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Federal Income Taxation - Tax Accounting - When a Cash Basis Taxpayer Should Deduct Prepaid Insurance Premiums

Alfred A. Heon

RECENT DECISIONS

Federal Income Taxation: Tax Accounting: When a Cash Basis Taxpayer Should Deduct Prepaid Insurance Premiums—The petitioner, a corporation, was engaged in the business of ownership and management of real estate. In 1950, 1951, and 1952 it purchased insurance coverage for its holdings and deducted in the year of purchase the full amount of the premium paid, although the coverage extended a number of years beyond the year of payment. The taxpayer, since its incorproation in 1905, had consistently followed this practice of deducting as a business expense, the entire prmieum in the year it was paid. The taxpayer utilized the cash receipts and disbursements method of accounting and reported its income on the same basis. The Commissioner disallowed the deduction and under the authority of *Commissioner v. Boylston Market Association*,[1] contended that the cost of prepaid insurance must be prorated over the term of the insurance. The Commissioner's position was upheld by the Tax Court which followed the *Boylston Market* case.[2] *Held:* Judgment reversed. Prepaid insurance premiums are an "ordinary and necessary" business expense which may be deducted in full in the year of purchase. *Waldheim Realty and Investment Co. v. Commissioner*, 245 F. 2d 823 (8th Cir. 1957).

The question as to when a cash basis taxpayer should deduct prepaid insurance premiums has been a source of controversy for some time and is reflected in three conflicting appellate decisions on the subject. These decisions are the instant case, the *Boylston Market* case, and *Welch v. DeBlois*.[3] Prior to 1938 the Commissioner ruled that the cost of prepaid insurance must be prorated.[4] In 1938 he reversed his position to conform with the *DeBlois* case, which held that prepaid insurance was not a capital asset the cost of which must be amortized, but an "ordinary and necessary" business expense.[5] In 1943 the Commissioner reverted to his original position requiring proration following the *Boylston Market* case, a 1942 decision which overruled the *DeBlois* decision, and held prepaid insurance to be a capital asset.[6]

In the instant case, the court treats the problem of qualifying an expenditure for prepaid insurance as an ordinary business expense under sec. 23(a)(1)(A) of the 1939 Code as a dual one.[7] First, it decides that prepaid insurance may be distinguished from other capital assets, in spite of extended coverage, and hence is not subject to pro-

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[1] 131 F.2d 966 (1st Cir. 1942).
[2] Waldheim Realty and Investment Co. v. Commissioner, 25 T.C. 1216 (1956).
[3] 94 F.2d 842 (1st Cir. 1938).
[4] G.C.M. 13148 XIII, 1 CUM. BULL. 67 (1934).
[5] G.C.M. 20307 1938, 1 CUM. BULL. 157 (1938).
[6] G.C.M. 23587 1943, CUM. BULL. 213 (1943).
[7] INT. REV. CODE §23(a)(1)(A) (1939). "In computing net income—there shall be allowed as deductions: All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, ..."

ration via amortization deductions. The court states that the basis for the distinction is that:

> "The payment of the insurance premiums adds nothing to the taxpayer's plant or equipment or his ability to produce income. In this respect the insurance premiums differ from prepaid rent, lease bonuses and commissions, as such expenditures are not for the purpose of providing the taxpayer the place in which to carry on his business."[8]

After ruling that prepaid insurance was not a capital asset, the court then determined that such a deduction would not distort the taxpayer's income to an extent which would permit disallowance by the Commissioner under the authority of sec. 41 and sec. 43 of the 1939 Code.[9] To prove its point, the court goes to some length to illustrate statistically that, in the long run, the taxpayer in the instant case would pay approximately the same amount of taxes, regardless of which method of deduction was used. In other words, the court is saying that in the absence of distortion the taxpayer's method of accounting determines the timing of the deductions and he cannot be forced to adopt the accrual method of accounting which would necessitate a ratable deduction over the term of the coverage under sec. 23(a)(1)(A).

