fer") an estimated amount from gross income, instead of deducting it therefrom (as in *Brown*), the net result, from the tax standpoint, is the same under either method. As Congress recognized when it repealed Sections 452 (deferral of prepaid income) and 462 (accrual of estimated expenses) of the 1954 Code, "if section 452 is not repealed at the same time section 462 is repealed, a number of taxpayers who have reported a greatly reduced tax liability by electing the benefits of section 462 would be able to accomplish the same result by electing to defer income under section 452." H. Rep. No. 293, 84th Cong., 1st Sess., p. 4 (1955-2 Cum. Bull. 852, 854-855).[15]

Recent decisions of this Court have continued to sustain the application of the annual accounting rule to both accrual basis and cash-basis taxpayers despite its sometimes inequitable results.[16] Thus in *Lewyt Corp.* v. *Commissioner,* 349 U.S. 237, it was stated (p. 242) that "the concept 'accrued' embodies the annual accounting principle," and that the settled meaning of that term would be effectively vitiated if an accrual basis taxpayer were permitted to take "events after the taxable year * * * into account." In *United States* v. *Consolidated Edison Co.,* 366 U.S. 380, 384, it was regarded as "settled' that each 'taxable year' must be treated as a separate unit, and all items of gross income and deductions must be reflected in terms of their posture at the close of such year." In *United States* v. *Lewis,* 340 U.S. 590, the Court stated (p. 592) "Income taxes must be paid on income received (or accrued) during an annual accounting period." In *Healy* v. *Commissioner,* 345 U.S. 278, it reiterated (pp. 284-285): "Congress has enacted an annual accounting system under which income is counted up at the end of each year * * *. This basic principle cannot be changed simply because it is of advantage to a taxpayer or to the Government in a particular case that a different rule be followed." And in *American Automobile Assn.* v. *United States,* 367 U.S. 687, which we submit is dispositive of the instant case with respect to the advance receipts, the Court concluded (p. 692) that the taxpayer's system of accounting "fails to respect the criteria of annual tax accounting and may be rejected by the Commissioner."[17]

[15] Indeed, the impact upon the revenues of the deferral of gross income is even greater than the accrual of estimated expenses, since included in the gross income deferred is an element of profit which will be taxed, if at all, only in a later year when returned as "earned income" or "gains from cancellations." On the other hand, if future expenses are presently estimated and deducted, the profit element would at least be taxed in the year the income is received. Both methods, however, fail to satisfy the annual accounting requirement and may be rejected by the Commissioner.

[16] In *Libson Shops, Inc.* v. *Koehler,* 353 U.S. 382, 386, the Court observed that the special net operating loss carryover and carryback provisions of the statute (not applicable here) were enacted "to ameliorate the unduly drastic consequences of taxing income strictly on an annual basis * * * and to strike something like an average taxable income computed over a period longer than one year."

[17] In harmony with this Court's decisions, the clear weight of authority in the court of appeals, and the uniform authority in the Tax Court, has required adherence to the annual accounting rule in a variety of contexts. See, e.g., *Spencer, White & Prentis* v. *Commissioner,* 144 F. 2d 45 (C.A. 2d), affirming 1943 P-H T. C. Memorandum Decisions, par. 43,306, certiorari denied, 323 U.S. 780; *Automobile Club of New York* v. *Commissioner,* 304 F. 2d 781 (C.A. 2d), affirming 32 T.C.

It is settled, as a familiar corollary of the annual accounting rule, that a taxpayer (whether on the

