South Carolina Law Review

Volume 19 | Issue 2 Article 2

1967

Tax Accounting for Prepaid Income--1967

Colin E. Harley

TAX ACCOUNTING FOR PREPAID INCOME—1967

COLIN E. HARLEY*

For many years one of the most difficult questions faced by accrual method taxpayers has been how to account for prepaid income. The Commissioner of Internal Revenue has always contended that an accrual basis taxpayer must include prepayments in income upon receipt. Judicial decisions have often seemed to conflict both with each other and with commercial accounting techniques. However, since the 1963 Supreme Court decision in *Schlude v. Comm'r*,[1] the courts have largely resolved the issue. Hereafter all advance payments received by accrual method taxpayers in exchange for goods or services will probably have to be included in gross income in the year of receipt.

There are some quite valid business and tax objections to this departure from normal accounting practice, but as a practical matter taxpayers have very little hope of reversing the trend. Nevertheless there is at least one issue in the prepaid income field which still deserves consideration. This article will attempt to show that, although the government's position is generally invulnerable, the recent extension of the *Schlude* doctrine to the sale-of-goods area[2] may be unjustified.

A. The Problem

Assume, for example, that an imaginary corporation, Information Inc. ("the Company"), is in the business of conducting market surveys for manufacturing companies. In a typical case a customer retains Information Inc. in December of 1967 to conduct market surveys during 1968. The contract specifies that Information Inc. will give the customer a written report at the end of each quarter. The fee is 10,000 dollars per year payable in advance, but the customer may cancel the contract and receive a partial refund at the end of any quarter if dissatisfied.

Information Inc. is on the accrual method of accounting, and its books are kept on a calendar year basis. As of December 31, 1967, ten customers have contracted for the Company's services

* LL.B. University of South Carolina. LL.M. (taxation) New York University. Mr. Harley is associated with the firm of Davis, Polk, Wardwell, Sunderland & Kiendl, New York, New York.

1. 372 U.S. 128 (1963).

2. Hagen Advertising Displays, Inc., 47 T.C. 139 (1966).

during 1968, and advance payments of 100,000 dollars have been received and deposited in the Company's general checking account. It can be estimated with reasonable accuracy that the Company will incur 60,000 dollars of expenses in performing the services during 1968. At this point the Company must decide how to treat the 100,000 dollars of prepaid fees. There are three possibilities:

(1) to include the 100,000 dollars in gross income for 1967 and to deduct the 60,000 dollars of related expenses in 1968;

(2) to include the 100,000 dollars in gross income in 1968 when the services are performed and the related expenses are incurred; or

(3) to include the 100,000 dollars in 1967 gross income and to take a 60,000 dollar deduction in 1967 for estimated expenses related to the prepaid income.

The issue is not *whether* an item of income is taxable but is *when* it is taxable. Timing can have a dramatic effect on taxable income and, therefore, on the effective tax rate in many situations. In the hypothetical case above, the first alternative method of treating the prepayments tends to distort the computation of taxable income. By including the full 100,000 dollars of prepayments in 1967, a small corporation may have artificially high income in that year and may pay a tax on the prepayments at the maximum rate of 48 percent. The next year, when the related expenses are incurred, taxable income may fall below 25,000 dollars to a tax rate of 22 percent, and a portion of the surtax exemption may be wasted. An individual taxpayer who receives prepayments may be affected even more because of the application of graduated rates to his prepaid income. On the other hand, the second and third alternatives seem to give a more accurate picture of taxable income by putting both the income and the related expenses into a single taxable year.

The main consideration which has prompted the Treasury to insist on including prepayments in gross income upon receipt seems to be revenue. Although prepaid income which is received in 1967 will eventually be taxed under any of the alternatives, the government, like most creditors, would like to be paid off as soon as possible. The government has the additional argument that a corporation which has 100,000 dollars of prepaid taxable income every year will, in effect, obtain a permanent interest-

free loan of 48,000 dollars (the potential tax) if the prepaid income is deferred to a later year. The revenue from an enormous amount of prepaid income would be suspended indefinitely.

