REPLY BRIEF FOR PETITIONERS

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1962

No. 80

MARK E. SCHLUDE and MARZALIE SCHLUDE

v.

COMMISSIONER OF INTERNAL REVENUE

REPLY BRIEF FOR PETITIONERS

ROBERT ASH
CARL F. BAUERSFELD
1921 Eye Street, N. W.
Washington 6, D. C.
Attorneys for Petitioners

Of Counsel:
ASH, BAUERSFELD & BURTON

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I. REPLY TO RESPONDENT'S ARGUMENT THAT THE TIME WHEN INCOME ACCRUES IS EITHER (1) WHEN PAYMENT IS RECEIVED, OR (2) WHEN PAYMENT BECOMES DUE, OR (3) WHEN SERVICES ARE PERFORMED

The respondent (Br. 13 and 67) concedes that the Commissioner and the Courts below erred in treating the entire amount of the contract as having accrued at the time the contract was executed. While this concession has narrowed the issue, the basic issue remains —When does income accrue under the accrual method of accounting? In *Spring City Foundry Co.* v. *Commissioner* (1934), 292 U. S. 182, the question was answered: "When the right to receive an amount becomes fixed, the right accrues." It has always been the position of the petitioners that "the right to receive" became fixed when earned by performance of the services.[1] In his brief (pp. 66-67) the respondent contends that "the right to receive" became fixed at various times, (1) when an advance payment is actually received; or (2) when a payment becomes due, even though not made; or (3) when services are performed. Accordingly, the issue to be resolved is what is meant under accrual accounting principles by the term "the right to receive."

The respondent, at pages 19 and 20 of his brief, sets forth the following definition of accrual accounting:

> "* * * Under the accrual method, gross income items are reported in the year in which the right to receive them becomes fixed, even though they are not immdiately receivable, *but no later than the year of actual receipt*; conversely, deduction items are reported in the year in which they are incurred, i.e., when the liability to pay becomes fixed in fact and reasonably ascertainable in amount, even though payment is not then due, *but no later than the year of actual payment.*" [Italics supplied.]

In order to place the Studio on a cash basis with respect to advance receipts and to justify his position that income accrues when payments are received, the respondent has added the italicized phrases to the definition of accrual accounting. Under the accrual method of accounting, advance receipts are taken into account as income when earned by performance. It is not concerned with the receipt of payments nor the flow of cash.

Not only is the respondent's definition in conflict with the proper definition of accrual accounting, but it is also at odds with the decisions of this Court and the

definition of the accrual method set forth in Treasury Regulations. See Brief of Amicus, pp. 18-25; Treas. Reg. 118, § 39.41-2(a) and § 39.42-1(a) under 1939 Code; Treas. Reg. § 1.446-1(c)(ii) and § 1.451-1(a) under 1954 Code, Appendix, Brief for Petitioners at pp. 9a-11a. If the accrual method of accounting requires a taxpayer to include as income all receipts "no later than the year of actual receipt," then those decisions and regulations authorizing the use of the accrual accounting method must be overturned.

Likewise, the respondent's definition of the accrual of deduction items is in error when it states that they are reported in the year in which incurred even though payment is not then due, "but no later than the year of actual payment." For example, an accrual basis taxpayer must prorate rent paid in advance over the period for which the rent was paid;[1] he must prorate expense for fire and other insurance premiums over the perior covered by the insurance policy;[2] interest prepaid must be deducted over the period to which the prepayment relates and not entirely in the year of payment.[3] Similarly, expenses incurred in obtaining a loan must be amortized over the period of the loan.[4]

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[1] See *Bloedel's Jewelry, Inc.* (1925), 2 B.T.A. 611; *Main & McKinney Building Co. v. Commissioner* (CA 5, 1940), 113 F. 2d 81; *Baton Coal Co.* (1930), 19 B.T.A. 169, aff'd. (CA 3, 1931), 51 F. 2d 469; *Galatoire Bros. v. Lines* (CA 5, 1928), 23 F. 2d 676; *J. Alland & Bro., Inc. v. United States* (D.C. Mass.; 1928), 28 F. 2d 792.