906; *Streight Radio and Television, Inc.* v. *Commissioner*, 280 F. 2d 883 (C.A. 7th), affirming 33 T.C. 127, certiorari denied, 366 U.S. 965; *Capital Warehouse Co.* v. *Commissioner*, 171 F. 2d 395 (C.A. 8th), affirming 9 T.C. 966; *South Dade Farms* v. *Commissioner*, 138 F. 2d 818 (C.A. 5th), affirming 1942 P-H B.T.A. and T.C. Memorandum Decisions, par. 42,516; *Clay Sewer Pipe Ass'n* v. *Commissioner*, 139 F. 2d 130 (C.A. 3d), affirming 1 T.C. 529; *New Capital Hotel* v. *Commissioner*, 261 F. 2d 437 (C.A. 6th), affirming *per curiam* 28 T.C. 706; *New Jersey Automobile Club* v. *United States*, 181 F. Supp. 259 (C. Cls.), certiorari denied, 366 U.S. 964; *Automobile Club of Southern California* v. *United States*, 5 A.F.T.R. 2d 901 S.D. Cal. 1960), appeal dismissed (C.A. 9th) November 28, 1961; *Sandegren* v. *Commissioner*, decided January 30, 1962 (1962 P-H T.C. Memorandum Decisions, par. 62,016; appeal pending (C.A. 9th); *Andrews* v. *Commissioner*, 23 T.C. 1026; *Your Health Club, Inc.* v. *Commissioner*, 4 T.C. 385; *Pioneer Automobile Service Co.* v. *Commissioner*, 36 B.T.A. 213.

The only cases of which we are aware that might be viewed as departures from the principles of annual tax accounting are *Beacon Publishing Co.* v. *Commissioner*, 218 F. 2d 697 (C.A. 10th), reversing 21 T.C. 610; *Schuessler* v. *Commissioner*, 230 F. 2d 722 (C.A. 5th), reversing 24 T.C. 247; and *Bressner Radio, Inc.* v. *Commissioner*, 267 F. 2d 520 (C.A. 2d), reversing 28 T.C. 378; cf., *Harrold* v. *Commissioner*, 192 F. 2d 1002 (C.A. 4th), reversing 16 T.C. 134; *Pacific Grape Prod. Co.* v. *Commissioner*, 219 F. 2d 862 (C.A. 9th), reversing 17 T.C. 1097. Of these, the *Bressner* case was effectively overruled, and the *Beacon Publishing Co.* and *Schuessler* cases were distinguished on their facts, in *American Automobile Assn.* v. *United States*, 367 U.S. 687, pp. 689, 691, note 4. We share the Tax Court's view (*Andrews* v. *Commissioner*, 23 T.C. 1026, 1033; *Automobile Club of New York* v. *Commissioner*, 32 T.C. 906, 912) that *Beacon Publishing Co.* and *Schuessler* were erroneously decided. This Court has expressly refrained from endorsing them as correct. See *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180, 189, note 20. In any event, as pointed out below, they are distinguishable from the present

case for the same reasons they were distinguished in *American Automobile Assn.*, *supra*, p. 691, note 4.

cash or accrual basis) who receives income under a claim of right and without restriction as to its use must report it in the year received, even though he may later be required to restore the income. *North American Oil* v. *Burnet*, 286 U.S. 417; *United States* v. *Lewis*, 340 U.S. 590; *Healy* v. *Commissioner*, 345 U.S. 278; see also *Security Mills Co.* v. *Commissioner*, *supra*. In the *Lewis* and *Healy* cases it was held that a taxpayer who received money under a mistaken or invalid claim, and became obliged in a later year to refund part of it, was nonetheless required to report the full amount received in the year of receipt because the money had been received under a claim of right and was treated by the taxpayer as belonging to him. The Court stated in *Healy* (345 U.S. at 282–285):

> The phrase "claim of right" is a term known of old to lawyers. Its typical use has been in real property law in dealing with title by adverse possession, where the rule has been that title can be acquired by adverse possession only if the occupant claims that he has a right to be in possession as owner. The use of the term in the field of income taxation is analogous. There is a claim of right when funds are received and treated by a taxpayer as belonging to him. The fact that subsequently the claim is found to be invalid by a court does not change the fact that the claim did exist. A mistaken claim is nonetheless a claim, *United States* v. *Lewis*, 340 U.S. 590 (1951).

