

Murray escrow fund, those two items alone exceeded the collected amount or deferred income at the end of each fiscal year.

Q. Will you tell us what the Arthur Murray escrow fund is?

[fol. 157] A. That is a fund accumulated at the rate of five percent of gross receipts for the purpose of protecting and indemnifying Arthur Murray and to provide a source from which refunds can be made for paid and unused lessons sold.

Q. From what records was this document prepared?

A. This was prepared from the partnership records and the partners' personal bank accounts.

Q. So that included in the item of cash, it includes not only the cash in the partnership account but in the individual accounts of the partners—

A. That's correct.

Q. —at the time?

A. That's correct.

Q. Are the books and other records from which this was prepared in the courtroom?

A. Yes, sir.

Mr. Bayersfeld: I offer the document in evidence.

The Court: Do you wish to examine that, Mr. McCormick?

Mr. McCormick: Yes, sir.

The Court: Do you have a copy there for him?

Mr. McCormick: We have a copy.

The Court: All right.

Mr. McCormick: The only thing is we would like again to reserve the opportunity to object.

The Court: You mean you want to reserve as you did on the other?

Mr. McCormick: Yes, sir.

The Court: The Court will hear any objection when we reconvene this afternoon. The exhibit, Petitioner's Exhibit No. 25, is received.

(The schedule referred to, heretofore marked as Petitioner's Exhibit No. 25, for identification, was received in evidence as Petitioner's Exhibit No. 25.)

Schedule Reflecting Excess of Assets Over Liabilities at  
End of Each Fiscal Year

Arthur Murray Dance Studio—A Partnership.

	March 31, 1950	March 31, 1951	March 31, 1952	March 31, 1953	March 31, 1954
<b>Assets</b>					
Cash .....	\$ 38,534.60	\$ 46,744.14	\$ 49,720.26	\$ 78,833.11	\$127,214.53
Loans and Miscellaneous Receivables .....	25.00	200.00	62.50	11,000.00	6,487.50
Investments—At Cost .....					26,990.00
Arthur Murray Escrow Fund .....	18,802.01	26,827.77	30,225.73	34,922.59	37,677.61
Fixed Assets—At Cost Less Accumulated De- preciation .....	9,946.93	13,753.30	15,074.94	28,035.32	36,825.59
Other Assets .....	77.00	77.00	77.00	152.00	182.00
Prepaid Expenses .....	337.39	840.51	983.09	874.78	699.04
<b>Total Assets .....</b>	<b>\$ 67,722.93</b>	<b>\$ 88,442.72</b>	<b>\$ 96,143.52</b>	<b>\$153,817.80</b>	<b>\$236,076.27</b>
<b>Liabilities and Deferred Income</b>					
Accounts Payable and Accrued Expenses Pay- able .....	\$ 4,038.93	\$ 4,771.68	\$ 7,331.58	\$ 7,878.30	\$ 15,933.53
Deferred Income—(Liability for Cash Received and Unearned at End of Year) .....	28,776.92	43,187.43	59,572.95	111,496.39	129,029.97
<b>Total Liabilities and Deferred Income .....</b>	<b>\$ 32,815.85</b>	<b>\$ 47,959.11</b>	<b>\$ 66,904.53</b>	<b>\$119,374.69</b>	<b>\$144,963.80</b>
<b>Net Worth</b>					
<b>Excess of Assets Over Liabilities and Deferred Income .....</b>	<b>\$ 34,907.08</b>	<b>\$ 40,483.61</b>	<b>\$ 29,238.99</b>	<b>\$ 34,413.11</b>	<b>\$ 91,112.47</b>

[fol. 158]

PETITIONER'S EXHIBIT 25

[fol. 159] By Mr. Bauersfeld:

Q. Are you familiar with the adjustments made by the Commissioner in the statutory notices of deficiency regarding deferred income account?

A. Yes, sir.

Q. Do the adjustments made in the notices of deficiency as to deferred income result in a determination of the partnership's true income?

