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. . . . 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. . . .*" (Emphasis added.)

See to the same effect, Treas. Reg. 118, § 39.42-1(a).

Both the statutes and the regulations thus are entirely lacking in any support for the position that an accrual basis taxpayer who receives amounts in advance from customers that obligate him to perform services in subsequent tax years must report all such amounts as income in the year of receipt. Section 451 is explicit to the contrary, and nothing in Section 446 requires such a result. And the Treasury Regulations refer to situations in which the reporting of income may be postponed to a tax year subsequent to that in which the taxpayer receives such advances. Uniformly requiring the reporting of advance receipts as income in the year of receipt would thus disregard the plain import of the applicable statutes and regulations and would effectively deny the use of accrual accounting for such items. The Institute sees no reasons why, in the face of the long history of the recognition of accrual accounting in the federal tax laws,[17] this result should be desired by the Commissioner or accepted by this Court.

3. ***The Practical Consequences.*** The substantial adverse consequences that would result from requiring

[17] See American Automobile Association v. United States, 367 U.S. 687, 711-712 (dissenting opinion).

accrual basis taxpayers to report income no later than the year of its advance collection supply additional reasons for rejecting any such rule.

a. In the judgment of the Institute unnecessary differences between established principles of commercial accounting and accounting for tax purposes should be eliminated wherever possible. This objective has been frequently voiced by the Institute,[18] and has been urged by others, including Government officials having responsibility for tax policy.[19] The area of accounting for advance receipts is one in which, the Institute believes, there is no persuasive reason for according judicial sanction to the distinctions between commercial accounting principles and tax accounting law that the Commissioner of Internal Revenue has been advocating.

As we have shown above, no considerations that flow from the tax laws and regulations themselves, or from the decisions of this Court, require rejection in this area of the applicability of commercial accounting principles to accrual accounting for tax purposes. To do so, therefore, will produce an unwarranted distinction between commercial accounting and tax accounting. Any such distinction, the Institute respectfully urges, not only lacks a statutory or decisional law basis but does positive harm by requiring accrual taxpayers to account for the same transaction differently for com-

[18] *E.g.*, J. Accountancy, pp. 719 *et seq.* (Dec. 1952); *id.*, pp. 294-295 (Sept. 1953).

[19] *E.g.*, 1954 Budget Message of the President, reprinted in H. Doc. No. 264, 83d Cong., 2d Sess. (1954); S. Rep. No. 372, 84th Cong., 1st Sess., p. 6 (1955) (repeal of Sections 452 and 462); H.R. Rep. No. 381, 87th Cong., 1st Sess., p. 2 (1961) (enactment of Section 456); S. Rep. No. 543, 87th Cong., 1st Sess., p. 2 (1961) (same).

mercial purposes than for tax purposes. Surely this result need not be encouraged when it is not required by law and furthers no sought for objective of policy.

b. Acceptance of the rule of accrual accounting for advance receipts advocated by the Commissioner would seriously distort the reporting of "income" by accrual basis taxpayers in the numerous industries in which customers ordinarily make advance payments against the taxpayer's performance of future services.[20]

It is fundamental that an advance payment from a customer is no different from—and is in fact—a financing transaction entered into by the taxpayer; in a practical sense the services that the taxpayer obligates him-

[20] A sampling of businesses on the accrual basis in which this practice is common, of which the Institute is aware, includes the following: Correspondence schools; technical instruction courses such as radio and television repair instruction; investment counseling services; gymnasium facilities; subscriptions to book of car wash certificates; purchase of tax or other legal research services with commitment to keep material therein up-to-date over specified period; purchase of tickets for theatrical, dramatic or musical performances series; purchase involving series of dinners with accompanying entertainment at selected restaurants; bookkeeping work to be performed over 3-year period; service of typewriters and other office equipment; purchase of encyclopedia with commitment to furnish supplementary volumes over next 5 or 10 years; purchase of toll road tickets; purchase of series of beauty treatments, purchase involving TV servicing and repair; purchase of flying lessons or driving lessons; purchase of instruction in foreign languages; contracts for taking of family photographs at half-year intervals; contracts to develop film negatives and provide film; premiums paid for health and medical treatment and facilities; contracts to provide telephone answering services; contracts for construction and sale of project homes; contracts to erect prefabricated houses; contracts for building upkeep and maintenance, *e.g.*, window-washing services; contracts for exterminators' services and pest control; manufacturers' service contracts, *e.g.*, service contracts on tabulators and computers or on canning equipment.

