

APPENDIX

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 16,443

MARK E. SCHLUDE AND MARZALIE SCHLUDE,
Husband and Wife, *Petitioners*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

On Petition to Review Decision of The Tax Court
of the United States

[December 15, 1961.]

Before SANBORN, VAN OOSTERHOUT and MATTHES, Circuit
Judges.

PER CURIAM.

For the second time this case is here for determination. Our first opinion, 283 F. 2d 234, reversed the decision of the Tax Court. On June 19, 1961, the Supreme Court of the United States rendered its decision in *American Automobile Association v. United States*, 367 U.S. 687. On the same day the Supreme Court, by per curiam order in this case, directed that "(t)he judgment is vacated and the case is remanded in light of *American Automobile Association v. United States* * * *." *Commissioner of Internal Revenue v. Schlude et ux.*, 367 U.S. 911. On October 9, 1961, in denying petition for rehearing, the Supreme Court amended its per curiam order of June 19, 1961, as follows: "The judgment is vacated and the case is remanded for further consideration in the light of *American Automobile Association v. United States* * * *." (Emphasis supplied).

Pursuant to our invitation, counsel for petitioners and the Commissioner filed supplemental briefs and presented

oral arguments directed largely to the question of whether this case falls within the ambit of the teachings of *American Automobile Association*, supra. 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.

Accordingly, our judgment previously entered is vacated, and the decision of the Tax Court is affirmed.

A true copy.

Attest:

Clerk U. S. Court of Appeals, Eighth Circuit.

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 16,443

MARK E. SCHLUDE AND MARZALIE SCHLUDE,
Husband and Wife, Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

Petition to Review Decisions of the Tax Court
of the United States

[October 19, 1960.]

Before SANBORN, WOODBUGH, and MATTHEA, Circuit
Judges.

MATTHEA, Circuit Judge.

The Commissioner of Internal Revenue determined that a deficiency existed in the tax liability of petitioners for the years 1952 to 1954, inclusive, as follows:

| | |
|---------------------------------------|-------------|
| Mark E. Schlude for 1952 | \$ 9,264.69 |
| Marzalie Schlude for 1952 | 8,971.55 |
| Mark E. and Marzalie Schlude for 1953 | 83,395.82 |
| Mark E. and Marzalie Schlude for 1954 | 11,544.32 |

The Tax Court, with three Judges dissenting, affirmed the action of the Commissioner. See 32 T.C. 4271. Pursuant to §§ 1141, 1142 of the Internal Revenue Code of 1939 and §§ 7482, 7483 of the 1954 Code, petitioners have brought the case to this Court for review.

The facts, established by stipulation of the parties and evidence, are detailed in the findings of the Tax Court. Those essential to a proper understanding of the question presented for our determination are: Petitioners, husband and wife, on June 18, 1946, formed a partnership known as Arthur Murray Dance Studio for the purpose of conducting and operating dance studios authorized by certain franchise agreements entered into with Arthur Murray, Inc., of New York City. The venture was carried into effect and the partnership operated studios in the States of Nebraska, Iowa and South Dakota, for the specific purpose of teaching private ballroom dancing to individual students.

Basically, there were two kinds of contracts entered into between the partnership and students desiring dancing instruction. Under one type, a portion of the total tuition was paid in cash when the contract was executed, and the balance in deferred installments. Under the other, a portion of the down payment was paid in cash at the time the contract was entered into, and the balance of the down payment was to be paid in installments, the remainder of the contract price being evidenced by a negotiable note taken from the student, payable in designated installments in accordance with the terms of the note. Under the contract the student agreed to take a designated number of hours of dancing lessons and pay therefor the amount

specified as tuition. All types of contracts contained a non-cancellable provision and provided that the student should not be relieved of his obligation to pay the tuition agreed upon. The hours of lessons or instructions contracted for ranged from 5 to 1,000 to 1,200. Some of the contracts were for lifetime courses which meant that, over and above 1,200 specified hours, the student was entitled to 2 hours of lessons per month plus two parties a year for life. By explicit terms, the studio was required to give the number of hours of instruction agreed upon. The contracts, however, did not schedule the dates when the studio was required to give and the student was to receive instructions, this detail being arranged and agreed upon from time to time as lessons were given. Under many of the contracts, lessons extended beyond the fiscal year in which the contract had its inception.