A. I don't believe I understand the question.

Q. Do the adjustments made in the notice of deficiency to the deferred income of the partnership result in a determination of the partnership's true income?

Mr. McCormick: Your Honor I'd like to object to that, as being—

The Court: I suppose you mean to ask him this, that—

Mr. McCormick: His opinion.

The Court: —as a certified public accountant is it his opinion that it is what you state?

Mr. Bauersfeld: Yes, sir, that is correct, Your Honor.

The Court: That is the way the respondent was going to suggest you asked it?

Mr. McCormick: Yes, sir.

The Court: Otherwise it might be termed a conclusion, but he may give his opinion.

Mr. Bauersfeld: You may answer that.

A. No, sir, it doesn't reflect properly the income, in fact it completely distorts the income.

By Mr. Bauersfeld:

Q. Why, in your opinion as a certified public accountant, do you believe that the Commissioner's adjustments distort the income?

A. Well, there are several reasons why it distorts the income. The Commissioner's method concludes that the dollar sales each year are income in the year in which the contract is signed, when the actual cancellation experience of the Studio proves that a substantial amount of these [fol. 160] contracts never will be realized as income. Secondly, the distortion of income occurs because it violates

one basic principle of the accrual method of accounting, that the income must be recorded in the same period, the same fiscal year, as are the costs and expenses incurred for the rendering of the services that produce that income. In other words, it isn't an accrual system of accounting unless you properly match your income with the costs and expenses that produce that income. Another thing I believe the Commissioner's method completely disregards is that in order to be income for any business organization, that business organization must give something of value to the customer before income can be realized. Income is not realized by the mere scratching of a pen across the surface of a contract. You have to give something. It is the teaching of the hours that create the right to the income and not the mere execution of the contract.

Q. Do I understand your testimony to be that the Commissioner's determination of income is not based upon even the actual receipt of cash?

A. No, it isn't based on the actual amount of money received, it's based on the execution of the contract whether or not cash has been received on it.

Mr. Bauersfeld: I ask that this be marked as Petitioner's Exhibit No. 26 for identification.

The Court: It will be marked for identification as Petitioner's Exhibit No. 26.

(The schedule referred to was marked as Petitioner's Exhibit No. 26, for identification.)

By Mr. Bauersfeld:

Q. I hand you Petitioner's Exhibit No. 26 and ask you to identify it?

A. This is a schedule I have prepared reflecting the comparison of gross income computed on the contract-executed basis with the gross income computed on the cash basis for each of the fiscal years from March 31, 1960, through March 31, 1954. It shows that the—

Q. May I interrupt you there?

A. Yes.

Q. And ask you what you mean by contract-executed basis?

[fol. 161] A. Well, for lack of a better way, that is what I call the Commissioner's method. It isn't an established used method. I just refer to it as the contract-executed basis.

Q. You will so refer to it in your future testimony here?

A. Yes, sir.

The Court: Does that represent what the Commissioner has done in his determination of the deficiency?

The Witness: Yes, sir.

The Court: All right.

The Witness: The gross income on the contract executed basis is tabulated in the first column for each year and the gross income on the cash basis—in other words, the actual cash received from lessons—is reflected in the second column. In the third column it reflects the excess on the contract executed basis of gross income; for the year ended March 31, 1950, the income on the contract executed basis exceeded the gross income \$46,069.04; for the year ended March 31, 1951, the excess amounted to \$48,448.61; for the year ended March 31, 1951, the excess amounted to \$48,200.13, and for the year ended March 31, 1953, the excess amounted to \$115,609.39, and for the year ended March 31, 1954, the excess amounted to \$80,791.54.

Mr. Bauersfeld: At this time I'd like to offer the document in evidence, Petitioner's Exhibit No. 26.

Mr. McCormick: We'd like to reserve again.

The Court: Yes, sir, you may make the same reservation. The Court will make this remark at this particular juncture, the Court does not understand that the Commissioner has undertaken to put the Petitioners on the cash basis.

Mr. McCormick: No, sir.