B. Accounting Principles

Section 446 of the Internal Revenue Code of 1954 provides the ground rules for determining proper accounting methods.[3]

> (a) GENERAL RULE—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.
>
> (b) EXCEPTIONS—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.*[4] (Emphasis added.)

The Internal Revenue Service has understandably relied on commercial accounting concepts in administering section 446.

> A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.[5]

The dominant purpose of accrual method accounting is to "match" revenues with expenses in order to reflect clearly the results of a business operation.[6]

> The revenues of a particular period should be charged with the costs which are reasonably associated with the product represented by such revenues.[7]

---

3. This has been the governing language since section 212(b) of the Revenue Act of 1918 was enacted.

4. INT. REV. CODE of 1954, § 446.

5. Treas. Reg. § 1.446-1(a)(2), T.D. 6282, 1958-1 CUM. BULL. 215.

6. AMERICAN INSTITUTE OF ACCOUNTANTS, ACCOUNTING TERMINOLOGY BULL., No. 2, 3 (1955).

7. PATON & LITTLETON, AN INTRODUCTION TO CORPORATE ACCOUNTING STANDARDS, 69 (1940).

Reviewing the alternatives which Information Inc. had in the hypothetical situation previously outlined, a commercial accountant would either (1) defer the inclusion of the 1967 prepayments until 1968 or (2) include them in 1967 and deduct a reserve for the related estimated expenses in the same year. In no other way could the revenues and expenses be "matched". Moreover, since income is said to accrue for tax purposes when "all events" fixing the right to the income have occurred,[8] Information Inc. should defer the 100,000 dollars in prepayments from income until the Company has fulfilled its obligations under the contract and the right to the income is "fixed".

The Commissioner of Internal Revenue long ago decided that the usual principles of accrual accounting would not serve the government's purpose in the prepaid income controversy. The Commissioner found a potent weapon for protecting the revenues in section 446(b).[9] That section provides that "if the method used does not clearly reflect income," the Secretary or his delegate may choose a method which, "in the opinion of the Secretary or his delegate," does clearly reflect income.

THE CLAIM OF RIGHT DOCTRINE

The early cases dealing with prepaid income seem to have been influenced by the "claim of right" doctrine, which was first expounded by the Supreme Court in *North American Oil Consol. v. Burnet*.[10] In that case a cash basis taxpayer whose business had been temporarily placed in receivership attempted to recover the assets and the 1916 earnings which the receiver had collected. In 1917, a district court ordered the receiver to turn the assets over to the taxpayer. The receiver complied with the order, and an appeal was filed by the government. The government's appeal was finally dismissed in 1922. In considering the income tax consequences of the litigation, the Supreme Court rejected the taxpayer's contention that the income should be included in 1922 when the appeal was dismissed. The Court held that the proper year for including the earnings from 1916 in the taxpayer's income was 1917, the year in which the "earnings" were received "under a claim of right and without restriction as to its disposition."[11]

8. *See* United States v. Anderson, 269 U.S. 422 (1926), and Treas. Reg. § 1.451-1(a), *as amended*, T.D. 6282, 1958-1 CUM. BULL. 215.
9. INT. REV. CODE of 1954, § 446(b).
10. 286 U.S. 417 (1932).
11. *Id.* at 424.

The Commissioner of Internal Revenue had no difficulty in persuading the Supreme Court to apply the claim of right doctrine to prepaid income.[12] Thereafter a number of cases and rulings required accrual basis taxpayers to include prepayments in gross income in the year of receipt if they were received under a claim of right and "without restriction as to disposition."[13]

From a technical point of view, the claim of right doctrine was not an appropriate theory for deciding prepaid income cases.[14] In *North American Oil*, money which had been "earned" in 1916 had to be included in income when it was received in 1917 under a claim of right. In contrast, prepaid income of an accrual method taxpayer does not become "earnings" until the recipient fulfills his obligations in respect to the income. Until performance has been completed, the taxpayer's right to the funds he received has not accrued.[15] During the 1950's, several courts of appeals perceived the flaw in the government's claim of right argument, and taxpayers began winning some cases in the prepaid income field.[16]

THE TAXPAYERS' VICTORIES

The courts which rejected the Treasury's position on prepaid income usually did so because the Commissioner was unable to prove that the matching of income with expenses did not clearly reflect income. The taxpayers argued logically and successfully that tax accounting and commercial accounting should be reconciled and that commercial accounting requires income to be matched with related expenses within the same accounting period.