Notes taken from students were transferred with full recourse, to a local bank, which at the time of acquiring a note, would deduct therefrom the interest charges, and give approximately 50% of the balance of the note to petitioners. Installment payments on the remainder of the note were held by the bank in a reserve account, but this reserve was not available to petitioners until the note was paid in full by the student, after which the reserve was transferred to the partnership's general bank account.

A sizeable number of contracts was cancelled annually, the non-cancellable provision to the contrary notwithstanding. In its opinion, the Tax Court conceded that "cancellations were considerable in amount", noting that records of the partnership disclosed that cancellations for the respective years involved were 17%, 15%, and 19% of sales for the respective years.¹

¹ 32 T.C. at p. 1279. Petitioners insist that the Tax Court's percentages of cancellations are inaccurate; that sales in the amount of approximately 28.4%, 19.1% and 25.2% were cancelled in the fiscal years 1952, 1953 and 1954.

A complete double entry bookkeeping system was installed for the partnership by a certified public accounting firm at the time that the partnership was organized, and an accrual system of accounting was employed, with the fiscal year ending March 31. This accounting system was used continually and consistently from the time the partnership was formed. Additionally, individual student record cards were maintained, listing all pertinent information such as name and address of student, type of contract, hours involved, total contract price, history of lessons taught, and payments made under the contract.

Since the method pursued by the partnership with respect to its operations under its accrual system of accounting and the effect thereof from an income tax standpoint are fully and correctly shown in the findings of the Tax Court, we shall forego a repetitious analysis of the manner in which the student transactions were processed insofar as they bear upon the tax question. It is sufficient to say that when a contract was entered into with a student, the "deferred income" account was credited with the total contract price. At the close of each fiscal year, the student record cards were analyzed and determination was made of the number of hours of lessons taught which, multiplied by the rate per hour of each contract, gave the amount of income earned. This amount was then charged to "deferred income" and credited to "earned income." Earned income thus arrived at was reported as income on the partnership's tax return. If there was any gain resulting from cancellation of a contract, this amount was also considered as taxable income and reported as such. Detailed schedules which correctly and precisely reflect the result of the partnership's accrual system of accounting during the years in question appear in the findings of fact of the Tax Court.

The deficiencies under consideration resulted from the Commissioner increasing the ordinary net income of the

partnership for the fiscal years ending March 31, 1952, 1953 and 1954, by the amount of the increases in the deferred income account in those years, as follows: \$24,602.29 in 1952, \$104,798.41 in 1953, and \$12,797.97 in 1954. This determination was made and upheld by the Tax Court through application of the "claim of right doctrine," meaning that, for income tax purposes, the full amount of its contract price had to be returned as income in the year in which the contract was entered into, irrespective of any obligation on the part of the partnership to render services under the contract in years subsequent to the year in which the agreement was made.

This case once more brings into sharp focus the question of when income shall be taken into account for tax purposes.² Section 41 of the Internal Revenue Code of 1939 is the starting point in determining petitioners' "income" for purposes of the internal revenue laws. It directs that net income shall be *computed* on the basis of taxpayer's annual accounting period, "in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income." Section 42 of the 1939 Code sets out the *period* in which items of gross income shall be recognized. It provides:

"The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period." (Emphasis supplied.)

² Mertens Law of Federal Income Taxation [Zimet & Stanley Rev.] states, Vol. 2, § 12.01: "The fundamental questions of *who* items become income and *when* items are deductible, despite years of extensive litigation, are still troublesome today."

Regulations issued by the Commissioner reiterate the principle that the accounting methods and computations thereunder are to be made in a manner which will clearly reflect the taxpayer's income.³

As permitted by § 41, the practice of accrual accounting has long been recognized for the purpose of tax accounting. See *United States v. Anderson*, 269 U.S. 422, and § 446(e) Internal Revenue Code of 1954. Generally, under such a system, it is contemplated that income, earned but not yet received, is to be reported, with the corresponding accrual of expenses incurred but not yet paid. It is not surprising that considerable litigation has arisen as to the proper treatment to be given specific items in specific instances.