The Court: Apparently both concede that the Petitioner is on an accrual basis.

Mr. Bauersfeld: Yes, sir.

The Court: And as I understand it, the dispute between you is that under an accrual basis the petitioner [fol. 162] has pursued the proper method and the Commissioner has pursued the wrong method. This Exhibit makes a comparison between what the Commissioner has done and

what would have been the case if the cash basis had been used. It appears to the Court that is more or less immaterial. It may be useful from an argumentative standpoint. I don't know. But certainly it is frequently the case that income on an accrual basis might be considerably greater than it would be on the cash basis, yet that wouldn't spell anything at all if the Petitioner was on an accrual basis and had properly used the accrual basis or had not properly used it and the Commissioner had made adjustments. It would not spell anything at all. It would have showed by comparison he would have much less income on the comparison basis. I'm just leaving that open. It could only be useful at all for argumentative purposes because I don't understand the Commissioner is contending he should be on the cash basis. They both agree they should be on the accrual basis.

Mr. Bauersfeld: Your Honor stated the situation correctly. We contend and the Commissioner contends he should be on the accrual basis. However, there are certain cases where they have, as I said in my opening statement, the Commissioner hasn't specifically said at this time he was relying on the claim-of-right doctrine in this case. However, there is another case where they have. In no case has the Court held a taxpayer is taxable on more than the actual cash received.

The Court: The Court was wondering what the purpose would be. I understand you are both agreed it's on the accrual basis. It would be only admissible on the theory you're speaking of.

It has been received and the respondent, if he does object, may do so when we reconvene.

(The schedule referred to, heretofore marked as Petitioner's Exhibit No. 26, for identification, was received in evidence as Petitioner's Exhibit No. 26.)



[fol. 163]

## PETITIONER'S EXHIBIT 26

Schedule Reflecting Comparison of Gross Income  
Computed on Contract Executed Basis With  
Gross Income Computed on Cash Basis.

## Arthur Murray Dance Studio—A Partnership.

Fiscal Year Ended	Gross Income on Contract Executed Basis	Gross Income on Cash Basis	Contract Executed Basis Over Cash Basis
March 31, 1950 .....	\$185,933.50	\$139,864.46	\$ 46,069.04
March 31, 1951 .....	209,453.30	161,004.69	48,448.61
March 31, 1952 .....	235,396.68	187,196.55	48,200.13
March 31, 1953 .....	430,293.65	314,684.26	115,609.39
March 31, 1954 .....	452,040.70	371,249.16	80,791.54

The Court: You may now proceed with the witness.

By Mr. Bauersfeld:

Q. Does the Commissioner's determination include as income all accounts receivable?

A. Yes, sir, the inclusion of accounts receivable into income is admittedly the normal thing to do under the accrual system of accounting. However, there is a great distinction; under the accrual system of accounting it must be determined receivables in order to be included in the determination of net income and not just a memorandum of an account reflecting a total contract that might be involved. In other words, to put it a different way, you might refer to it as a contractor here in the city of Omaha might receive a \$2,000,000.00 contract. He may book that contract immediately upon signing of that contract and debit contracts receivable and credit reserve for incomplete contracts. However, that is not earned receivables and would not be earned income at that time. That might take three years to complete and there would be earned billings during the three year period those would be earned. You could

compare it to a company who has received some back orders for merchandise yet to be delivered or to be manufactured. [fol. 164] Those orders could also be placed on the books as an asset and a credit to reserve for uncompleted orders. However, that is not a good accounts receivable, it's merely setting up the contract on the books, so you have control of those contracts so that for the future you know what you have to work with. They are by no stretch of the imagination an earned account receivable.

Mr. McCormick: Your Honor, do I understand this gentleman's testimony the same as you do, that it's all related to his opinion?

