# Statement
# of
# Amicus Curiae

No. 50

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IN THE

# Supreme Court of the United States

October Term, 1962

Marie L. Schlude and [illegible] Schlude, [illegible]

v.

Commissioner of Internal Revenue, [illegible]

## STATEMENT OF AMICUS CURIAE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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Dean Acheson
Fontaine C. Bradley
John T. Sapienza
701 Union Trust Building
Washington 5, D. C.
*Attorneys for Amicus Curiae American Institute of Certified Public Accountants*

Robert L. Randall
Alvin Friedman
Covington & Burling
*Of Counsel*

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IN THE

# Supreme Court of the United States

OCTOBER TERM, 1962

No. 80

MARK E. SCHLUDE and MOZALIE SCHLUDE

*v.*

COMMISSIONER OF INTERNAL REVENUE

*ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT*

## STATEMENT OF AMICUS CURIAE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

The arguments of the parties require the Court to decide whether the accrual method of accounting (which has to do only with accounting for income as earned) may hereafter be used with respect to advance receipts for income tax purposes. The Institute submits this brief Statement in order to clarify the basic question that issue presents.

That question is: whether, in repeatedly ruling that an accrual basis taxpayer is taxed when he has the "right to receive" income, the Court has held that the "right" arises, as the Institute urges, only in the taxable year in which the receipts are earned, whether previously paid or yet to be paid, or, as respondent contends, that the "right" arises no later than the taxable year of receipt.

The briefs make clear that the parties are in sharp disagreement over the meaning of literally every decision of this Court that bears on this question—the decisions involving tax accounting for advance receipts and for deductions by accrual basis taxpayers. As previously set forth at length (Amicus Br. pp. 18-25), we believe the position of the Institute is fully supported by those decisions once it is agreed that *American Automobile Association* v. *United States*, 367 U.S. 687, decided only that the particular method of accrual accounting there involved was so imprecise that the Commissioner's decision to set it aside was not arbitrary. Because further review of the decisions would be superfluous, we urge only that the Court finally resolve this key issue in order to avoid a most wasteful controversy that otherwise will continue without respite between accrual basis taxpayers and the Commissioner.

The Court should be aware, however, that if the term "right to receive" is given the meaning respondent urges, accrual accounting of advance receipts for income tax purposes will have been eliminated. Simply stated, the fundamental concept that underlies accrual accounting, insofar as it determines when receipts are to be recognized as income, is the taxpayer's earning of

that income by performing services or providing goods, as the case may be.[1] That concept will lose all signifi-

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[1] If the earning of income rather than receipt determines the year of taxability, then the Court need pay scant attention to respondent's strenuous effort (Br. pp. 10, 34) to label the *Schlude* taxpayers' method of accrual accounting for advance receipts as the use of a "reserve for future expenses." Respondent could then make no point of the fact that analytically the portion of the advance receipts not recognized as income until a subsequent tax year included two elements—recovery of the cost of performance and realization of an anticipated profit—and that recognition of the profit as income is postponed until the tax year in which the cost of performance is incurred.

Although respondent correctly states that deferring recognition of receipts as income until earned by performance excludes both elements from taxable income in the year of receipt (Br. p. 26, n. 15), the result is entirely proper once the accounting relationship between such deferral and the use of reserves for future expenses is understood. Insofar as the application of accepted principles of accrual accounting is concerned, the determination of which technique is appropriate in any business context will depend upon the nature of the taxpayer's business and what relationship the advance receipts bear to it.