In contrast to the dual approach of the instant case, the court in the *Boylston Market* case, disregards the possibility of forcing a cash basis taxpayer to use an accrual approach and simply rules that prepaid insurance is a capital asset. It reasons that the life of the asset extends beyond the taxable year and hence its cost must be recovered by amortization allowances. For, to permit the taxpayer to take a full deduction would result in distortion of income as the cost of the asset is chargeable to several years income.[10] The court compares prepaid insurance to such cost items as prepaid rent,[11] bonuses for the acquisition of leases,[12] bonuses for the cancellation of leases,[13] and commissions for

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[8] 245 F.2d at 825.

[9] INT. REV. CODE §41 (1939): "The net income shall be computed upon the basis of the taxpayer's annual accounting period—in accordance with the method of accounting regularly employed in keeping the books of the taxpayer; *but—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 income.*" [Emphasis added] INT. REV. CODE §43 (1939); "The deductions and credits—provided for in this chapter shall be taken for the taxable year in which 'paid or accrued' or 'paid and incurred' dependent upon the method of accounting upon the basis of which the net income is computed, *unless in order to clearly reflect the income the deduction or credit should be taken as of a different period.*" [Emphasis added.]

[10] The Tax Court has held that insurance for a one year period is an expense deductible in full at time of purchase although it carries protection for part of a subsequent year. Kauai Terminal Ltd., 36 B.T.A. 893 (1937); Irene L. Bell, 13 T.C. 344 (1949).

[11] Baton Coal Co. v. Comm., 51 F.2d 469 (3rd Cir. 1931).

[12] Home Trust Co. v. Comm., 65 F.2d532 (8th. Cir. 1933).

[13] Steele-Wedeles Co., 30 B.T.A. 841 (1934).

negotiating leases,[14] all of which are normally considered to be capital expenditures, and states that there is no essential difference between them and prepaid insurance.

From the above discussion it can be seen that there are two conflicting views as to the treatment of prepaid insurance. One view is that prepaid insurance is not a capital asset and where consistent practice obviates any distortion of income, the taxpayer's method of accounting prevails. Hence, a cash basis taxpayer cannot be forced to amortize the cost of the insurance nor ratably deduct it and thus in effect adopt the accrual method of accounting. The other position, of course, is that prepaid insurance is a capital asset, for the life of the asset extends beyond the taxable year and hence, distortion of income is inevitable for the expenditure is chargeable to the income of more than one year. The Commissioner, it would appear, has adopted a middle ground position, for while he concurs in the result of the *Boylston Market* case, he has taken the stand in his rulings that the cost of prepaid insurance should be deducted ratably as an ordinary business expense.[15] In other words, he feels that the cash basis taxpayer should be forced to adopt the accrual method of accounting as far as prepaid insurance is concerned.[16] This type of approach would, for all practical purposes, yield the same result as the *Boylston Market* case, although via a different statutory route.

The issue, basic to all of the above positions, appears to be in the definition of the word "expense" in sec. 23(a)(1)(A) of the 1939 Code. Can it be said that an expenditure which is chargeable to more than one year's income fits the discription of an "expense" because of the taxpayer's method of accounting, or will the fact that it is chargeable to income of several years disqualify it, because of inherent distortion, in spite of the method of accounting? In addition to the basic issue, there is also the question of how the expenditure should be treated if disqualified for full deduction under sec. 23(a)(1)(A). Should the expenditure be considered capital and hence subject to amortization, or should the cash basis taxpayer be required to take ratable business expense deductions?

In suport of the contention that an expenditure for prepaid insurance does not fit the definition of an ordinary business expense, the following factors are of importance. Sections 23(1) and 24(a)(2) and (3) of the 1939 Code which determine the treatment of capital expen-

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[14] Bonwit Teller and Co. v. Comm., 53 F.2d 381 (2nd Cir. 1931).

[15] In G.C.M. 13148 XIII,1 CUM. BULL. 67 (1934), pertaining to prepaid insurance and the cash basis taxpayer, section 41 of the 1939 Code is quoted and is followed by the statement: "In order to reflect clearly the income of such taxpayer, only the amounts applicable to carrying such insurance for the taxable year constitute *an ordinary and necessary expense in the earning of the income for that year.*" [Emphasis added].