self to perform constitute repayment of the customer's "loan." At the time such advance payments are made, therefore, and before the taxpayer performs any required services, the payments "are liabilities and should be shown as such."[21] When a taxpayer receives such advances, he has no income. He has at most only an amount that is yet to be offset by his costs of performing services (or producing goods, as the case may be) in part in a subsequent tax year, at which time such part would be included in "gross income." To treat as taxable income funds that the taxpayer has "raised" in advance from his customers will produce a distortion of taxable income.[22] Conversely, taxable

[21] Accountants' Handbook, § 20, p. 8 (4th ed. 1956), states:

"DEFERRED REVENUES. Advances by customers or clients which are to be satisfied by the future delivery of goods or performance of service are liabilities and should be shown as such. These items have often been labeled 'deferred revenues' or 'deferred credits,' and occasionally are classified on the equities side of the balance sheet between liabilities and proprietorship. Such titles are inclined to be misleading, and such classification is unwarranted. The essential peculiarity of such accounts lies in the fact that they are payable in goods or services rather than in cash, and that as a rule a margin of profit will emerge in making such payment. Under no circumstances should these items be offset against outstanding receivables; nor should they be recorded as earned income prior to delivery of goods or rendering the service for which advance payment has been received."

[22] Paton, W. A., "'*Deferred Income*'—*A Misnomer*," J. Accountancy, p. 39 (Sept. 1961):

"If there is a major point upon which there is general agreement in accounting it is that revenue results from the over-all process of production, and not from borrowing or otherwise raising funds. Moreover, for most lines of business, revenue is regarded as recognizable when product is delivered to the customer. It is also axiomatic that net income, if any, is the amount by which total revenue for the period, repreincome will also be distorted by the improper allocation of costs—that is, by allocation of costs that the taxpayer must necessarily incur in the year of performance to receipts of any tax year other than that year.[23]

sented by the sale value of the delivered product, exceeds all the expenses, losses, and taxes properly applicable to such total revenue. In the face of these basic considerations how can we justify using the word 'income,' even with the qualifying term 'deferred' attached, to describe the amount of a customer advance? Such an advance may be received before the process of production has even been started, before any costs have been incurred, and before anyone knows for certain that any 'income' will ever be realized on the particular operation or contract!"

[23] These distortions of income created by any rule of tax accounting that requires the reporting of receipts as income no later than the year of receipt may be simply illustrated. In the first year that a taxpayer receives advance payments for performance over subsequent tax years, such a rule would show his income to be unrealistically high, since in that year he would not be permitted to deduct costs of performance in subsequent tax years from the advance payments. Of course, new advance payments received in subsequent tax years will be in part offset, and thus not reported as taxable income, by the deduction of performance costs incurred in those years that are attributable to advance payments reported as income in prior tax years. However, the taxpayer's income will continue to be distorted, since performance cost deductions of each year will not be matched with the advance payment items of prior years that necessitated those costs. Thus, in any tax year, if low performance costs that may be all that is required under prior years' contracts are deducted from relatively high advance payments of the current year, reportable income for the current year will be inflated. Admittedly income in any year might be *deflated* if the converse occurred, *i.e.*, relatively high performance costs attributable to earlier contracts are offset against low advance payments on the current year's contracts. But such inflation *or* deflation will occur purely by chance and will bear no rational connection to the earning of income by the taxpayer. Finally, if the taxpayer terminates his business, with the result that he receives no new advance payments but is required to incur performance costs under contracts entered into in prior tax years, he will report apparent losses in the amount of such performance costs, even though such contracts may in reality reflect profitable transactions.

See *American Automobile Ass'n v. United States*, 367 U.S. 687, 714 (dissenting opinion); Bierman & Helstein, *Accounting for Prepaid Income and Estimated Expenses Under the Internal Revenue Code of 1954*, 10 Tax L. Rev. 83, 88-89 (1954); Note, *Taxation of Prepaid Income: A Temporary Solution*, 67 Yale L.J. 1425, 1428-1429 (1958).

