING STANDARDS FOR PREPAID INCOME AND ESTIMATED FUTURE EXPENSES

The Internal Revenue Code allows taxpayers to determine their taxable income according to the method of accounting regularly used in keeping their books, provided the method used clearly reflects income.³³ Since the essence of the accrual method of accounting is the determination of income by matching revenues and expenses,³⁴ taxpayers using that method determine taxable income by deducting from gross income³⁵ the expenses attributable to the earning of that income during the taxable year. The Internal Revenue Code provides:

"The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.³⁶ . . . The amount of any deduction or credit allowed . . . shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income."³⁷

Under these Code provisions, the proper time for the inclusion of receipts and the deduction of expenses is largely controlled by the method of accounting used by the taxpayer. It would seem, there-

³² Authorities cited notes 24, 26 & 27 *supra*.

³³ INT. REV. CODE OF 1954, § 446.

³⁴ *United States v. Anderson*, 269 U.S. 422, 440 (1926). See also FINNEY 367.

³⁵ For an applicable definition of gross income, see INT. REV. CODE OF 1954, § 61.

³⁶ INT. REV. CODE OF 1954, § 451(a).

³⁷ INT. REV. CODE OF 1954, § 461(a).

fore, that a taxpayer using the accrual method should, as discussed in the preceding section, defer prepayments until the taxable year in which the related obligation to deliver goods or render services is discharged; likewise, estimated future expenses should be deductible in the taxable year in which the related revenues are included in the computation of taxable income. However, both of these generally accepted accounting procedures have been rejected by the Commissioner on the ground that they do not clearly reflect income.³⁸ Consequently, taxpayers are required to include prepayments in the computation of taxable income when they are received, and are denied the right to deduct future expenses which are related to the current production of taxable income.³⁹ To substantiate this position, the Commissioner has resorted to four basic and rather separate contentions.

A. *The "Taxable Year" Concept*

At first, the rejection of taxpayers' attempts to match revenues with related expenses through the use of professional accounting procedures was based on the Treasury's concept of the annual accounting period.⁴⁰ It was felt that any attempt to match revenues and related expenses not occurring in the same taxable year was a departure from a periodic determination of income.⁴¹ The rule that income should not be determined on a transaction basis received its first approval in *Burnet v. Sanford & Brooks Co.*,⁴² a case in which the taxpayer had entered into an unprofitable dredging contract. After completion of the work, however, the taxpayer sued for breach of warranty as to a certain aspect of the job and recovered the losses it had suffered during the prior three years. The Court held that the taxpayer could not amend prior returns

³⁸ Rev. Rul. 85, 1960-1 CUM. BULL. 181 (prepaid income); 3 CCH 1962 STAND. FED. TAX REP. ¶ 2916.08 (estimated future expenses). *But cf.* INT. REV. CODE OF 1954, §§ 455, 456; Rev. Rul. 446, 1955-2 CUM. BULL. 531 (allowing accrual of bonuses); Rev. Rul. 608, 1954-2 CUM. BULL. 8 (allowing accrual of vacation pay).

³⁹ *Ibid.*

⁴⁰ Ch. 852, § 41, 45 Stat. 805 (1928) (now INT. REV. CODE OF 1954, § 441).

⁴¹ *Heiner v. Mellon*, 304 U.S. 271 (1938); *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931); *Spencer, White & Prentiss, Inc. v. Commissioner*, 144 F.2d 45 (2d Cir.), *cert. denied*, 323 U.S. 780 (1944); *Blum v. Helvering*, 74 F.2d 482 (D.C. Cir. 1934). *But cf.* *American Automobile Ass'n v. United States*, 367 U.S. 687, 701 (1961) (dissenting opinion); *Harrold v. Commissioner*, 192 F.2d 1002, 1006 (4th Cir. 1951). See also Krahmer, *Taxation of Advance Receipts for Future Services*, 1961 DUKE L.J. 230, 242.

⁴² 282 U.S. 359 (1931).

to offset the losses sustained under the contract with the income received from the damage award. Properly construed, however, this case merely prevents the matching of *losses* and *earnings* derived from a transaction in different taxable years;⁴³ it does not apply to the matching of *revenues* and *expenses*. Further clarification was necessary in order to apply this doctrine to the proper allocation of expenses and revenues.⁴⁴

B. *The "All Events" Rule*

The Commissioner's second ground for the rejection of professional accounting standards for prepayments and estimated future expenses was based on the so-called "all events" rule.⁴⁵ This rule, as originally formulated, called for the inclusion of revenues in the taxable year in which all the events have occurred which are necessary to fix their amount and the taxpayer's right to receive them;⁴⁶ in like manner, the deduction of expenses must be postponed until the taxable year in which all the events have occurred which are necessary to establish the fact and the amount of the taxpayer's liability.⁴⁷ When this rule is applied to prepaid income, it would seem that *all* the events necessary to determine the taxpayer's right to such prepayments have not occurred until they have been "earned" in the accounting sense—a position contrary to that taken by the Commissioner.⁴⁸

Although completely disregarding the "all events" rule in the case of prepaid income, the Commissioner has successfully used it to bolster his position with respect to estimated future expenses.⁴⁹ Early cases before the Board of Tax Appeals denied deduction for these items on the ground that all the events necessary to determine

⁴³ Goodhue, *Claim of Right and Changes in Accounting Method*, N.Y.U. 18TH INST. ON FED. TAX 209, 213-14 (1960); Krahmer, *supra* note 41, at 243-45.

⁴⁴ Harrold v. Commissioner, 192 F.2d 1002, 1006 (4th Cir. 1951).

⁴⁵ See *United States v. Anderson*, 269 U.S. 422, 441 (1926).

⁴⁶ Treas. Reg. § 1.446-1(c)1(ii) (1957).

⁴⁷ *United States v. Anderson*, 269 U.S. 422, 441 (1926); Treas. Reg. § 1.446-1(c)1(ii) (1957).

⁴⁸ *Bressner Radio, Inc. v. Commissioner*, 267 F.2d 520, 524 (2d Cir. 1959), *nonacq.*, Rev. Rul. 85, 1960-1 CUM. BULL. 181.

⁴⁹ See, e.g., *New Capitol Hotel, Inc. v. Commissioner*, 261 F.2d 437 (6th Cir. 1958), *affirming per curiam* 28 T.C. 706 (1957); *Hirsch Improvement Co. v. Commissioner*, 143 F.2d 912 (2d Cir.), *cert. denied*, 323 U.S. 750 (1944); *Clay Sewer Pipe Ass'n v. Commissioner*, 139 F.2d 130 (3d Cir.), *affirming* 1 T.C. 529 (1943); *South Dade Farms, Inc. v. Commissioner*, 138 F.2d 818 (5th Cir. 1943); *Automobile Club of N.Y., Inc.*, 32 T.C. 906 (1959); *National Airlines, Inc.*, 9 T.C. 159 (1947).

the amount of the expense and the fact of the taxpayer's liability had not yet occurred. In *Uvalde Co.*,⁵⁰ the taxpayer had paved certain streets under a contract which required him to maintain them for a period of several years. The taxpayer, computing taxable income by the accrual method, included revenues from the transaction in gross income and deducted an estimate of the future maintenance expenses. The Board denied the deduction because no liability for any expense had been incurred within the taxable year. A mere contractual obligation to perform services in the future does not meet the "all events" test; payment, or a specific obligation to pay for the services, is required. In addition, the fact that the obligation to incur expense in the future was contingent provided the Board with an alternative ground for decision. Under either approach, application of the "all events" rule in this context has effectively denied taxpayers the right to deduct estimated future expenses in the taxable year in which related revenues were included in the computation of taxable income.