12. In Brown v. Helvering, 291 U.S. 193 (1934), the Supreme Court cited *North American Oil* and held that a fire insurance agent on the accural method had to include all commissions in income upon receipt even though the commissions were subject to refund in the event any policies were cancelled.

13. *See* Automobile Club of Mich. v. Comm'r, 353 U.S. 180 (1957) (membership dues); South Dade Farms, Inc. v. Comm'r, 138 F.2d 818 (5th Cir. 1943) (prepaid rent); New Capitol Hotel, Inc., 28 T.C. 706 (1957) (prepaid rent); Capital Warehouse Co., 9 T.C. 966 (1947) (services); National Airlines, Inc., 9 T.C. 159 (1947) (advance sales of tickets); Your Health Club, Inc., 4 T.C. 385 (1944) (membership dues); South Tacoma Motor Co., 3 T.C. 411 (1944) (future services); Rev. Rul. 58-225, 1958-1 CUM. BULL. 258 (prepaid interest).

14. *See* Behren, *Prepaid Income—Accounting Concepts and the Tax Law*, 15 TAX LAW REV. 343 (1960).

15. This point was finally conceded by the government in American Auto. Ass'n v. United States, 367 U.S. 687 (1961).

16. For example, the Tenth Circuit specifically denied the relevance of the "claim of right" doctrine in Beacon Publishing Co. v. Comm'r, 218 F.2d 697, 699-700 (10th Cir. 1955).

In *Beacon Publishing Co. v. Comm'r*[17] a newspaper publisher received advance payments on subscriptions, some of which extended several years into the future. The prepaid income was spread over the lives of the subscriptions for tax purposes, a proportionate amount of the prepayments being taken into gross income each year.[18] The Tenth Circuit upheld the taxpayer's method of accounting for prepayments as a clear reflection of income.

> The tax court, as it has in other cases, took the literal language from the context of the opinions in the foregoing cases and applied it to the prepaid income here even though there is no dispute as to the ownership of the funds. It gave no consideration to the fact that the taxpayer accounts for its income under the accrual method and will not incur the expenses necessary to earn the income until following taxable years. In other words, the tax court holds that advance payments received by a taxpayer which are subject to income tax, must be returned in the year of receipt if owned or claimed by the taxpayer, regardless of the method of accounting, which has been adopted, or when the funds are actually earned . . . . The application of the doctrine would in most cases result in a distortion of an accrual taxpayer's true income.[19]

The Second Circuit allowed prepaid income for personal services to be spread evenly over the lives of the service contracts in *Bressner Radio, Inc. v. Comm'r*.[20] The taxpayer received prepayments near the end of its 1948 and 1949 fiscal years for one-year contracts to service television sets. Prior experience showed that the taxpayer would make from eight to twelve calls on each customer during the contract year. Accordingly, in both 1948 and 1949 a portion of the income was deferred until the later fiscal year during which the services were performed. The Court

17. 218 F.2d 697 (10th Cir. 1955).

18. In an early ruling the Commissioner had permitted the very method which the taxpayer in *Beacon Publishing Co.* adopted. *See* I.T. 3369, 1940-1 CUM. BULL. 46. The apparent inconsistency of the Commissioner's position in *Beacon Publishing Co.* was explained by the argument that, although the deferral method might be permissible for taxpayers who had always used it, the publisher in this case could not *change* to the deferral method without the Commissioner's permission. *See* INT. REV. CODE of 1954, § 446(e).

