BRIEF AMICUS CURIAE

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IN THE

Supreme Court of the United States

October Term, 1961

Mark E. Schlude and Margaret Schlude

v.

Commissioner of Internal Revenue

BRIEF AMICUS CURIAE OF AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

Fontaine C. Bradley
John T. Sapienza
Robert L. Randall
Alvin Friedman
701 Union Trust Building
Washington 5, D. C.
Attorneys for Amicus Curiae

Covington & Burling
Of Counsel

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STATEMENT OF INTEREST OF THE INSTITUTE

The American Institute of Certified Public Accountants is a nation-wide professional organization of more than 42,500 certified public accountants out of a total of approximately 70,000 in the United States. It is a non-profit organization chartered under the laws of the District of Columbia, and is the only national professional organization of certified public accountants. Its membership embraces certified public accountants from every state and territory, and from the District of Columbia and Puerto Rico.

The Institute and its members have a profound interest in maintaining a proper relationship between accepted accounting principles and accounting for tax purposes. They believe the Petition should be granted because the Court of Appeals for the Eighth Circuit has erroneously construed and applied this Court's decision in the *American Automobile* case in a manner that will have a far-reaching and adverse impact upon many taxpayers who report income on an accrual basis. Review of the decision in the *Schlude* case, the Institute believes, is of importance to assure the proper administration of the federal income tax laws and to avoid unnecessary confusion, uncertainty and litigation that may otherwise develop in the field of tax accounting by accrual basis taxpayers. The Institute, accordingly, submits this brief *amicus curiae* in support of the Petition for a Writ of Certiorari in the *Schlude* case and urges that the Writ be granted for the reasons set forth below.

The consent of the parties to the filing of this brief *amicus curiae* has been filed with the Clerk of the Court.

OPINIONS BELOW, JURISDICTION AND STATUTES INVOLVED

The Institute respectfully refers the Court to the Petition of the taxpayers for the statement of the Opinions Below, Jurisdiction and Statutes Involved.

QUESTION PRESENTED

The question presented is: When an accrual basis taxpayer's method of accounting accurately matches revenues derived from services performed in the tax year with related costs, does the decision in *American Automobile Association* v. *United States*, 367 U.S. 687,

authorize the Commissioner to tax as income the entire face value of long-term executory service contracts in the year such contracts are signed although a large portion of amounts received under the contracts has not yet been earned and an even larger portion of the face value of the contracts has been neither received nor earned?

STATEMENT

Petitioners operated a partnership that provided dance instruction services. The students paid a portion of the face value of contracts entered into with the partnership when the contracts were signed and promised to pay the remainder thereafter in installments (R. 108-111, 121-122, 207).[1] The contracts giving rise to the income here in question ran for a term greater than an annual tax year (R. 145, 208). Although the contracts bound the partnership to perform the required services, the dates for each hour of instruction were not scheduled in the contracts but were agreed to from time to time with the student as individual lessons were given (R. 186-187, 207-208). Each contract, how-

[1] Under some contracts a student made all subsequent payments directly to the partnership. Under another type of contract the student made a part of the subsequent payments to the partnership and another part, evidenced by the student's negotiable note, to a bank to which the partnership had transferred the note. Upon such transfer, the bank deducted interest charges, paid approximately 50 percent of the balance of the note to the partnership and retained the remainder in a reserve account which the partnership could not draw upon until the student had paid the note in full (R. 108-111, 122-123, 208).

"R. —" references are to the record before the Court of Appeals below on appeal from the decision of the Tax Court, a copy of which was filed in this Court on March 15, 1962, together with the Petition for a Writ of Certiorari.

ever, provided a period certain before the expiration of which all the hours of instruction contracted for were required to be taken, and the partnership followed the practice of cancelling any contract under which no instruction had been requested by a student for one year (R. 108-111, 154, 210).

