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Federal Income Taxation: Tax Accounting: When an Accrual Basis Taxpayer Should Report Prepaid Income Items

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> new trials are to be held covering the same charges. . . . To say the least, the Government should have an opportunity to present its evidence under these changed conditions." (*i.e.,* in light of this decision)."[21]

While this writer agrees with Justice Clark, this question becomes rather academic in light of recent developments. The Government, apparently recognizing that this decision weakened its case against the petitioners to such an extent that convictions would be impossible to secure, moved for dismissal in the District Court, which motion was granted.

The reader should also note that two Justices, Black and Douglas, only concur in the acquittals of the five petitioners and, dissenting from the majority, hold that the other nine should also have been acquitted. Justice Douglas, in his opinion, quotes with approval a statement by Jefferson that ". . . it is time enough for the rightful purposes of civil government, to interfere when principles break out into overt acts against peace and good order."[22] One can only wonder if the entire Court is tending towards this approach. Certainly the "subtle and difficult to grasp" distinctions found by the majority do not lend themselves to a clear and distinct answer to such a query.

Application of the *Yates Case* in lower court decisions to the detriment of the Government has already been found in *United States v. Silverman.*[23] In that case a prospective Party member was not urged to immediate bloodshed but merely asked to join a group which would use such means if necessary. The Court of Appeals held that a statement that force will be necessary, accompanied by good proof of the specific evil intent of the speaker, is not an example of incitement. Statements that the Party will take action "at the proper time to overthrow the present system" and that the Party "will fight for Socialism" were considered too remote from concrete action to regarded as a violation of the Smith Act. The Court bases this decision on the *Yates Case.* This almost appears to be approaching the Douglas view.

RICHARD T. BECKER

Federal Income Taxation - Tax Accounting - When an Accrual Basis Taxpayer Should Report Prepaid Income Items — The taxpayer corporation, owner of certain hotel property, entered into a 10 year lease contract in 1949, for the period 1950-1959. The contract called for an annual rental of $30,000, with an advance payment to the taxpayer of $30,000, the latter to apply on the rental for the last year of the lease.[1] The taxpayer, in accordance with its accrual method

[21] *Id.* at 346-347.
[22] *Id.* at 340.
[23] U.S. v. Silverman, 26 *U.S.L. Week,* 2155 (2d Cir. 1957).
[1] The taxpayer had also argued that since the lessee had preferred paying the

of accounting, reflected the advance rental receipt in a liability account entitled "Deposit on Lease Contract," and failed to include this amount in its 1949 gross income. By commercial accounting standards, the advance rental would not be considered as earned until 1959. The Commissioner determined that the $30,000 advance receipt constituted gross income in 1949 under Section 22 (a), Internal Revenue Code of 1939,[2] and accordingly assessed a deficiency for 1949. *Held:* The advance receipt was includible in income for 1949, the year it was received. Although inclusion in the year of receipt rather than the year earned is not in accord with the prinicples of commercial accounting, nevertheless it could not be said that the Commissioner abused the discretion given him under Section 41, Internal Revenue Code of 1939,[3] in determining that inclusion in the year of receipt was necessary in order to clearly reflect the taxpayer's income. *New Capital Hotel, Inc. v. Commissioner,* 28 T.C. No. 77 (1957), on appeal to the 6th Circuit.

The foundation for the Tax Court's reasoning in the *New Capital Hotel* case, was laid in *North American Oil Co. v. Burnett,*[4] the case in which the "claim of right" doctrine had its origin. Here the taxpayer company operated oil lands, legal title to which was in the United States government. The government commenced an action to oust the company from possession, and as a consequence a receiver was appointed in 1916 to supervise operations on the property and to hold the net income thereof. In 1917 the government's action was dismissed by the District Court, and money representing profits from 1916 was paid over to the company by the receiver. Although the government appealed from the decision and litigation was not finally terminated until 1922, the Supreme Court of the United States held that the amounts received should properly have been included in the taxpayer's 1917 gross income. The court stated that if a taxpayer receives earnings under a claim of right and without restriction as to their use and disposition, he has received income which he is required to report,

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$30,000 in advance in lieu of executing a performance bond, the payment in effect was a security deposit. If the court could have been persuaded to believe that the payment was a security deposit and not an advance rental, there would have been no problem over its allocation to any given year, since a security deposit would not constitute an income item in the first instance. However, the court held that the payment was primarily intended by the parties to be rent.