It is evident that if year-to-year distortion of the taxable income of accrual basis taxpayers having advance receipts is to be avoided, a precise and accurate matching of revenues from services performed in each tax year with related costs of performance should be achieved. Whenever this is possible, any tax accounting rule that requires income to be reported no later than the year of receipt can not be justified.[24]

[24] The Institute acknowledges that accrual basis taxpayers are required to report advance collections on certain types of commercial transactions as income in the year of receipt. This rule is perhaps most clear in the case of advance collections under a lease. See, e.g., Hort v. Commissioner, 313 U.S. 28, 30 (dictum); Hyde Park Realty Co. v. Commissioner, 211 F.2d 462 (2d Cir. 1954); Treas. Reg. § 1.61-8(a). Although the Institute takes issue with this rule from an accounting standpoint, the taxation of such advance receipts in this manner may be explainable by the fact that the major right which the lessor of premises or other property grants to the lessee at the time he enters into a lease is the right to occupy or use the property, and typically there is little else by way of further performance required of him in subsequent years. In any event, however, that such an established rule exists in this and other areas of tax law does not justify its extension, and thereby the perpetuation of a further unwarranted distinction between commercial accounting principles and tax accounting, to the situation of taxpayers whose advance collections are related to their performance of services that very largely are to be rendered in subsequent tax years.

II. The Method of Accrual Accounting for Advance Receipts Used by the Taxpayers in *Schlude* Accurately and Precisely Matched Revenues from Services Performed in Each Tax Year With Related Costs of Performance.

The question remains whether the accrual accounting method used by the *Schlude* taxpayers precisely and accurately matched revenues derived from services performed in each tax year with the cost of performing such services, and thus reflected "true income." The Institute believes that the accounting method achieved this result and that for this reason the decisions of the Court of Appeals below and of the Tax Court were erroneous.

1. There can be no serious dispute over whether the accrual accounting method used by the *Schlude* taxpayers was such as to satisfy even the stringent standards set forth in *American Automobile* with regard to the matching of receipts with the cost of performance. The *Schlude* taxpayers operated a type of business which—like many others—enabled them to account accurately for receipts from, and costs of, individual business transactions. Under the accounting method used there was recorded on a card for each student who had entered into an instruction contract with the partnership the number of hours of instruction provided to him under his contract in each tax year. The gross income from each contract was determined for each tax year by multiplying the hours of instruction given by the hourly rate applicable to that contract. There were then offset against that year's gross income from all contracts the various costs incurred during the year (R. 185-188).

This accounting method accomplished an appropriate matching of receipts and costs since the partnership's costs were incurred in the period and to the extent that it rendered services under each contract (R. 193-194, 218-219, 252). Typical items of cost incurred by the partnership, such as rent and utilities, were of course readily determinable and, as expense items applicable to all the service contracts, required no allocation among individual contracts. The single major item of cost that varied from contract to contract, depending upon when instruction was given, was the payment of salary to instructors. This cost was precisely allocable to each contract, since instructors were paid by the number of lessons taught (R. 194-195). Taxable income of the partnership was thus reported in each tax year precisely to the extent it was earned in fulfilling the partnership's contract with each student that year, as reflected in the partnership's records (R. 185-188, 251-257).

2. The accounting procedures used in *Schlude* leave open only one objection of those that were urged upon the Court to sustain the Commissioner's rejection of the taxpayer's accrual accounting method in *American Automobile*. That relates to the claim that, in *Schlude* as in *American Automobile*, the contracts did not definitely schedule the performance of services by the taxpayers in tax years subsequent to the year a contract was entered into.[23]

Admittedly, *American Automobile* quoted approvingly from the prior *Automobile Club of Michigan* decision in which the Court deemed it to be a factor that

[23] However, while no schedule was set forth in the contract, as each lesson was given the next lesson was scheduled (R. 227).

services in subsequent tax years were performed by the taxpayer "only upon a member's demand" and that "the taxpayer's performance was not related to fixed dates after the tax year." 353 U.S. at p. 189, n. 20; 367 U.S. at p. 691. The substance of the opinion in the more recent decision, however, makes it apparent that the Court's chief concern was not with this aspect of the taxpayer's business dealings with its members. Rather, as we have previously urged (pp. 12-13 above), *American Automobile* emphasized the Association's inability to point precisely to its cost of performing services for individual members in contrast to its over-all costs for all service contracts "on a group or pool basis." *Id.* at p. 693.