Although each contract contained a clause prohibiting the student from cancelling the contract and thereby avoiding payments thereunder, in fact almost 20 percent of the contracts were cancelled in the tax years 1952, 1953 and 1954—the years here in issue (R. 197, 215). The partnership, moreover, was frequently compelled to reduce the hours of instruction—and, accordingly, the payments due—under other contracts in order to avoid cancellations (R. 153, 208).

The partnership has always used an accrual method of accounting that had been designed by a certified public accounting firm to match the partnership's revenues derived from services rendered under each contract in the tax year with costs of performing such services. As each contract was signed, the total contract price was credited to a "deferred income" account. Individual student record cards were maintained that identified each student, the type of contract, hours involved, total contract price, and the hours of instruction given and payments made under the contract. At the end of the partnership's tax year, the card for each student was reviewed, and the amount of income earned under each contract was determined by multiplying the number of hours of instruction given by the rate per hour on that contract. The "deferred income" account was then reduced by that

amount and an "earned income" account increased by the same amount. Earned income from all contracts was totalled and was reported as income on an accrual basis in the partnership's tax return for that year (R. 146-149, 209-214).[2]

Contending that the entire face amount of each contract constituted income to the partnership in the year the contract was signed, the Commissioner rejected the partnership's accounting system for tax purposes and instead increased the net income of the partnership for each of the tax years 1952, 1953 and 1954 by some $24,000, $105,000 and $13,000—the total increase in the "deferred income" account for each such year (R. 213-215). On this basis, he determined deficiencies against the taxpayers for these years of some $18,000, $83,000 and $11,500, respectively (R. 204). The Tax Court, three judges dissenting, sustained the Commissioner's ruling. It held that the entire face value of each contract was income in the year it was signed, although in that year a large portion of payments made by the student was as yet unearned by performance and an even larger portion of the face value of the contract remained both unpaid and unearned (R. 215).

The Court of Appeals for the Eighth Circuit reversed and held that the accrual accounting system used by the partnership was "eminently designed to reflect true income" (Pet., App. B, p. 13a). This Court thereafter granted a Writ of Certiorari, vacated the judgment of the Court of Appeals and remanded the case to that court "for further consideration in light

[2] Any gain arising from the cancellation of a contract by a student or by the partnership (where no instruction had been given for a year) was also reported as income on the tax return (R. 153-154, 210).

of *American Automobile Association v. United States*, [367 U.S. 687]." See 367 U.S. 911 and 368 U.S. 873. On December 15, 1961, the Court of Appeals rendered a *per curiam* opinion affirming the decision of the Tax Court. Citing nothing more than the *American Automobile* decision, the court stated: "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" (Pet., App. A, p. 2a).

REASONS WHY THE INSTITUTE BELIEVES THE WRIT SHOULD BE GRANTED

THE DECISION BELOW SERIOUSLY MISINTERPRETS THIS COURT'S *AMERICAN AUTOMOBILE* DECISION

The decision below represents a wholly unwarranted departure from this Court's decision in *American Automobile Association* v. *United States*, 367 U.S. 687. There this Court sustained the Commissioner's authority to reject for income tax purposes an accrual accounting system which, the Court ruled, deferred the reporting of income to subsequent years without precise regard to expenses incurred by the taxpayer in exchange for receipts paid to it. In the *Schlude* case, the court below, relying solely on the *American Automobile* decision, upheld the Commissioner's rejection of what the Institute believes to be a most accurate accrual accounting system that precisely matched revenues derived from services performed in the tax year with the cost of performing such services. Further, and certainly more important from the taxpayers' point of view, *American Automobile* involved the taxation only of advance receipts; it did not tax unreceived and unearned income. Nevertheless, that decision was applied in *Schlude* to tax the entire contract price of long-term executory service contracts as current income in the year such contracts are signed even though the taxpayer can neither receive nor earn the contract price except by performing services in subsequent tax years. These rulings, which constitute the holding below, conflict with established accounting principles and with the law of the *American Automobile* decision.

