BRIEF AMICUS CURIAE

No. 80

IN THE

Supreme Court of the United States

OCTOBER TERM, 1962

MARK E. SCHLUDE and MARZALIE SCHLUDE

v.

COMMISSIONER OF INTERNAL REVENUE

ON [redacted] WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF AMICUS CURIAE OF AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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INDEX

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STATEMENT OF INTEREST OF THE INSTITUTE

The American Institute of Certified Public Accountants is a nation-wide professional organization of more than 42,500 certified public accountants out of a total of approximately 70,000 in the United States. It is a non-profit organization chartered under the laws of the District of Columbia, and is the only national professional organization of certified public accountants. Its membership embraces certified public accountants from every state and territory, and from the District of Columbia and Puerto Rico.

The Institute and its members have a profound interest in maintaining a proper relationship between accepted accounting principles and accounting for tax purposes. They believe the decision of the Court of Appeals for the Eighth Circuit in *Schlude* v. *Commissioner* has erroneously construed and applied this Court's decision in *American Automobile Association* v. *United States*, 367 U.S. 687, in a manner that will have a far-reaching and adverse impact upon many taxpayers who report income on the accrual basis. Reversal of the decision below, the Institute believes, is required to assure the proper administration of the federal income tax laws and to avoid unnecessary confusion, uncertainty and litigation that may otherwise develop in the field of tax accounting by accrual basis taxpayers. The Institute, accordingly, submits this brief *amicus curiae* in support of the position of the taxpayers in the *Schlude* case and urges that the decision of the Court of Appeals be reversed for the reasons set forth below.

The consent of the parties to the filing of this brief *amicus curiae* has been filed with the Clerk of the Court.

OPINIONS BELOW, JURISDICTION AND STATUTES INVOLVED

The Institute respectfully refers the Court to the brief of the taxpayers for the statement of the Opinions Below, Jurisdiction and Statutes Involved.

QUESTION PRESENTED

The question presented is: When an accrual basis taxpayer's method of accounting accurately matches revenue derived from services performed in the tax year with related costs, does the decision in *American Automobile Association* v. *United States*, 367 U.S. 687, authorize the Commissioner to tax as income the entire face amount of long-term executory service contracts in the year such contracts are signed even though a large portion of amounts received under the contracts in that year has not yet been earned and another large portion of the face amount of the contracts has been neither received nor earned?

STATEMENT

Petitioners operated a partnership that provided dance instruction services. The students taking instruction paid a portion of the face amount of contracts entered into with the partnership when the contracts were signed and promised to pay the remainder thereafter in installments (R. 146-149, 160, 249-250).[1] The contracts giving rise to the income here in question ordinarily ran for a period greater than a single tax year (R. 184, 250). Although the contracts bound the partnership to perform the required services, the dates for each hour of instruction were not scheduled in the contracts but were agreed to from time to time with the student as individual lessons were given (R. 227, 249-250). Each contract, however, provided a period certain before the expiration of which all the hours of instruction contracted for were required to be taken,

[1] Under some contracts a student made all subsequent payments directly to the partnership. Under another type of contract the student made a part of the subsequent payments to the partnership and another part, evidenced by the student's negotiable note, to a bank to which the partnership had transferred the note. Upon such transfer, the bank deducted interest charges, paid approximately 50 percent of the balance of the note to the partnership and retained the remainder in a reserve account which the partnership could not draw upon until the student had paid the note in full (R. 146-149, 160-161, 250-251). ("R.—" references are to the printed record in this Court.)

and the partnership followed the practice of cancelling any contract under which no instruction had been requested by a student for one year (R. 146-149, 193, 252-253).

Although each contract contained a clause prohibiting the student from cancelling the contract and thereby avoiding payments thereunder, in fact almost 20 percent of the contracts were cancelled in the tax years 1952, 1953 and 1954—the years here in issue (R. 239, 258). The partnership, moreover, was frequently compelled to reduce the hours of instruction—and, accordingly, the payments due—under other contracts in order to avoid cancellations (R. 192, 251).

The partnership always used the accrual method of accounting. It employed procedures that had been designed by a certified public accounting firm accurately to match the partnership's revenues derived from services rendered under each contract in the tax year with costs of performing such services. As each contract was signed, the total contract price was recorded in a "deferred income" account. Individual student record cards were maintained that identified each student, the type of contract, hours involved, total contract price, and the hours of instruction given and payments made under the contract. At the end of the partnership's tax year, the card for each student was reviewed, and the amount of income earned under each contract was determined by multiplying the number of hours of instruction given by the rate per hour on that contract. Whether cash in the amount of such income had been received or not, the "deferred income" account was then reduced by that amount and an "earned income" account increased by the same amount. Earned income from all contracts was totalled

and was reported as income on the accrual basis in the partnership's tax return for that year (R. 185-188, 251-256).[2]

Contending that the entire face amount of each contract constituted income to the partnership in the year in which the contract was signed, the Commissioner rejected the partnership's accounting system for tax purposes and instead increased the net income of the partnership for each of the tax years 1952, 1953 and 1954 by some $24,000, $105,000 and $13,000 the total increase in the "deferred income" account for each such year (R. 256-258). On this basis, he determined deficiencies against the taxpayers for these years of some $18,000, $83,000 and $11,500, respectively (R. 247).[3] The Tax Court, three judges dissenting, sustained the Commissioner's ruling. It held that the entire face amount of each contract was income in the year in which it was signed, although in that year a large portion of amounts collected from the student was as yet unearned by performance and another large portion of the face amount of the contract remained both uncollected and unearned (R. 246, 258).