19. Beacon Publishing Co. v. Comm'r, 218 F.2d 697, 700 (10th Cir. 1955).

20. 267 C.2d 520 (2d Cir. 1959). *Cf.* Streight Radio & Television, Inc. v. Comm'r, 280 F.2d 883 (7th Cir. 1960).

of Appeals for the Tenth Circuit rejected the Commissioner's claim of right argument and stated:

> In conclusion, petitioner's regularly employed method of accounting on an accrual basis and its deferral of income so that it most closely matched the corresponding expenses clearly reflected its true income. Its method and the statistical material supporting its figures were not "purely artificial." They bore a carefully estimated relationship to the services petitioner would be called upon to render. The record does not reveal a factual basis for permitting the Commissioner to adopt a method of his own on the ground that petitioner's method "does not clearly reflect income."[21]

The taxpayer in *Bressner Radio* was very careful to prove that the expenses related to the prepayments were incurred evenly and predictably over the contract period. This allowed the Court of Appeals for the Second Circuit to distinguish *Automobile Club v. Comm'r*,[22] in which prepaid dues were required to be included when received. In that case the Supreme Court felt that deferral of income over the life of a membership was "artificial" because the taxpayer had not shown that the obligations and expenses related to the prepayments were incurred evenly throughout the period. If expenses occurred arbitrarily and sporadically, the Court reasoned, spreading the income would not necessarily "match" income with expenses.[23]

The second way of matching income with related expenses is to include prepayments in the year of receipt but to deduct in the same year a reserve for the estimated related expenses, on the theory that the liability to perform services, deliver goods, or otherwise incur expenses is "fixed" when the prepayments are received. In *Schuessler v. Comm'r*[24] a taxpayer sold furnaces and as part of the bargain agreed to cut them on and off at the beginning and the end of each winter for five years. The entire sales price was taken into income in the year of the sale, but the estimated cost of the future service calls was simultaneously deducted. Because the taxpayer incurred a legal liability in the

21. Bressner Radio, Inc. v. Comm'r, 267 F.2d 520, 529 (10th Cir. 1955).

22. 353 U.S. 180 (1957).

23. For two other cases allowing prepayments to be deferred, see Bayshore Gardens, Inc. v. Comm'r, 267 F.2d 55 (2d Cir. 1959) and Smith Motors, Inc. v. United States, ¶ 61-2 CCH U.S. Tax Cas. 9627 (D. Vt. 1961).

24. 230 F.2d 722 (5th Cir. 1956).

year of the sale to make service calls at regular intervals in the future, the Fifth Circuit decided that "petitioner's method of accounting comes much closer to giving a correct picture of his income"[25] and to coinciding with commercial accounting techniques.[26]

At the end of the 1950's, there was a clear conflict in the cases. The Commissioner and the Tax Court were solidly allied against the taxpayers. But the arguments presented by the taxpayers persuaded the Second, Fourth, Fifth, Ninth and Tenth Circuit Courts of Appeals to reverse the Tax Court and to allow the matching of income and expenses.

C. The Role of Congress

Congress recognized the need for more certainty in the prepaid income area. Because of the split in judicial decisions, some taxpayers were able to match income with expenses, while others were not. Enacted with the Internal Revenue Code of 1954 were two new provisions designed to allow commercial accounting principles to govern prepaid income and to place all taxpayers on the same basis. Section 452 allowed prepaid income of an accrual method taxpayer to be spread over a five-year period if the taxpayer's normal method of commercial accounting would permit. Section 462 allowed an accrual taxpayer to deduct reasonable reserves for estimated expenses.

The impact of sections 452 and 462 upon the revenues apparently had been grossly underestimated. In 1955, the Secretary of the Treasury asked Congress to repeal the sections retroactively, and Congress obliged.[27] It seems clear from the legislative history that the repeal was intended to be neutral, at least in respect to prepaid subscription income.