The Court: Yes, the Court understands it. I think I understand the illustrations that the accountant has in mind as to the difference in accounts receivable. For example, if an automobile dealer in Omaha, Nebraska, makes a sale of a car for \$2,000.00, that's a completed transaction. It may be it's payable over 24 months or 36 months but on the accrual basis he would accrue the entire account then and there and this witness concedes that is an account receivable, that all accounts receivable of that kind goes into accrued income. But he states that in his opinion that as in this Arthur Murray Dance Studio there is a contract to give a certain number of dance lessons for a certain amount, that that is not like the sale of goods. It's an agreement to render services and only such services as were rendered in the taxable year would be subject to accrual. Is that correct?

Mr. Bauersfeld: That's correct, sir.

The Court: Yes. Of course, that is an expert opinion.

Mr. McCormick: Yes, sir. I just wondered if it was understood in the record.

The Court: Well, the Court understands perfectly well. The Court also understands that there are a good many income-tax transactions which do not comply with good accounting. He also understands that but he is not passing on this. In other words, income taxes don't always square up with good accounting. I'm not passing on this case at all, but it's perfectly proper, I think, for the witness to give the testimony he has given. As I understand it, that is the substance of it. This is not a case of an auto-

mobile salesman or hardware merchant selling merchandise, even though they may be payable in two or three or four [fol. 165] years, nevertheless they have to be accrued. On the other hand, he says this is entirely different. This is not the sale of goods but the sale of services. That makes a difference, as I understand it, from the viewpoint of the accounting witness.

Is there anything else you want to ask?

Mr. Bauersfeld: Yes. I haven't completed my examination.

The Court: Yes. All right.

Mr. Bauersfeld: May I have this marked as Petitioner's Exhibit No. 27.

The Court: It will be marked for identification as Petitioner's Exhibit No. 27.

(The schedule referred to was marked as Petitioner's Exhibit No. 27, for identification.)

By Mr. Bauersfeld:

Q. I hand you Petitioner's Exhibit No. 27 and ask you to identify it.

A. This is a schedule I prepared reflecting the dollar amount of executed contracts cancelled and relating to the uncollectible students accounts receivable or contracts cancelled for each of the fiscal years ended March 31, 1950, through March 31, 1954.

The Court: And these were made from books and records that are in the courtroom?

The Witness: Yes, sir.

By Mr. Bauersfeld:

Q. What do the columns show? Will you explain the schedule?

A. The first column is headed "dollar amount of executed contracts cancelled" and the second column is headed "uncollectible accounts receivable on contracts cancelled". In other words, to take the fiscal year ended March 31, 1954, as an illustration, the total amount of contracts cancelled during that year amounted to \$113,975.76. That is the total

unearned portion of the contracts that were cancelled during that year because of lack of student activity thereon. On those contracts that were cancelled, there was an unpaid [fol. 166] balance amounting to \$85,527.15. The difference between those two figures would represent the gain on cancellations for that particular year.

Q. And the gain on cancellations again is the figure that is set forth in paragraph XII of the stipulation of facts and this in the year ended March 31, 1954, would be \$28,448.61?

A. Yes, sir, that is correct.

Q. And that amount was taken into income on the cancellations in 1954?

A. Yes, sir.

The Court: By the taxpayer?

By Mr. Bauersfeld:

Q. By the taxpayer?

A. Yes, that's correct.

The Court: That Petitioner's Exhibit No. 27, have you examined it, Mr. McCormick?

Mr. McCormick: Yes. I'd like to reserve on that one also.

The Court: All right, it will be received, Petitioner's Exhibit No. 27.

(The schedule referred to, heretofore marked as Petitioner's Evidence No. 27, for identification, was received in evidence as Petitioner's Exhibit No. 27.)

## PETITIONER'S EXHIBIT 27

Schedule Reflecting Dollar Amount of Executed Contracts  
Cancelled and Related Uncollectible Students Ac-  
counts Receivable on Contracts Cancelled.

Arthur Murray Dance Studio—A Partnership.

