goods to one who became insolvent during the taxable year was required to accrue and report the full sale gain for federal income tax purposes, notwithstanding that under accepted business accounting practices it was proper to defer the portion which the seller did not expect to collect from the insolvent vendee. The Court stated (p. 189–190):

> Petitioner insists that "good business practice" forbade the inclusion in the taxpayer's assets of the account receivable in question or at least the part of it which was subsequently found to be uncollectible. But that is not the question here. Questions relating to allowable deductions under the income tax act are quite distinct from matters which pertain to an appropriate showing upon which credit is sought. It would have been proper for the taxpayer to carry the debt in question in a suspense account awaiting the ultimate determination of the amount that could be realized upon it, and thus to indicate the status of the debt in financial statements of the taxpayer's condition. But that proper practice, in order to advise those from whom credit might be sought of uncertainties in the realization of assets, does not affect the construction of the statute, or make the debt deductible in 1920, when the entire debt was not worthless, when the amount which would prove uncollectible was not yet ascertained, rather than in 1923 when that amount was ascertained and its deduction allowed.

Recently, in *Commissioner* v. *Hansen, supra,* the Court held that an automobile dealer was not entitled to exclude from its gross income a "dealer's reserve", representing a portion of the sales price withheld by finance companies, even though it was the "common

pattern" (p. 448) and "consistent practice" (p. [illegible]2) in the trade to treat such reserves as unaccrued and unearned until paid over to the dealer. The more recent decision in *American Automobile Assn., supra,* is directly in point. It was there admitted by the government (p. 691), as the Court of Claims had found, that the taxpayer's income-deferral method was "in accord with generally accepted [commercial] accounting principles"; nevertheless, the Court held (p. 692) that the method "fails to respect the criteria of annual tax accounting and may be rejected by the Commissioner."

It is noteworthy that for general business purposes the accounting profession has ascribed a meaning to "net income" which differs significantly from the meaning of that term as used in the Internal Revenue Code and consistently applied by this Court. The term has been defined by the American Institute of Accountants (the amicus) as synonymous with "earnings" over a "period of years", and as having reference, moreover, to "the results of operations after deducting from revenues all related costs and expenses and all other charges and losses assigned to the period."[28] Furthermore, the transactional or "earn-

[28] The American Institute of Accountants, in its Accounting Terminology Bulletin No. 2, pp. 3–4 (March, 1955), defines "net income" as follows:

> The terms *net income* or *net profit* refer to the results of operations after deducting from revenues all related costs and expenses and all other charges and losses assigned to the period.
>
> * * * * *
>
> The term earnings is not used uniformly but it is generally employed as a synonym for "net income," particularly over a period of years. * * *

ings" method of arriving at "net income", approved by the accounting profession for commercial accounting purposes, entails allocations of "charges and credits" which are "estimated" and are "based on assumptions as to future events which may be invalidated by experience."[29] Such a method of accounting, while it may serve useful business purposes, is completely at odds with settled tax accounting precepts.

In any event, there is no reason to suppose that application of generally accepted commercial accounting practices in the area of prepaid income would more clearly reflect "true" net income for a given tax accounting period than the application of established tax accounting rules. Indeed, the accounting profession itself candidly recognizes that commercial accounting practices are diverse and inexact—that they sanction different procedures, and often produce disparate calculations of net income for a particular period.[30] To substitute the "earned income" theory of accounting espoused by the amicus for the annual

[29] As stated by the American Institute of Accountarts in its Accounting Research Bulletin No. 43, p. 59 (1953):

> Allocations to fiscal periods of both charges and credits affecting the determination of net income are, in part, estimated and conventional and based on assumptions as to future events which may be invalidated by experience. While the items of which this is true are usually few in relation to the total number of transactions they sometimes are large in relation to the other amounts in the income statement.