[16] Proposed U.S. Treas. Reg. §1. 461-1(a)(1)(1956).

ditures, are silent as to the precise definition of a capital asset. In fact, the latter section would on its face deny any deduction at all, although its intention is merely to prevent the full deduction in the year of purchase.[17] Hence it can be seen that the determination of whether an expenditure is capital or not will depend upon the judicial interpretation of the word "expense" in sec. 23(a)(1)(A). In cases involving cost items such as prepaid rent, bonuses for the acquisition of leases, bonuses for the cancellation of leases, and commissions for negotiating leases, the courts have clearly held that sums spent for the acquisition of assets which have a life beyond the taxable year are capital expenditures and do not qualify as "expense" for the expenditures are chargeable to more than one year's income.[18] The basic reasoning for this holding, of course, is the assumption that a full deduction will distort income, and hence the solution is proration under sec. 23(1) regardless of which method of accounting the taxpayer uses. It can be clearly seen that if proration of prepaid insurance is justified by this reasoning, the decision is not based on explicit statutory authority, but rather on the judicial interpretation of the word "expense" in sec. 23(a)(1)(A). (The question of whether a consistent practice of full deduction will obviate distortion will be treated later.)

The court in the instant case attempts to evade this interpretation by distinguishing prepaid insurance from the expenditures mentioned above on the ground that insurance is not income producing. This distinction, however, appears to be dubious and it would seem that the court is drawing a line between direct and indirect income producing assets rather than between income and non-income producing assets. In addition, the basic issue of income distortion is ignored by such a distinction.

Another approach which will yield approximately the same result, namely proration, is that of considering prepaid insurance an ordinary business expense, but one which the cash basis taxpayer must deduct ratably over the term of the insurance as if he were on an accrual basis. This is apparently the position of the Commissioner although he has hedged in the instant case and depended upon the *Boylston Market* decision as authority for proration. In this approach the judicial inter-

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[17] INT. REV. CODE §23 (1)(1939): "In computing net income—there shall be allowed as deductions: A reasonable allowance for the exhaustion, wear, and tear—(1) of property used in the trade or business, or (2) of property held for the production of income."
INT. REV. CODE §24(a)(2)(3)(1939): "In computing net income no deduction shall in any case be allowed in respect of:————(2) any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate except expenditures for the development of mines or deposits deductible under section 23 (ee); (3) any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made; . . . ."

[18] See notes 11, 12, 13, and 14 *supra*.

pretation of the word "expense" in sec. 23(a)(1)(A), will again play a prominent role, for it is necessary that "expense" be limited to a charge against the income of the current year, or otherwise the cash basis taxpayer's method of accounting will control the timing of the deduction under the general rule of sec. 41 and sec. 43. However, with the definition of "expense" so limited, because of the distortion inherent in charging one year's income with another year's expense, it would appear that the Commissioner would have authority under the qualifying clauses of sec. 41 and sec. 43 to disregard the taxpayer's method of accounting and require prorated sec. 23(a)(1)(A) deductions.[19] This would, in effect, force the taxpayer from a cash to an accrual basis insofar as prepaid insurance is concerned.

In support of this theory we have the following language of the committee reports of both the House and Senate when the qualifying clause of sec. 43 was added in the Revenue Act of 1924.

> ". . . the necessity for such a provision arises in cases in which a taxpayer pays in one year interest or rental payments or *other items* for a period of years. If he is forced to deduct the amount in the year in which paid, it may result in a distortion of his income which will cause him to pay either more or less taxes than he properly should."[20] [Emphasis added]

While the above portion of the legislative history of sec. 43 does not, in terms, include prepaid insurance within its scope, it would seem that such an inclusion would be in keeping with the spirit of the report.