Since its inception, the "all events" rule has been modified to the extent that a deduction will be allowed in the year in which all the events necessary to establish the fact of the liability have occurred, provided the amount of the liability can be estimated with reasonable accuracy.⁵¹ However, there has been no change in the treatment of estimated future expenses by the Tax Court or the Commissioner. This was demonstrated in *National Bread Wrapping Mach. Co.*,⁵² where the taxpayer sold machinery to be installed on the purchaser's premises during the subsequent taxable year. The taxpayer reported all revenue from the transaction and deducted a reasonable estimate for the prospective installation costs. The deduction was disallowed on the ground that all the events necessary to determine the fact of liability would not occur until the services were performed giving rise to the obligation to pay for the labor used in installing the machinery. Thus, the requirement of an existing obligation to pay money as distinguished from an obligation to perform services is still applied by the Commissioner and the Tax Court to deny a deduction for estimated future expenses. However, the distinction between money obligations and performance obligations has not received consist-

⁵⁰ 1 B.T.A. 932 (1925).

⁵¹ Treas. Reg. § 1.461-1(a)(2) (1957).

⁵² 30 T.C. 550 (1958).

ent application by the various courts of appeals.⁵³ In *Harrold v. Commissioner*,⁵⁴ the taxpayer operated a strip coal mine. Mining laws required him to refill the area excavated to reach the coal. Although the backfilling operations would not commence until a future taxable year, the taxpayer deducted an estimate of the backfilling expense attributable to current operations. The Commissioner's disallowance was sustained by the Tax Court because the petitioner had not incurred any liability in the taxable year for the payment of amounts required to refill the excavation.⁵⁵ On appeal, the Court of Appeals for the Fourth Circuit reversed. All the events necessary to determine the *fact* of the taxpayer's liability had occurred in the taxable year and the amount of the liability could be estimated with reasonable accuracy. The court did not address itself to the distinction between a performance obligation and an obligation to pay money.

It should be observed that the future performance obligation in *Harrold* was not contingent; therefore, the reasons relied on by the Tax Court in *Uvalde Co.* were not fully contravened. The question of whether the cost of contingent future performance obligations should be deductible is of utmost importance in accounting for estimated future expenses. Contingent future performance obligations include new product warranties and other service obligations undertaken in connection with the sale of goods, obligations which might well provide significant deductions, if allowed. While it is impossible to estimate the future expense associated with the sale of a single product, the aggregate future expenses associated with the sale of many articles of the same type can often be estimated with remarkable accuracy.⁵⁶ However, if the form of the transaction, rather than its substance, is to control the deductibility of estimated future expenses from contingent future obligations, the taxpayer will have to convince the Com-

⁵³ Compare *Denise Coal Co. v. Commissioner*, 271 F.2d 930 (3d Cir. 1959); *Schuessler v. Commissioner*, 230 F.2d 722 (5th Cir. 1956); *Pacific Grape Prod. Co. v. Commissioner*, 219 F.2d 862 (9th Cir. 1955); *Harrold v. Commissioner*, 192 F.2d 1002 (4th Cir. 1951), with *Central Cuba Sugar Co. v. Commissioner*, 198 F.2d 214 (2d Cir.), *cert. denied*, 344 U.S. 874 (1952); *Capital Warehouse Co. v. Commissioner*, 171 F.2d 395 (8th Cir. 1948); *Spencer, White & Prentis, Inc. v. Commissioner*, 144 F.2d 45 (2d Cir.), *cert. denied*, 323 U.S. 750 (1944); *Amalgamated Housing Corp. v. Commissioner*, 108 F.2d 1010 (2d Cir. 1940), *affirming per curiam* 37 B.T.A. 817 (1938).

⁵⁴ 192 F.2d 1002 (4th Cir. 1951).

⁵⁵ *Paul Harrold*, 16 T.C. 134 (1951).

⁵⁶ See *Ocean Acc. & Guar. Corp. v. Commissioner*, 47 F.2d 582, 584 (2d Cir. 1931).

missioner and the courts that a liability has been incurred although the obligation to perform may be contingent. Under the "all events" rule, the Commissioner has successfully asserted his contention that a contingent future performance obligation does not establish the *fact* of the taxpayer's liability until the contingency has been resolved.⁵⁷ Under this view, the future expense of such obligations would not be deductible. On the other hand, it may be argued that all the events necessary to establish the *fact* of the taxpayer's liability have occurred when he has agreed to render a contingent future performance, and the contingency merely makes the *amount* of the liability less susceptible to estimation with reasonable accuracy. This view, if accepted, would permit the deduction of future performance obligations provided they could be estimated with reasonable accuracy.

In *Milwaukee & Suburban Transp. Corp.*⁵⁸ the Tax Court sustained the Commissioner's disallowance of a deduction for the estimated future expenses from personal injury claims which arose from the operation of its buses during the taxable year. In doing so, the court reviewed the accuracy with which *individual* claims were estimated notwithstanding the taxpayer's argument that the amount deducted reflected the *aggregate* claims expense with reasonable accuracy. However, the *Milwaukee* case involved disputed liabilities rather than contingent obligations such as sales warranties (where the taxpayer's liability is admitted). The deductibility of disputed liabilities has been frequently discussed in connection with deductions for estimated future expenses, although they are clearly distinguishable. It is reasonable to deny the taxpayer the right to deduct amounts which in good faith he does not believe he will incur as expenses.⁵⁹ In addition, it has been suggested that allowing the deduction of disputed liabilities would encourage the manipulation of the year in which taxable income is reported.⁶⁰ Therefore, it is suggested that there are sufficient in-

⁵⁷ *Streight Radio & T.V., Inc. v. Commissioner*, 33 T.C. 127 (1959), *aff'd on other grounds*, 280 F.2d 883 (7th Cir. 1960), *cert. denied*, 366 U.S. 965 (1961). *Cf.* *American Automobile Ass'n v. United States*, 367 U.S. 687, 692 (1961).

⁵⁸ 28 P-H Tax Ct. Mem. 904 (1959).