[30] In a recent article the former President of the American Institute of Certified Public Accountants (the amicus in this case) stated:

> There is some reason to believe that this phrase—'generally accepted accounting principles"—suggests to the or-

accounting rule and related accrual principles would not, therefore, furnish any practical solution to the accounting problem presented by this case.

> dinary reader the existence of some authoritative code of accounting, which when applied consistently will produce precise and comparable results. The appearance of precision is strengthened by the reporting of net income in exact dollars and cents, instead of rounded approximations.
>
> Now, we accountants know that "generally accepted accounting principles" are far from being a clearly defined, comprehensive set of rules which will ensure identical accounting treatment of the same kind of transaction in every case in which it occurs. We know that "generally accepted accounting principles" are broad concepts evolving from the actual practices of business enterprises, and reflected in the literature of the accounting profession. To be sure, many of these principles have been formally defined or clarified in the accounting research bulletins of the American Institute. But we all know that in some areas there are equally acceptable alternative principles or procedures for the accounting treatment of identical items, one of which might result in an amount of net income reported in any one year widely different from the amount an alternative procedure might produce.
>
> * * * * *
>
> Yet, I suspect it would come as something of a shock to some people to realize that two otherwise identical corporations might report net income differing by millions of dollars simply because they followed different accounting methods—and that the financial statements of both companies might still carry a certified public accountant's opinion stating that the reports fairly presented the results in accordance with "generally accepted accounting principles."

Eaton, "Financial Reporting in a Changing Society," 104 Journal of Accountancy 24, 26–27 (August 1957); see also Spacek, "Can We Define Generally Accepted Accounting Principles," 106 Journal of Accountancy 40 (December 1958); Knauth, "An Executive Looks at Accounting," 103 Journal of Accountancy 29 (January 1957); Wienshienk, "Accountants and the Law," 96 Pa. Law Rev. 48 (1947).

(*c*) *The Treasury Regulations.*—The amicus also stresses (Br. 26–30) those provisions of the Treasury Regulations which authorize use of the "accrual" in lieu of the "cash" method of accounting. See Regulations under the 1954 Code Sections 1.446–1, 1.451–1, 1.461–1, Appendix, *infra*, pp. 85–99. But nothing in the Regulations permits a taxpayer who chooses the accrual system to postpone reporting prepaid service income in order to "match" the income against future (yet-to-be-incurred) service expenses. On the contrary, the Regulations explicitly provide that "[u]nder an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." Regulations Section 1.451–1(a).[31] The succeeding sentence of the Regulations which the amicus emphasizes (Br. 28–29) furnishes no basis for its inference that the Regulations authorize an accrual basis taxpayer to postpone reporting advance receipts for services. It deals with amounts not yet received, and provides that "if" no determination can be made as to the right to receive compensation for services until the services are completed, the compensation ordinarily is income for the taxable year in which the determination can be made. The very sentence relied upon by the amicus contemplates that there may be situations where the taxpayer's right to receive (and

[31] Conversely, [u]nder an accrual method of accounting an expense is deductible for the taxable year in which all the events have occurred which determine the fact of liability and the amount thereof can be determined with reasonable accuracy." Regulations Section 1.461–1(a)(2).

corresponding duty to accrue) compensation antedates performance of the services. Such a situation exists where, as here, under the terms of the service contract the taxpayer is entitled to and does receive payment in advance for future services. Thus, Rev. Rul. 60–85, 1960–1 Cum. Bull. 181–182, addressed to the precise situation here presented, specifically provides that:

> where a taxpayer receives prepaid income under a claim of right and without restriction as to its disposition, it must report the entire amount received each year as income. * * *
>
> Accordingly, the Service will continue its general policy of taxing prepaid income in the year of receipt. This policy applies to income from contracts to furnish services and to other types of prepaid income, such as prepaid royalties, rent, bonuses, etc., regardless of whether the period of proration is definite or indefinite, unless a different treatment is specifically provided in the Internal Revenue Code of 1939 or 1954 or the regulations thereunder.