[2] "Gross Income includes gains, profits and income derived from . . . rent. . . ." Under the 1954 Code, this language is found in Section 61 (a).

[3] "The net income shall be computed on the basis of the taxpayer's annual accounting period (fiscal year or calendar year as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer, but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. . . ." This language is now found in Section 446 (a) and (b) of the 1954 Code.

[4] 286 U.S. 417 (1932).

even though it is claimed that he is not entitled to retain the money and even though he may later be adjudged liable to restore its equivalent. Nor, under the facts of the *North American Oil* case was it material whether the company's return was filed on a cash or on an accrual basis.

The heart of the claim of right doctrine is the actual receipt of an income item coupled with the unrestricted use and disposition of same. The rationale is that the taxpayer is using and benefiting from his receipt and therefore for all intents and purposes it is properly income to him in the year of receipt, even though under his accrual method of accounting, he defers the item until some future period when he considers it earned. However, in the *North American Oil* case, the fact situation involved an item that had *already been earned* in a prior year (1916), but which was not received until a subsequent year (1917), at which time its ownership was disputed. The subsequent receipt of an income item, earned at a prior time when there was no unconditional right to receive it, is readily seen to be includible in gross income when received. It is also apparent in such a situation, that the taxpayer's method of accounting is immaterial. If the taxpayer is on a cash basis, he includes the item in gross income when he receives it, regardless of when the transaction giving rise to it took place. If he is on an accrual basis, he cannot take it up as income in the year the transaction took place. The item is not earned because there is no unconditional right to receipt. He, therefore, should properly take it up as income when he acquires an unconditional right to receive the item,[5] and this right will probably arise at a time which is substantially simultaneous with the time of actual receipt. In the prepaid income item area, however, at the time the item is received, its ownership is not in dispute, and more important yet, it is not in any sense earned by commercial accounting standards. The question is then whether or not it is proper to apply to a prepaid income item fact situation, a doctrine which originated in a fact situation where it was uniquely true that the taxpayer's method of accounting was immaterial to the issues of whether or not an income item was properly includible in gross income when it was received.

Another illustration of the application of claim of right to a prepaid income item situation is *Andrews v. Commissioner.*[6] Here a dance studio operator contracted with his students for a specified number of lessons, with tuition payments to be made in advance. In some of the cases, the period of instruction extended beyond the year in which Andrews received the tuition payments. The proceeds from the payments were deposited in a general bank account. Thy were not segregated nor was there any restriction as to their use. Since Andrews was

[5] More specifically, the accrual basis taxpayer should report an item of income when an unconditional right to receive it arises, its amount is reasonably ascertainable, and there exists a reasonable certainty of payment.
[6] 23 T.C. 1026 (1955).

on an accrual basis of accounting, he attempted to defer until subsequent years, that portion of each payment which would not be considered earned in the year of receipt. The tax court held that the entire amount of each tuition payment was includible in gross income in the year of receipt; that while his accounting system may have clearly reflected his income by commercial accounting standards, accounting practice must bow to established rules of law in the determination of taxable income. Claim of right therefore controlled the *Andrews* fact situation.

While the accrual basis taxpayer in receipt of prepaid income items has not been faring well in the Tax Court, a decision handed down by the 10th Circuit Court of Appeals represents the opposite approach to the problem. In *Beacon Publishing Co. v. Commissioner,*[7] this court reversed the Tax Court, and allowed a newspaper, in receipt of prepaid subscription income, to allocate it over the years to which it was properly attributable under an accrual basis of accounting. It was held that the Tax Court misapplied the claim of right doctrine to a situation where there was no dispute as to ownership of the funds. The court said that where there is a prepaid income item, ownership of which is admitted by the taxpayer, the question as to when the item is to be includible in income is to be determined by reference to the taxpayer's method of accounting. To force an accrual basis tarpayer to accrue the item in the year of receipt would be to disregard the fact that the tarpayer will not incur the expenses necessary to earn the income until future years.[8] The result: A hybrid bookkeeping system in which the taxpayer reports his prepaid income on a cash basis and accrues his deductions with the resultant distortion of income. According to *Bea-*

[7] 218 F. 2d 697 (10th Cir. 1955).

