exactly allocable to the "services . . . rendered"; they reported as much income as had been earned "through the fulfillment of [their] required performances" under each service contract. See *Tax Accounting and Generally Accepted Accounting Principles*, Committee on Accounting Principles for Income Tax Purposes of the American Institute of Certified Public Accountants, pp. 6-7 (1953). See also *Accountants' Handbook*, § 20, p. 8 (4th ed. 1956); Paton, W.A., *"'Deferred Income'—A Misnomer,"* J. Accountancy, p. 39 (Sept. 1961).[5] (The pertinent text of these authorities is set forth in the Appendix.)

The accounting procedures used in *Schlude* leave open only one conceivable objection of the many that have heretofore been made by the Commissioner. That relates to the claim that the long-term contracts did not definitely schedule the performance of services by the taxpayers in the tax years subsequent to the year a contract was signed. However, while no schedule was

[5] The concern of the accounting profession is, of course, that business and other taxpayers use accounting procedures which reflect their true income, not only for tax purposes but for commercial, regulatory or personal needs, as the case may be. It is, therefore, as significant to the accountant that there be no over-statement of income as it is that there be no understatement of income. In Matter of C. Cecil Bryant, 15 S.E.C. 400, 402 (1944), the Commission permanently disqualified a certified public accountant from practice before it on grounds among which was:

> "The financial statements covered by the aforesaid certificate contained material misstatements and misrepresentations. For example, accounts receivable shown as 'not yet due' (representing the corporation's principal asset) were found to comprise items for the most part due or past due. In addition, substantial payments received by the corporation for services to be performed in future years were credited in their entirety to income when received, and the result was an overstatement of the income and surplus of the corporation."

set forth in the contracts, as each lesson was given the next lesson was scheduled (R. 186-187). In any event, the Institute believes that this factor alone should not be sufficient to determine whether the Commissioner shall be permitted to reject an accrual accounting system that satisfies accepted accounting principles in every respect and at the same time gives rise to no loss of federal revenues. To give dominance to this [illegible]de and fortuitous aspect of any business, despite the fact that it is wholly insignificant from the standpoint of protecting the revenues, is not required by the Internal Revenue Codes of 1939 or 1954, or by decisions of this Court. Nor can it be justified by reason or common sense.

The Institute, as an *amicus curiae*, therefore urges the Court to review the decision below so that accrual taxpayers may be apprised as to whether the *American Automobile* decision permits accrual accounting of advance receipts to be used for tax purposes where income is reported precisely and accurately as it is earned.

2. Putting to one side the need for review of the rejection of the precise and accurate accrual accounting system used in *Schlude*, the enactment and subsequent repeal by Congress of Sections 452 and 462 of the Internal Revenue Code of 1954 supply no support for the Commissioner's action. Despite the Court's reliance upon the legislative history of these Code sections dealing with prepaid income and reserves for estimated expenses, the Court's full consideration of the particular accrual accounting system at issue in *American Automobile* indicates that the Court's *holding* was only that the action of the Commissioner in rejecting that accounting system as inadequate was not unsound.

of accrual accounting methods was permissible for tax purposes before the enactment of Sections 452 and 462 and was not affected by their repeal in 1955.

(B) THE COURT BELOW MISAPPLIED THE *AMERICAN AUTOMOBILE* DECISION IN HOLDING SUBJECT TO TAX PORTIONS OF THE FACE VALUE OF SERVICE CONTRACTS WHICH HAD BEEN NEITHER RECEIVED NOR EARNED

What has been said so far has had to do with the Institute's professional concern over the mischief that the *Schlude* decision does to the use of precise and accurate accepted methods of accounting for tax purposes. The error committed below is made even more graphic when one considers that the court also found the *American Automobile* decision to be authority for a proposition with which that decision did not even purport to deal, *i.e.*, that the *unearned future contract receipts* of an accrual basis taxpayer are taxable in the year the contract is signed.

The *Schlude* taxpayers' business was conducted to a very large extent on the basis of executory service contracts under which a student made a down payment and promised to make future payments during the life of the contract, which extended into subsequent tax years (R. 122-123, 148, 208). This situation is essentially the reverse of that in *American Automobile*, where the business was conducted on the basis of amounts actually prepaid by customers. 367 U.S. at p. 690. Nevertheless, the court below, relying entirely on *American Automobile*, affirmed the Commissioner's determination that the entire contract price of each contract was to be reported as income by the taxpayers in the tax year in which the contract was entered into, including that part of the price representing payments to be made in subsequent years.

The court below thus wholly disregarded a fundamental distinction between accrual taxpayers who have received advance receipts, on the one hand, and such taxpayers whose performance and receipts are postponed to subsequent tax years, on the other. The result was a misapplication of the *American Automobile* ruling in a further respect that will be of far greater impact upon accrual basis taxpayers than any decision affecting tax accounting for advance receipts alone.

1. Wholly apart from any question of the adequacy under accounting principles of accounting methods used by accrual taxpayers such as *Schlude*, the *American Automobile* decision can not be read to authorize the Commissioner to require the reporting as income under long-term service contracts of the entire contract price in the year in which the contract is signed. Nothing in the *American Automobile* decision sustains such a result. The taxpayer there always received in advance funds paid by its members as dues and in return for which the taxpayer became obligated to perform services. These funds were immediately available to the taxpayer for its unrestricted use.