(A) THE COURT BELOW IMPROPERLY HELD THAT THE *AMERICAN AUTOMOBILE* DECISION DOES NOT PERMIT THE USE FOR TAX PURPOSES OF ACCOUNTING PROCEDURES THAT ACCURATELY MATCH INDIVIDUAL ITEMS OF REVENUE WITH COSTS AS ACCRUED

1. The court below has interpreted this Court's decision in the *American Automobile* case to mean that established procedures of accrual accounting, which accurately and precisely match revenues derived from services performed in the tax year with related items of cost, may no longer be used by accrual basis taxpayers for income tax accounting purposes. The Institute believes that this sweeping result is contrary to the decision in the *American Automobile* case.

The error committed below had its beginning in the court's failure to recognize the substantial and significant distinctions that exist between the system of accrual accounting in the *American Automobile* case and that here involved. The taxpayers in *Schlude* had consistently, since the inception of their business, relied upon accepted accounting principles to report as income for federal tax purposes amounts which the taxpayers had actually earned in performing the services under their contracts. There was recorded on a card for each student the number of hours of instruction given to him in each tax year. Income reported under each contract was determined by mul-

tiplying the hours of instruction given by the hourly rate applicable to such contract. The income was thus reported in each tax year precisely to the extent it was earned by the partnership in fulfilling its contract with each student that year, as reflected in these records (R. 146-149, 209-214).[3] This accomplished an appropriate matching of revenues and costs since costs were incurred in the period in which the services were rendered.

In the *American Automobile* case the taxpayer was unable to rely upon a comparably precise and detailed method of ascribing membership dues it received from individual members, all of which the members paid in advance, to the period when actual costs of performing its services were incurred. The accounting system there required only that a ratable portion of these total advance receipts be reported as income for tax purposes on a month-by-month basis over the membership period, without regard to the actual cost of services rendered to each member. 367 U.S. at pp. 688, 690. For this reason, the Court considered the *American Automobile* case controlled in essential respects by *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180, 189, which upheld the Commissioner's rejection for income tax purposes of substantially the same accrual accounting system because recording the accrual of the membership dues paid to the tax-

[3] All revenue received or receivable was reported in the appropriate tax year, and there was thus no avoidance of taxable income by the taxpayers. The taxpayers' established accounting practice was also to report as income all cash amounts received greater than income earned by performance on contracts that were cancelled by students or contracts under which no instruction had been given for one year (R. 153-154, 210). Further, each contract required that all the lessons thereunder be taken in a time certain (R. 108-111).

payer "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 members."

From an accounting point of view, therefore, both the *Michigan* and *American Automobile* cases turn on the fact that in recording the accrual of income for tax purposes in any year neither taxpayer could point to the portion of the membership dues that related to the expense of rendering services to individual members. They found it necessary to employ "statistical computations" reflecting the over-all estimated cost of services to all members on a group basis. This deficiency was deemed crucial by the Court in *American Automobile*. Thus, the Court characterized the accrual accounting system there used as one which caused earned income to be reported over the membership period "without regard to correspondingly fixed individual expense or performance justification" and which was not keyed to "the actual incidence of cost in serving an individual member" or "in fact related to the expenses incurred." 367 U.S. at pp. 692-693.[4] In the *Schlude* case the taxpayers achieved exactly what the Court found was lacking in the automobile decisions.

The Institute urges that the *Schlude* petition be considered with the knowledge that the accrual accounting system there used accurately and precisely reflected income as earned—as it accrued to these taxpayers. The taxpayers reported as income those receipts that were

[4] Reliance by the taxpayer upon over-all averages in accruing deductions for claims lodged against it also distinguishes the decision on remand in Milwaukee & Suburban Transport Co. v. Commissioner, 293 F. 2d 628 (7th Cir. 1961), *cert. denied*, 7 L. Ed. 2d 438 (January 22, 1962). See pp. 2-4 of the Memorandum for the Respondent in opposition to the Petition for Certiorari filed by the taxpayer in the Milwaukee case, No. 603, October Term, 1961.