⁵⁹ See, e.g., *Security Flour Mills Co. v. Commissioner*, 321 U.S. 281, 284 (1944); *Dixie Pine Prods. Co. v. Commissioner*, 320 U.S. 516 (1944). *Cf.* *Consolidated Edison Co. v. United States*, 279 F.2d 152, 157 (2d Cir. 1960), *aff'd*, 366 U.S. 380 (1961), 60 MICH. L. REV. 383 (1962).

⁶⁰ See *Consolidated Edison Co. v. United States*, *supra* note 59, at 157; Powell, *New Developments in Accruals*, N.Y.U. 19TH INST. ON FED. TAX 1337, 1357-58 (1961).

dependent reasons for finding that all the events necessary to establish the *fact* of the taxpayer's disputed liability cannot be established until the dispute has been resolved. But the decision in *Milwaukee* and other disputed liability cases should not necessarily conclude the taxpayer's right to aggregate admitted obligations in order that the future expenses may be estimated with reasonable accuracy.

C. The "Claim of Right" Doctrine

Thirdly, the Internal Revenue Service turned to the "claim of right" doctrine to justify the Commissioner's contention that prepayments must be included in the computation of taxable income for the year received, even though they are not earned until a subsequent taxable year.⁶¹ The claim of right doctrine, which originated in *North Am. Oil Consol. v. Burnet*,⁶² requires a taxpayer who has received earnings under a claim of right and without restriction as to their disposition to report them as taxable income in the year in which they were received even though he may still be required to restore their equivalent. In the *North Am. Oil* case, the taxpayer had received income which it would have to restore if it could not successfully defend its title to the land from which the income was derived. The taxpayer prevailed in the title dispute and claimed the income should be reported in the taxable year in which the suit was settled. The Supreme Court held the income was properly reported in the taxable year in which it was received. Two years later, in *Brown v. Helvering*,⁶³ the Court further refined the claim of right doctrine by denying a taxpayer the right to deduct an estimate of the income he might have to restore. In both of these cases, it was clear that the claim of right doctrine was used to determine the proper period for reporting net income. Thus, this is not authority for the proposition that the mere receipt of a prepayment determines its year of inclusion.⁶⁴

⁶¹ See, e.g., *New Capitol Hotel v. Commissioner*, 261 F.2d 437 (6th Cir. 1958), *affirming per curiam* 28 T.C. 706 (1957); *Hirsch Improvement Co. v. Commissioner*, 143 F.2d 912 (2d Cir.), *cert. denied*, 323 U.S. 750 (1944); *Clay Sewer Pipe Ass'n v. Commissioner*, 139 F.2d 130 (3d Cir.), *affirming* 1 T.C. 529 (1943); *South Dade Farms, Inc. v. Commissioner*, 138 F.2d 818 (5th Cir. 1943); *Automobile Club of N.Y., Inc.*, 32 T.C. 906 (1959); *National Airlines, Inc.*, 9 T.C. 159 (1947).

⁶² 286 U.S. 417 (1932).

⁶³ 291 U.S. 193 (1934).

⁶⁴ *Bressner Radio, Inc. v. Commissioner*, 267 F.2d 520, 525 (2d Cir. 1959), *nonacq.*.

However, the Commissioner and the Tax Court have relied upon the claim of right doctrine to require the inclusion of prepayments in the taxable year of receipt. In *E. B. Elliott Co.*,⁶⁵ the Board of Tax Appeals required the taxpayer to include prepaid rentals in its current determination of taxable income on the ground that the taxpayer had the unrestricted use of the cash received. The Board did not recognize the offsetting liability of the taxpayer to perform its obligation or restore the money advanced. In *Wallace A. Moritz*,⁶⁶ the Tax Court required the taxpayer, a professional photographer, to include deposits on picture orders in his determination of taxable income for the year in which they were received. The deposits were to be refunded if the customers did not accept the finished pictures. Again the court relied on the claim of right doctrine, indicating that the taxpayer had the unrestricted use of the funds deposited.

While the Tax Court has continued to rely on the claim of right doctrine, courts of appeals have not consistently applied it in prepaid income cases.⁶⁷ In *Beacon Publishing Co. v. Commissioner*,⁶⁸ the Court of Appeals for the Tenth Circuit reversed the Tax Court's decision which had required the taxpayer to include prepaid newspaper subscriptions in taxable income for the year in which they were received. The court held the claim of right doctrine was not applicable to prepayments because there was no dispute as to the ownership of the funds.⁶⁹ It was recognized that acceptance of the claim of right doctrine would require the taxpayer to report prepayments as if he were using the cash receipts

Rev. Rul. 85, 1960-1 CUM. BULL. 181; *Beacon Publishing Co. v. Commissioner*, 218 F.2d 697, 700 (10th Cir. 1955). Cf. *American Automobile Ass'n v. United States*, 367 U.S. 687, 700 (1961) (dissenting opinion); *Automobile Club v. Commissioner*, 353 U.S. 180, 191 (1957) (dissenting opinion). See Goodhue, *supra* note 43, at 232.

⁶⁵ 45 B.T.A. 82 (1941).

⁶⁶ 21 T.C. 622 (1954).

⁶⁷ Compare *Schlude v. Commissioner*, 283 F.2d 234 (8th Cir. 1960), *rev'd per curiam*, 367 U.S. 911, *modified*, 368 U.S. 873 (1961); *Bressner Radio, Inc. v. Commissioner*, 267 F.2d 520 (2d Cir. 1959), *nonacq.*, Rev. Rul. 85, 1960-1 CUM. BULL. 181; *Beacon Publishing Co. v. Commissioner*, 218 F.2d 697 (10th Cir. 1955), *with* *Streight Radio & T.V., Inc. v. Commissioner*, 280 F.2d 883 (7th Cir. 1960), *cert. denied*, 366 U.S. 965 (1961); *New Capitol Hotel v. Commissioner*, 261 F.2d 437 (6th Cir. 1958), *affirming per curiam* 28 T.C. 706 (1957); *Hirsch Improvement Co. v. Commissioner*, 143 F.2d 912 (2d Cir.), *cert denied*, 323 U.S. 750 (1944); *Clay Sewer Pipe Ass'n v. Commissioner*, 139 F.2d 130 (3d Cir.), *affirming* 1 T.C. 529 (1943); *South Dade Farms, Inc. v. Commissioner*, 138 F.2d 818 (5th Cir. 1943).

⁶⁸ 218 F.2d 697 (10th Cir. 1955).