> The Secretary of the Treasury in the letter previously referred to which he sent to the chairman of the House Committee on Ways and Means indicated that the repeal of section 452 would not be taken as an indication by the

25. *Id.* at 723.

26. Deductions for estimated expenses had also been allowed earlier in Harrold v. Comm'r, 192 F.2d 1002 (4th Cir. 1951) (strip miner allowed to deduct cost of "backfilling" the mine as required by state law) and Pacific Grape Products Co. v. Comm'r, 219 F.2d 862 (9th Cir. 1955) (fruit canner allowed to deduct estimated packing and shipping charges in accordance with industry-wide practice). *See also* Denise Coal Co. v. Comm'r, 271 F.2d 930 (3d Cir. 1959).

27. Sec. 1, P.L. 84-74 (1955), 1955-2 CUM. BULL. 748.

> Treasury Department of congressional intent as to the proper treatment of prepaid subscription income under prior law or under other provisions of the 1954 Code. He also indicated that the repeal of section 452 will not be considered by the Department as either acceptance or rejection by Congress of the decision in *Beacon Publishing Company v. Commissioner* or in any other judicial decisions. It has come to your committee's attention that the vast majority of publishing concerns having prepaid income are already deferring their income with Treasury approval. It is recommended to the Treasury Department that it modify its published ruling to the end that the remaining publishers may be entitled to defer prepaid subscription income so that they may be placed upon a fair and equitable basis.[28]

In later years, however, when considering the general problem of prepaid income, the Supreme Court attached great significance to the series of events leading to the repeal of sections 452 and 462.[29]

Eventually Congress was persuaded to relieve two classes of taxpayers from the prepaid income problem, because of special circumstances which were felt to burden the two groups unduly. Section 455 of the 1954 Code[30] allows a publisher of a "newspaper, magazine or other periodical" to elect to spread prepaid subscription income over the subscription period; if the publisher's commercial method of accounting would permit the deferral. Section 456 extends a similar privilege to prepaid dues of "membership organizations" which come within the definition of that section.[31] There has been no further Congressional action in the prepaid income area since 1961.

D. The A.A.A. and Schlude Cases

In 1961 the Supreme Court dealt squarely with the prepaid income issue in *American Auto. Ass'n v. United States*.[32] Another automobile club had raised and lost the same issue in 1957,[33] but the American Automobile Association (hereafter

28. S. REP. No. 372, 84th Cong., 1st Sess., 1955-2 CUM. BULL. 852, 861. *See also* H. REP. No. 293, 84th Cong., 1st Sess., 1955-2 CUM. BULL. 855.

29. *See* American Auto. Ass'n v. United States, 367 U.S. 687 (1961).

30. INT. REV. CODE of 1954, § 455, *as amended*, 72 Stat. 1625 (1958).

31. INT. REV. CODE of 1954, § 456, *as amended*, 75 Stat. 222 (1961).

32. 367 U.S. 687 (1961).

33. Automobile Club of Mich. v. Comm'r, 353 U.S. 180 (1957).

"A.A.A.") contended that it had substantially stronger evidence than had been presented in the earlier case. The A.A.A.'s activities consisted of supplying its members with road maps, advice on travel routes, emergency road service, automobile insurance, and bail bond protection. Memberships ran for a year, dues were collected in advance, and the funds were used by the A.A.A. without restriction.

The services were rendered to members upon request; therefore, there was a variance in the amount of service rendered to one member as compared with that rendered to another member, and there was an over-all variance from month to month. The A.A.A. produced accountants who testified that such minor irregularities did not prevent an accountant from spreading prepayments over the period of membership so long as there was a rough monthly average in the pattern of related expenses. The Supreme Court majority, however, felt that a "rough" over-all average was an inadequate basis for proper tax administration.