In the *Schlude* case, not only were many payments under the service contracts to be made in subsequent years, but, the record discloses, there was no assurance whatsoever that such subsequent payments would in fact be made. A large number—almost 20 per cent—of the service contracts were cancelled or defaulted by the students; others of the contracts were required to 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. 153, 197). 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 non-cancellable (R. 108-111). In these circumstances, it is apparent that the taxpayers could by no means expect that they would ever receive the unpaid portion of a long-term contract signed by a student.

The only case cited to the court below by the Commissioner in support of his action was *Commissioner* v. *Hansen*, 360 U.S. 446.[9] *Hansen* is, however, inapposite here since the accounting method used by the taxpayers in the *Schlude* case for unpaid portions of the service contracts did not result in deferring the recognition of income which those taxpayers had a "fixed right to receive," as was the case in *Hansen*. *Id.* at p. 464.

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 tax 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 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. In *Schlude*, on the other hand, substantial portions of the contract remained not only unpaid when signed, but

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

also remained unearned by the taxpayers until they performed the services the contracts called for.[10] Simply stated, the unpaid amounts were amounts which the *Schlude* taxpayers would have a "fixed right to receive" only as they performed services.

Not only may no support be gleaned from the *Hansen* and *American Automobile* decisions for this aspect of the decision below, but as a matter of simple justice it cannot be that the entire unpaid and unearned portion of the face value of a service contract for a term of years may be taxed 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 of all future interest coupons on a bond, or of all future unpaid rental under a lease, in the year in which the bond is purchased or the property leased.

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

[10] 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" should be no more determinative of when the Schlude taxpayers received reportable income than is the fact that the bank actually paid them 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 or of the reserve accounts—like payments made by students to the taxpayers directly—was earned in any tax year.

The taxpayers' accounting method in *Schlude* was as accurate in determining income in a tax year for the unpaid 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 in fact been paid by a student. It was thus possible that the taxpayers would have reported income under a long-term contract as to which they had performed more services than they had actually been paid for in cash. This result, of course, is 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. See, *e.g., Continental Tie & L. Co.* v. *United States*, 286 U.S. 290, 295-296; *Beacon Publishing Co,* v. *Commissioner of Internal Revenue*, 218 F. 2d 697, 699 (10th Cir. 1955). The *Schlude* taxpayers' objection, therefore, and the concern of the Institute, is not merely that there should be no taxation of unpaid portions of contracts in the year the contract is signed because the taxpayers have received no cash amounts as to such unpaid portions, but more importantly, that the unpaid portions of contracts should not be taxed until the time the taxpayers' performance of services earns income.

3. The construction of the *American Automobile* decision by the court below will have a severe impact upon all accrual basis taxpayers who agree to perform services or produce goods in the future in return for a buyer's promise to pay. There is no satisfactory basis

upon which that construction may be narrowed to the facts of the *Schlude* case. The decision of the Tax Court, which became in effect the decision of the Court of Appeals, was that the "fixed and unconditional right of the studio to receive" the full price of a long-term contract arose at the time the contract was entered into (R. 215). The Tax Court's ruling in respect of the unpaid portions of the contracts, therefore, did not rely upon such considerations as the accuracy of the taxpayers' accounting system, the fact that the services the taxpayers were to perform in subsequent years were not scheduled for fixed times, or any other factors that were treated in this Court's *American Automobile* decision. Accordingly, because this aspect of the *Schlude* ruling necessarily will have broad application in the future to a variety of different business and accounting contexts, the Court should review the decision and determine whether it shall continue to govern the tax accounting practices of the many accrual basis taxpayers whom it affects.

CONCLUSION

For the foregoing reasons, the Institute urges that the Petition for a Writ of Certiorari in *Schlude* v. *Commissioner* be granted.

Respectfully submitted.

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APPENDIX

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Pertinent Text From Accounting Authorities

Tax Accounting and Generally Accepted Accounting Principles, Committee on Accounting Principles for Income Tax Purposes of the American Institute of Certified Public Accountants, pp. 6-7 (1953):

> "The process of matching or properly assigning revenues and expenses to an accounting period involves recognition of revenue which has been earned but has not yet been received and of expense which has been incurred but has not yet been paid; it involves the deferring or carrying forward as a charge against the future of some expenditures which have been incurred or paid, and the deferring or carrying forward to future periods of certain revenues which have been received.
>
> "The fundamental generally accepted accounting principles which govern the treatment of revenues, costs and expenses falling within the areas of divergence under consideration may be stated briefly as follows:
>
> "1. Revenues are recognized as entering into the determination of income when sales are made or services are rendered.
>
> "2. The mere receipt of money or promise of another person to pay money for goods or services does not represent revenue which should be recognized in the determination of income of the period of receipt if it is burdened with an obligation to deliver goods or render services in the future. Items of this nature are treated as resulting in liabilities or deferred credits until they are earned through the fulfillment of the required performances. However, the fact that incidental costs or claims are yet to be met does not warrant deferring recognition of revenues; for example, revenues from sales are recognized despite the fact that they are subject to product guarantees or sales allowances. These incidental costs and allowances are deemed to be charges of the period in which the revenues are taken into income."

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

> "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."

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, represented 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!"