⁶⁹ *Beacon Publishing Co. v. Commissioner*, 218 F.2d 697, 700 (10th Cir. 1955).

and disbursements method of accounting, although actually using the accrual method, thereby creating a hybrid accounting system which would not clearly reflect income.⁷⁰ The claim of right doctrine as advanced by the Commissioner received a further setback in *Bressner Radio, Inc. v. Commissioner*⁷¹ when the court allowed the taxpayer to exclude prepayments received from the sale of repair services from its current determination of income. The court limited the claim of right doctrine to the situation in which it arose: the determination of the taxable year in which *earned income* must be reported. The court reviewed the decision in *North Am. Oil* and concluded that the Supreme Court “held only that money that was *earned and held under a claim of right* was includible in the year of receipt.”⁷²

The Commissioner’s contention that the claim of right doctrine required the inclusion of prepayments in the computation of taxable income when received was placed before the Supreme Court in *Automobile Club v. Commissioner*,⁷³ where the taxpayer sought to reverse a Sixth Circuit decision which had relied on that doctrine to require the inclusion of prepaid membership dues.⁷⁴ The Court affirmed the decision, but in doing so, it disregarded the claim of right doctrine on which the Commissioner had relied. Mr. Justice Harlan, dissenting, stated:

“The Commissioner seeks to justify that course [the inclusion of prepayments] under the ‘claim of right’ doctrine announced in *North American Oil v. Burnet*. . . . However, that doctrine, it seems to me, comes into play only in determining whether the treatment of an item of income should be influenced by the fact that the right to receive or keep it is in dispute. . . . *The Court, however, now bypasses the Commissioner’s ‘claim of right’ argument*, and rests its decision instead on the ground that the pro rata allocation of the membership dues in monthly amounts is purely artificial.”⁷⁵

Yet, after the *Automobile Club* decision, the claim of right doctrine continued to be applied in both the Tax Court⁷⁶ and the

⁷⁰ *Id.* at 701.

⁷¹ 267 F.2d 520 (2d Cir. 1959), *nonacq.*, Rev. Rul. 85, 1960-1 CUM. BULL. 181.

⁷² *Bressner Radio, Inc. v. Commissioner*, *supra* note 71, at 525.

⁷³ 353 U.S. 180 (1957).

⁷⁴ *Automobile Club v. Commissioner*, 230 F.2d 585 (6th Cir. 1956).

⁷⁵ *Automobile Club v. Commissioner*, 353 U.S. 180, 191-93 (1957). (Emphasis added.)

⁷⁶ *Automobile Club of N.Y., Inc.*, 32 T.C. 906 (1959).

courts of appeals.⁷⁷ In *American Automobile Ass'n v. Commissioner*,⁷⁸ the Supreme Court took a second look at the problem. Again, the Court required inclusion of prepayments in the computation of taxable income when received without indicating reliance upon the claim of right doctrine. This was carefully presented in the dissenting opinion of Mr. Justice Stewart, where it was said:

"The Commissioner's basic argument against the deferred reporting of prepayments has traditionally been that such a method conflicts with a series of decisions of this Court which establish the so-called 'claim of right doctrine.' In this case the Government abandoned that argument with good reason. As four Circuits have correctly held, the claim of right doctrine furnishes no support for the Government's position. . . . A claim of right without 'restriction on use' may be the crucial factor in *determining that particular funds are includable in gross income*. . . . But it hardly follows that all such funds must necessarily be reported by an accrual basis taxpayer as income in the year of receipt, whether or not then earned."⁷⁹

Thus, it is possible that the Commissioner may have finally abandoned the claim of right doctrine with respect to prepayments. It is hoped that the Commissioner will act consistently and not reassert the claim of right doctrine in cases before those lower courts which have previously applied it to require the inclusion of prepayments when received. In this manner, it may be possible to obtain some uniformity of judicial thought on a correct basis for the inclusion or exclusion of such advances.

D. *The Automobile Club Decision*

In both the *Automobile Club* and *American Automobile Ass'n* cases the taxpayer had received prepayments in consideration for

⁷⁷ *Streight Radio & T.V., Inc. v. Commissioner*, 280 F.2d 883 (7th Cir. 1960), *cert. denied*, 366 U.S. 965 (1961).

⁷⁸ 367 U.S. 687 (1961).

⁷⁹ *Id.* at 699, 700. (Emphasis added.) Circuit court decisions cited with approval were *Schlude v. Commissioner*, 283 F.2d 234 (8th Cir. 1960); *Bressner Radio, Inc. v. Commissioner*, 267 F.2d 520 (2d Cir. 1959); *Schuessler v. Commissioner*, 230 F.2d 722 (5th Cir. 1956); *Beacon Publishing Co. v. Commissioner*, 218 F.2d 697 (10th Cir. 1955).

future services, including some services which would be performed upon the happening of a contingency. Each taxpayer prorated the prepayment over the period during which he might be obligated to render services, and included the portion allocated to the current year in its computation of taxable income. In *Automobile Club*, the Court concluded that the Commissioner had not exceeded his authority because "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."⁸⁰ Thus, the *Automobile Club* decision provided the Commissioner with a fourth basis to support his contention that prepayments must be included in taxable income for the year of receipt. It should be noted that the Court distinguished *Beacon Publishing* and *Schuessler v. Commissioner*,⁸¹ indicating that it did not wish to pass upon the more difficult question presented where the time of future performance can be accurately determined. Consequently, it may be argued that the decision would sustain the Commissioner's position only in cases involving future obligations so contingent that the year of performance cannot be accurately determined. However, in *Bressner Radio, Inc.*,⁸² which also involved contingent future obligations, the Second Circuit rejected the Commissioner's argument that *Automobile Club* was dispositive of the case at bar. The court found that the taxpayer's deferral of prepayments "bore a carefully estimated relationship to the services petitioner would be called upon to render."⁸³ Thus, it seemed that *Automobile Club* decision might not apply if the taxpayer could prove that the deferral of prepayments was not "artificial." The Government indicated it would not follow the *Bressner* decision.⁸⁴ In *American Automobile Ass'n* the Supreme Court granted certiorari⁸⁵ in order to resolve the apparent conflict between *Bressner* and the decision of the Court of Claims which had sustained the Commissioner's rejection of the Association's method of accounting.⁸⁶ The Supreme Court affirmed the decision below, relying on its earlier

⁸⁰ *Automobile Club v. Commissioner*, 353 U.S. 180, 189 (1957).

⁸¹ 230 F.2d 722 (5th Cir. 1956).

⁸² 267 F.2d 520 (2d Cir. 1959). See text at notes 71, 72 *supra*.

⁸³ *Id.* at 529.

⁸⁴ Rev. Rul. 85, 1960-1 CUM. BULL. 181.

⁸⁵ 364 U.S. 813 (1960).