[2] *Higginbotham-Bailey-Logan Co.* (1927), 8 B.T.A. 566; *Two-L Realty Co., Inc.*, T.C. Memo., Oct, 31, 1955; ¶55,297 P-H Memo. T.C.

[3] I.T. 3740, C.B. 1945, p. 109.

[4] *Longview Hilton Hotel Co.* (1947), 9 T.C. 180, acq. 1947-2, C.B. 3. Cf. *Helvering v. Union Pacific Railroad Co.* (1934), 293 U.S. 282.

Even the respondent apparently recognizes that the addition to the rule relating to the accrual of deductions is not valid in all cases since he attempts to except the decision of this Court in *United States* v. *Consolidated Edison Co.* (1961), 366 U. S. 380, from his rule.[5] The foregoing authorities are sufficient to show that it is not the law that the accrual of a deduction may never follow the year of payment. On the contrary, where a payment is for an expense which relates to a period after the close of the taxable year, a deduction may not be taken in the year of payment but must be taken in the year to which the expense relates.

The Commissioner of Internal Revenue has recognized in some instances advance receipts need not be reported as income in the year received. See I.T. 3369, 1940-1, C.B. 46, where prepaid subscriptions to periodicals were permitted to be spread over the subscription period; I.T. 2080, III-2 C.B. 48 (1924) where payments for tickets were received by travel agent in one year for cruises to be taken in the following year were not to be reported as income in year of receipt under accrual method of accounting which was the only method that clearly reflected income.[6] Moreover, both the Tax Court and the Commissioner have approved the deferral of advanced payments as income where goods were to be delivered in a subsequent year. See *Veenstra & DeHaan Coal Co.* (1948), 11 T.C. 964; acq. 1949-1 C.B. 4; cf. *Summit Coal Co.* (1930), 18 B.T.A. 983; *Woodlawn Park Cemetery Co.* (1951), 16 T.C. 1067; acq. 1951-2 C.B. 4.

[5] See footnote 13 (p. 20) of Brief for the Respondent.

[6] These rulings demonstrate that the Commissioner recognized that under accrual accounting it was proper to defer income, and that legislation such as section 452 of the 1954 Code was not necessary.

From the standpoint of common justice, as well as from the standpoint of accrual accounting, there is no justification for a different treatment of advance receipts where services are involved rather than goods. In both instances, the cost of the goods sold or the cost of rendering the services cannot be incurred until the succeeding year, so that deferral is essential in order to match receipts with related expense to clearly reflect income.

Likewise, respondent's second test for determining when income accrues, i.e., when payments become due under the contracts, even though not then made, is wrong and in direct conflict with decisions of this Court since *United States* v. *Anderson* (1926), 269 U. S. 422. See also *American National Co.* v. *United States* (1927), 274 U. S. 99; *Niles-Bement-Pond Co.* v. *United States* (1930), 281 U. S. 357; *Aluminum Castings Co.* v. *Routzahn* (1930), 282 U. S. 92. Cf. *Brown* v. *Helvering*, 291 U. S. 193. Under these cases, the test for determining when income accrues is not concerned with a scheduled due date in "a technical legal sense." Rather, the test under the statute is to be made in an "economic and bookkeeping sense." It is significant to note that the position the Government is now taking in the case at bar is diametrically opposite to its position in the *Anderson* case. In that case, the Government's brief (See Brief for the United States in *United States* v. *Yale & Towne Mfg. Co.*, pp. 31-32, No. 420 Supreme Court, October Term, 1925 [companion case to *Anderson*]) stated its position as follows:

> "* * * The basic idea under the accrual system of accounting is that the books shall immediately reflect obligations and expenses definitely incurred

> and income *definitely earned* without regard to whether payment has been made or whether payment is *due*. Under this system, the use of the word 'accrued" does not signify that the item *is due*. On the contrary, the accrual system wholly disregards *due* dates. * * *." [Italics added.]