> That "irregularity," however, is highly relevant to the clarity of an accounting system which defers receipt, as earned income, of dues to a taxable period in which no, some, or all the services paid for by those dues may or may not be rendered. The Code exacts its revenue from the individual member's dues which, no one disputes, constitute income. When their receipt as earned income is recognized ratably over two calendar years, without regard to correspondingly fixed individual expense or performance justification, but consistently with overall experience, their accounting doubtless presents a rather accurate image of the total financial structure, but fails to respect the criteria of annual tax accounting and may be rejected by the Commissioner.[34]

A much more important aspect of the Supreme Court opinion in the *A.A.A.* case was the discussion of the repeal of sections 452 and 462 of the Internal Revenue Code of 1954.

> This repeal, we believe, confirms our view that the method used by the Association could be rejected by the Commissioner. While the claim is made that Congress did not "intend to disturb prior law as it affected permissible accrual accounting provisions for tax purposes," H. R. Rep.

34. American Auto. Ass'n v. United States, 367 U.S. 687, 692 (1961).

> No. 293, 84th Cong., 1st Sess. 4-5, the cold fact is that it repealed the only law incontestably permitting the practice upon which the Association depends. To say that, as to taxpayers using such systems, Congress was merely declaring existing law when it adopted § 452 in 1954, and that it was merely restoring unaffected the same prior law when it repealed the new section in 1955 for good reason, is a contradiction in itself, "varnishing nonsense with the charm of sound."[35]

The Court then held that the Commissioner had explicit discretion under section 446 to reject a taxpayer's method of accounting and that the rejection of the A.A.A. accounting method was a valid exercise of that discretion.

Four members of the Court in *A.A.A.* joined in a sharp dissent. They stated flatly that the repeal of sections 452 and 462 had no significance whatever in view of the legislative history. The minority also felt that the principles of commercial accounting as applied in *Bressner Radio*[36] and *Beacon Publishing Co.*[37] should be applied to prepaid income.[38]

The split in the Supreme Court in the *A.A.A.* case, although interesting from an academic standpoint, was of little comfort to taxpayers with prepaid income. The only hope lay in attempting to limit *A.A.A.* to its facts. The Supreme Court quickly dismissed that possibility in *Schlude v. Comm'r.*[39] The taxpayer in *Schlude* operated a dance studio. Students either paid tuition in advance or signed negotiable notes which the taxpayer immediately discounted at a bank. The students were entitled to a designated number of lesson hours, but no refunds were granted if the lessons were not taken.

The *Schlude* decision followed the *A.A.A.* case in every respect. The Court split 5-4, upholding the Commissioner's rejection of the deferral of prepayments. Both the majority and the dissenters repeated the views they had expressed in *A.A.A.*

The *Schlude* facts were not really appropriate for testing the scope of the *A.A.A.* case. As in *A.A.A.* the services in the *Schlude* case were rendered only upon the demand of the cus-

35. *Id.* at 695.
36. 267 F.2d 520 (2d Cir. 1959).
37. 218 F.2d 697 (10th Cir. 1955).
38. 367 U.S. 687, 713 (1961).
39. 372 U.S. 128 (1963).

tomer. Facts such as those in *Beacon Publishing Co.* and the *Schuessler* case, in which the liabilities related to the prepayments were incurred evenly and predictably over the life of the contracts, have yet to be considered by the Supreme Court.[40]

Nevertheless, since the *Schlude* case was decided, not one case has allowed prepayments to be deferred. *Schlude* has been applied both to prevent deferrals of prepaid income,[41] and to disallow deductions of reserves for estimated expenses related to prepayments.[42]

Although there seems to be an inevitable trend in the post-*Schlude* cases, there is a theoretical possibility that *Beacon Publishing Co.*, *Bressner Radio*, and the *Schuessler* case are still alive.[43] Most of the post-*Schlude* cases have been Tax Court decisions which have not been appealed; and the Tax Court has never admitted, even prior to *A.A.A.* and *Schlude*, that the taxpayer may have a valid argument for deferral. Because *Schlude* may have discouraged taxpayers from appealing Tax Court decisions, neither the courts of appeals nor the Supreme Court have, since 1963, considered any prepaid income cases with the strong factual patterns which were presented in *Beacon*, *Bressner*, and *Schuessler*. Admittedly, however, the chance of a taxpayer victory in this area is slight.