> The inequities of treating an amount as income which eventually turns out not to be income are urged upon us. * * * Congress has enacted an annual accounting system under which income is counted up at the end of each year. It would be disruptive of an orderly collection of the revenue to rule that the accounting must be done over again to reflect events occurring after the year for which the accounting is made, and would violate the spirit of the annual accounting system. This basic principle cannot be changed simply because it is of advantage to a taxpayer or to the Government in a particular case that a different rule be followed.
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> * * * * *

The so-called "claim of right doctrine" and its rationale lend strong support to the government's position. Since the annual accounting rule requires a taxpayer who receives income under a claim of right and without restriction as to its use to report it in the year received, notwithstanding that he may later be required to *refund* the very income received, it would seem to follow that a taxpayer must report income in the year received even though he may later be required to *use* some or all of it to meet alleged "related" expenses. See *Streight Radio and Television, Inc.* v. *Commissioner*, 280 F. 2d 883 (C.A. 7th), affirming 33 T.C. 127, certiorari denied, 366 U.S. 965; *Spencer, White & Prentis* v. *Commissioner*, 144 F. 2d 45 (C.A. 2d), affirming 1943 P-H T.C. Memorandum Decisions, par. 43,306, certiorari denied, 323 U.S. 780; *South Dade Farms* v. *Commissioner*, 138 F. 2d 818 (C.A. 5th), affirming 1942 P-H B.T.A. and T.C.

Memorandum Decisions, par. 42,516; *Capital Warehouse Co.* v. *Commissioner*, 171 F. 2d 395 (C.A. 8th), affirming 9 T.C. 966; *Clay Sewer Pipe Ass'n* v. *Commissioner*, 139 F. 2d 130 (C.A. 3d), affirming 1 T.C. 529. In the case of a taxpayer who is required to repay income received in a previous taxable year, the amount repaid is deductible on the accrual basis only in the year in which the liability to repay becomes fixed. Similarly, in the case of a taxpayer who is required to incur expenses attributable to or in consideration of income received in a prior year, the expenses are deductible only in the year in which the liability to pay them becomes fixed. *Security Mills Co.* v. *Commissioner*, 321 U.S. 281; *Brown* v. *Helvering*, 291 U.S. 193; *United States* v. *Anderson*, 269 U.S. 422; *Dixie Pine Co.* v. *Commissioner*, 320 U.S. 516.

The treatment of the advance receipts in this case is controlled by this Court's decision in *American Automobile Assn.* v. *United States*, 367 U.S. 687. See also *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180. In the *AAA* case, the taxpayer, filing its returns on the calendar year-accrual basis, reported as gross income only that portion of its annual receipts from membership dues which ratably corresponded to the number of months of the membership year falling within the taxable year of receipt, and "deferred" accrual of the balance, on the theory that the amounts received were ratably "earned" and accruable over the entire contract period, *i.e.*, as and when it performed related services for its members. The Court of Claims, sustaining the Commissioner's determination, held that the entire amount received, was includable in gross income in the year of receipt. Expressly recognizing a conflict with *Bressner Radio, Inc.* v. *Commissioner*, 267 F. 2d 520 (C.A. 2d), involving a similar method of accounting with respect to prepaid income for service guaranties, this Court granted certiorari and affirmed. It pointed out (pp. 690–692) that while the taxpayer's accounting method had been regularly and consistently employed, and was also in accord with generally accepted commercial accounting practices, it "fails to respect the criteria of annual tax accounting" required by the taxing statute, and, moreover, was "artificial" since rendition of the service was contingent upon members' demands. As a separate and independent ground for its decision, the Court pointed (pp. 694–697) to pertinent legislative history showing that Section 452 of the 1954 Code (dealing with "prepaid income") expressly authorized the very method of accounting employed by the taxpayer, but that Congress retroactively repealed the section and has subsequently refused to re-enact it despite repeated efforts to reinstate the repealed provisions.

The Studio (Br. 18–20) and amicus (Br. 12–14) attempt to distinguish *AAA* on the theory that the Association could not demonstrate that its method of accounting "precisely matched" receipts against estimated future "related costs" of performing services, since the services there contracted for were to be rendered upon demand and were therefore uncertain and contingent, whereas here the contracts called for a specific number of lessons and the Studio's method

did "accurately match" its receipts against estimated related future service expenses.[18]