The Court obviously adopted the Government's position in the *Anderson* case when it held that the munitions tax accrued in 1916 under the "all events" test, although the tax was not assessed nor due until 1917.

The third test offered by the respondent for determining when income accrues, i.e., at the time services are performed, is correct. The taxpayers agree this is the time when the fixed right to receive "ripened" or was "realized", or "earned." Furthermore, this is the time the Studio accrued income under the contracts with the students, whether or not actual payments had been received. Looking at the problem from an "economic and bookkeeping sense," the right to receive could only come into being at the time the services were rendered. This is the time when the labor was performed that produced the income.

The respondent's multi-test formula for determining when income accrues[7] fails to satisfy the "all events" test. Under the "all events" test, the time an item is determined to be income is when all events have

[7] Respondent includes in his concept of what accrues as income the entire face amount of the notes transferred to the bank with full recourse, irrespective of payment dates and the amount held by bank in reserve. He does not consider the fact that the notes are stated to be "Negotiable Note Given for Tuition" (see Sections 62-303—62-305, Revised Statutes of Nebraska 1943, Reissue of 1958, Appendix 21-22) or whether they are given merely as evidence of a contractual obligation, or other factors affecting the market value or collectibility of the notes.

occurred which fix the right to receive such income. This is a time certain, it either is or is not income at a particular time; and if it is, it cannot be income at any other time. Therefore, respondent's alternate time test is in conflict with the "all events" test. Much confusion would result from use of the respondent's multi-formula test as compared with the simplicity of the "all events" test. Under the "all events" test, income would accrue at the time it was "earned" by the rendering of the service.

II. REPLY TO RESPONDENT'S ARGUMENT THAT THE STUDIO'S METHOD OF ACCOUNTING VIOLATES THE ANNUAL ACCOUNTING REQUIREMENT

The respondent contends (Br. 18-56) that the Studio's accrual method of accounting violates the annual accounting requirement of the statute. His argument in this respect is the same that was made and rejected by this Court in *American Automobile Association* v. *United States* (1961), 367 U. S. 687.[8] Nothing can be said in this reply brief as to the invalidity of the respondent's argument regarding the violation of the annual accounting requirement of the statute that was not fully covered in the dissenting opinion in *American Automobile* where it was said: (p. 702)

> " * * * The underlying premise of the annual accounting requirement is that *otherwise reportable income* derived from a transaction cannot be excluded from gross income in order to let the taxpayer wait to see in a later year how the overall transaction turns out. That is not the issue in

[8] See dissenting opinion of Mr. Justice Stewart, 367 U.S. 687, at p. 701, where it is stated: "The Court today does not base its decision on this theory, ["annual accounting requirement"], presumably because the Court believes, as I do, that the theory is not valid."

this case. The question here is whether any reportable income has been derived from a transaction when payments are received in advance of performance." [Italics the Court.]

III. REPLY TO RESPONDENT'S ARGUMENT THAT THE CLAIM OF RIGHT DOCTRINE IS APPLICABLE AS A COROLLARY OF THE ANNUAL ACCOUNTING RULE

The respondent contends (Br. 28-31) that the claim of right doctrine is a "corollary" to the annual accounting rule, and that the two theories working together lend strong support to the Government's position. In *American Automobile*, the respondent, pointing to the dissenting opinion of Mr. Justice Harlan in *Automobile Club of Michigan* v. *Commissioner*, 353 U. S. at 191-192, agreed that the so-called "claim of right doctrine" was not applicable.[9] The dissenting opinion in *American Automobile* at 699-700, specifically points out that the Government abandoned the claim of right doctrine in that case. Once, again, nothing further can be said in this reply brief as to the fallacy of the respondent's argument based upon the claim of right doctrine that has not been fully covered in the dissenting opinion of *American Automobile* and *Michigan* cases.