E. Extension of Schlude to Sale of Goods

The tax accounting rule which has emerged from the *A.A.A.* and *Schlude* cases is a policy decision based upon the need to protect the Federal revenues. It is neither "right" nor "wrong" in the legal sense, but it is generally accepted as the prevailing

40. *Beacon Publishing Co.* and *Schuessler* were carefully distinguished on this basis in Automobile Club of Mich. v. Comm'r, 353 U.S. 180, 189 (1957) (footnote 20 of the opinion) and again in American Auto. Ass'n v. United States, 367 U.S. 687, 691 (1961) (footnote 4 of the opinion).

41. *See* Parkchester Beach Club Corp. v. Comm'r, 335 F.2d 478 (2d Cir. 1964) (membership dues); Paul B. Huebner, T.C. Mem. 1966-73 (attorney's fees); William O. McMahon, Inc., 45 T.C. 221 (1965) (information service); E. Morris Cox, 43 T.C. 448 (1965) (investment services); Rev. Rul. 65-141, 1965-1 CUM. BULL. 210 (rent held in escrow).

42. *See* Villafranca v. Comm'r, 359 F.2d 849 (6th Cir. 1966) (dance lessons); Michael V. Lawless, T.C. Mem. 1966-12 (dance lessons); Bell Electric Co., 45 T.C. 158 (1965) (deduction of reserve for warranty expenses); Simplified Tax Records, Inc., 41 T.C. 75 (1963) (accounting services).

43. The Second Circuit majority opined in Automobile Club of N.Y. v. Comm'r, 304 F.2d 781 (2d Cir. 1962), that *Bressner Radio* had not been overruled by the *A.A.A.* case. In addition, *Beacon Publishing Co.* and *Schuessler* were distinguished on the facts by the Supreme Court in *Automobile Club of Mich.* and *A.A.A.*

administrative law. However, the scope of the recent extension of *Schlude* into the sale-of-goods situation seems to be legally "wrong."[44]

In the 1940's when nearly all of the judicial decisions denied the taxpayers' attempts to defer prepaid income, an important distinction was made, *i.e.*, that *gross receipts* from the sale of goods could not be subjected to the Commissioner's rule on prepaid income.

> The trouble with his argument is that its major premise is unsound. The amounts in question were actually, as the stipulation shows, a part of the cost of goods sold and are not being claimed by this petitioner as a deduction under section 23. Section 23 makes no provision for the cost of goods sold, but the Commissioner has always recognized, as indeed he must to stay within the Constitution, that the cost of goods sold must be deducted from gross receipts in order to arrive at gross income. *No more than gross income can be subjected to income tax upon any theory.* (Emphasis added.)[45]

Prepayments from the sale of goods can clearly be included in income in the year of receipt, but only if the *amount* included is gross receipts *less* the cost of goods sold, *i.e.*, the gross income from sales.[46] Nevertheless, in 1965 the Tax Court applied the *Schlude* doctrine to gross receipts from sales of goods;[47] but the taxpayer in that case apparently failed to raise the cost-of-goods issue.

The Tax Court did deal with the problem in 1966 in *Hagen Advertising Displays, Inc.*[48] The taxpayer made and sold trade-name signs to nationwide business concerns. The customers often placed large "blanket" orders and paid in advance. At the end of each taxable year the taxpayer had in its closing inventory account partially completed signs and signs which were completed but not yet delivered. The taxpayer had consistently deferred the inclusion of prepayments for tax purposes until the signs were delivered.

---

44. *See* Hagen Advertising Displays, Inc., 47 T.C. 139 (1966).
45. Lela Sullenger, 11 T.C. 1076, 1077 (1948). *See also* Woodlawn Park Cemetery Co. 16 T.C. 1067 (1951); Veenstra & DeHaan Coal Co. 11 T.C. 964 (1948); Treas. Reg. § 1.61-3(a).
46. Fifth and York Co. 65-1 CCH U.S. Tax Cas. ¶ 9155 (W.D. Ky. 1965).
47. Chester Farrara, 44 T.C. 189 (1965).
48. 47 T.C. 139 (1966).