Fiscal Year Ended	Dollar Amount of Executed Contracts Cancelled	Uncollectible Accounts Receivable on Contracts Cancelled
March 31, 1950	\$ 31,580.53	\$ 26,203.69
March 31, 1951	38,926.73	28,920.29
March 31, 1952	66,874.83	39,983.43
March 31, 1953	82,217.78	62,734.42
March 31, 1954	113,975.76	85,527.15

[fol. 167] Mr. Bauersfeld: I ask that this document be  
Petitioner's Exhibit for identification No. 28.

The Court: It will be marked for identification as Peti-  
tioner's Exhibit No. 28.

(The schedule referred to was marked as Petitioner's  
Exhibit No. 28 for identification.)

By Mr. Bauersfeld:

Q. I hand you Petitioner's Exhibit No. 28 and ask you  
to identify it.

A. This is a schedule I prepared reflecting the result  
of the Commissioner's determination of gross income on  
contracts executed basis for the fiscal years ended March  
31, 1950, through March 31, 1954. The schedule for the  
determination of net income reflects the total dollar sales  
made during each of those years from those dollar sales  
we have deducted expenses as shown by the partnership  
and have in addition deducted the bad debts during each  
of those years that the Commissioner has automatically  
allowed by picking up the net increase in deferred income  
and arriving at the net taxable income for each of the

years on the so-called contract executed basis. The lower  
half of the schedule is headed up "cash receipts and dis-  
bursements statement" and actually shows the impossible  
situation that would result if the Commissioner's method  
of reporting income was to be sustained. For each of the  
years we have the amount of cash receipts and deducted  
from the cash receipts the amount of operating expenses  
paid by the partnership and the escrow funds paid to  
Arthur Murray and acquisition of fixed assets and the in-  
come-tax costs that would be paid on that basis of deter-  
mining income. For the year ending March 31, 1950, there  
would be a cash deficit of \$5,121.14; for the year ending  
March 31, 1951, there would be a cash deficit of \$11,768.42;  
for the year ending March 31, 1952, there would be a cash  
surplus of \$8,844.02; for the year ending March 31, 1953,  
there would be a cash deficit of \$22,632.49; for the year  
ending March 31, 1954, there would be a cash surplus of  
\$15,418.11. For the five-year period from April 1, 1949  
through March 31, 1954, there would be an accumulated  
cash deficit of \$15,259.92 if the Commissioner's method of  
[fol. 168] determining income and the resulting income tax  
on that income were paid.

Also, I'd like to note this, it will be noted in each of these  
cases the sales for each of these years has actually increased  
and that if the sales, for instance, for the year ending March  
31, 1954, had decreased the result for that five-year period  
would have been greater.

Q. From what did you prepare this schedule?

A. Well, the sales, of course, are shown on the books of  
account.

Q. Were these prepared from the books of account?

A. That's right. Every single item on here is reflected by  
the books of account, with the exception of the income-tax  
costs which were calculated.

Q. I notice it is computed at the 1954 tax levels?

A. Yes, I believe that to be somewhat conservative inso-  
far as the 1954 rates were somewhat less than in earlier  
years.



Schedule Reflecting Result of Commissioner's Determination  
of Gross Income on Contract Executed Basis.

Arthur Murray Dance Studio—A Partnership.