One line of cases has dealt with the problem of *when* income accrues, and in this connection, the so-called "claim

³ Regulations 118, issued under the 1939 Code provide [see Vol. 2, Mertens Law of Federal Income Taxation, § 12.02, p. 11].

" * * * The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it."

"It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his *true* income. He must, therefore, maintain such accounting records as will enable him to do so." (Emphasis supplied).

of right" doctrine first made its appearance, apparently in *North American Oil Consolidated v. Burnet*, 286 U.S. 417. In that case, it was conceded that net profits earned by property in receivership during 1916 and paid over in 1917 constituted income. After holding that the income could not be said to have accrued during 1916, inasmuch as there was no constructive receipt of monies, nor right in taxpayer to demand the profits, the court further held that the profits were income for 1917, and not income for the year 1922, the year in which litigation was finally terminated, stating at p. 424:

"If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent."

The "claim of right" test has been frequently applied, both from the standpoint of determining receipt of income, and of determining the propriety of deduction of expenses or reserves, and as to taxpayers on an accrual basis as well as to those on a cash basis. See and compare, *Brown v. Helvering*, 291 U.S. 193; *Spring City Co. v. Commissioner*, 292 U.S. 182; *Guaranty Trust Co. v. Commissioner*, 303 U.S. 493; *Commissioner v. Hansen*, 360 U.S. 446, 463-468; *Commissioner of Int. Rev. v. Cleveland Trinidad Pur. Co.*, 6 Cir., 62 F. 2d 85. Recently, the Supreme Court, in *Healy v. Commissioner*, 345 U.S. 278, had occasion to apply the test, in holding that cash basis taxpayers are required to report salaries when received although subsequently it was determined excessive salaries had been paid to them. There the Court stated, 345 U.S. at p. 281:

"Not infrequently, an adverse claimant will contest the right of the recipient to retain money or property, either in the year of receipt or subsequently. In

North American Oil v. Burnet, 286 U.S. 417 (1932), we considered whether such uncertainty would result in an amount otherwise includible in income being deferred as reportable income beyond the annual period in which received. That decision established the claim of right doctrine now deeply rooted in the federal tax system." (*United States v. Lewis*, 340 U.S. 590, 592)."

A second line of cases has dealt with the problem from the standpoint of the deductibility of anticipated expenses. See and compare, *United States v. Anderson*, 269 U.S. 422; *Spring City Co. v. Commissioner*, 292 U.S. 182; *McCauley-Ward Motor Supply Co. v. Commissioner*, 10 B.T.A. 394; *Capital Warehouse Co. v. Commissioner of Internal Revenue*, 8 Cir., 171 F. 2d 395; *Hilinski v. Commissioner of Internal Revenue*, 6 Cir., 237 F. 2d 703. From these cases, the rule has evolved that no expense may be accrued and deducted in the absence of a fixed and definite liability for a sum which may be determined with reasonable certainty. Frequently in fixing a strict standard of proof, the courts speak in terms of deduction as being a matter of "legislative grace," not a matter of right. See *U. S. v. Olympic Radio & Television*, 349 U.S. 232, 235; *Capital Warehouse Co. v. Commissioner of Internal Rev.*, *supra*, at p. 397.

There remains yet a third type of situation, typified by that before us—that is, the proper tax treatment of receipts which are in part unearned. It is our view that the concept of "prepaid receipts" requires consideration of factors not present in dealing with concededly "earned income." However, it is apparent from our review of Tax Court decisions, that this distinction has not been made, and that the Commissioner is unyielding in his position, which, broadly stated, is that all payments actually or constructively received by a taxpayer for future services, are taxable in the year of receipt, without regard to taxpayer's accounting system, and regardless of whether such