As a general rule, a reserve for future expenses rather than deferring the recognition of advance receipts would be used where the product or service the taxpayer is obligated to supply in subsequent tax years represents a material obligation but is not sufficiently substantial in relation to the main income-producing transaction to require deferral of the receipts and future fulfillment of this obligation is not a separate income-producing activity. By contrast, if the cost-of-performance element of the advance receipts is a substantial and significant part of the taxpayer's income-producing activities, accrual accounting recognizes that he can earn the profits embraced by those receipts only by expending the cost of performance. Hence, recognition of those profits as income is deferred until the subsequent period in which the requisite cost of performance is incurred. Admittedly, where a taxpayer receives a single payment for all goods or services he supplies, and all aspects of those goods or services represent his income-producing activity, it may become a fine question whether deferring the recognition of advance receipts or the use of reserves for future expenses is more appropriate. See Shapiro, D., Tax Accounting cance for tax purposes if respondent's position prevails. And there will be no rational basis for stopping. For the Court will be inevitably compelled to abandon also the correlative principle of accrual accounting, clearly enunciated in *United States* v. *Anderson,* 269 U.S. 422, and in *United States* v. *Consolidated Edison Co.,* 366 U.S. 380, that expenses are to be taken as deductions only in the tax year in which the taxpayer's obligation to pay is determined, and substitute instead respondent's rule that expenses must be taken as deductions no later than the tax year in which paid.[2]

The practical consequence of respondent's position is that accrual basis taxpayers will be placed on the cash basis to the extent they receive advance payments or anticipate the payment of expenses incurred. This will introduce a wholly unwarranted distinction between those taxpayers' business accounting practices

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for Prepaid Income and Reserves for Future Expenses. Compendium of Papers on Broadening the Tax Base. House of Representative Committee on Ways and Means. 85th Cong., 2d Sess., vol. 2, pp. 1133-1134 (1959). However that may be, deferral was quite proper in the *Schlude* situation, since the taxpayers' costs of performance were directly keyed to their major business activity—providing dance instruction services.

[2] The bizarre nature of respondent's new rule concerning deductions may be readily illustrated. If a lease that runs for more than one tax year obligates the lessee to prepay several years rent when the lease is entered into, or if an insurance policy for a period of years requires the insured to pay all premiums when the policy is issued, respondent's view now apparently is that such expenses must be taken as deductions in the year in which they are paid. Respondent fails to indicate how this rule will affect the well-established precedents that require such prepaid expenses to be deducted over the period of years to which they relate. See, *e.g.*, Baton Coal Co., 19 B.T.A. 169 (1930), *aff'd*, 51 F.2d 469 (3d Cir. 1931); Bloedel's Jewelry, Inc., 2 B.T.A. 641 (1925); Higginbotham-Bailey Logan Co., 8 B.T.A. 566, 571 (1927).

and their accounting for income tax purposes. Whatever description may fit that new method of accounting, it will not be accrual accounting and it should not be denominated as such.

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Any consideration of respondent's position would be deficient if it did not touch upon the gross errors in respondent's repeated reliance (Br. pp. 20, 23, 26-27, 28, 30, *et seq.*) upon the "claim of right" doctrine and upon the "annual accounting requirement" to buttress its reading of the Court's decisions.

a. *The "Annual Accounting Requirement."* No decisions of this Court cited by respondent sugg that the "annual accounting requirement" compels an accrual basis taxpayer to treat advance receipts as income in a taxable year without regard to whether such receipts *become* income in that year by reason of their having been earned by the taxpayer's performance. In confusingly urging that advance receipts must be treated as income no later than the year of receipt simply because the "annual accounting requirement" demands that result, respondent merely assumes the conclusion of its argument. At best respondent supports that conclusion with a barrage of disjointed quotations from numerous cases the relevance of which to the problem at hand is not explained by respondent (Br. pp. 20-28). In truth, as applied to advance receipts, the "annual accounting requirement" comes into play only when there has first been a determination, on the basis of wholly independent tax accounting considerations that such receipts have accrued (by the taxpayer's performance) in a particular taxable year and thus are income for that reason. Then and only then does the "annual accounting requirement" direct the accrual basis taxpayer to report such receipts as income in that year.[3] See *American Automobile Ass'n* v. *United States,* 367 U.S. 687, 701-702 (dissenting opinion); *Harrold* v. *Commissioner,* 192 F. 2d 1002, 1006 (4th Cir. 1951).