⁸⁶ 181 F. Supp. 255 (Ct. Cl. 1960).

decision in *Automobile Club*. Although the taxpayer had sought to show that its correlation of cost and the period of deferral was justified by "proof of experience," evidence based on statistical computations of average monthly cost per member could not, without legislative authorization and over the objection of the Commissioner, be used as a basis for deferral.⁸⁷ This decision apparently is determinative of the taxpayer's right to defer prepayments when the taxpayer has incurred a contingent future performance obligation. However, it is suggested that, so limited, the Court's decision is subject to the same criticism mentioned in connection with the deduction of the estimated expense of contingent future performance obligations—allowing the form of the transaction to control its substance.⁸⁸ As the Court indicated, it is impossible to determine the future time or times the Association would have to render services on behalf of a member. However, when the memberships are viewed in the aggregate, an accurate determination of the portion of the prepaid dues earned within a given taxable year can be obtained by statistical estimation based upon past experience. If the purpose of tax accounting is to reflect income accurately, the Court seemingly should have concerned itself with the accuracy of the Association's estimate of dues which had been earned. Instead, the Court has apparently prohibited the use of such estimates without regard to the degree that they may accurately reflect income. However, Congress expressed dissatisfaction with the Court's result by the enactment of section 456⁸⁹ which provided for the deferral of prepaid membership dues. Speaking specifically to the Court's decision, the congressional committee report expressed approval of deferring prepaid membership dues because that method of accounting more clearly reflected income than reporting dues in the taxable year received.⁹⁰ Consequently, it is not clear what weight will be given to this aspect of *American Automobile Ass'n* in future litigation.

In *American Automobile Ass'n*, the Court announced an addi-

⁸⁷ *American Automobile Ass'n v. United States*, 367 U.S. 687, 691-93 (1961).

⁸⁸ *American Automobile Ass'n v. United States*, *supra* note 87, at 691. The Court continued to distinguish *Beacon Publishing Co. v. Commissioner*, 267 F.2d 520 (2d Cir. 1959) and *Schuessler v. Commissioner*, 230 F.2d 722 (5th Cir. 1956) on the ground that future performance was certain. See *American Automobile Ass'n v. United States*, *supra*, at 691 n.4.

⁸⁹ INT. REV. CODE OF 1954, § 456, 75 Stat. 222 (1961).

⁹⁰ H.R. REP. NO. 381, 87th Cong., 1st Sess. (1961).

tional reason for its decision which indicated that even if the taxpayer could show that the deferral of prepayments clearly reflected economic net income, it might nevertheless be rejected for tax purposes. The apparent denial of any opportunity to defer "prepaid income" may be found in the Court's construction of recent legislation. Sections 452⁹¹ and 462⁹² of the Internal Revenue Code of 1954, as originally enacted, contained the first legislative approval of the deferment of prepayments and the deduction of estimated future expenses. In 1955, these provisions were retroactively repealed because the estimated loss of revenue attributable to the newly-enacted provisions would have been much greater than estimated.⁹³ The Court construed the enactment and repeal of these sections as indicating a legislative intent that no deferral of prepayments should be allowed unless specifically authorized. In strong dictum the Court said:

"[T]he fact is that § 452 for the first time specifically declared petitioner's system of accounting to be acceptable for income tax purposes, and overruled the long-standing position of the Commissioner and the courts to the contrary. And the repeal of the section the following year, upon insistence by the Treasury that the proposed endorsement of such tax accounting would have a disastrous impact on the Government's revenue, was just as clearly a mandate from the Congress that petitioner's system was not acceptable for tax purposes."⁹⁴

Sections 452 and 462 would have clearly included those areas which the Court had specifically sought to distinguish. Consequently, it may be argued that, logically, the decision in *American Automobile Ass'n* concludes the taxpayer's right to defer prepayments, even where the taxpayer is required to perform his obligation at a fixed future date. This conclusion was further strengthened by the Court's disposition of *Schlude v. Commissioner*,⁹⁵ decided in the same term as *American Automobile Ass'n*. In *Schlude*, the Eighth Circuit factually distinguished *Automobile Club v. Commissioner* as follows:

"Here, petitioners' obligation to provide services subsequent

⁹¹ Int. Rev. Code of 1954, ch. 736, § 452, 68A Stat. 152.

⁹² Int. Rev. Code of 1954, ch. 736, § 462, 68A Stat. 168.

⁹³ Ch. 143, 69 Stat. 134 (1955).

⁹⁴ *American Automobile Ass'n v. United States*, 367 U.S. 687, 695 (1961).

⁹⁵ 283 F.2d 234 (8th Cir. 1960).

to the tax year was fixed, definite and certain, thereby effectively rebutting any contention that petitioners' method of deferral was purely artificial."⁹⁶

On appeal, the Supreme Court remanded *Schlude* for further consideration in the light of its decision in *American Automobile Ass'n*.⁹⁷ After reconsideration, the Eighth Circuit vacated its decision and affirmed the Tax Court since, in the court's language, petitioners' method of accounting did not, "for income tax purposes, clearly reflect income."⁹⁸ The Eighth Circuit had distinguished *Schlude* from *Automobile Club* for the same reason that the Supreme Court had distinguished *Beacon* and *Schuessler* from that case, a distinction that was followed in *American Automobile Ass'n*.⁹⁹ Thus, it would appear from the Second Circuit's earlier evaluation of the accounting methods used in *Schlude* that those methods did not come within *American Automobile Ass'n*'s prohibition against arbitrary deferrals. However, section 452 would have applied to *Schlude*'s facts; therefore, it may be speculated that, on remand, the court felt compelled to reject petitioner's accounting methods because of the Supreme Court's interpretation of the legislative history of that section. If this interpretation is deemed to control tax accounting, it would appear that any further attempt to apply generally accepted professional accounting methods to prepayments would be futile. Furthermore, *American Automobile Ass'n* may be expected to have a similar effect on situations involving estimated future expenses, as the Court's interpretation of legislative intent would apply equally to the identical history of section 462 which had allowed the deduction of such expenses.

III. TAX ACCOUNTING STANDARDS FOR PREPAID INCOME FROM THE SALE OF PROPERTY—AN ANOMALY

Unlike prepayments made in connection with the sale of services or the rental of property, the inclusion of prepayments from the sale of property must be deferred until the sale has been completed.¹⁰⁰ While attempts have been made to distinguish the sale

⁹⁶ *Id.* at 241.

⁹⁷ 368 U.S. 873 (1961).

⁹⁸ *Schlude v. Commissioner*, 296 F.2d 721, 722 (8th Cir. 1961), *cert. granted*, 370 U.S. 902 (1962). (Emphasis added.)

⁹⁹ *American Automobile Ass'n v. United States*, 367 U.S. 687, 691 n.4 (1961).