It is true that the Court, both in *AAA* and its predecessor, *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180, pointed to the contingent nature of the services as a factor making the method of deferral used "artificial". Additionally, the Court distinguished *Beacon Publishing Co.* v. *Commissioner*, 218 F. 2d 697 (C.A. 10th), and *Schuessler* v. *Commissioner*, 230 F. 2d 722 (C.A. 5th), on the ground that in those cases the taxpayer was required "to furnish services at specified times in years subsequent to the tax year" while, in the case of the automobile clubs, "substantially all services are performed only upon a member's demand and the taxpayer's performance was not related to fixed dates after the tax year" (353 U.S. at 189, n. 20; 367 U.S. at 691, n. 4). Even assuming, however, that the *AAA* decision leaves open the validity of such a distinction, this case would fall on the *AAA*, rather than the *Beacon Publishing*, side of the line. While the contracts were nominally for a stated number of dance lessons to be given within

[18] It is anomalous to speak, as do the Studio and amicus throughout their briefs, of an accounting system which "accurately and precisely matches" income currently received for future services with "related costs of [future] performance". The "related costs" which they would "match" against a current year's income consist of nothing more than a *presently estimated amount of future service expenses* to be incurred in a subsequent year. An income-deferral system based upon matching current income with estimated yet-to-be incurred expenses may hardly be dignified as an "accurate and precise" accounting system.

stated time limits, the services were not to be performed, as in *Beacon* and *Schuessler*, at "fixed dates" in the future but only as and when demanded by the student. Nor is that a merely formal distinction, for the Studio's experience has been that a large proportion of the lessons contracted for are never taken, with the result that its actual performance under any individual contract is in fact uncertain and contingent. As we have stated, a substantial number of the contracts were cancelled when the student failed to appear for a year, others were renegotiated for a lesser number of lessons, and, presumably, individual lessons were skipped without any adjustment. While the automobile clubs' per-month method of accrual was at least consistent with their actual group experience, the Studio's per-lesson method of accrual (based on the false assumption that all lessons contracted for will be taken) is contradicated by its own experience.

More importantly, however, we do not believe that the *AAA* decision can be limited, as the Studio and amicus would limit it, to cases in which the services to be performed are uncertain. Under the annual accounting requirement and related accrual concepts, compensation must be reported as gross income in the taxable year in which the right to receive it becomes fixed (in this case the year in which it was collected under claim of right and without restriction as to its use), and may not be diminished by a "matching" amount of estimated future service expenses which the

recipient admittedly has not yet incurred but merely expects to incur in a later year.[19]

Furthermore, the distinction which the Studio and amicus seek to draw between *AAA* and this case does not meet the second and independent ground for decision in *AAA*. Pointing to "other considerations requiring our affirmance" (367 U.S. at 694), the Court went on to demonstrate, from the history of the 1954 Code and its amendments dealing with the income-deferral problem, affirmative Congressional endorsement of the view long held by the Commissioner and the courts disallowing the deferral of income for tax purposes.[19a] From that demonstration, the Court concluded that it should follow the established administrative and judicial practice barring deferral and leave to Congress the carving out of appropriately limited exceptions, a course made particularly desirable by "the complications inherent in the problem and its seriousness to the general revenue" (367 U.S. at 697). Whatever may be said of the implication of the first part of the opinion, there is nothing in the rationale of the latter part by which to confine it to contingent-service contracts. That ground of the decision is applicable to *any* method of deferral of prepaid service income—whether the services are to be rendered on certain or uncertain dates in the future—and was properly found to be controlling by the courts below.

[19] See Costelloe, "Con Edison and AAA cases seen as landmarks in the law of tax accounting", 15 J. Taxation 216 (October 1961)

[19a] See, *e.g.*, the passage from the Senate Report quoted at 367 U.S. 694–695, note 8, reproduced *infra*, pp. 58–59, note 36.