The court in the instant case seek to avoid such a result under the qualifying clauses of sec. 41 and sec. 43 by attempting to prove statistically that in the long run there will be no distortion of income if the taxpayer consistently follows the practice of deducting prepaid insurance premiums entirely in the year of payment. While it does not specifically state, it can reasonably be inferred from the decision that th court is restricting its ruling to instances where a taxpayer has regularly deducted prepaid premiums for a considerable number of years, so as to rule out short run tax advantages. Such an inference is substantiated by the following statement of the court:

> "We do not have before us the question of whether, under appropriate circumstances, a cash basis taxpayer who *regularly,* upon his books and in his tax returns charges as a business expense each year only a prorated portion of his insurance expense would thereby properly reflect his income. We express no opinion on the issue. Some flexibility is essential in the administration of the tax laws."[21] [Emphasis added]

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[19] INT. REV. CODE §43 (1939): " . . . . unless in order to clearly reflect the income the deductions or credits should be taken as of a different period."

[20] S. Rep. No. 398, 68th Cong., 1st Sess. 10 (1924); 1939-1 CUM. BULL.-276 (1939). H. R. Rep. No. 179, 68th Cong., 1st Sess. 10 (1924); 1939-1 CUM. BULL.-251 (1939).

[21] 245 F.2d at 828.

From the above language it appears that the court is using the past practice of the taxpayer as its criterion as to which method of deduction is allowable. In other words, habitual usage tends to validate either method. Such a test is flexible as the court intimates, but it would seem that flexibility is attained only by sacrificing consistency and certainty. The taxpayer who has had prior insurance dealings will constantly be faced with the problem of determining whether his past practice was of sufficient duration to support his method of deduction, while the first time purchaser of prepaid insurance will be completely at sea as to when he may take his deductions. It must be remembered that not all taxpayers will have the past experience of the petitioner in the instant case, and even in such a situation distortion is possible if the taxpayer should withdraw from the insurance market.

In support of the contention that an expenditure for prepaid insurance is deductible in full in the year of purchase by the cash basis taxpayer, it should be noted that insurance costs for a year or less are concededly a proper business deduction under sec. 23(a)(1)(A).[22] In effect then, a cash basis taxpayer will be forced to adopt the accrual method of accounting if such an otherwise "ordinary and necessary" expense is called either a capital expenditure or a ratable business expense simply because of the extended coverage. Sections 41 and 43 of the 1939 Code lay down the general rule that the timing of a deduction is dependent upon the method of accounting used, and under these sections the cash receipts and disbursements method of accounting is permissible. The reason for its permissibility is the fact that it is a simple, uncomplicated system of accounting, well adapted to needs of the majority of taxpayers. In other words, simplicity is the essence of the system and while it does not reflect income as accurately as the accrual method, the distortion is tolerated because of this simplicity. Therefore it would seem to be a poor policy decision to force a cash basis taxpayer to switch to an accrual basis in regard to prepaid insurance, for by such a move the simplicity of the cash system has been destroyed, and that is the very justification for its existence in the tax field.

Some changes have been made in the applicable sections of the 1954 Code, but none seems radical enough to definitely settle the controversy surrounding the timing of the deduction of prepaid insurance premiums. Sections 162(a), 167(a), 263(a) and 446(a), (b) of the 1954 Code are substantially the same as their respective counterparts in the 1939 Code, namely sections 23(a)(1)(A), 23(1), 24(a)(2)(3), and 41. The one change of note is in sec. 43 of the 1939 Code which reappears in the 1954 Code as sec. 461 (a) without the qualifying phrase "unless in order to clearly reflect the income the deductions or credits

[22] U.S. Treas. Reg. 118, §39, 23(a) (1953).

should be taken of a different period."[23] This omission, however, is offset by the following words found in the Senate Finance Committee Report on sec. 461(a):

> "Section 461 adopts the provisions of section 43 of the 1939 Code in rearranged form. The timing of deductions and credits, otherwise allowable, is determined by the taxpayer's method of accounting. *The method must clearly reflect the income of the taxpayer.*"[24] [Emphasis added]

The omission is further offset by the existence of sec. 446(b) in the 1954 Code, for it would seem that this section would provide sufficient authority for an exception to the general rule that the accounting method determines the time of deduction.[25]