¹⁰⁰ See, e.g., *Virginia Coal & Coke Co. v. Commissioner*, 99 F.2d 919 (4th Cir. 1938);

of goods from the sale of services based on the nature of the transaction,¹⁰¹ it would seem that the distinction arises from the definition of gross income as used in section 451. "In a manufacturing, merchandising, or mining business, 'gross income' means the total sales, less the cost of goods sold"¹⁰² Consequently, when property is sold, prepayments cannot be included in gross income until the cost of the property sold can be ascertained and deducted from gross receipts in order to determine the amount to be included in the computation of taxable income.¹⁰³ On the other hand, gross income from the sale of services or rental of property is equivalent to the gross receipts from such activities, which must be included in the computation of taxable income when received.¹⁰⁴ This distinction was derived from the apparent requirement that capital be recovered *before* an income tax can be imposed.¹⁰⁵ However, under the claim of right doctrine this distinction should have been insignificant because that doctrine treats funds received under a claim of right and without restriction as to their disposition as taxable income regardless of the type of transaction from which the funds are derived.¹⁰⁶ Furthermore, the dissimilar treatment accorded prepayments from the sale of property cannot be sustained under the reasoning set out in *American Automobile Ass'n v. Commissioner*,¹⁰⁷ which has apparently rejected the claim of right doctrine.¹⁰⁸ Section 452 expressly allowed the deferral of prepayments attributable to the sale of goods and the rental of property.¹⁰⁹ Con-

Woodlawn Park Cemetery, 16 T.C. 1067 (1951); Veenstra & De Haan Coal Co., 11 T.C. 964 (1948). See also Behren, *Prepaid Income—Accounting Concepts and the Tax Law*, 15 TAX L. REV. 343, 353 (1960); Goodhue, *Claim of Right and Changes in Accounting Method*, N.Y.U. 18TH INST. ON FED. TAX. 209, 214 (1960).

¹⁰¹ Veenstra & De Haan Coal Co., *supra* note 100.

¹⁰² Treas. Reg. § 1.61-3(a) (1957).

¹⁰³ See, e.g., *Virginia Coal & Coke Co. v. Commissioner*, 99 F.2d 919 (4th Cir. 1938); *Woodlawn Park Cemetery*, 16 T.C. 1067 (1951); *Veenstra & De Haan Coal Co.*, 11 T.C. 964 (1948); *Summit Coal Co.*, 18 B.T.A. 983 (1930); *Sophia M. Garretson*, 10 B.T.A. 1381 (1928). The Commissioner may not anticipate the amount of gross income by deducting the estimated cost of sales; see *Woodlawn Park Cemetery*, *supra*.

¹⁰⁴ INT. REV. CODE OF 1954, § 451; Treas. Reg. §§ 1.61-2(a)1, 1.61-3(a) (1957).

¹⁰⁵ *Doyle v. Mitchell Bros. Co.*, 247 U.S. 179 (1918); *Hays v. Gauley Mountain Coal Co.*, 247 U.S. 189 (1918).

¹⁰⁶ See, e.g., *James v. United States*, 366 U.S. 213 (1961) (embezzlement); *Rutkin v. United States*, 343 U.S. 130 (1952) (extortion); *United States v. Lewis*, 340 U.S. 590 (1951) (bonus paid by mistake).

¹⁰⁷ 367 U.S. 687, 694-97 (1961).

¹⁰⁸ *Id.* at 701 (dissenting opinion).

¹⁰⁹ INT. REV. CODE OF 1954, ch. 736 § 452(e)2, 68A Stat. 152.

sequently, under the Court's interpretation of the legislative intent manifested by its repeal, prepayments from the sale of goods as well as the sale of services and the rental of property would seemingly be includible in the computation of taxable income when received.¹¹⁰ The distinction between the sale of services and the sale of property can raise difficult problems of classification, as illustrated by the recent case of *Wallace A. Moritz*,¹¹¹ in which a photographer had received refundable deposits for portraits which were completed and accepted in the following taxable year. The Tax Court required the deposits to be included in the current determination of taxable income on the theory that they were for the rendition of services rather than the sale of portraits.¹¹² It is probable that similar problems of classification will be encountered whenever deposits are received in connection with the sale of products made to the customer's specifications, an arrangement frequently encountered. It has been suggested that such problems could be avoided by recognizing that there is no economic difference between the determination of income from the sale of property and the sale of services or the rental of property and, therefore, no basis for continuing the present distinction.¹¹³

IV. THE NEED FOR A LEGISLATIVE SOLUTION

Prior to the decision in *American Automobile Ass'n* the question of acceptable tax accounting methods for prepaid income and estimated future expenses was considered incapable of resolution.¹¹⁴ The Commissioner and the Tax Court resisted the introduction of generally accepted accounting methods regardless of the situation in which the prepayment was received or the estimated future expense deducted.¹¹⁵ The courts of appeals had rendered conflict-

¹¹⁰ The validity of the dissimilar treatment accorded to prepayments for goods has been seriously questioned. See Behren, *supra* note 100, at 354; Goodhue, *supra* note 100, at 214-15.

¹¹¹ 21 T.C. 622 (1954).

¹¹² *Id.* at 624-25.

¹¹³ Goodhue, *supra* note 100, at 215.

¹¹⁴ See generally Behren, *supra* note 100; Krahmer, *Taxation of Advance Receipts for Future Services*, 1961 DUKE L.J. 230.

¹¹⁵ Rev. Rul. 85, 1960-1 Cum. Bull. 181. See, e.g., *National Bread Wrapping Mach. Co.*, 30 T.C. 550 (1958); *E. W. Schuessler*, 24 T.C. 247 (1955), *rev'd*, 230 F.2d 722 (5th Cir. 1956); *Wallace A. Moritz*, 21 T.C. 622 (1954); *Pacific Grape Prods. Co.*, 17 T.C. 1097 (1952), *rev'd*, 219 F.2d 862 (9th Cir. 1955); *Capital Warehouse Co.*, 9 T.C. 966 (1947), *aff'd*, 171 F.2d 395 (8th Cir. 1948).

ing decisions.¹¹⁶ In addition, separate standards prevailed for the treatment of prepayments from the sale of property and prepayments from the sale of services and rental of property without apparent economic justification.¹¹⁷ The decision in *American Automobile Ass'n* was based upon alternative grounds. One of these, dealing with the clarity of accounting procedure used, has been rejected by Congress. Furthermore, this reasoning did not purport to control accounting for prepayments and estimated expenses where non-contingent obligations had been incurred;¹¹⁸ nor did it dispose of the apparent anomaly regarding the sale of property. The other ground, based on legislative intent, would have disposed of the entire question. However, the Court was careful to discuss this asserted basis in dictum and restricted its decision to finding that the Commissioner did not abuse his discretion in rejecting the Association's accounting system.¹¹⁹ Insofar as the decision was limited, it cannot fairly be interpreted as resolving prior conflicting decisions. Thus, the need for legislation governing prepaid income and estimated future expenses cannot be underestimated. Congressional resolution of these conflicting decisions is necessary to enable businessmen to make an intelligent choice between competing methods of obtaining payments for goods and services. The decision in *American Automobile Ass'n* placed the burden upon Congress to determine what relief, if any, shall be offered to taxpayers who must account for prepayment or estimated future expenses.¹²⁰ The Court's failure to take more decisive action is not entirely unjustified. Many of the underlying policy reasons for and against the adoption of accounting methods which would allow the deferral of prepaid income and the deduction of estimated future expenses are not properly the subject of judicial recognition.¹²¹

¹¹⁶ Cases cited notes 53 & 67 *supra*.

¹¹⁷ See text at notes 100-14 *supra*.

¹¹⁸ See text at notes 89 & 90 *supra*.