Moreover, the Treasury Regulations are to be read as a whole, not by isolating one part from another. The interpretation which the amicus places upon the Regulations renders superfluous the long standing provisions of the Regulations specifically authorizing use of either a "percentage of completion" or "completed contract" method of reporting income from "long-term contracts", defined as "building, installation, or construction contracts" covering a period in excess of one year. Regulations 118, Section 39.42–4 under the 1939 Code, Appendix, *infra*, pp. 81–82; Regulations under the 1954 Code, Section 1.451–3, Appendix, *infra,* pp. 95–96. See also *Burnet* v. *Sanford & Brooks Co.,* 282 U.S. 359, 366. No claim is or can be made that the Studio's contracts to furnish dancing lessons constituted "long-term contracts" falling within the purview of the Regulations.

In short, it is the Studio, not the Commissioner, who is seeking to circumvent the "all events" test enunciated in the Regulations and decisions.

(*d*) *The decisions relied upon by the Studio and amicus.*—Neither the Studio nor the amicus points to any decision which sanctions the deferral, for federal income tax purposes, of prepaid service income. Indeed, the cases upon which they mainly rely (e.g. *United States* v. *Anderson,* 269 U.S. 422) support the government's position. They involved deduction items, and they hold that such items are deductible on the accrual basis only in the taxable year in which the taxpayer's liability to pay them becomes fixed. In contravention of those decisions the Studio is here attempting, by way of "deferral" of "unearned income", to deduct estimated future service expenses from a current year's gross income.

In *Anderson* the Court sustained the Commissioner's determination that a munitions tax was deductible in the year it was imposed (1916), not in the following year in which it became due and payable, because (pp. 440–441) "all the events" had occurred in the earlier year to "fix the amount of the tax and determine the liability of the taxpayer to pay it."[illegible]

[illegible] In *Anderson* the Court was interpreting T.D. 2433, 19 Treasury Decisions, Internal Revenue 5 (1917), promulgated under Section 13(d) of the Revenue Act of 1916, c. 463, 39 Stat. 756, wherein Congress for the first time provided that a return might be made in accordance with a taxpayer's books of account. T.D. 2433 limited the accrual of reserves for tax purposes to reserves for liabilities actually "incurred" during the taxable year; reserves for contingent liabilities were expressly disapproved. It further provided that "in cases wherein deductions are made on the accrual basis as hereinbefore indicated income from fixed and determinable sources accruing to the corporations must be returned, for the purpose of the tax, on the same basis."

Nothing in the opinion may fairly be read as supporting the proposition that accrual of an item of gross income may be postponed from the taxable year in which it is received under claim of right and without restriction as to its use until some later year in which related expense items become deductible.[illegible] To be sure, in *Anderson* (p. 440) the Court spoke of "charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period." But when the opinion is read as a whole, and in the light

[illegible] In the instant case "all of the events" obviously had *not* occurred in the taxable year to fix the Studio's "liability to pay" for the related expenses of performance which it seeks to match against the advance receipts. For example, compensation to instructors, a major item of expense, was based on the number of hours of lessons actually taught by them (R. 155–156); hence the Studio had no obligation (fixed or otherwise) to pay compensation to an instructor except as and when he gave lessons. The Studio's contractual obligation to students *to incur* expenses of performance may not be equated with deductible expenses *already incurred.* See *Spencer, White & Prentis* v. *Commissioner, supra; Streight Radio and Television, Inc.* v. *Commissioner, supra.* Here as in *Spencer, White & Prentis* (p. 47), "liability for the work done after * * * [the taxable year] had not been incurred for the work had not been performed."

of later decisions of this and other courts,[24] it is clear that the Court—far from sanctioning any deferral-of-prepaid income method of accounting—was there strictly applying the annual accounting rule to a taxpayer claiming deductions on the accrual basis. In *Spencer, White & Prentis* v. *Commissioner, supra,* which involved essentially the same issue here presented, the Court stated (p. 47):