IV. REPLY TO RESPONDENT'S ARGUMENT BASED ON THE LEGISLATIVE HISTORY OF THE ENACTMENT AND REPEAL OF SECTIONS 452 AND 462 OF THE INTERNAL REVENUE CODE OF 1954

The respondent argues (Br. 56-61) that the enactment and repeal of sections 452 and 462 of the Internal Revenue Code of 1954 support the decision below. The

[9] See pages 35-36, Brief for the United States in *American Automobile Association* v. *United States*, No. 288, Supreme Court, October Term 1960.

petitioners' answer to this argument appears at pages 26 and 27 of their brief. In addition, it should be pointed out that congressional action in enacting and repealing sections 452 and 462 did not have any effect on sections 41 and 42 of the 1939 Code or sections 446 and 451 of the 1954 Code. These are the statutory provisions authorizing accrual accounting and the time when items shall be taken into account. Section 42 states generally that items of gross income shall be included for the taxable year received—"*unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period.* * * *" Section 41 was designed specifically to authorize accrual accounting. Section 42 was designed specifically to authorize that aspect of accrual accounting relating to the time when items are to be included in income. It is the petitioners' position that the issue here to be decided must be reached by interpreting sections 41 and 42 of the 1939 Code and 446 and 451 of the 1954 Code, and that the enactment and repeal in 1954 and 1955 of sections 452 and 462 has no relevancy to whether the taxpayers' method of accounting clearly reflects income.

V. REPLY TO RESPONDENT'S ARGUMENT THAT THE STUDIO'S METHOD OF ACCOUNTING MUST BE REJECTED AS BEING ARTIFICIAL

The respondent (Br. 62-65) argues that the Studio's method of accounting was artificial because (1) contracts did not provide for the giving of lessons on fixed dates after the taxable year, and were thus contingent on the student's demand, and (2) the Studio deducted certain expenses in the taxable year they were paid or incurred, without regard to when the amounts received under the contracts were reported as earned.

With respect to the first point, failure to provide for fixed dates, the appointments for lessons were not as haphazard as the respondent would indicate. Each of the contracts required that the lessons be taken within a definite period of time. (R. 146-149.) While no schedule of lessons was set forth in the contracts, the lessons were scheduled from lesson to lesson in a routine manner.[10] (R. 227.) In *Automobile Club of Michigan v. Commissioner* (1957), 353 U. S. 180, *Schuessler* v. *Commissioner* (CA. 5, 1956), 230 F. 2d 722, was distinguished because "performance of the service agreement required the taxpayer to furnish services at specified times in years subsequent to the tax year." In *Schuessler*, furnaces were to be turned on in the fall and turned off in the spring for a five-year period. It is common knowledge of everyone who uses a gas furance that the user calls the service man and agrees on a date for turning on or turning off the furnance, depending upon weather conditions. The scheduling of dancing lessons by the Studio was much more "fixed" than in *Schuessler*.[11]

Intertwined with his argument on "fixed dates" is one respecting the Studio's liability to perform services contingent upon the students' demands. The respond-

[10] It is illogical to assume, as does the respondent, that the time for lessons was left entirely contingent upon the student's demands. During 1952, 1953 and 1954 the Studio taught 17,436, 28,436 and 39,159 hours of lessons, respectively. (R. 191.) If a routine schedule or standing appointment for lessons were not in existence, the large number of hours of lessons could not have been taught and confusion would have prevailed as to time of appointments between student and teacher.

[11] On this point, assuming *arguendo* the respondent was factually correct, it is not vital to taxpayers' case. See Brief Amicus, pp. 37-40.

