

BRIEF FOR THE RESPONDENT

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No. 80.

In the Supreme Court of the United States

OCTOBER TERM, 1962

MARK E. SCHLUDE, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF HABEAS CORPUS TO THE UNITED STATES COURT OF
APPEALS FOR THE EIGHTH CIRCUIT

—
BRIEF FOR THE RESPONDENT

—
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COMMISSIONER OF INTERNAL REVENUE

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BRIEF FOR THE RESPONDENT

PRIOR OPINIONS

The findings of fact and opinion of the Tax Court (R. 246-264) are reported at 32 T.C. 1271. The first opinion of the court of appeals (R. 278-291) is reported at 283 F. 2d 234. The *per curiam* order of this Court granting certiorari and remanding the case is reported at 367 U.S. 911. The order of this Court denying rehearing and amending the previous *per curiam* order is reported at 368 U.S. 873. The *per curiam* opinion of the court of appeals upon remand (R. 273-274) is reported at 296 F. 2d 721.

JURISDICTION

The judgment of the court of appeals was entered on December 15, 1961. (R. 274-275.) The petition

(1)

for a writ of certiorari, filed on March 15, 1962, was granted on May 28, 1962. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the courts below correctly sustained the Commissioner's determination that an accrual basis taxpayer who contracts to furnish dancing lessons during a period extending beyond the close of the taxable year is required to accrue and report as gross income for the taxable year (a) cash and negotiable notes received in that year as an advance payment of the contract price, and (b) future installments contractually due in that year whether or not the "related" lessons have been taken.¹

STATUTES AND REGULATIONS INVOLVED

The statutes involved are Sections 21(a), 22(a), 23(a)(1)(A), 23(e), 41, 42(a), 43, and 48(a) and (c), Internal Revenue Code of 1939; Sections 61, 63(a), 162(a), 165(a) through (c), 441(a) through (e), 446, 451(a), and 461(a), Internal Revenue Code of 1954. See Appendix, *infra*, pp. 69-76.

¹ The petitioners, husband and wife, are members of a partnership which operates a dance studio. Though a partnership is not a separate taxable entity, the partners being liable for income tax in their individual capacities (see 1939 Code, Sections 181-188; 1954 Code, Sections 701-706), for convenience, the petitioners are sometimes referred to in the singular as "the taxpayer" or "the Studio."

Three "taxable years" of the Studio (fiscal years 1952-1954) are involved, and, for convenience, reference is sometimes made to a single taxable year. Numerous individual contracts are also involved, and they are also sometimes referred to in the singular.

The Regulations involved are Treasury Regulations 118 (1939 Code), Sections 39.41-1, 39.41-2, 39.41-3, 39.41-4, 39.42-1(a), 39.42-4, 39.43-1(a), and 39.43-2; Treasury Regulations on Income Taxes (1954 Code), Sections 1.441-1, 1.446-1, 1.451-1(a), 1.451-3, and 1.461-1(a). See Appendix, *infra*, pp. 76-99.

STATEMENT

The taxpayers, husband and wife, formed a partnership in 1946 known as Arthur Murray Dance Studio (the "Studio"), for the purpose of giving dance instruction and operating studios under franchise agreements received from Arthur Murray, Inc., of New York City. The partnership operated studios in the States of Nebraska, Iowa and South Dakota. (R. 248-249.)

Basically, there were two kinds of contracts entered into between the Studio and students. Under one type, all of the down payment was made in cash at the time the contract was executed, with the balance of the contract price to be paid in installments. Under the other, a portion of the down payment was paid in cash at the time the contract was entered into, and the balance was to be paid in installments; the remainder of the contract price was evidenced by a negotiable note taken from the student, which was payable in designated installments. (R. 249-250.)

All the contracts provided that (1) the student would pay for lessons in a certain amount, (2) the student should not be relieved of his obligation to pay the agreed amount, (3) no refunds would be made,

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and (4) the contract was noncancellable. They further provided for a specific number of hours of lessons ranging from 5 to 1,200, and some of the contracts were for lifetime courses under which, in addition to 1,200 specified hours, the student was entitled to two hours of lessons per month plus two parties a year for life. Although the contracts specified a period during which the lessons had to be taken, they did not schedule specific dates for the lessons, these being arranged from time to time as lessons were given. Under many of the contracts the period of instruction extended beyond the fiscal year in which the contract was made, but in such cases the period usually ended in the next fiscal year. (R. 250.)

Notes accompanying contracts were negotiated by the Studio with a local bank. The bank would deduct its interest charges, pay approximately 50 per cent of the balance of the note to the Studio, and set up a reserve account for the other 50 per cent which the Studio could not use until after the note was paid in full by the student. When the note was paid, the balance in the reserve account was transferred to the Studio's general bank account. (R. 250-251.)

Cash payments received directly from students, the amounts received at the time notes were transferred to the bank, and the amounts received when notes transferred to the bank were fully paid, were either deposited or credited to the Studio's general bank account without segregation from its other partnership funds. (R. 251.)