> The petitioner's reliance upon *United States* v. *Anderson,* 269 U.S. 422, 46 S. Ct. 131, 70 L. Ed. 347, is misplaced. There the deduction of certain estimated tax liabilities set up in a reserve entered on the taxpayer's books in accordance with a Treasury Regulation was allowed, though the taxes had not been assessed. But all the events had occurred which determined the liability to pay the tax. Here liability for the work done after * * * [the taxable year] had not been incurred for the work had not been performed. * * *

[24] Whatever else may be said of *Anderson,* it continues to be cited by this Court primarily for the proposition that an expense is deductible on the accrual basis only in the taxable year when it is incurred, i.e., when all the events have occurred which fix the liability to pay and determine its amount. *United States* v. *Consolidated Edison Co.,* 366 U.S. 380, 385 *Dixie Pine Co.* v. *Commissioner,* 320 U.S. 516, 519; *Aluminum Castings Co.* v. *Routzahn,* 282 U.S. 92, 96; *Lucas* v. *Ox Fibre Brush Co.,* 281 U.S. 115, 120; *Lucas* v. *American Code Co.,* 280 U.S. 445, 452. See also *Security Mills, supra,* pp. 286-287; Guaranty *Trust Co., supra,* p. 498; *Brown* v. *Helvering, supra.* Significantly, *Anderson* was relied upon by the Second Circuit in support of the deferral system involved in *Bressner Radio, Inc.* v. *Commissioner, supra,* but that case, as previously noted, was effectively overruled in *American Automobile Assn.* v. *United States,* 367 U. S. 687, 689. Cf. concurring opinion of Judge Clark in *Automobile Club of New York, Inc.* v. *Commissioner,* 304 F. 2d 781 (C.A. 2d).

Unless inconsistent accrual principles are to govern for purposes of determining when gross income and deduction items respectively accrue, the "all events" test applied in *Anderson* demands accrual of the income items here in question. For when the Studio received advance payments for lessons to be furnished, pursuant to the terms of its contract with students, "all the events" had occurred to "fix" its right to receive payment and the amount receivable—albeit that in some later year the taxpayer might be required either to refund the income or to incur related deductible expenses. *Security Mills Co.* v. *Commissioner, supra.*

Levin v. *Commissioner,* 219 F. 2d 588 (C.A. 3d), also relied upon by the Studio (Br. 17–18), likewise involved a deduction item and supports the government's position. It was there held that an accrual basis partnership which contracted in one taxable year to pay for advertising services to be rendered in the following year was not entitled to deduct as an expense of the taxable year the full amount payable under the contract because its liability to pay remained contingent in that year. In this case, as in *Levin,* the Studio is improperly attempting (in the guise of deferral of prepaid income) to deduct service expenses which it had no liability to pay in the taxable year. *Helvering* v. *Union Pacific Co.,* 293 U.S. 282, also cited by the Studio (Br. 12–15), involved an issue far removed from that here presented; it was there held that a corporation issuing bonds was entitled to amortize discount and commission allowed over the life of the bond.

As for the cases involving income accrual, upon which the Studio and amicus rely (e.g. *Spring City Co.* v. *Commissioner*, 292 U.S. 182; *Continental Tie & Lumber Co.* v. *United States*, 286 U.S. 290), they too support the Government's position. They illustrate the proposition that income must be reported on the accrual basis in the year when the "right to receive" it becomes fixed, which of course may precede the year of actual receipt. Nothing in the opinions of those cases even remotely suggests that a taxpayer who receives compensation under a claim of right and without restriction as to its use has no fixed "right to receive" it in the accrual accounting sense merely because it is received for services to be performed in the future.