In conjunction with sec. 446(b), it is worthy to note that a literal reading of the statute gives the impression that the Commissioner is vested with discretionary powers in regard to the method of accounting to be used in a particular case, only if there is distortion of income. In other words, the Commissioner may exercise discretion as to the accounting method once it has been determined that the taxpayer's present method of accounting does not clearly reflect income, but it would seem that the Commissioner is not given unlimited discretion in determining whether income is or is not clearly reflected by the present method, for as an end result his judgment is subject to judicial review. Such an interpretation is not rebutted by the legislative history of the section.[26] In contrast to this construction is the following excerpt from the legislative history of sec. 43 of the 1939 Code:

> "In subdivision (d) of this section authority is granted to the Commissioner to allow or require deductions and credits to be taken as of a year other than that in which 'paid or accrued,' when, *in his opinion, it is necessary in order to cleraly reflect income.*"[27] [Emphasis added]

The above portion of the House and Senate Committee report concerns the addition of the qualifying clause to sec. 43 in 1924 and it is clear that under such section the Commissioner had discretion as to the method of accounting to be used when income was not clearly re-

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[23] INT. REV. CODE OF 1954, §446(b): "The amount of any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing the taxable income."

[24] S. Rep. No. 1622, 83rd Cong., 2nd Sess. 324 (1954).

[25] 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."

[26] S. Rep. No. 1622, 83rd Cong., 2nd Sess. 319 (1954); House Rep. No. 1337, 83rd Cong., 2nd Sess. 280 (1954).

[27] See note 20 *supra*.

flected by the present method of accounting, and as to when the present method did or did not clearly reflect income. While this issue has not been taken up squarely by any court as yet, there are cases such as the instant case and *Beacon Publishing Co. v. Commissioner*[28] where the court has taken it upon itself to decide when there is or is not distortion of income. As the law stands today, there is a clear split in the Circuits, the instant case being handed down by the U.S. Court of Appeals of the Eighth Circuit and the *Boylston* decision by the U.S. Court of Appeals of the First Circuit. Hence, it is difficult to forecast which rule will ultimately prevail if the Supreme Court undertakes to resolve the conflict. While there are strong policy reasons for the result of the instant case, there would seem to be abundant authority for a contrary ruling.

ALFRED A. HEON

Unauthorized Practice: Conveyancing as Practice of Law Under Sec. 59.513, Wis. Stats.—On May 8, 1957 the Wisconsin Legislature published a statute which requires, as a condition of recordation, that every domestic instrument other than a will or a court decree, which in any way affects the title to or an interest in real property, must incorporate the name of the draftsman.[1]

The legislative purpose in enacting such a statute is subtly towfold. Mr. Phillip Haberman,[2] one of the draftsmen of the bill, has pointed out in a discussion of the bill with the present author, that the bill was intended to facilitate the detection of those who are drafting such instruments in violation of sec. 256.30(2),[3] as well as to enable any examiner of such instruments to contact its draftsman to resolve certain ambiguities. Wisconsin, like all other states, has adopted a system of well-defined licensing requirements for the practice of law.[4] The

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[28] 218 F.2d 697 (10th Cir. 1955).

[1] WIS. STATS. §59.513 "Including name of person drafting instrument:
(1) No instrument by which the title to real estate of any interest therein or lien thereon, is conveyed, created, encumbered, assigned, or otherwise disposed of, shall be recorded by the register of deeds unless the name of the person who, or governmental agency which, drafted such instrument is printed, typewritten, stamped or written thereon in a legible manner. An instrument complies with this section if it contains a statement in the following form: 'This instrument was drafted by ———— [name] ———— .'
(2) This section does not apply to an instrument executed before the effective date of this section, nor to
(a) A decree, order, judgment, or writ of any court
(b) A will or death certificate
(c) An instrument executed or acknowledged outside of this state."

[2] Secretary of Wisconsin Bar Association.

[3] "It is presumed that the bill is aimed at persons drawing documents who have not been admitted to the practice of law in Wisconsin." From a letter signed by the "Sec'ry—Wis. Recorders Ass'n" found in the Official Drafting Record of §59.513.

[4] WIS. STATS. §256.28 (1955).