ent is twisting the facts for this argument. (Br. 63.) The Studio sold services, i.e., dancing lessons. The students at the time of entering into the contract fully intended to take and receive the lessons they paid for. They were not paying for the privilege of having a dance studio available or instructors available to give lessons. They were paying for lessons. Consequently, the Studio was not selling the mere availability of service. Respondent made a similar argument earlier in his brief at page 34 when he points out that a large proportion of the lessons contracted for are never taken. (See footnote 1, Pet. Br. p. 5.) However, with respect to paid-up lessons, approximately 90.5% of such lessons were taken. (See below, footnote 13.) The only uncertain part of the transaction was with respect to lessons contracted for but never paid for by the students. The contingency was whether the student would perform his part of the contract by making the payments. The accrual of income by the Studio had no bearing or relationship to total lessons contracted for. As each unit of the contract is performed, i.e., as each hourly lesson is actually rendered, it was reported as income notwithstanding the fact that some or a part of a contract might have been altered or actually cancelled. It was similar to a contract calling for future delivery of goods at specific or sporadic intervals within a definite contract period. As the goods are actually identified and shipped, the unit price times the quantity is invoiced and income therefrom accrued. This is true notwithstanding that the balance of the contract may be cancelled or renegotiated for a higher or smaller amount or the terms thereof in any way changed. The actual event which gave rise to the income was the shipment of goods and not the terms of the contract.[12]

The respondent can hardly be serious in urging these minor and inconsequential objections to the accuracy of the Studio's accrual accounting method. We refer first to respondent's argument (Br. 63) that a substantial part of the Studio's income was attributable to gains on cancellations.[13] In other words, the respondent's argument is that when a student breached the contract by failing to pay, or failing to take the lessons within the prescribed time, this proves that the Studio's liability to perform is contingent. The situation that arises upon breach of contract by the student is not a fair criterion to conclude that petitioners' obligation to perform under the contracts is contingent.

The second point respondent makes is that commissions to sales personnel and royalties paid to Arthur Murray were deducted when paid instead of in the subsequent year in which related income was treated as earned. The Tax Court made a specific finding of fact on expenses as follows: (R. 252.)

[12] It is incorrect to state, as was stated at page 34 of the respondent's brief, that the Studio's per lesson method of accrual is based on the false assumption that all lessons contracted for will be taken. Under the method of accrual used by the Studio, it made no difference whether none, part, or all of the lessons were taken; the method of accrual used takes income into account on the basis of actual lessons given. This is a fact and not based on any assumption or conjecture.

[13] Gains on cancellations during 1952, 1953 and 1954 were 15.7%, 7.4% and 8%, respectively, or an average of about 9.5% of gross income derived from tuition fees. (R. 211.) Therefore, of the lessons paid for, approximately 90.5% were earned through performance of services.

> "(4) Expenses were recorded and deducted in the periods incurred except that the 10 per cent royalties to Arthur Murray, Inc., and certain other items were recorded and deducted when paid. (Actually many of these amounts were also incurred at about the same time as when paid.)" [Parentheses the Court's.]

The Tax Court recognized how these expenditures were accounted for (R. 251) but made no finding that the Studio's method of accounting was artificial. The Tax Court must have recognized that these expenses were overlapping items and fall within Treasury Regulations 1.461-1(3) which in part provides:[14]

> "* * * However, in a going business there are certain overlapping deductions. If these overlapping items do not materially distort income, they may be included in the years in which the taxpayer consistently takes them into account."

It is clear that respondent's objections of such a nature have no merit. Plainly, the Studio business was the type of business that had no difficulty in recording the revenue from each contract and the cost of performing under each contract. It was thus able to meet the requirements set forth in *Amcircan Automobile* with regard to the matching of receipts with the cost to perform. This case should be decided on whether "[A]ny system of deferral of prepaid service income * * * must be rejected as violating settled tax accounting principles, * * *"[15] rather than on inconsequential objections to the accrual method employed.

[14] See Treas. Reg. 1.461-1 set forth in full in Brief for Respondent, pp. 96-99.

[15] See Brief for the Respondent, p. 62.