B. Congress has authorized only two classes of taxpayers to use a deferral method of accounting for prepaid service income, and the Studio admittedly does not fall within either class

If more were needed to support the decision below, there are "other considerations requiring our affirmance" (*American Automobile Assn.* v. *United States*, *supra*, p. 694): (1) the history of the enactment and repeal of 1954 Code Sections 452 and 462, dealing respectively with deferral of prepaid income and deduction of reserves for estimated expenses; and (2) the history of the recent enactments of Sections 455 and 456, permitting income deferral, subject to carefully defined safeguards and limitations, by two specified classes of taxpayers (publishers and mem-

bership organizations)—classes to which the Studio admittedly does not belong.[illegible]

In the *AAA* case, the court pointed out (p. 695) that Section 452, which permitted deferral of income received for future services, "overruled the long administrative practice of the Commissioner and holdings of the courts in disallowing such deferral of income for tax purposes," and that its repeal the following year—

> 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 pro-

[illegible] Nor does the Studio come within any of the specific statutory exceptions to the annual accounting rule. See Section 44 of the Internal Revenue Code of 1939, and Section 453 of the Internal Revenue Code of 1954 (installment sales); Section 122 of the Internal Revenue Code of 1939, and Section 172 of the Internal Revenue Code of 1954 (net operating loss deduction); Section 23(k) of the Internal Revenue Code of 1939, and Section 166 of the Internal Revenue Code of 1954 (bad debt reserves); Sections 201(c)(2) and 202 of the Internal Revenue Code of 1939 (credit for estimated liability reserves of life insurance companies); Sections 802, 803(b) and 804(a), Internal Revenue Code of 1954 (deduction for estimated liability reserves of life insurance companies); Sections 204(b)(6) and (7), (c) (1), and (4), Internal Revenue Code of 1939, and Sections 832(b) (5) and (6), (c) (1) and (4), Internal Revenue Code of 1954 (definitions of "losses incurred" and "expenses incurred" with respect to deductions allowed insurance companies other than life and mutual); Section 461(c), Internal Revenue Code of 1954 (proration of real property taxes related to a definite period of time); Section 171, Internal Revenue Code of 1954 (amortizable bond premium); Sections 1301-1304, Internal Revenue Code of 1954 (long-term compensation).

visions for tax purposes." H.R. Rep. 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." Instead of constituting a merely duplicative creation, the fact is that § 452 for the first time specifically declared petitioner's system of accounting to be acceptable for income tax purposes, and overruled the long-standing position of the Commissioner and courts to the contrary. And the repeal of the section the following year, upon insistence by the Treasury that the proposed endorsement of such tax accounting would have a disastrous impact on the Government's revenue, was just as clearly a mandate from the Congress that petitioner's system was not acceptable for tax purposes. * * *[36]

[36] It is plain from the Senate Finance Committee's Report accompanying the 1954 Code that Congress understood prepaid service income to be includible in gross income for the year of receipt, whether the taxpayer used the accrual or the cash method of accounting. Thus in explanation of Section 452 ("Prepaid Income"), which authorized substantially the same deferral method of accounting as the Studio here employed, the Report stated (S. Rep. No. 1622, 83d Cong., 2d Sess., p. 30 (3 U.S.C. Cong. & Adm. News (1954) 4621, 4940)):

> Under the 1939 Code, *regardless of the method of accounting*, with minor exceptions established by regulations or administrative practice, amounts are includible in gross income by the recipient not later than the time of receipt

The Court further pointed out (p. 696) that the later addition of Section 455, permitting publishers to defer prepaid subscription income, coupled with denial of similar relief to automobile clubs with respect to prepaid membership dues, made it abundantly clear that Congress did not intend to grant such relief generally to all taxpayers. Moreover, since the *AAA* decision, Congress has re-confirmed that intention by adding to the Code a section specifically authorizing—again with carefully delineated restrictions and safeguards—automobile clubs and certain other membership organizations to defer prepaid dues income for taxable years after 1960. Section 456 of the 1954 Code, added by Section 1, Act of July 26, 1961, 75 Stat. 222. See H. Rep. No. 381, 87th Cong., 1st Sess. (1961–2 Cum. Bull. 390). Significantly, omnibus bills designed generally to permit deferral of income received for future services have been introduced in the Congress, but have not been passed.[37]

Thus the accounting problem which this case presents has been under continuing legislative study, and Congress has chosen to deal with the problem on

> if they are subject to free and unrestricted use by the taxpayer even though the payments [illegible] goods and services to be provided by the taxpayer at [illegible] future time. [Emphasis ours.]