[8] Where the accrual basis taxpayer is forced to include prepaid income items in gross income for the year in which received, the argument is sometimes advanced that if such is the case, he ought to be allowed to set off a "reserve" for future expenses as a deduction against that income. The argument is almost universally disallowed, as illustrated in *Bressner Radio Inc. v. Commissioner,* 28 T.C. No. 40 (1957), on the basis that the deduction sought has neither been paid nor incurred during the taxable year for which it is claimed, and is therefore in no sense deductible as an ordinary and necessary business expense. The courts feel that the "liability" created by a reserve is contingent at best, and that the proposed deduction fails to meet the *all events* test. However, in *Schuessler v. Commissioner,* 230 F. 2d 722 (5th Cir. 1956), an accrual basis seller of gas furnaces was allowed to deduct a reserve for future servicing expenses where he was able to prove that under the terms of his contracts with customers he had incurred a definite legal liability to service the furnaces sold over a subsequent 5 year period. The court held that his method of accounting was in accord with the spirit and the intent of the statute requiring him to clearly reflect his income. As was the case with *Beacon Publishing Co.,* the Supreme Court expressed no opinion on *Schuessler* in the *Automobile Club of Michigan* case, but stated that *Schuessler* was also distinguishable on its facts. It should also be noted that proposed Section 462, Internal Revenue Code of 1954, would have provided an answer to the "reserve" problem. Like Section 452, however, it was repealed retroactively due to the large estimated loss of revenue in the year of change.

con, claim of right should be restricted to situations where there is a dispute as to the ownership of the income item, coupled with a receipt by one of the parties involved. It should not be applied to situations involving a prepaid income item, ownership of which is admitted.

In *Automobile Club of Michigan v. Commissioner*,[9] the Supreme Court held that prepaid membership dues received by the club, an accrual basis taxpayer, were includible in their entirety in gross income when received, in spite of the taxpayer's attempt to partially defer them. The Commissioner had argued that the claim of right doctrine applied and undoubtedly under prior precedent in the Tax Court at least, the fact situation was ripe for an application of claim of right. It is not apparent from the decision, however, whether the Supreme Court actually agreed with the Commissioner that claim of right applied here. Had such been the case, there seemingly would be no reason for the statement of the court that the club's attempt to pro-rate its membership dues receipts in monthly amounts was purely artificial, and bore no relation to the services which the club might in fact be called upon to render for the member. It was for this very reason that the court refused to apply the *Beacon* approach, and while expressing no opinion on the merits of *Beacon*, distinguished it on its facts from the *Automobile Club of Michigan* fact situation. In *Beacon*, performance fo the subscription was in most instances necessarily deferred until publication dates after the tax year of receipt, whereas in *Automobile Club of Michigan*, substantially all the services were to be performed only upon a member's demand. The taxpayer's performance was not related to fixed dates after the tax year of receipt. The decision was based, then, on the fact that the taxpayer's contention that its accrual method of accounting clearly reflected its income was not binding on the Commissioner, who in the exercise of his discretion under Section 41, Internal Revenue Code of 1939,[10] could compute the taxpayer's income in accordance with the method that in his opinion did clearly reflect income. In other words, it appears that a valid exercise of the discretionary power of the Commissioner controlled the decision reached, rather than a strict application of the claim of right doctrine. From the courts discussion of the "artificiality" of the pro-rata allocation of membreship dues by the taxpayer, the court is actually passing judgment on the relative merits of a system of accounting. The inference follows that if the club could defiinitely establish that it would incur ascertainable expenses incident to earning the income over a period extending beyond the taxable year of receipt, a deferral of income would be allowed, claim of right notwithstanding. Moreover, it seems that under such circumstances the Commissioner could not

[9] 353 U.S. 180 (1957).
[10] See Note 3 *supra*.

decide that the taxpayer's method of accounting does not clearly reflect his income, without abusing his permissible discretion, or exceeding the discretion under Section 41 that actually exists in him.