Analysis of what is sought to be achieved by a precise and accurate method of accrual accounting for advance receipts reinforces this reading of *American Automobile*. The key aim of accrual accounting for tax purposes, as the Court has often recognized (see cases discussed at pp. 19-25 above), is to determine the proper reporting of taxable income by matching appropriate costs against related revenues of the tax period. If a taxpayer's accounting method is suitable to this task, and if it satisfies the requirement of *American Automobile* for a precise matching of costs and revenues of the tax year that are allocable to individual customers or transactions, there is no reason to attach significance to the fact that the taxpayer will perform in subsequent tax years, and thus incur costs and earn income, only upon the demand of his customers.

This is not to say that a taxpayer who had made advance collections would be authorized to postpone indefinitely the reporting of such amounts as income if it developed that no such customer demand

for performance were made. A common sense application of accrual accounting principles would of course require that after a *period certain* the taxpayer report as income any advance receipts that had not by that time been earned by performance. For this reason, although a taxpayer's ultimate performance under a long-term contract might be uncertain and contingent, its reporting of all advance receipts as income in some year or years would not be.

This was the case in both *American Automobile* and *Schlude*. In the former the taxpayer necessarily reported all advance receipts as income no later than the end of the period for which its service contracts were in force. 367 U.S. at pp. 688, 690. In *Schlude* each service contract required that all the instruction thereunder be taken in a time certain, and accordingly all income would have been reported by the end of that time (R. 146-149).[26] Moreover, all income might have been reported earlier, since the *Schlude* taxpayers' established accounting practice was to report as income the excess of all cash amounts received over income earned by performance on contracts where the contracts were cancelled by students or where no instruction had been given for one year (R. 192-193, 253). There could thus be no avoidance of taxable income by the taxpayers.

The Institute accordingly urges that the factor of uncertainty of performance alone should not be enough to authorize the Commissioner to reject an accrual accounting method—such as that of the *Schlude* taxpayers—that fully satisfies accepted accounting prin-

[26] Each contract included an explicit acknowledgment by the student "that this course of [number of] hours of dancing lessons expires on [specified date]." (*e.g.*, R. 146).

ciples in every respect and at the same time gives rise to no loss of revenues to the Government.

III. The Error of the Courts Below Is Highlighted by Their Ruling That the *Schlude* Taxpayers Must Report as Income in the Year of Execution Portions of the Face Amount of Long-Term Contracts That Have Been Neither Received Nor Earned.

Because of the manner in which the *Schlude* taxpayers' business was conducted, the decisions of the courts below involved an added element that in no sense could be said to fall within the *American Automobile* case and that, if not reversed by this Court, will have a far more severe impact upon accrual basis taxpayers than any decision affecting tax accounting for advance receipts alone.

The *Schlude* taxpayers carried on their business to a very large extent through executory service contracts under which a student made a down payment and promised to make future payments during the life of the contract, which frequently extended into subsequent tax years (R. 160-161, 184, 250). In addition to ruling that all advance payments actually received under any contract were to be reported as income in the tax year in which that contract was signed, the courts below further held that the taxpayers must report as income at the same time the face amount of the future contract payments to be made by students, even though such payments had been then neither earned nor received by the taxpayers. The decisions below thus required the reporting as income of the entire face amount of each contract in the tax year in which the contract was entered into.

This ruling, the Institute submits, highlights the erroneous understanding by the courts below of fundamental principles governing accrual accounting for tax purposes that should be corrected by this Court.

1. Wholly apart from any question of the adequacy under accounting principles of accounting methods used by accrual taxpayers such as those in *Schlude*, the *American Automobile* decision can not be read to authorize the Commissioner to require that the entire face amount of long-term service contracts be reported as income in the tax year in which the contract is signed. Nothing in *American Automobile* supports such a result. The taxpayer there always received in advance amounts paid by its members as dues and in return for which the taxpayer became obligated to perform services. In requiring the reporting of the advances as income when received, the Court was strongly influenced by the fact that such funds were immediately available to the taxpayer for its use.