As this Court pointed out in its *AAA* opinion (367 U.S. at 695–697), the repeal of 1954 Code Section 452 within a year after its enactment reinstated the law as it existed under the 1939 Code.

[37] See H.R. 8688, 86th Cong., 1st Sess., and H.R. 2245 and 2440, 87th Cong., 1st Sess., referred to the Ways and Means Committee, each a bill "To amend the Internal Revenue Code of 1954 to provide for the deferment of income from service contracts".

a selective step-by-step basis, and even as to the two classes singled out for special treatment it has imposed conditions and limitations for the protection of the revenue. Given this pattern of legislative activity, we submit that it would be highly inappropriate for the courts to attempt to carve out additional exceptions to the annual accounting rule in favor of classes of taxpayers other than those specified in the statute. In the concluding words of this Court in *AAA* (p. 697):

> To recapitulate, it appears that Congress has long been aware of the problem this case presents. In 1954 it enacted § 452 and § 462, but quickly repealed them. Since that time Congress has authorized the desired accounting only in the instance of prepaid subscription income, which, as was pointed out in *Michigan*, is ratably earned by performance on "publication dates after the tax year." 353 U.S. 180, 189, note 20. It has refused to enlarge § 455 to include prepaid membership dues. At the very least, this background indicates congressional recognition of the complications inherent in the problem and its seriousness to the general revenue. We must leave to the Congress the fashioning of a rule which, in any event, must have wide ramifications. The Committees of the Congress have standing committees expertly grounded in tax problems, with jurisdiction covering the whole field of taxation and facilities for studying considerations of policy as between the various taxpayers and the necessities of the general revenues. The validity of the long established policy of the Court in deferring, where possible, to congressional procedures in the tax field is clearly indicated in this case. * * *

The policy expressed in *AAA* of leaving to Congress the determination when, and in what circumstances, income deferral is permissible applies with equal force to the deferral system of accounting employed by the taxpayer here. If dance studios—or, for that matter, any taxpayer other than a publisher or membership organization qualifying under 1954 Code, Sections 455 and 456—are to be permitted to defer the reporting of income otherwise currently includible in gross income, the authorization and the concomitant protective provisions should come from Congress, not the courts.[38]

[38] The "complications inherent in the problem" and its "wide ramifications", to which the Court adverted in the *AAA* case (p. 697), are numerous. To mention but a few: (1) If the reporting of service income is deferred beyond the taxable year in which received, should not the deduction of expenses paid or incurred in that year; but attributable to the deferred income, also be deferred? (2) How define a "service contract"; *e.g.*, should it embrace a contract for the use of property, or a sale accompanied by a service warranty? (3) How deal with two discrete service liabilities created by a single contract, one to be performed in the current year and the other over several years? (4) Over how long a period should income-deferral be permitted in the case of long-term or lifetime service contracts?

The impact upon the revenue must also be considered. A change from current to deferred reporting would involve important one-time adjustments, and in many cases result not only in reduced tax liability for the year of transition, but in creating a net operating loss carry-back or carry-forward to other years. Consideration should also be given to requiring the revenue loss in the year of transition to be spread over several years.