Most significantly, moreover, respondent's contention that the "annual accounting requirement" demands that accrual basis taxpayers treat all receipts [illegible] income no later than the year of receipt studiously avoids giving any content to Section 451 of the Internal Revenue Code of 1954 (Sec. 42(a), 1939 Code). That section explicitly authorizes receipts to be included as

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[3] No other explanation can be given for language such as appears in United States v. Lewis, 340 U.S. 590, 592, a case involving a cash basis taxpayer that respondent cites without discussion (Br. p. 27), where this Court obviously recognized a clear distinction in the application of the "annual accounting requirement" to cash basis and to accrual basis taxpayers. Thus, when the Court stated that "income taxes must be paid on income received (*or accrued*) during an annual accounting period," it could only have meant that for an accrual basis taxpayer the annual accounting period in which income must be reported is determined by the year in which receipts "accrue" and not the year in which the taxpayer comes into possession of such receipts. (Emphasis added.) The same conclusion is to be drawn from the Court's statements in Burnet v. Sanford & Brooks Co., 282 U.S. 359, another decision that respondent discusses [illegible] length in connection with the annual accounting requirement (Br. pp. 20, 21, 42, 52). In a part of the opinion that respondent disregards when it quotes only language which had a bearing upon the cash basis status of the taxpayer in that case (Br. p. 21, n. 14), the Court stated (at p. 363) that items of gross income are "required to be included in the gross income for the taxable year in which received by the taxpayer, unless they may be properly accounted for on the accrual basis. . . ." The Court thus again indicated its awareness that the annual accounting requirement does not mean that accrual basis taxpayers must recognize receipts as income no later than the year of receipt.

income for a taxable year other than the year of receipt if such amount is to be properly accounted for as of a different period under the method of accounting the taxpayer uses in computing taxable income. Respondent cites (Br. pp. 2, 19, 76) but never addresses itself to the meaning of this provision. See our prior Brief, pp. 26-27.

b. *The "Claim-of-Right" Doctrine.* Respondent does not ask the Court to rely directly upon the "claim-of-right" doctrine to rule as it urges. Instead, respondent asserts that the "rationale" of that doctrine "lends strong support" to its position (Br. p. 30). Respondent's circumspection is understandable.

Respondent, of course, is aware that as a basis for the position it espouses, the "claim-of-right" doctrine was discredited by both *Automobile Club of Michigan* v. *Commissioner,* 353 U.S. 180, and *American Automobile Ass'n* v. *United States,* 367 U.S. 687. Even the majority members of the Court refused respondent's invitation to rest the decisions on that doctrine. Thus in the *Michigan Automobile Club* case Mr. Justice Harlan's dissent succinctly noted that the Court had "bypasse[d] the Commissioner's 'claim-of-right' argument." 353 U.S. at p. 192. Indeed, the statement in respondent's brief in the *American Automobile* case (p. 35) that the "claim-of-right doctrine is not directly applicable" in determining what tax year advance receipts are to become income apparently prompted Mr. Justice Stewart, writing for the four dissenting members in that case, to state that respondent had "with good reason" "abandoned" the doctrine. 367 U.S. at p. 700. As both Justices pointedly declared, the doctrine is of course controlling to determine whether particular receipts are includible in gross income, but is not relevant in determining the proper taxable year for including as income receipts that indisputably constitute items of gross income.

Once again, as with the "annual accounting requirement," respondent would subject the Court to a tyranny of confused meanings. Respondent's course, we suggest, would lead the Court to hold that rules of law having obvious application in one context may be transported in their entirety to a wholly different context and be relied upon as equally persuasive authority there. Respondent's lengthy argument of both the "annual accounting requirement" and "claim-of-right" does not squarely deal with the question that is truly at issue: what the Court has meant by its statement in numerous decisions that amounts which an accrual basis taxpayer has in fact received or has yet to receive are to be taxed as income only in the tax year in which the taxpayer has a "right to receive" such amounts.

Respectfully submitted,

Dean Acheson
Fontaine C. Bradley
John T. Sapienza
701 Union Trust Building
Washington 5, D. C.
*Attorneys for Amicus Curiae*
*American Institute of*
*Certified Public Accountants*

Robert L. Randall
Alvin Friedman
Covington & Burling
*Of Counsel*
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