The courts have consistently interpreted Section 41 as giving the Commissioner the discretion in the first and final instance to determine whether or not the method of accounting employed by the taxpayer clearly reflects his income. This is certainly not the result arrived at from a reading of the literal language of the statute, since the statute only gives him the express discretion to compute income according to the method of accounting that in his opinion clearly reflects income, once it has been determined that the method employed by the taxpayer does not clearly reflect income. The *Beacon* case by express declaration, and the *Automobile Club of Michigan* case by inference support the argument that under a proper interpretation of the statute, the function of determining whether or not the taxpayer's method of accounting clearly reflects his income, in the last analysis, properly belongs to the courts, since in both cases, the courts were actually passing judgment on the relative merits of systems of accounting; the Commissioner's exercise of discretion in so far as it is binding on the taxpayer is limited to computing the taxpayer's income under another accounting method, only if in fact the method employed does not clearly reflect income; that whether or not the taxpayer's method of accounting clearly reflects his income is a question of fact subject to court review; and that the Commissioner's decision as to whether or not the method employed clearly reflects income will not be taken as the final word on the controversy, which decision, if so taken, in effect prevents judicial review unless there has been a clear abuse of discretion.

Nevertheless, even if the power to determine whether or not the taxpayer's method of accounting clearly reflects his income, rests with the courts, they may approach the problem in the same way that the Commissioner has in the past; namely, where a method of accounting clearly reflects income for commercial accounting purposes, it does not necessarily follow that the method also clearly reflects income for tax purposes. Tax laws are used to achieve certain economic and social goals, which is not the case with "laws" of accounting. It is improper, therefore, to force the concepts of financial income and taxable income into a common mold, since the purpose of the two concepts differ. Taxable income is computed to determine the taxpayer's ability to make an immediate cash payment of his tax, whereas financial income is computed to determine the earning power of the business. Therefore there is no compelling reason for the computations to be made in the same manner, since the computations are made for different purposes.[12]

[11] See Note 3 *supra*.
[12] Hylton, *Disadvantages on Conforming Taxable Income to Good Accounting Concepts*, 3 Journal of Taxation 274 (1955).

It follows that the ability of an accrual basis taxpayer in receipt of prepaid income items, to make an immediate cash payment of his tax, is more accurately measured by having him include the item in gross income when received, rather than deferring it. This, the inference in *Automobile Club of Michigan* notwithstanding, has been the underlying philosophy of the Supreme Court, and the Tax Court, in the past. "It is not the province of a court to determine the relative merits of a system of accounting."[13]

The proposed Section 452, Internal Revenue Code of 1954 would have largely eliminated the problem of the accrual basis taxpayer in receipt of prepaid income items. The legislative intent was to design Section 452 in such a way as to bring the income tax provisions of the law relating to the prepaid income area, into harmony with generally accepted commercial accounting principles.[14] Under Section 452, an accrual basis taxpayer was permitted to defer his advance receipts over the periods in which earned, not to exceed five years after the year of receipt. In the case of items to be earned over an indefinite period, the five year limitation could be exceeded on the basis of a reasonable estimate and in accordance with regulations prescribed by the Secretary. Section 452 was repealed retroactively, however, due to an estimate that one to five billion dollars in revenue would be lost in the year of change. It is apparent, however, that the legislative intent was to take into consideration the relative merits of a system of accounting, and that this intent was stymied only by the loss of revenue involved in putting that intent into effect.

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[13] *Brown v. Helvering*, 291 U.S. 193 at 204 ( ).
[14] S. REP. No. 1622, 83rd Cong., 2d Sess. 62 (1954).