¹¹⁹ *American Automobile Ass'n v. United States*, 367 U.S. 687, 698 (1961).

¹²⁰ "We must leave to the Congress the fashioning of a rule which, in any event, must have wide ramifications." Clark, J., in *American Automobile Ass'n v. United States*, *supra* note 119, at 697.

¹²¹ "The Committees of the Congress have standing committees expertly grounded in tax problems, with jurisdiction covering the whole field of taxation and facilities for studying considerations of policy as between the various taxpayers and the necessities of the general revenues." *Ibid*.

A. Effect of Present Tax Accounting Standards

If income is the value added as a result of economic activity, it is clear that the present tax accounting rules do not in fact measure income as so defined. Instead, income for tax accounting purposes is measured from transactions undertaken and completed within the taxable year, increased by current prepayments for future services, and decreased by current expenditures incurred in earning prepayments reported in a prior taxable year. Under the present tax accounting standards a new business receiving prepayments incurs a higher tax in its initial year than it would if only the value added through its operations were measured. An established business which enjoys increasing prepaid sales from year to year likewise pays a higher tax than would be incurred were it allowed to measure taxable income under the "value added" concept; conversely, an established business with decreasing prepaid sales reports less taxable income than it actually earns. If, on the other hand, the amount of prepaid sales remains fairly constant from year to year, the present tax accounting standards result in the same computation of taxable income as would be computed under a method of accounting designed to measure income according to the "value added" concept.

Although the computation of the total income for the life of the business will be the same regardless of the accounting method used, the present rules hinder the organization of new businesses which receive substantial prepayments.¹²² These businesses must obtain additional capital to pay the additional tax they incur under the present tax accounting standards. It may be argued that the only hardship is the minimal cost of interest on the additional funds until the tax has been recaptured through deduction of the expenses incurred in earning the prepayments. This analysis disregards the possibility that a new business may lack a sufficient credit standing to enable it to obtain capital for this purpose. A similar economic hardship is suffered by expanding businesses which receive sizeable prepayments. Instead of being able to re-invest those funds used to pay the tax increment, the company must seek additional capital to finance further expansion. Again, the additional cost factor is limited to interest on the capital ob-

¹²² HOUSE COMM. ON WAYS & MEANS, 86th Cong., 1st Sess., PANEL DISCUSSIONS ON INCOME TAX REVISION 646, 664 (Comm. Print 1960).

tained. However, since the additional capital will be needed as long as the business continues to expand, the cumulative annual interest charges could become prohibitive. Another adverse effect that may result from application of the present tax accounting rules is that individual taxpayers who receive prepayments may incur a greater total tax than those who do not, even though they may earn, in the "value added" sense, the same income from year to year. The difference in their tax burden results from application of the progressive income tax rates to the distorted income computations made in compliance with present tax accounting standards. Under these standards, the prepayments may well be taxed at a higher marginal rate than the marginal rate applicable to the last increment of income in the year in which the expenses are deducted. A further economic hardship resulting from present tax accounting rules may be incurred when prepayments are used to finance the seller's future performance.¹²³ Often this is the only financing method available. But under the present standards the unexpended portion of the prepayments is taxed as if it were income; consequently, the attractiveness of financing through prepayments is significantly lessened. It would seem that these claims of hardship are sufficiently meritorious to indicate clearly the need for change in the present tax accounting rules. In response to this need, many authorities have expressed their belief that, as a solution, generally accepted accounting standards should be adopted for tax purposes.¹²⁴

B. *Effect of the Adoption of Accounting Standards*

The adoption of professional accounting standards for prepayments and estimated future expenses would remove the present economic disadvantages incurred by taxpayers who have such receipts and expenses. The present Internal Revenue Code has granted these taxpayers limited relief in only two instances. Sections 455¹²⁵ and 456¹²⁶ allow the deferral of prepaid subscriptions

¹²³ *Id.* at 664; PATON 315.

¹²⁴ *Cf.* Behren, *supra* note 100, at 366; Berlfein, *Tax vs. Commercial Accounting Considerations in Reserve Accounts*, U. SO. CAL. 1961 TAX INST. 387, 411; Freeman, *Tax Accrual Accounting for Contested Items*, 56 MICH. L. REV. 727, 747 (1958); Krahmer, *supra* note 114, at 258. *But cf.* Schapiro, *Tax Accounting for Prepaid Income and Reserves for Estimated Future Expenses*, 2 TAX REVISION COMPENDIUM 1133, 1151 (House Ways & Means Comm. 1959).

¹²⁵ INT. REV. CODE OF 1954, § 455. This section codified the decision in *Beacon Publishing Co. v. Commissioner*, 218 F.2d 697 (10th Cir. 1955).

¹²⁶ See text at note 89 *supra*.

and prepaid membership dues; yet there is no significant economic difference which distinguishes these receipts from any other forms of prepayments. Thus, it may be surmised that these provisions merely indicate a congressional response to well-pleaded individual hardships.¹²⁷

The Government has opposed the extension of the advantages offered by 455 and 456 to taxpayers that do not come within their limited scope because it would place too great a burden on the Treasury and the Internal Revenue Service. The burden incurred by the Treasury would be the loss in revenue that would be sustained because of the change in accounting methods.¹²⁸ Although the loss would be incurred only once, in the taxable year during which the change in accounting methods occurs, it would be substantial. This prospective loss in revenue resulted in the retroactive repeal of sections 452 and 462 when it was belatedly estimated that the loss might have reached one billion dollars.¹²⁹ Also, allowing deferral of prepayments would obstruct the easy collection of taxes by making the Treasury stand the risk of the taxpayer's insolvency.¹³⁰ This important consideration has led to the enactment of withholding provisions,¹³¹ and the requirement of returning estimated tax.¹³² Thirdly, it has been argued that the professional accounting standards should not be adopted because it would unduly burden the Internal Revenue Service with additional administrative problems:¹³³ the time for the recognition of advance receipts is not clearly enough defined by professional accounting rules.¹³⁴ Finally, a shift to accounting principles has been resisted on the ground that the collection of taxes should not be made to depend on such standards because they are inherently conservative, thus tending to underestimate income.¹³⁵ Thus, it appears that the Government has valuable interests in the continuation of the present tax accounting standards even though they are a source of some hardship to the taxpayers who are required to use them.

¹²⁷ S. REP. NO. 1983, 85th Cong., 2d Sess. 42 (1958).

¹²⁸ Behren, *supra* note 100, at 364; Krahmer, *supra* note 114, at 257.

¹²⁹ H.R. REP. NO. 293, 84th Cong., 1st Sess. 3-4 (1955).

¹³⁰ Behren, *supra* note 100, at 363; Krahmer, *supra* note 114, at 259.

¹³¹ INT. REV. CODE OF 1954, §§ 3401-04.

¹³² INT. REV. CODE OF 1954, § 6153.