receipts will be retained or offset by expenses in future years. See *Curtis R. Andrews v. Commissioner*, 23 T.C. 1026, and compare *Consolidated Edison Co. of New York v. United States*, 2 Cir., 279 F. 2d 152, petition for certiorari pending; (pre-payment of tax not yet accrued). On the other hand, it is apparent that taxpayers have frequently found it difficult to obtain the Commissioner's approval of reserves set up and designed to offset the expenses of earning such income. See and compare, *Capital Warehouse Co. v. Commissioner of Internal Rev.*, supra, 171 F. 2d 395; *Hilinski v. Commissioner of Internal Revenue*, supra, 237 F. 2d at p. 704.⁴ It is our view that the decision in the case before us does not turn solely on the question of whether petitioners had the right to receive or keep the amounts of tuition designated in the contracts for lessons.⁵ The real question is whether petitioners' system of accounting reflected their true income. The Tax Court made no finding that it did not. The effect of the Commissioner's adherence to and application of the claim of right test here is to place petitioners on a cash basis as to income, irrespective of the fact that their books are kept on an accrual basis. It must be remembered that accrual accounting has been approved for the purpose of tax accounting. In the oft-cited case of *United States v. Anderson*, supra, the Supreme Court discussed the purpose

⁴ "It is not reasonable under these circumstances to compel the petitioners to accrue income and at the same time refuse to allow them to accrue the liability incurred in the production of that income."

⁵ Petitioners have argued with some persuasion that the "claim of right" doctrine will not extend to portions of the installment contracts not due or payable until a later year. Furthermore, as noted, the Tax Court found that petitioners' past experience indicated that a large portion of the sales would be cancelled. As to ownership of the reserves held by the bank, see and compare *Commissioner v. Hansen*, 360 U.S. 446. Because of our disposition of the case, it is not necessary to decide these issues.

of §§ 12(a) and 13(d) of the Revenue Act of 1916 (provisions similar to §§ 41, 42) in this language at p. 440 of 269 U.S.:

"It was to enable taxpayers to keep their books and make their returns according to scientific accounting principles, by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period; and indeed, to require the tax return to be made on that basis, if the taxpayer failed or was unable to make the return on a strict receipts and disbursements basis."

See also *United States v. Mitchell*, 271 U.S. 9, 12, 13; *Healy v. Commissioner*, 345 U.S. 278, 281; *Hilinski v. Commissioner of Internal Revenue*, supra, at p. 704; and *Beacon Publishing Co. v. Commissioner of Internal Rev.*, 10 Cir., 218 F. 2d 697, 699; where this pertinent statement appears:

"The obvious purpose of these provisions (appearing in §§ 41 and 42) is to obtain from the taxpayer a return reflecting its true income and to treat income received and deductible disbursements consistently. *United States v. Mitchell*, 271 U.S. 9, 12, 46 S. Ct. 418, 70 L. Ed. 799."⁶

In *Beacon Publishing Co. v. Commissioner of Internal Rev.*, supra; *Bayshore Gardens, Inc. v. C.I.R.*, 2 Cir., 267 F. 2d 55, and *Bressner Radio, Inc. v. C.I.R.*, 2 Cir., 267 F. 2d 520, the courts effectuated the purpose of these provisions and reversed the Tax Court on the identical position here advanced, the holding being that it was proper under the accrual method of accounting to defer prepaid receipts. The courts have also recognized a corollary to the foregoing rule, that is, when the accrual method of accounting is employed, it is proper under appropriate circumstances to set up a reserve in the year of receipt to meet the ex-

⁶ It is significant that the language of § 41 is directed to net income, which necessarily contemplates the matching of receipts and expenses.

penses attributable to the income. See *Pacific Grape Prod. Co. v. Commissioner of Int. Rev.*, 9 Cir., 219 F. 2d 862; *Schuessler v. Commissioner of Internal Revenue*, 5 Cir., 230 F. 2d 722; *Harrold v. Commissioner of Internal Revenue*, 4 Cir., 192 F. 2d 1002; *Hilinski v. Commissioner of Internal Revenue*, 6 Cir., 237 F. 2d 703; *Denise Coal Company v. Commissioner*, 3 Cir., 271 F. 2d 930. However, where there is a mere contingent liability to make refunds in the following year or doubt as to actual services to be performed, reserves may not be deducted. *Brown v. Helvering*, supra, at pp. 199-202; *Security Mills Co. v. Commissioner*, 321 U.S. 281, 284; *Whitaker v. Commissioner of Internal Revenue*, 5 Cir., 259 F. 2d 379 at 382, 384, and cf. *Capital Warehouse Co. v. Commissioner of Internal Rev.*, 8 Cir., 171 F. 2d 395.⁷