The Tax Court, citing *Schlude*, held that the Commissioner clearly had discretion to require the taxpayer to include the prepayments in the year of receipt. The taxpayer then argued that, given the Commissioner's power to require immediate inclusion, the *amount* to be included in any one year could not include the cost of goods sold. The Tax Court dismissed that objection with a rather subtle legalistic discussion of the method of accounting for the cost of goods.

> The same regulation defining "gross income" in a manufacturing business (sec. 1.61-3(a), *supra* fn. 2) on which petitioner relies in arguing that receipts from sales are not "gross income" since cost of goods sold must be subtracted therefrom to arrive at "gross income" provides that "The cost of goods sold should be determined in accordance with the method of accounting consistently used by the taxpayer." Nothing in this regulation suggests that an attempt must be made to match a particular purchase with a particular sale or a particular item in inventory. In fact in the case of this petitioner, no attempt is made to keep records in such a manner, and insofar as the record shows petitioner would be unable from its records to determine the precise cost or amount of gain realized from the sale of any particular sign. Petitioner makes no argument that either its cost of goods sold or inventories are incorrectly computed, and respondent has made no change in either amount as reported by petitioner for either year here in issue.[49]

According to the Tax Court's theory the constitutional requirement—that only the gross profits from the sale of goods may be treated as gross income—would be satisfied if in some future year when the goods are delivered a "deduction" or offset of some kind is allowed for the cost of the goods. This is an obvious deviation from basic tax theory. The difference between a return of capital (the cost of goods sold) and a "deduction from gross income" is well known. If prepaid gross receipts from sales are fully included in the year of receipt, there will be a direct tax upon capital (cost of goods sold) in that year.[50] The allowance of an offset in a later year for the cost of goods deliv-

49. *Id.* at 147.

50. Presumably such a tax would be invalid unless "apportioned" among the states. U.S. CONST., art. I, § 9. *See* Pollock Farmers Loan & Trust Co., 157 U.S. 429 (1895).

ered would hardly cure the apparently unconstitutional taxation in the year of receipt.

> Respondent's adjustments in this case, because they ignore the cost of goods sold, would go beyond a mere recomputation of taxable income using a different method of accounting from that used by petitioner; they would expand the scope of the Government's taxing power established in the Code (Sec. 61) as interpreted by respondent's own regulations. Such a result cannot be sustained under the guise of a section 446(b) accounting method adjustment.[51]

Unfortunately the taxpayer in *Hagen* failed to appeal the decision. Hopefully in the near future a braver taxpayer will try to overturn what appears to be a basically erroneous extension of the *Schlude* doctrine.

F. Conclusion

It may be helpful to summarize the current status of prepaid income. All prepayments for services must be included in income in the year of receipt as a general rule. There is a very remote possibility that a court of appeals would reverse the Tax Court and allow deferral of prepayments to match expenses, provided the related expenses were incurred evenly and predictably during the period of performance.

Publishers and certain membership organizations have specific statutory authority in sections 455 and 456 for deferring prepaid income.

Prepayments from the sale of goods may be included in the year of receipt, but the amount included should be limited to gross profits, notwithstanding the Commissioner's successful inclusion of gross receipts in *Hagen Advertising Displays*.

Possibly the most effective way to combat the problem is to stop accepting prepayments. In *Decision, Inc.*,[52] the Commissioner successfully required the taxpayer to include prepayments in the year of receipt during 1959-62. The taxpayer turned the tables by refusing to accept any advance payments during 1963. A net operating loss resulted, and the carryback[53] of the loss to 1960 produced a refund.

51. Hagen Advertising Displays, Inc., 47 T.C. 139, 153 (dissenting opinion of Tax Court Judges Hoyt and Forrester).

52. 47 T.C. 58 (1966).

53. INT. REV. CODE of 1954, § 172.