C. Assuming arguendo that taxable income may be computed on a transactional rather than an annual basis, the Studio's method of accounting was properly rejected as even more artificial than that rejected in American Automobile Assn. v. United States

Thus far we have argued, as we did in the *AAA* case, that *any* system of accounting which fails to report prepaid service income in the taxable year of receipt, even though the income has not yet been "earned" by performance of the service paid for in advance, is contrary to the scheme of federal income taxation and may be rejected by the Commissioner. This Court in *AAA* apparently agreed, for it held that the income-deferral system there involved "fails to respect the criteria of annual tax accounting", and transgressed the clear Congressional "mandate" (manifested by repeal of 1954 Code, Sections 452 and 462) rendering such systems "not acceptable for tax purposes". 367 U.S. at 692, 695. However, it sustained the Commissioner's rejection of the Association's deferral system on the *further* ground that it was "purely artificial", i.e., "substantially all services are performed only upon a member's demand and the taxpayer's performance was not related to fixed dates after the tax year." 367 U.S. at 691. See also *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180, 189, note 20.

If, as we submit, any system of deferral of prepaid service income (other than those specifically authorized by the special provisions of 1954 Code, Sections 455 and 456) must be rejected as violating settled tax accounting principles, then there is no need to determine whether the particular system of deferral employed by the taxpayer should be rejected on the alternative and independent ground that it is "artificial". But even assuming *arguendo* that such an inquiry were necessary, we submit that the Studio's system of accounting was no less artificial than that condemned in *American Automobile Assn.*

In the first place, the Studio's contracts did not provide for the giving of lessons on fixed dates after the taxable year, but left such dates to be arranged from time to time by the student and his instructor. In fact, many students paid for lessons without ever demanding or arranging that they be given, with the result that a substantial part of the taxable income returned by the Studio each year was attributable to "Gains from cancellation" of contracts rather than "Earned Income". (R. 256.) "Gains from cancellation", of course, represented monies which the Studio had collected (either in advance or in installments) for lessons which it had not been, and never would be, called upon to give.[29] Thus, the record establishes beyond question that the Studio's right to receive (and retain) the advance payments was in no way contingent upon the actual performance of services. On the contrary, it establishes that the Studio's liability to perform services was entirely contingent upon the student's demands. In the words of this Court in *American Automobile Assn.* (p. 692), "no, some, or all the services paid for * * * may or may

[29] Refunds which the Studio occasionally made were charged against "Deferred Income" before "Gains from cancellation" were computed. (R. 253.) Accordingly, "Gains from cancellation" represent the Studio's "unearned" profit from its contracts after allowance of refunds.

not be rendered", and there was no "fixed individual expense or performance justification" for its accounting system.

Furthermore, the Studio's accounting system carries a feature which stamps it as even more artificial than the Association's. Whereas the Association treated certain operating expenses (*e.g.*, commissions paid to personnel for selling contracts to members) "as prepaid membership costs and deducted [them] ratably over the same periods of time as those over which dues were recognized as income" (367 U.S., p. 690), the Studio deducted all of its "related" expenses in the taxable year they were paid or incurred, without regard to when the amounts received under its contracts were reported as "earned." Commissions to sales personnel, for example, were deducted when paid, as were the percentage royalties paid to Arthur Murray on each week's receipts. (R. 218–219, 252.) Consistency would require that these expenses, instead of having been deducted in the year of payment, should have been treated as deductions only in the subsequent year in which the "related" gross income items were treated as "earned." Under its accounting system, however, the Studio was claiming the best of both worlds—immediate deduction of expenses and deferral of "related" gross income. The Commissioner, we submit, was amply justified in rejecting such a system of accounting.

In any event, whether or not the Studio's system is deemed artificial, we think it is clear that the "long standing position of the Commissioner and courts",

and the repeal of the "only law incontestably permitting the practice upon which the * * * [Studio] depends" (367 U.S. at 695) fully justifies the Commissioner's refusal to approve the Studio's method of accounting for advance receipts.

II. THE FUTURE INSTALLMENTS

THE STUDIO WAS REQUIRED TO ACCRUE AND REPORT FUTURE INSTALLMENTS REPRESENTING SERVICES RENDERED DURING THE YEAR (REGARDLESS OF THE CONTRACTUAL DATE FOR PAYMENT) AND FUTURE INSTALLMENTS DUE UNDER THE CONTRACT DURING THE YEAR (REGARDLESS OF THE CONTRACTUAL OR ACTUAL DATE OF PERFORMANCE).