	Fiscal Years Ended				
	March 31, 1950	March 31, 1951	March 31, 1952	March 31, 1953	March 31, 1954
Determination of Net Income					
Gross Income—Sales	\$185,983.50	\$209,453.30	\$235,396.68	\$430,293.65	\$452,040.70
Operating Expenses	\$106,543.90	\$123,351.31	\$137,267.91	\$223,390.69	\$301,609.76
Expenses—Per Partnership Return	26,203.60	28,929.29	39,983.43	62,734.12	85,527.15
Bad Debts					
Total Operating Expenses	\$132,747.50	\$152,280.60	\$177,251.34	\$286,125.11	\$387,136.91
Net Taxable Income	\$ 53,186.00	\$ 57,172.70	\$ 58,145.34	\$144,168.54	\$ 64,903.79
Income Tax Cost					
Computed at 1954 Tax Rates	\$ 20,881.00	\$ 23,323.00	\$ 23,926.00	\$ 57,831.51	\$ 28,116.00
Cash Receipts and Disbursements					
Cash Receipts	\$139,864.16	\$161,004.69	\$187,196.55	\$314,684.26	\$351,249.16
Cash Disbursements					
Operating Expenses Per Partnership Return Reduced by Depreciation	\$101,303.94	\$118,589.54	\$130,133.53	\$215,383.68	\$289,350.66
Partners Salaries	14,653.33	14,266.67	14,560.00	14,560.00	14,560.00
Escrow Fund Payments to Arthur Murray	7,181.50	8,025.76	3,397.96	4,696.86	2,755.02
Acquisition of Fixed Assets	965.83	8,568.14	6,335.04	16,841.70	21,049.37
Income Tax Costs—(Per Above)	20,881.00	23,323.00	23,926.00	57,831.51	28,116.00
Total Disbursements	\$144,985.60	\$172,773.11	\$178,352.53	\$337,316.75	\$355,831.05
Balance (Deficit)	(\$ 5,121.14)	(\$ 11,768.42)	\$ 8,844.02	(\$ 22,632.49)	\$ 15,418.11
Accumulative Cash Deficit	(\$ 5,121.14)	(\$ 16,889.56)	(\$ 8,045.54)	(\$ 30,678.03)	(\$ 15,259.92)

fol. 169

PETITIONER'S EXHIBIT 25



[fol. 170] Mr. McCormick: Subject to our reservations.

The Court: I understand when we reconvene you may state your objection to any of these exhibits that are now being received and the Court will consider them at that time.

Mr. Bauersfeld: I ask that this be marked as Petitioner's Exhibit for identification No. 29.

The Court: It will be marked for identification as Petitioner's Exhibit No. 29.

(The schedule referred to was marked as Petitioner's Exhibit No. 29, for identification.)

By Mr. Bauersfeld:

Q. I hand you Petitioner's Exhibit No. 29 and ask you to identify it, please.

A. This is a schedule I prepared reflecting items of income comprising the closing income reported on the partnership tax returns. In other words, for each of the fiscal years—March 31, 1950 through March 31, 1954—it's merely a classification and breakdown of the income items on the partnership return.

The Court: It does represent the income that the partnership returned in those particular years?

The Witness: Yes, sir.

The Court: You have broken it down?

The Witness: That's right.

The Court: All right, it will be received as Petitioner's Exhibit No. 29.

(The schedule referred to, heretofore marked as Petitioner's Exhibit No. 29, for identification, was received in evidence as Petitioner's Exhibit No. 29.)

**Schedule Reflecting Items of Income Comprising Gross  
Income Reported on Partnership Tax Returns.**

**Arthur Murray Dance Studio—A Partnership.**

	March 31. 1950	March 31. 1951	Fiscal Years Ended March 31. 1952	March 31. 1953	March 31. 1954
<b>Items of Gross Income</b>					
Earned Income From Teaching of Dance Lessons .....	\$119,585.14	\$136,596.74	\$143,949.63	\$243,277.46	\$325,266.97
Gain Received From Cancellation of Inactive Courses .....	5,376.93	9,997.44	26,861.40	19,483.36	28,448.61
Income Received From Other Arthur Murray Dance Studios on Transfer Hours.....				1,066.75	2,020.57
Income Received From Contests Derby Fees & Prizes .....				820.00	3,030.19
Income Received From Advertising Rebate .....	623.37			1,441.98	2,639.45
Income Received From Budget Plan Interest, etc. ....	760.90	882.69	4,041.21	8,098.50	8,722.86
Income Received From Investments .....					574.24
Miscellaneous Income .....	14.00	91.32			
Income Received From Special Class Course .....		994.97			
	<u>\$126,360.34</u>	<u>\$148,563.16</u>	<u>\$174,852.24</u>	<u>\$274,187.05</u>	<u>\$370,702.89</u>

(fol. 171)

PETITIONER'S EXHIBIT 29