The Court of Appeals for the Eighth Circuit reversed and held that the accrual accounting system used by the partnership was "eminently designed to reflect true income" (R. 288). This Court thereafter granted a Writ of Certiorari on the Petition of the Commissioner, vacated the judgment of the Court of Appeals and remanded the case to that court "for further consideration in light of *American Automobile Association* v. *United States*, [367 U.S. 687]." See 367

[2] Any gain arising from the cancellation of a contract by a student or by the partnership (where no instruction had been given for a year) was also reported as income on the tax return (R. 192, 253).

U.S. 911 and 368 U.S. 873. On remand the Court of Appeals rendered a *per curiam* opinion in which it affirmed the decision of the Tax Court (R. 273). Citing nothing more than the *American Automobile* decision, the court stated: "In light of that case we have carefully examined and considered petitioners' method of accrual accounting and are convinced that such method does not, for income tax purposes, clearly reflect income" (R. 274). On May 28, 1961, this Court issued a Writ of Certiorari on the Petition of the taxpayers (R. 276).

SUMMARY OF POSITION OF THE INSTITUTE

I

***American Automobile Association* v. *United States*, 367 U.S. 687, does not bar taxpayers from using the accrual method of accounting for advance receipts whereby the reporting of such amounts as income may be postponed to a later tax year if, by such postponement, such method accurately and precisely matches revenues from services performed in each tax year with related costs of performance. That decision held only that the Commissioner of Internal Revenue is empowered to disregard such method if it does not precisely and accurately match the taxpayer's cost of performing services for individual customers with revenues derived from each such customer.**

The discussion by the majority of the Court in *American Automobile* of the enactment and repeal of Sections 452 and 462 of the Internal Revenue Code of 1954 does not support any broader reading of that decision to bar the use for tax purposes of any method

of accrual accounting for advance receipts, no matter how accurate and precise, because it may involve reporting such receipts as income in a subsequent tax year. The Court's consideration of these Code sections had application only to the particular accrual accounting method presented in *American Automobile*, in which the taxpayer used over-all estimates and averages of costs to determine when the advance receipts there involved were reportable as income. Moreover, to read into this portion of *American Automobile* any broad rejection of accrual accounting for advance receipts would disregard legislative and administrative developments that have occurred subsequent to the decision in that case.

Any such broad interpretation would, in addition, conflict with fundamental principles governing accrual accounting for tax purposes that the Court has developed over the years commencing with *United States* v. *Anderson*, 269 U.S. 422. That case and the subsequent consistent precedents of the Court in this field establish that: 1) as to the reporting of receipts as income, "all events" must have occurred that fix an accrual basis taxpayer's right to funds that may previously have been paid to him—or that may still be due; and 2) as to taking deductions, "all events" must have occurred that fix such a taxpayer's obligation with regard to an expense that may previously have been paid by him—or that he may be required to pay. *Continental Tie & Lumber Co.* v. *United States*, 286 U.S. 290; *Spring City Foundry Co.* v. *Commissioner*, 292 U.S. 182; *Security Flour Mills* v. *Commissioner*, 321 U.S. 281; *Lewyt Corp.* v. *Commissioner*, 349 U.S. 237; *Consolidated Edison Co.* v. *United States*, 366 U.S. 380.

These decisions supply no warrant for selecting any year in which to tax receipts of an accrual basis taxpayer other than the year in which the receipts—whether received or to be received—are earned by the taxpayer's performance. This rule is in full accord with the relevant provisions of the Internal Revenue Code and the Treasury Regulations that govern accounting for income tax purposes. It is further supported by the adverse practical consequences that would result from requiring accrual basis taxpayers to report receipts as income no later than the year of receipt.

II

The accrual accounting method for advance receipts used by the taxpayers in *Schlude* fully satisfied the standards set forth in *American Automobile* with regard to matching receipts with the costs of performance. Income was reported in each tax year precisely to the extent it was earned by the taxpayers in fulfilling contracts with students that year. It is not significant in appraising the taxpayers' method of accrual accounting for tax purposes that the contracts did not definitely schedule the performance of services by the taxpayers in years subsequent to the year in which a contract was entered into. This uncertainty as to the taxpayers' performance could not affect their reporting of all receipts as income. Under the taxpayers' accounting practice, all income from each contract was reported not later than the year in which the contract expired, which was fixed in every case, or earlier if the student cancelled the contract or took no instruction for one year.