2. The Studio's accounting system violates the annual accounting rule and related accrual principles.

(a) *The transactional or "earned income" method of accounting urged by the Studio.*—The Studio's method of accounting, on its face, fails to satisfy the annual accounting requirement and related accrual concepts. Instead of accruing and reporting as gross income in each taxable year the entire amount of compensation received in that year, and deducting only expenses actually incurred and losses actually sustained in the same year, the Studio has excluded ("deferred") from gross income all payments assumed to be "related" to future service expenses. This deferral of items of gross income currently received in order to reflect estimated items of deduction not yet incurred cannot be squared with the injunction in *Security Mills* (321 U.S. at 286–287) against "allocating income or outgo to a year other than the year * * * in which the right to receive, or the obligation to pay, has become final and definite in amount." Far from clearly reflecting its "net income" for a single "taxable year" on the basis of gross income actually accrued and expenses actually incurred within that year, as demanded by the statute and this Court's decisions, the Studio's returns purported to reflect the net result of its service contracts over a period of two or more taxable years (indeed, over a lifetime in the case of life contracts).

In advocating approval of its method of accounting, the Studio and amicus misconceive the fundamental tax accounting principles which they purportedly accept. Contrary to their assumption, in

determining taxable income for a given taxable year on the accrual method it is immaterial whether gross income and deduction items enumerated in the taxing statute stem from the same contract or are otherwise transactionally "related." The only relevant question is whether the taxpayer had a fixed "right to receive" the gross income item or a fixed "liability to pay" the deduction item within the taxable year. Insofar as they appear to accept the correct test, petitioner and amicus escape the normal result only by making an assumption contrary to fact and inventing a rule of law which finds no support in the statute, Treasury Regulations, or the controlling decisions. The fact assumed is that the Studio had no fixed "right to receive" the advance payments for services at the times it did receive them; the rule supposed is that a "right to receive" payment in no event arises until the services are performed, *i.e.*, when the related service expenses are incurred.

The first premise fails to distinguish between the absolute right, accorded the Studio by the terms of its service contracts, to receive compensation in advance of performance (which gives rise to accrual of the compensation), and a contingent obligation to refund all or part of the prepaid compensation in the event it failed to perform (an event which would give rise to a deductible loss for breach of the contract).[20]

[20] Even in such event, the loss would not be deductible on the accrual basis until the year in which the liability for the damages became fixed. See *Lucas* v. *American Code Co.*, 280 U.S. 445, where the Court said (p. 450): "Obviously, the mere refusal to perform a contract does not justify the deduction, as a loss, of the anticipated damages." Similarly, the mere

While the right to receive normally precedes actual receipt, it can arise no later than the time the taxpayer *actually receives* the income under a claim of right and treats it as his own. Indeed, there is no better evidence of a fixed right to receive income than its receipt under claim of right, coupled with its unrestricted use by the recipient. One who demands and collects money pursuant to the terms of his contract, and enjoys all its economic benefits, is scarcely in a position to maintain that he had no fixed right to receive it. In this case, the Studio unquestionably acquired a fixed "right to receive" in the taxable year the amounts which it did collect in that year from students in advance of giving dancing lessons. The amounts admittedly were collected under claim of right, pursuant to its contract with the student, were received without restriction as to their use, and were deposited in its general bank account. (R. 251.) The Studio not only had a right to *receive* the amounts collected, ~~but a right to *retain*~~ them whether or not the lessons paid for were taken; upon cancellation of a contract the Studio normally made no refund of prepaid amounts, thereby realizing substantial "gains from cancellation." (R. 253–256.) Since one who receives money under a claim of right and without restriction as to its use must report it in the year received even though he may be required to refund it in a later year[19] (*Healy* v. *Commissioner, supra; United States* v. *Lewis, supra; Security Mills* v. *Commissioner, supra*), *a fortiori* one who receives it irrevocably must report it in the year received even though he expects to incur future related expenses.[20a]

obligation to perform a contract does not justify the deduction of the anticipated expenses of performance. *Spencer, White & Prentis* v. *Commissioner, supra.*

The second premise underlying the Studio's argument, a corollary of the first, disregards the annual accounting requirement and would substitute a transactional system of accounting by permitting a taxpayer to report as gross income from service contracts only that portion of prepaid compensation which he treats as "earned" under the respective contracts during the taxable year.[21] In contending that the federal income tax is imposed only upon "earned" income, which they vaguely define as the result of "matching" items of gross income against "related" items of deduction, the Studio and amicus seek to cut across annual accounting periods and employ a "hybrid system, partly annual and partly transactional"—a system which, as this Court held in *Security Mills* (p. 287), finds no place in the statutory scheme for computing federal income tax liability. The situation here is essentially no different from any other in which a taxpayer on the accrual basis receives income in one taxable year, out of which expenses or losses will have to be paid in a later year. Under long settled tax accounting principles, the tax on the income in the year of receipt

[20a] Even monies illegally obtained and used are taxable in the year of receipt. See *Rutkin* v. *United States*, 343 U.S. 130.