VI. REPLY TO RESPONDENT'S ARGUMENT THAT AN ACCURATE ACCRUAL METHOD OF ACCOUNTING FOR ADVANCE RECEIPTS WOULD UNDULY BURDEN THE ADMINISTRATION OF THE TAX LAWS

Although the taxing statutes[16] give the taxpayer a choice as to the accounting method to be employed, the respondent in substance argues that the Studio must use a cash basis for reporting advance receipts because an accrual method would result in a burden in the administration of the laws. The Brief for the Respondent at pages 42-43 states:

> "* * * The transactional or earnings approach, on the other hand, would place on the Commissioner the enormous burden of evaluating and verifying complex statistical evidence submitted by millions of taxpayers in an endless variety of business contexts to prove that they have reliably "related" and "matched" present income with estimated future expenses, or present expenses with estimated future income. * * *"

Even though the cash method of accounting is easier to administer than the accrual method, the respondent cannot compel a taxpayer to use a cash method unless the taxpayer's method does not reflect true income. The choice of the method to be used is the taxpayer's, not the Commissioner's. Administrative convenience cannot prevail over the statutory right given the taxpayer. Aside from the legal right supporting the taxpayer's position, the use of the accrual method of accounting where advance receipts are involved, is not as complex as the respondent assumes. On the accrual basis, the time for including items in income is de-

[16] Sections 41 and 42, Internal Revenue Code 1939, and sections 446 and 451, Internal Revenue Code 1954.

termined by the delivery of goods or the rendition of services. This is not a difficult test to be applied. A merchant or a manufacturer, using the accrual method, who receives payments in advance, would defer taking the payments into income until the time of delivery of the goods. Applied to a business rendering services, such as the Studio's, advance receipts are includible as income in the taxable year the services are rendered. This is the period when the income is earned. Certainly these rules are not complex. The use of these standard accounting rules consistently over the years results in clearly reflecting a taxpayer's true income.[17]

VII. REPLY TO RESPONDENT'S BRIEF IN GENERAL

Throughout his brief, the respondent bases his arguments on assumptions and presumptions that are not based on facts or justified by the record in this case. For example, the respondent refers to the advance receipts as "income" or "compensation" when received.[18] In this regard he completely ignores the fact that this case involves accrual and not cash accounting. The respondent's argument is misleading and not justi-

[17] The respondent at footnote 25, page 43, (also Br 36) intimates that the Studio indefinitely defers income on so-called lifetime courses. This is not true. Lifetime courses are for a specified number of hours, either 1,000 or 1,200 hours. In addition, such a student was entitled to two hours of lessons per month, plus two parties per year for life. (R. 184, 250.) However, at the end of the specified 1,000 or 1,200 hours, all income under the contract would have been included in earned income and reported for tax purposes. Aside from lifetime courses, the record shows that income is not indefinitely deferred; rather most of the deferred income at the end of any fiscal year represents current year's sales. (R. 212-213.)

[18] Brief for Respondent, pp. 16-17, 24-25, 27, 28-29, 30, 34-36, 37, 38, 39, 42, 52, 62, 66.

fied by the record when he states the Studio "prorated" the contract price.[19]

The respondent's brief speaks of "reserves"[20] or a deduction for an "estimated future service expense."[21] Under the accrual method of accounting, there are two systems that may be employed for purposes of matching expenses against receipts: (1) deferring a portion of the advance receipts properly earned in a later period, and (2) setting up a suitable reserve to cover future cost related to receipts accounted for in an earlier period. For all practical purposes, the two methods accomplish the same result, i.e., matching of expenses against receipts. Illustrative of cases involving accrual accounting where advance receipts were deferred are: *American Automobile Association* v. *United States* (1961), 367 U.S. 687; *Automobile Club of Michigan* v. *Commissioner* (1957), 353 U.S. 180; *Beacon Publishing Co.* v. *Commissioner* (CA 10, 1955), 218 F. 2d 697; *Bressner Radio, Inc.* v. *Commissioner* (CA 2, 1959), 267 F. 2d 520; *Bayshore Gardens, Inc.* v. *Commissioner* (CA 2, 1959), 267 F. 2d 55. Cases involving the accrual method of accounting in which a reserve was set up to cover future cost related to receipts accounted for in an earlier period are: *Schuessler* v. *Commissioner* (CA 5, 1956), 230 F. 2d 722; *Harrold* v. *Commissioner* (CA 4, 1951), 192 F. 2d 1002; *Denise Coal Co.* v. *Commissioner* (CA 3, 1959), 271 F. 2d 930; *Hilinski* v. *Commissioner* (CA 6, 1956), 237 F. 2d 703; and *Pacific Grape Products Co.* v. *Commissioner* (CA 9, 1955, 219 F. 2d 862.