III

The error below is highlighted by the ruling that the *Schlude* taxpayers must report as income in the year of execution portions of the face amount of the service contracts that were neither received nor earned by the taxpayers. Nothing in *American Automobile* supports such a result. Nor does *Commissioner* v. *Hansen*, 360 U.S. 446, where the accrual basis taxpayers—unlike the taxpayers in *Schlude*—had fully performed their obligations under contracts with customers and had accordingly earned all of the contract price.

The method of accrual accounting as used in *Schlude* was as accurate in fixing the year for taxing uncollected portions of the service contracts as it was in fixing the year for taxing advance receipts. For this reason the improper extension of *American Automobile* to amounts not yet collected would be remedied if the Court held the *Schlude* taxpayers' accounting method proper for tax purposes.

POSITION OF THE INSTITUTE

The *Schlude* case presents the Court with a needed opportunity to clarify the principles that govern accrual accounting for advance receipts in federal income tax law. This opportunity, the Institute respectfully submits, is most timely. The Court's decision in *American Automobile Association* v. *United States*, 367 U.S. 687, although reviewing and restating the applicable law, left unanswered substantial questions that *Schlude* squarely presents. Without resolution of these questions by the Court, it appears likely that controversy in this area between the Commissioner of Internal Revenue and accrual basis taxpayers will persist. *Cf. Automobile Club of New York* v. *Commis-*

sioner, 304 F.2d 781 (2d Cir. 1962), *aff'g*, 32 T.C. 906 (1959);[3] *Beverley J. Sandegren*, 21 T.C.M. No. 16, Dkt. No. 76622 (1962) (on appeal to the Court of Appeals for the Ninth Circuit); *Smith Motors, Inc.* v. *United States*, 61-2 U.S.T.C. ¶ 9627 (D. Vt. 1961).[4]

From the viewpoint of this *amicus*, the key issue is whether *American Automobile* may properly be construed, as the court below apparently did, to foreclose the use for income tax purposes of accrual accounting for advance receipts because it may postpone reporting of income to a subsequent tax year, notwithstanding that, by such postponement, there is an accurate and precise matching of revenues from services performed in each tax year with related costs of performance. If, as we urge, the Court cannot have intended such a sweeping rule, *Schlude*, of course, presents for decision the question of the validity for tax accounting purposes of the accrual accounting method used by the taxpayers there. Finally, the case requires resolution of a narrower issue which, the Institute considers, is encompassed by the preceding questions. It is whether the face amount of an execu-

[3] In *Automobile Club of New York*, *supra*, two judges of the Court of Appeals for the Second Circuit indicated their view that this Court's decision in *American Automobile* had not shaken the authority of Bressner Radio, Inc. v. Commissioner, 267 F. 2d 520 (2d Cir. 1959), which permitted advance receipts on television repair contracts to be reported as income in the year repair services were rendered. However, the third member of the panel in *Automobile Club of New York*, although concurring, expressed the view that *Bressner* had been rejected by the *American Automobile* decision.

[4] See Krahmer, J.R., Taxation of Prepaid Receipts, 47 A.B.A.J. 1218, 1220 (1961); Note, Accrual Method of Accounting for Federal Tax Purposes: A Need for Stability in an Area of Confusion, 48 Va. L. Rev. 731, 742-743 (1962).

tory contract—in *Schlude*, for the performance of services—may be taxed as income to an accrual basis taxpayer in the year in which the contract is signed although a large part of the contract price will be neither received nor earned by the taxpayer until a subsequent tax year.

I. Accrual basis taxpayers may report income for tax purposes by use of accrual accounting procedures for advance receipts that accurately and precisely match revenues from services performed in each taxable year with related costs of performance.

From a commercial and accounting point of view a business man using the accrual method of accounting is not regarded as having income upon merely entering into a contract to perform services or to deliver goods in subsequent years or upon the mere receipt of funds under such a contract. He is regarded as having income only when he has earned it by having performed the services or delivered the goods.[5] On the same basis, it has long been recognized in the income tax laws that receipts should be taxed as income in the tax year in which they are earned, since in this way there is offset against the amount earned the cost of earning it. On the many occasions on which this Court has examined this business and accounting principle it has never rejected its validity, though it has, on occasion, held that particular methods of applying it did not achieve its basic purpose—to bring into the same

[5] See Kohler, E., *Auditing*, p. 432 (1954); Mason, Davidson and Schindler, *Fundamentals of Accounting*, p. 271 (3d ed. 1959); Moonitz and Staehling, *Accounting: An Analysis of Its Problems*, Vol. I, p. 309 (1952); Paton and Paton, *Corporate Accounts and Statements*, p. 282 (1955); see also authorities cited at p. 33 below.