Many of the decisions relied upon by the Commissioner concerned fully executed contracts and concededly earned income. This factor has been treated to considerable discussion by many courts in arriving at their conclusions. See *Dayle v. Commissioner of Internal Revenue*, 2 Cir., 110 F. 2d 157, cert. den. 311 U.S. 658; *Denise Coal Company v. C.I.R.*, 3 Cir., 271 F. 2d 930; *Baird v. Commissioner of Internal Revenue*, 7 Cir., 256 F. 2d 918, 924, aff'd. Com-

⁷ In *Schuessler v. Commissioner of Internal Revenue*, supra, the Court in discussing deductibility of anticipated expenses observed, 230 F. 2d at p. 724:

"The decisions of the Tax Court and of the several Courts of Appeals are not uniform on this subject, some circuits requiring a mathematical certainty as to the exact amount of the future expenditures that cannot be satisfied in the usual case. Other circuits, seemingly more concerned with the underlying principle of charging to each year's income reasonably ascertainable future expenses necessary to earn or retain the income, have permitted the accrual of restricted items of future expense. Two of this latter category are *Harrold v. Commissioner* and *Pacific Grape Products Co. v. Commissioner*."

missioner v. Hansen, 360 U.S. 446; *Universal Oil Products Co. v. Campbell*; 7 Cir., 181 F. 2d 451, 469, 472, cert. den. 340 U.S. 850, (pointing out that an agreement for services had been fully performed); and *Whitaker v. Commissioner of Internal Revenue*, 5 Cir., 259 F. 2d 379, 384.

On the facts we have a case closely analogous to *Beacon Publishing Co. v. Commissioner of Internal Rev.*, supra; *Bressner Radio, Inc. v. C.I.R.*, supra, and *Banshee Gardens, Inc. v. C.I.R.*, supra, and on principle, one that is identical with those cases. In *Bressner*, the Second Circuit, in a well reasoned, sound and exhaustive opinion, deals with all facets of the question. In our view, it is not only apposite but persuasive.

Even assuming arguendo that petitioners received cash payment in full at the time of contracting, the receipt of the funds could not be considered to be *earned* until petitioners had discharged their liabilities under the contract. Under their method of accounting, established when the partnership was formed and continually employed thereafter,⁸ petitioners reported as income in their tax returns such portion of the total amount received, as under their system of accounting had been *earned*, deferring the remainder of the amount received for inclusion in the year or years in which the remainder of their liability was discharged. Such system seems eminently designed to reflect true income.

Manifestly, *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180, the only case in which the Supreme Court considered on the merits the question of the pro-

⁸ This is not a situation where taxpayers are attempting to change their method of accounting. See *Brown v. Helvering*, 291 U.S. 193; *United States v. Anderson*, 269 U.S. 422; *Beacon Publishing Co. v. Commissioner of Internal Rev.*, supra, at pp. 701-702. Three qualified experts testified that the system here employed did reflect true income and in fact was the only method which would do so.

riety of deferring prepaid funds, is distinguishable and therefore not controlling. Although the Tax Court in that case applied the claim of right doctrine to disallow the deferral of unearned receipts, 20 T.C. 1033, aff'd, sub nom. *Automobile Club of Mich. v. Commissioner of Int. Rev.*, 6 Cir., 230 F. 2d 385, 391, this question was not reached, for the Supreme Court delineated the issues and based its decision on the narrow ground that the *particular method* of deferral employed by the Club was unsatisfactory. The Court found that "(t)he pro rata allocation of membership dues in monthly amounts is purely artificial and bears no relation to the services which petitioner may in fact be called upon to render for the member." 353 U.S. at p. 189. The Court distinguished *Beacon Publishing Co. v. Commissioner of Internal Rev.*, supra, and *Schuessler v. Commissioner of Internal Revenue*, supra, on their facts, expressing no opinion upon the correctness of these decisions.