[21] That the Studio is advocating a transactional as distinguished from an annual method of accounting is apparent from the example given in fn. 6 (p. 15) of its brief. Moreover, the table set forth in its Exhibit 31 (R. 215), upon which it relies, points up the distortion of its annual net taxable income (gross less deductions) resulting from its deferral of gross income received in one taxable year to a later year through the attempted "matching" of estimated future service expenses.

may not be withheld or diminished by excluding or deducting from the gross income a reserve to cover an estimated amount of anticipated expenses or losses. See *Brown* v. *Helvering, supra.* Basically the same transactional or "earnings" approach advocated by the Studio was rejected by this Court in the *AAA* case.[33]

The term "earnings" has never been used in the income tax statutes to describe either the object of the tax or its method of computation or reporting.[34] And

[33] The Second Circuit's decision in *Bressner Radio, Inc.* v. *Commissioner*, 267 F. 2d 520, typical of the lower courts decisions upon which the amicus relies, appears irreconcilable with its decision in the *Spencer, White & Prentis* v. *Commissioner*, 144 F. 2d 45, certiorari denied, 323 U.S. 780. See also *Commissioner* v. *Fifth Avenue Coach Lines*, 281 F. 2d 556 (C.A. 2d), certiorari denied, 366 U.S. 964. *Bressner* was not followed by the Seventh Circuit in *Streight Radio and Television, Inc.* v. *Commissioner*, 280 F. 2d 883, certiorari denied, 366 U.S. 965, which presented the same issue. In Rev. Rul. 60-85, 1960-1 Cum. Bull. 181, the Internal Revenue Service announced that it would not follow *Bressner*, stating:

> The *Bressner Radio Inc.*, decision conflicts in principle with a long line of judicial authority holding that where a taxpayer receives prepaid income under a claim of right and without restriction as to its disposition, it must report the entire amount received each year as income. * * *

This Court (367 U.S. at 689) predicated its grant of certiorari in the *AAA* case upon conflict with *Bressner*, and its *AAA* decision effectively overruled that decision.

[34] Under the 1939 Code (Sections 11 and 12) the tax is imposed on the "net income." The term "net income" is defined in Section 21 as "the gross income computed under section 22, less the deductions allowed by section 23." Section 41 provides that the taxpayer's computation of "The net income" must clearly reflect "the income". The statutory scheme in the 1954 Code is basically the same, except that the term "taxable income" has been substituted for "net income". See Sections 61,

this Court has specifically rejected the notion that "earnings"—rather than annual "net income"—forms the basis of tax accounting. As stated in *Guaranty Trust Co.* v. *Commissioner*, 303 U.S. 493, 498:

> It is true that the acts of Congress taxing income have consistently laid the tax upon the net income received by or accrued to the taxpayer in a "taxable year," which is either the calendar year or a different fiscal year, as the taxpayer may elect. But they have never undertaken to limit the income taxable in any one year to that derived from the taxpayer's activities occurring in that or any other single year. The items of gross income and of allowed deductions to be included in the income return, are those of the taxpayer for his taxable year, even though they may have resulted from or be affected by his business transactions of other years. *Burnet* v. *Sanford & Brooks Co., supra,* 364, 365. Circumstances wholly fortuitous may determine the year in which income, whenever earned, is taxable, and may thus affect the amount of tax. Receipt of income or accrual of