¹³³ Behren, *supra* note 100, at 364; Krahmer, *supra* note 114, at 258.

¹³⁴ Behren, *supra* note 100, at 364.

¹³⁵ *Ibid.*

C. *Suggested Resolution of the Conflicting Interests*

It is apparent from the Code provisions which allow the deduction of substantially all business expenses that Congress intended to tax only net business income.¹³⁶ Accordingly, the Government arguably has no legitimate interest in the continued application of accounting standards which do not accurately measure net income. Although the present tax accounting standards for prepayments and estimated future expenses should for this reason be abandoned, it does not necessarily follow that the applicable professional accounting methods should be wholly adopted. While such accounting methods accurately measure net income, they should be subordinated to the Government's interests in protecting and insuring adequate sources of revenue. The Government's needs are illustrated by its interest in collectibility of taxes and ease in administering the federal tax system.

With respect to the taxation of unearned prepayments, it would seem that the interests of both Government and taxpayer could best be protected through the return of an estimated tax on income to be earned in the performance of future obligations. The idea of returning estimated tax has proved workable in other situations.¹³⁷ The assessment of estimated tax would require the taxpayer to estimate the cost of earning prepayments and deduct this amount in order to estimate the net income from such transactions. The estimated expenses should be deducted even though the obligation to incur them may be contingent or disputed;¹³⁸ so long as the estimate of net income is reasonably accurate the interests of the Government would be fully protected. Once an accurate estimate of net income is obtained, the problem of determining an appropriate tax rate remains to be resolved. It is suggested that the estimated net income be returned at the marginal rate applicable to earned income reported in the year the prepayment is received. This would eliminate the additional problem of guessing the marginal rate that would be applicable to the estimated income in the year it is earned. When the income from the prepayments is actually earned, it would be included in the determination of tax for that year and a credit would be taken for the estimated tax

¹³⁶ BITTKER, *FEDERAL INCOME ESTATE AND GIFT TAXATION* 193 (1958).

¹³⁷ INT. REV. CODE OF 1954, §§ 6015, 6016.

¹³⁸ See text at notes 56 & 57 *supra*.

previously paid. This mode of computing net income and the tax thereon is consistent with generally accepted accounting principles to the extent that it matches revenues with related expenses. However, where professional accountants would defer the recognition of income, this method estimates income and returns the tax at the time the taxpayer receives cash, thus protecting the Government's interest in collectibility.

The Government's interest in ease of administration could also be protected under accounting methods which provide for the return of estimated tax. Proper accounting for estimated income would require the taxpayer to establish a reserve for the expenses to be incurred. A separate reserve could be established for the unearned prepayments at the end of each taxable year. As these prepayments are earned the expenses incurred would be charged against the reserve leaving a terminal balance in the reserve, a feature not found in present reserve accounts.¹³⁹ This terminal balance would indicate the error in the estimate of income, thereby facilitating audit. Since, in a business setting, estimates of the cost of earning prepayments are made as a normal incident to the determination of prices and production schedules, it would be reasonable for the Internal Revenue Service to demand a high degree of accuracy. As an added impetus to accurate estimation, taxpayers should be allowed to pay the amount by which the tax is underestimated without paying any interest or penalty if the estimate of net income was at least 90 percent of the amount actually earned.¹⁴⁰ If the estimate of net income should fall below 90 percent, and there is no evidence of bad faith, the taxpayer should be allowed to pay the amount by which the tax was underestimated with interest thereon at the statutory rate of six percent. If the estimate was so inaccurate as to indicate bad faith, the Government should be able to assert its criminal or civil fraud penalties.¹⁴¹ Under such a system of penalties it is hoped that the taxpayer's self-interest would inhibit the deduction of expenses which are not fairly allocable to earning prepayments. To further ease the administrative burden, taxpayers should have an adequate cost

¹³⁹ See, e.g., INT. REV. CODE OF 1954, § 166(c).

¹⁴⁰ Under present standards the taxpayer incurs no interest obligation if its Estimated Tax paid equals at least 70% of its actual tax liability. See INT. REV. CODE OF 1954, §§ 6654(d), 6655(d).

¹⁴¹ INT. REV. CODE OF 1954, § 6653.

accounting system as a prerequisite to returning estimated tax. This would be necessary to protect the integrity of the terminal balance as an indicator of errors in estimating income. Where the taxpayer has obligated itself to deliver a fairly standardized product or render a standardized service, a cost accounting system based on process cost or average cost should be sufficiently accurate. On the other hand, where the taxpayer sells diverse products or services, a unit cost accounting system may be required.¹⁴² A further limitation on the return of estimated tax should be one in terms of time. Both the Internal Revenue Service and taxpayers would seem to have an interest in being able to close off transactions of prior years. Thus, it is suggested that the return of estimated tax on income from prepayments be denied unless it can be credited against the taxpayer's tax liability within the present three-year statute of limitations.¹⁴³ Also, once an election to return an estimated tax is made, the taxpayer should not be able to rescind it without prior permission of the Commissioner. This would be necessary in order to prevent the taxpayer from returning to the present accounting standards in years with fewer prepaid sales in order to reduce his taxes.

It should be noted that this method of accounting for prepayments is similar to the professional accounting method of handling estimated future expenses.¹⁴⁴ Consequently, it would be consistent to adopt such accounting standards as are applicable to those expenses. That portion of current receipts which corresponds to the cost of providing future services would be recognized when received, with a simultaneous deduction of estimated future expenses.

While this solution is in effect a compromise with generally accepted principles, since designed to protect the Government's interests, it also removes much of the economic hardship incurred under the present rules. Rather than tax the total receipts from prepayments, only the tax on the estimated net income from such receipts would have to be returned. Thus, the taxpayer would be left with the bulk of the cash received and would not have to look elsewhere to obtain means of financing. Furthermore, since taxpayers receiving prepayments would be taxed on their net income

¹⁴² See generally AMORY, ACCOUNTING 530-69 (2d ed. 1953).

¹⁴³ INT. REV. CODE OF 1954, § 6501(a).

¹⁴⁴ See text at notes 23-32 *supra*.

when it is actually earned, there would be no possibility that they might incur greater total taxes than other taxpayers.

To make adoption of this proposed solution economically and politically feasible it would be necessary to soften the impact of the loss of revenue that would be incurred due to the change in accounting methods. The failure to supply an adequate transitional adjustment resulted in the repeal of sections 452 and 462 of the 1954 Code.¹⁴⁵ However, since the loss would be non-recurring, it would be possible to spread it over a sufficient number of years to reduce the annual decrease in revenue to manageable proportions.¹⁴⁶ Once this obstacle has been overcome, there seems to be no sufficient reason barring the adoption of an estimated tax on net income from prepayments and professional accounting standards for estimated future expenses.

Jerome M. Salle, S.Ed.

¹⁴⁵ See text at notes 91-93 *supra*.

¹⁴⁶ A discussion of the technical aspects of such a device is beyond the scope of this comment.