Although the contracts stated that they were noncancellable, some of them were in fact cancelled, ac-

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counting for about 17% of the taxpayer's total sales (R. 256, 258), and the Studio frequently rewrote contracts to reduce the number of lessons and the total charge. Also, despite the fact that the contracts provided that no refund would be made, and despite the fact that the Studio discouraged refunds, occasionally a refund would be made on a canceled contract. (R. 251.)

When the partnership was organized in 1946, a complete double entry bookkeeping system was installed by a firm of certified public accountants, and an accrual system of accounting, with a fiscal year ending March 31, was employed. This accounting system was used continuously and consistently from the time the partnership was formed. Additionally, individual student record cards were maintained, listing all pertinent information such as name and address of student, type of contract, hours involved, total contract price, history of lessons taught, and payments made under the contract. (R. 251-252.)

The accounting method used by the Studio is shown in detail in the findings of the Tax Court. In substance, when a contract was entered into with a student, a "deferred income" account was credited with the total contract price. At the close of each fiscal year, the student record cards were analyzed and the number of hours of lessons taught multiplied by the contract rate per hour was then deducted from "deferred income" and credited to "earned income." The so-called "earned income" thus derived was reported as gross income on the Studio's tax return. (R. 252-253.)

Expenses were recorded and deducted in the fiscal year incurred except that royalties to Arthur Murray, Inc., and certain other items² were recorded and deducted when paid (R. 252).

Additional gross income was reported by the Studio each year as "gains from cancellation" of contracts. The Studio would treat as canceled any contract which had been inactive for more than a year. Gain on a cancelled contract would be computed as the amount by which the "deferred income" account with respect to such contract exceeded the unpaid portion of the contract price, i.e. the amount received in advance for untaught lessons. (R. 253.)³

Schedules reflecting the Studio's system of accounting during the years in question (R. 253-256) show, *inter alia*, that the ending balances in its "deferred income" account were \$131,143.92, \$235,942.33, and \$248,740.30 for the fiscal years 1952, 1953, and 1954, respectively (R. 254). Of these ending balances, the aggregate amounts and percentages attributable to cash in hand⁴ plus funds held in the reserve account⁵

² E.g., commissions to personnel for selling lessons (R. 218-219). Refunds were not recorded or claimed as separate items of deduction, but were charged to "deferred income", thereby reducing the "gains" ultimately reported from contract cancellations. (R. 220-221.)

³ The Studio did not report any losses from cancellation during the years in question. (R. 256.)

⁴ Denoted as "Deferred Income Collected." (R. 255.)

⁵ Denoted as "Reserve Fund Held by Bank on Students Notes Financed." (R. 255.) On the original exhibit, from which the schedule was drawn, there were alternative computations the first of which treated the "Reserve Fund" separately, and the second of which treated it as part of "Deferred Income Collected." (Ex. 14-N; R. 145, 218-219.)

were \$67,516.69, or 52 per cent, for fiscal 1952; \$149,244, or 63 per cent, for fiscal 1953; and \$163,563.20, or 66 per cent, for fiscal 1954.⁶ (R. 255.) The remainder of the annual ending balance in the "deferred income" account was attributable to "Students Accounts Receivable" of \$63,627.23, or 48 per cent, for fiscal 1952; \$86,698.33, or 37 per cent, for fiscal 1953; and \$85,177.10, or 34 per cent for fiscal 1954. (R. 255.) "Students Accounts Receivable" was in turn comprised of "Installment Contracts Carried by Studio, Notes Not Yet Processed Through the Bank, and Unpaid Balances on Planned Cash Courses." (R. 255.)

The ordinary net income of the Studio, as reflected on its books and returns for the years in question, was computed in the following manner (R. 256):

	March 31, 1952	March 31, 1953	March 31, 1954
Gross Income:			
Contract Amts. transferred to Earned Income	\$143,949.63	\$243,277.46	\$325,266.97
Gains from cancellation	26,861.40	19,483.36	28,448.61
Other Income	4,011.21	11,126.23	10,887.31
Total	\$174,822.24	\$273,887.05	\$370,702.89
Deductions:			
	137,267.91	223,309.69	301,609.76
Ordinary Net Income	\$37,554.33	\$50,577.36	\$69,093.13

⁶ A typical computation is as follows: For fiscal 1954, the sum of the ending balances of "Deferred Income Collected" (\$129,029.98) and "Reserve Fund" (\$34,533.22) is \$163,563.20. (R. 255.) This total is approximately 66 percent of the ending balance in the "deferred income" account (\$248,740.30). (R. 254.)

The record does not contain an arithmetical or percentage breakdown of the subsidiary items comprising "Students Accounts Receivable," nor does it show precisely how much of the overall ending balance in the "deferred income" account for each year derived from contracts entered into in that year, as opposed to contracts entered into in a previous year (or years).