[19] Brief for Respondent, p 14.

[20] Brief for Respondent, pp. 39-40, 44, 45, 46.

[21] Brief for Respondent, pp. 25-26, 33, 34, 36, 42, 43, 52, 55.

While either the deferring of advance receipts or reserving for future expenses perform the same function, i.e., matching expenses against receipts, they should not be equated one with the other. Which practice should be followed to clearly reflect income depends on the particular problem presented. As a general rule, good accounting practice calls for establishing a reserve for future expense, rather than deferring advanced receipts where the product or service the accrual basis taxpayer is obligated to supply in a future year is *incidental* to the main transaction, and fulfillment of the obligation is not a separate income-producing activity. This is the situation where a large majority of the performance required has already been rendered and the income resulting from such performance recognized and accrued. On the other hand, good accounting practice calls for deferring advance receipts where the product or service the accrual basis taxpayer is obligated to supply in a future year is the main transaction or principal income producing activity. The deferral practice is the only practice in such a situation which will achieve the reporting of income in the year in which it is earned through performance of services. It should be pointed out that the Studio, in following good accounting practice, deferred advance receipts. The giving of the dancing lessons was the Studio's principal income activity. It cannot be said to be incidental. The Studio deferred taking into income the advance payments for dance instruction until the lessons were given. At the time the lesson was given, the income was earned and the operating cost known. The right to the income did not become fixed and absolute until it was earned through the performance of services which created the right to the income. Consequently, in the instant case there were no actual reserves set up nor were there any actual estimates of future expenses. All deductions were based on fact rather than estimates.

Finally, the respondent's brief fails to discuss the meaning and real purpose of the statutory provisions applicable to this case. He does not deny that sections 41 and 42 of the Internal Revenue Code of 1939 and sections 446 and 451 of the Internal Revenue Code of 1954 are applicable,[22] but he fails to discuss their meaning and significance. Section 42 states:[23]

> "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.* * * *"[24] [Italics supplied.]

This is the statutory authority for deferring income under the accrual method of accounting. A cardinal principle of accrual accounting is that advance receipts do not constitute income until such time as goods are delivered or services rendered. The respondent refuses to recognize this important aspect of accrual accounting, thereby ignoring that part of section 42 which is in italics above. Congress did not use these words meaninglessly or without reason. These words were

[22] Brief for Respondent, pp. 18-19.

[23] Similarly, see section 451 of the 1954 Code.

[24] Section 41 requires that the method of accounting used by the taxpayer in keeping his books shall govern the computation of his net income. It is only when the method of accounting used by the taxpayer in keeping its books does not clearly reflect the income that the Commissioner has a discretion to compute his tax by another method.

placed in the statute because the accrual accounting method as distinguished from cash accounting is not concerned with the flow of cash. It is concerned rather with when the right to receive becomes fixed and certain. The statute recognizes that money may be received before the right to it becomes fixed. The statute clearly says that income is includable in the year of receipt *unless*, under a method of accounting permitted under section 41 (an accrual method is permitted under section 41), such amounts are to be properly accounted for as of a different period. This provision of the statute conclusively disproves the respondent's addition to the definition of accrual accounting[25] which would require the accrual as income of all receipts in the year received. This Court, in *Burnet* v. *Sanford & Brooks Co.* (1931), 282 U. S. 359, recognized that all advance receipts need not be returned in the year received. It was there stated: (p. 363)

> "* * * The amount of all such items [income derived from business] is required to be included in the gross income for the taxable year in which received by the taxpayer, unless they may be properly accounted for on the accrual basis under § 212(b). See United States v. Anderson, 269 U. S. 422; Aluminum Castings Co. v. Routzahn, 282 U. S. 92, ante 234."