The facts before us are distinguishable. Here, petitioners' obligation to provide services subsequent to the tax year was fixed, definite and certain, thereby effectively rebutting any contention that petitioners' method of deferral was purely artificial. The system and method of accounting on an accrual basis, with the deferral of income so that it could be closely matched to the corresponding expenses, was designed to clearly reflect petitioners' true income within the meaning of the applicable statutes and regulations. As pointed out in the *Beacon* and *Schuessler* cases, any other method would result in a distortion of true income. Compare, *Waldheim Realty & Inv. Co. v. Commissioner of Int. Rev.*, 8 Cir., 243 F. 2d 823, ruling that a cash basis taxpayer was entitled to deduct *prepaid expenses* of insurance premiums in the year paid against the Commissioner's contention that the cost thereof must be proportioned over the term of the policy. This court observed, at p. 828, "To require the taxpayer to treat its insurance payments upon an accrual basis would, as the Supreme Court

states in *Security Flour Mills Co.*, supra, create 'a divided and inconsistent method of accounting not properly to be denominated either a cash or accrual system.'"

Neither do we regard *Capital Warehouse Co. v. Commissioner of Internal Rev.*, supra, as apposite; certainly not controlling. In that case the crucial question was whether the taxpayer could, for the tax year involved, exclude from its gross income that portion thereof which it had set aside on its books as a reserve fund to cover a contractual liability. As we understand the opinion, the taxpayer was denied the deduction because the amount which it had set up in the reserve account was not fixed and certain.

It is our view that the recent decision of the Seventh Circuit in *Straight Radio and Television, Inc. v. Commissioner*, . . . F. 2d . . . , decided July 28, 1960, and affirming the Tax Court, is analogous to the *Automobile Club of Michigan* holding, being based upon a finding that taxpayer's system of deferring income attributable to future services was arbitrary and without proper foundation. In referring to the decision of the Tax Court in the *Straight* case, 33 T.C. No. 15, at p. 11, we observed that that court found that the taxpayer had "failed to prove that the method of deferral used bore any significant relation to the services to be performed."

Even indulging the assumption that petitioners came into possession of the monetary amount of the contracts when executed within the contemplation of the claim of right doctrine, we are satisfied that to apply the doctrine to petitioners' operation, without regard to its accrual system of accounting, would result in emasculation of the law long recognized, which affords taxpayers the right "to keep their books and make their returns according to scientific accounting principles, by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income dur-

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ing that period." *United States v. Anderson*, *supra*, 269 U.S. at p. 440.

On this record we must hold that there is no showing that the method of accounting employed by taxpayers did not clearly reflect income, and consequently there is no basis for the Commissioner to adopt a method of his own. Accordingly, the decision of the Tax Court is

Reversed.

Woodrough, Circuit Judge, dissenting.

This Court twelve years ago considered the question that is the crux of the presently involved controversy in the case of *Capital Warehouse Co., Inc. v. Commissioner of Internal Revenue*, (C.A. 8, 1948) 171 F. 2d 395.

In that case the taxpayer sought to exclude from its gross income that portion thereof which it had set aside on its books as a reserve to cover its contractual liabilities to its customers to remove merchandise from its warehouse at the end of its storage period. The Tax Court held that the Commissioner rightfully refused to uphold the exclusion. We affirmed the decision of the Tax Court. Although other Courts of Appeals have since reached contrary conclusions, I would adhere to our former decision and affirm the Tax Court in this case.

A true copy.

Attest:

Clerk, U. S. Court of Appeals, Eight Circuit.

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APPENDIX C

Judgment

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 16443, September Term, 1961

MARK E. SCHLEDE AND MARZALIE SCHLEDE,
Husband and Wife, Petitioners,

COMMISSIONER OF INTERNAL REVENUE,

On Petition to Review Decision of The Tax Court
of the the United States

This cause came on to be heard on the Petition to Review the Decisions of the Tax Court of the United States entered November 23, 1959 (Tax Court Docket Nos. 69591, 69592 and 69593), determining that there are deficiencies in the income taxes of the Petitioners for the years 1952, 1953 and 1954, after remand by the Supreme Court of the United States for further consideration in the light of the decision in *American Automobile Association v. United States*, 367 U.S. 687, and was argued by counsel.

On Consideration Whereof, It is now here Ordered and Adjudged by this Court that the Opinion of this Court heretofore filed October 19, 1960, be withdrawn, and the judgment entered thereon is hereby vacated, set aside and held for naught.