In the *Schlude* case, not only were large amounts to be collected under the service contracts in subsequent years, but, the record discloses, there was no assurance whatsoever that such subsequent payments would in fact be made.[27] A great number—almost 20 percent—of the service contracts were cancelled or defaulted by the students; others of the contracts were required to

[27] In the tax years in question—1952, 1953 and 1954—the taxpayers had neither received from students nor earned by performance $71,570.97, $124,445.84 and $119,710.38, respectively, on contracts entered into in each of the above years and in prior years (R. 145, Pet. Ex. 14-N). (The above figures are derived from Exhibit 14-N by subtracting for each year the "Deferred Income Collected-Ending Balance," considering the Reserve Fund held by the bank as not collected (see p. 3, n. 1 above), from "Contract Amount of Deferred Income-Ending Balance.")

be rewritten for a smaller number of lessons than had been contracted for initially, in order to persuade students not to cancel or default entirely on the contracts (R. 192, 239). And, the cancellations and defaults took place, and the rewriting of contracts for shorter periods was necessary, even though each contract contained a clause providing that it was noncancellable (R. 146-149, 193). In these circumstances, it is apparent that the taxpayers could by no means expect that they would receive the uncollected portion of a long-term contract signed by a student.

Far more significant, of course, from the standpoint of the Institute in opposing taxation of the uncollected amounts is the fact that when the service contracts were signed, those amounts were not at all earned by the taxpayers' performance. For this reason there was no warrant for taxing the future payments as income when the contracts were signed.

Commissioner v. *Hansen*, 360 U.S. 446, the only case cited to the Court of Appeals below by the Commissioner in support of taxing the entire face amounts of the service contracts, is wholly inapposite.[28] In *Hansen* the accrual basis taxpayers had fully performed their obligations under contracts with customers—by delivery of vehicles that had been sold—and had accordingly earned all of the contract price. See *id.* at p. 448. For this reason it was of no significance for accrual accounting purposes that a part of the contract price was being held in reserve accounts for the taxpayers by their financing organizations and would not be paid to them in cash until subsequent tax years. The amounts held in reserve had been as much earned by

[28] Supplemental Memorandum for the Respondent on Remand to the Court of Appeals for the Eighth Circuit in *Schlude* v. *Commissioner* (pp. 6-8).

those taxpayers as the amounts actually paid in cash to them as down payments by car buyers and the amounts paid by the financing organizations, to whom the taxpayers sold the negotiable notes of the car buyers for the balance of the contract price. The conclusion was thus compelled that the *Hansen* taxpayers had a "fixed right to receive" the amounts they were seeking to postpone reporting as income, and under fundamental principles governing accrual accounting for tax purposes (see pp. 19-25 above) this was sufficient to subject those amounts to tax.

In *Schlude*, on the other hand, substantial portions of the contract amounts remained not only uncollected when the contracts were signed, but also remained unearned by the taxpayers until they performed the services the contracts called for.[29] Simply stated, the

[29] It would, of course, be equally improper to equate the situations of the taxpayers in the *Hansen* and *Schlude* cases merely because in both proceedings the taxpayers discounted with financing organizations all or part of long-term contracts on which amounts remained unpaid. See p. 3, n. 1 above. The fact that in both cases the financing organizations withheld a portion of the discounted value of the contract in a "reserve account" no more determines the tax year in which the *Schlude* taxpayers should have reported income than the fact that the bank actually paid them only 50 percent of the unpaid portion of the contract in cash immediately. The test in each instance should be: what portion of the cash payments and of the reserve accounts—like payments made by students to the taxpayers directly—was earned in any tax year.

The "services" rendered by the taxpayers in *Schlude*, moreover, were the essence of their business. They were thus unlike the incidental services (*e.g.*, account collection, repossession of goods, repurchase of contracts defaulted) to which taxpayers comparable to those in *Hansen* have pointed in unsuccessful attempts to urge that part of the purchase price of goods had not been earned at the time of sale. See General Gas Corp. v. Commissioner, 293 F.2d 35, 40-41 (5th Cir. 1961), *cert. denied*, 369 U.S. 816; Bruce Flournoy Motor Corp. v. United States, CCH Trade Reg. Rep. ¶ 9695, at page 85,820 (E.D. Va. July 16, 1962).

uncollected amounts—like the advance receipts—were amounts that the *Schlude* taxpayers would have a "fixed right to receive," only as they performed services.