The burden of our argument thus far has been that payments actually received without restriction as to use must be deemed accrued income. But, in addition to supporting this proposition, most of the authorities already discussed also teach that income often accrues *before* receipt—when the right to receive becomes fixed. Ordinarily, it is performance of the services which fixes the amount and the right to receive payment. But, exceptionally, the parties may agree otherwise. The contract may provide that the right to payment antedates the obligation to perform.

As we have seen, that is the situation here. These atypical contracts* call for down-payment of a por-

* In this connection it may be noted that at least one state (California) has recently enacted legislation designed to prevent dance studios from engaging in practices which result in forfeitures of advance payments. Declaring that "the purpose" of such legislation is "to safeguard the public against fraud, deceit, imposition and financial hardship * * * by prohibiting or restricting false or misleading advertising, onerous contract terms, harmful financial practices * * * by which the public has been injured in connection with contracts for health and dance studio services", the California statute (1) prohibits

tion of the stipulated price and installment payments of the balance, without regard to when, or whether, lessons will actually be requested by the students. Neither the amounts payable nor the due dates of the installments bear any relationship to the number of lessons expected to have been given at the time of payment. Normally, payments were made when due and the rule applicable to actual receipts would apply. But there were, of course, defaults and delays in payments. These are our present concern.

Under the circumstances of this case, it is clear that the right to receive accrued, at the latest, when payment became due under the agreement, even though not then made. Neither the creditor's failure to demand payment, nor the debtor's refusal to pay, can affect the legal right to receive a matured installment. And, under settled principles, once that right has ripened, income is deemed accrued. The consequence is that accrued income in any given year includes: (1) payments actually received, (2) payments presently

dance studios from entering into contracts measured by the life of the person receiving the services, from requiring payments over a period exceeding two years from the date of the contract or in a total amount exceeding $500, and from cutting off defenses by assignment of the contract or negotiation of notes received thereunder; and (2) requires every contract for dance studio services to contain a provision for refund of prepayments, and for relief from further payments, upon the death or disability of the person contracting for the service. Title 2.5, California Civil Code (Sections 1812.80–1812.95), added by Stat. 1961, c. 1675, § 1.

due under the contract, and (3) promised compensation for services already performed, regardless of the contractual date for payment.

Initially, the Commissioner went further, asserting that installment payments should be accrued even before they became due, since the signing of the contract itself fixed the amount and the right to ultimately receive them. Upon reconsideration, however, we concede the error of accruing future payments which are neither due as a matter of contract, nor matured by performance of the related services. Indeed, the Studio's right to collect the installment on its due date depends on its continuing ability and willingness to perform. Until that time, its right to receive payment has not fully ripened.

Because neither the Commissioner nor the taxpayer segregated amounts received, matured installments, and payments not yet due, disposition of the case on the basis outlined will require re-examination of the studio's books and records and appropriate new findings. Accordingly, we urge a remand of the cause for this purpose.

CONCLUSION

For the foregoing reasons, it is respectfully submitted (1) that the judgment of the court of appeals should be affirmed in so far as it is predicated upon inclusion in the Studio's gross income for the respective taxable years involved of the amounts received by it in those years in cash or its equivalent; and (2) that the case should be remanded for a determination of the additional amounts includible by reason of its having acquired a fixed right to receive them in those years.

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APPENDIX

Internal Revenue Code of 1939:

SEC. 21. NET INCOME.

(a) *Definition.*—"Net income" means the gross income computed under section 22, less the deductions allowed by section 23.

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(26 U.S.C. 1952 ed., Sec. 21.)

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

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(26 U.S.C. 1952 ed., Sec. 22.)

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) [As amended by Sec. 121(a), Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses.*—

(1) *Trade or business expenses.*—

(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services