It is further Ordered and Adjudged by this Court that the decisions of the Tax Court of the United States be and they are hereby, affirmed.

And it is further Ordered and Adjudged by this Court that the petition to review in this cause be, and the same is hereby, dismissed.

December 15, 1961.

APPENDIX D

Internal Revenue Code of 1939:

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. • • •

(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 actually rendered: • • • and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

(26 U.S.C. 1952 ed., Sec. 23.)

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

(26 U.S.C. 1952 ed., Sec. 41.)

SEC. 42 [As amended by Sec. 114, Revenue Act of 1941, c. 412, 55 Stat. 687]. PERIOD FOR WHICH ITEMS OF GROSS INCOME EXCLUDED.

(a) *General Rule.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. • • •

(26 U.S.C. 1952 ed., Sec. 42.)

SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this chapter shall be taken for the

taxable year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *

(26 U.S.C. 1952 ed., Sec. 43.)

Sections 61, 162, 446(a), (b) and (c), 451 and 461 of the Internal Revenue Code of 1954, applicable to the year 1954, correspond to the sections of the 1939 Code set out above.

Treasury Regulations 118, promulgated under the Internal Revenue Code of 1939:

SEC. 39.41-1. Computation of net income. Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. Items of income and of expenditure which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See §§ 39.42-1 to 39.42-3, inclusive.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.

SEC. 39.41-2. Bases of computation and changes in accounting methods. (a) Approved standard methods

of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 48 for definitions of "paid or accrued" and "paid or incurred."

All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. But see sections 42 and 43. See also section 48. For instance, in any case in which it is necessary to use an inventory, no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method. A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him with restriction. (See §§ 39.42-2 and 39.42-3.) On the other hand, appreciation in value of property is not even an accrual of income to a taxpayer prior to the realization of such appreciation through sale or conversion of the property. (But see § 39.22(c)-5.)

SEC. 39.41-3. Methods of Accounting. It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his true income . . .

SEC. 39.42-1. When included in gross income--(a) In general. Except as otherwise provided in section 42, gains, profits, and income are to be included in the gross income for the taxable year in which they are received by the taxpayer, unless they are included as

✓ of a different period in accordance with the approved method of accounting followed by him. See §§ 39.41-1 to 39.41-3, inclusive.

Sec. 39.43-1. "Paid or incurred" and "paid or accrued." (a) The terms "paid or incurred" and "paid or accrued" will be construed according to the method of accounting upon the basis of which the net income is computed by the taxpayer. (See section 48(c).) The deductions and credits provided for in chapter 1 (other than the dividends paid credit provided in section 27), must be taken for the taxable year in which "paid or accrued" or "paid or incurred," unless in order clearly to reflect the income such deductions or credits should be taken as of a different period. If a taxpayer desires to claim a deduction or a credit as of a period other than the period in which it was "paid or accrued" or "paid or incurred," he shall attach to his return a statement setting forth his request for consideration of the case by the Commissioner together with a complete statement of the facts upon which he relies. However, in his income tax return he shall take the deduction or credit only for the taxable period in which it was actually "paid or incurred," or "paid or accrued," as the case may be. Upon the audit of the return, the Commissioner will decide whether the case is within the exception provided by the Internal Revenue Code, and the taxpayer will be advised as to the period for which the deduction or credit is properly allowable.

Sec. 39.43-2. When charges deductible. Each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct

return. The expenses, liabilities, or deficit of one year cannot be used to reduce the income of a subsequent year. A taxpayer has the right to deduct all authorized allowances, and it follows that if he does not within any year deduct certain of his expenses, losses, interest, taxes, or other charges, he cannot deduct them from the income of the next or any succeeding year. It is recognized, however, that particularly in a growing business of any magnitude there are certain overlapping items both of income and deduction, and so long as these overlapping items do not materially distort the income they may be included in the year in which the taxpayer, pursuant to a consistent policy, takes them into his accounts.

Sections 1.4411(a) to (e), 1.446-1(a) to (e) and 1.451-1 (a), Treasury Regulations on Income Tax (1954 Code), are in material respects substantially the same as the sections set out above.

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