Such a "fixed right," moreover, did not exist at the time the contracts were entered into merely because contract payments were ordinarily received prior to any performance by the taxpayers and at any point during the life of a particular contract such payments might or might not be greater in amount than the contract value of the services rendered by the taxpayers. A contract providing for payment prior to or unrelated in time to performance does not give the party obligated to perform in the future a fixed right either to retain prior payments or to receive future payments if he disables himself from performing or attempts to alter the performance required of him under the contract. 3A Corbin, *Contracts*, § 654 (1960 ed.); 3 Williston, *Contracts*, §§ 812, 830, 860 (1936 ed.); *Restatement, Contracts*, §§ 269-270; Patterson, E. W., *Constructive Conditions in Contracts*, 42 Colum. L. Rev. 903, 914, *et seq.* (1942). Under settled law, therefore, the *Schlude* taxpayers, as all other similar taxpayers who contract to perform services (or to produce goods) in subsequent tax years, were required to hold themselves in a position to perform in the manner that they had agreed as a condition to receiving and retaining payment.[30]

[30] Respondent has disclaimed taking the position "that an accrual basis taxpayer must accrue income whenever he signs a contract to perform services." Urging what we believe to be an entirely outmoded argument of contract law concerning "dependent" and "independent" covenants, it has pointed to what it conceives of as the "seemingly unusual features" and the "atypical payment provisions" of the *Schlude* service contracts in an attempt to justify taxing their entire face amounts in the tax year in which the contracts were signed. See Brief for the Respondent in Opposition, *Schlude* v. *Commissioner*, pp. 11-12, No. 793, Supreme Court, 1961 Term. Respondent thus appears to have agreed that if its understanding of the applicable law of contracts is erroneous, its position that the *Schlude* taxpayers had a "fixed right to receive" the face amounts of the contracts in the tax year of signing is likewise in error.

Not only may no support be gleaned from the *Hansen* and *American Automobile* cases for the aspect of the decisions below dealing with the contract amounts that were both uncollected and unearned, but as a matter of simple justice it cannot be that such portions of the face amount of a service contract for a term of years may be taxed in their entirety as income in the year the contract is signed. Such a result is improper and arbitrary. It has no more justification than would the taxation at the face amount of all future interest coupons on a bond, or of all future rental under a lease, in the year in which the bond is purchased or the property leased. And it would compel accrual basis taxpayers to report as income amounts far in excess of what is demanded in comparable situations of cash basis taxpayers, who report in the tax year of receipt only the discounted fair market value of compensation paid to them in property other than cash.[31]

2. The improper extension of this Court's *American Automobile* decision by the Court of Appeals below to amounts not yet received would be remedied if this Court were to decide that the *Schlude* taxpayers' accrual accounting system is proper for tax purposes.

The taxpayers' accounting method in *Schlude* was as accurate in determining income in a tax year for

[31] See Treas. Reg. § 1.61-2(d); see also Note, 48 Va. L. Rev. 731, 745-749 (1962).

the uncollected portions of the service contracts as it was for the portions as to which the taxpayers received advance receipts. Under the accounting procedures that were followed, the taxpayers simply reported all income precisely as it was earned under each contract through their performance of services in each tax year, without regard to whether cash amounts allocable to the taxpayers' performance might or might not have been in fact paid by a student. It was thus possible that the taxpayers would have reported income under a contract as to which they had performed more services than they had actually been paid for in cash. As we have noted (p. 21 above), this result is of course proper under accrual accounting, and can not be objected to by accrual basis taxpayers, for the reason that income in such a case has been "earned"—that is, properly accrued—by the taxpayer. The *Schlude* taxpayers' objection, therefore, and the concern of the Institute, is not merely that uncollected contract amounts should not be taxed in the tax year the contract is signed because the taxpayers have received no cash as to such amounts, but more importantly, that the uncollected amounts should not be taxed until the tax year in which the taxpayers' performance of services earns income.

CONCLUSION

For the foregoing reasons, the Institute urges that the decision of the Court of Appeals for the Eighth Circuit be reversed.

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