The respondent's brief confuses and misleads its reader because it quotes as authority cases that factually have no bearing on the issue here presented. The

[25] Brief for Respondent, p. 19, states: "Under the accrual method, gross income items are reported in the year in which the right to receive them becomes fixed, even though they are not immediately receivable, *but no later than the year of actual receipt;* * * *" [Italics supplied.]

quotes are not only out of context, but often are from cases involving cash basis taxpayers and not accrual basis.[26] The only cases cited involving advance receipts are the *Automobile Club of Michigan* v. *Commissioner* (1957), 353 U. S. 180, and *American Automobile Association* v. *United States* (1961), 367 U. S. 687, which we have distinguished in Brief for Petitioners, pp. 18-26. Furthermore, practically all the cases cited by the respondent presented factual situations that showed the income in question had been earned by the delivery of goods or the rendering of services.[27]

CONCLUSION

For the foregoing reasons and those expressed in petitioners' original brief, the decision of the Court of Appeals for the Eighth Circuit should be reversed.

Respectfully submitted,

ROBERT ASH
CARL F. BAUERSFELD
1921 Eye Street, N. W.
Washington 6, D. C.
Attorneys for Petitioners

Of Counsel:

ASH, BAUERSFELD & BURTON

December 4, 1962.

[26] *Guaranty Trust Co.* v. *Commissioner* (1938) 303 U.S. 493; *Burnet* v. *Sanford & Brooks Co.* (1931), 282 U.S. 359; *Healy* v. *Commissioner* (1953), 345 U.S. 278; *Heiner* v. *Mellon* (1938), 304 U.S. 271; *United States* v. *Lewis* (1951), 340 U.S. 590.

[27] *North American Oil Consolidated* v. *Burnet* (1932), 286 U.S. 417; *Brown* v. *Helvering* (1934), 291 U.S. 193; *United States* v. *Lewis* (1951), 340 U.S. 590; *Healy* v. *Commissioner* (1953), 345 U.S. 278; *Commissioner* v. *Hansen* (1959), 360 U.S. 446; *Spring City Foundry Co.* v. *Commissioner* (1934), 292 U.S. 182.

APPENDIX

Revised Statutes of Nebraska, 1943, Reissue 1958.

Chapter 62—Negotiable Instruments

Article 3, Miscellaneous Provisions

Sections 62-303—62-305

62-303. *Tuition notes or contracts of business colleges; requirements; limitation upon negotiation.* It shall be unlawful for any proprietor, officer, agent or representative of any business college, or the business or commercial department of any school doing business within the State of Nebraska, or without the state when operating or soliciting within the state, to contract for or receive for tuition or scholarship a negotiable note or negotiable contract, unless such negotiable note or notes or negotiable contract shall have printed in red ink prominently and legibly and in twenty-four point bold type diagonally across the face thereof, and above the signatures thereto, the words "negotiable note given for tuition" if a note, or the words "negotiable contract note given for tuition and scholarship," if a contract, and unless a copy of said instrument shall be delivered to the makers thereof at the time of signing the same. It shall be unlawful for any such proprietor, agent or representative of any such school or department to sell or dispose of any such negotiable note or negotiable contract note, receive in payment for tuition or scholarship, prior to three days from the entrance and personal registration of the student, for whom the same was purchased, in the matriculation register at the place of the location of the school or department.

62-304. *Violations; penalty.* Any person who shall violate any of the provisions of section 62-303, shall be deemed guilty of a misdemeanor, and upon conviction thereof shall be punished for every offense by a fine of not less than one hundred dollars and not more than five hundred dollars, or by imprisonment in the county jail not to exceed sixty days, or by both such fine and imprisonment.

62-305. *Tuition notes or contracts of business colleges; when void.* Any note or contract taken by any business college, or the business or commercial department of any other school, or by their agents or representatives, for tuition or scholarships, without first having complied with all the provisions of section 62-303, shall be void.