63, 161-175, 241-247, 441, and 446, Internal Revenue Code of 1954. Compare the use of the term "earnings and profits" in Section 115 of the 1939 Code (Section 316 of the 1954 Code), relating to dividend distributions. As the Tax Court observed in *Streight Radio and Television, Inc.* v. *Commissioner*, 33 T.C. 127, 138, affirmed, 280 F. 2d 883 (C.A. 7th), certiorari denied, 366 U.S. 965: "Tax accounting does not concern itself with the fine question of whether items have been 'earned' in the accounting sense, * * * and this is true whether the item in question has been received, or is merely a receivable." See also *South Dade Farms* v. *Commissioner*, 138 F. 2d 818, 819 (C.A. 5th); *Automobile Club of New York* v. *Commissioner*, 32 T.C. 906, 912, affirmed, 304 F. 2d 781 (C.A. 2d); *Spencer, White & Prentis* v. *Commissioner, supra.*

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> the right to receive it within the tax year is the test of taxability, not the time it has taken the taxpayer to earn it * * *.

The transactional or "earnings" theory of tax accounting urged by taxpayer ignores the rationale of the annual accounting rule, to say nothing of the rule itself. As pointed out in *Sanford & Brooks, supra,* and again in *Security Mills,* the annual accounting system is rooted in strong practical and policy consideration—the need of the government for an ascertainable amount of revenue at regular intervals, collectible through a system capable of practical operation. By requiring an accrual basis taxpayer to report gross income when the right to receive it becomes fixed, and to deduct liabilities when all the events have occurred which fix both the fact and amount of the liability, the annual accounting system permits the taxpayer to compute, and the Commissioner to assess, the tax on the basis of facts rather than estimates. Moreover, these standards apply uniformly to accrual basis taxpayers in all types of business situations. 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.[24] Revenue agents will not only become involved in technical accounting problems in order to determine the validity and accuracy of the taxpayer's estimates in the first instance, but will be obliged to re-audit the taxpayer's accounts in later years to ascertain whether subsequent business experience corresponds with the taxpayer's previous estimates. And in cases where there is a variance between prior estimates and subsequent experience, adjustments of the resultant understatement or overstatement of actual "earnings" in earlier years, as well as adjustments of the taxpayer's current estimates to assure that past errors will not be perpetuated, will become necessary. Moreover, by "matching" against current income estimated future expenses, the taxpayer may effectively postpone the collection of tax until a later period without any guarantee that he will later be able to pay the tax.[25]

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[24] See Schapiro, "Tax Accounting for Prepaid Income and Reserves for Future Expenses," Tax Revision Compendium, submitted to the Committee on Ways and Means (1959), Vol. 2, pp. 1133, 1142–1145.

[25] The difficulties inherent in a system of "matching" future expenses against current receipts are magnified in cases where, as here, indefinite term or lifetime contracts are involved. Moreover, in such cases the "deferred" or "unearned" portion of the prepaid income would not only be increased, but the taxable year to which it would be allocated would be postponed far into the future. In addition, adoption of a "matching" system would pose insurmountable problems of ascertaining how much of the taxpayer's anticipated future overhead expenses (*e.g.* rent, salaries, entertainment, advertising, utilities, taxes, etc.) are allocable to a particular contract and are to be "matched" against the prepaid income received under that contract, especially in cases where (as here) the taxpayer enters into numerous contracts.

Adoption of the transactional or "earnings" approach would also pose difficult problems for the courts. It would invite litigation as to whether particular items of income and expense are sufficiently "related" to justify their being "matched", either by a deferral of income or the accrual of a reserve for estimated expenses; and, even if there is a discernible relationship between such items, as to whether the tabulations and ratios submitted by the taxpayer, or those prepared by revenue agents, more accurately reflect that relationship. The courts would thus inevitably become embroiled in accounting controversies far more numerous, complex, and time-consuming than those they are now called upon to decide under the annual accounting rule.

(*b*) *Commercial accounting practices.*—There is no warrant for the amicus' contention (Br. 31-35)[30] that the annual accounting rule and related accrual concepts laid down by this Court in federal income tax cases must yield to commercial (non-tax) accounting principles. It has often been emphasized that generally accepted commercial accounting practices are not controlling for purposes of computing federal income tax liability. *Brown* v. *Helvering, supra; Security Mills, supra; Lucas* v. *American Code Co.,* 280 U.S. 445; *Basley* v. *Commissioner,* 331 U.S. 737, 741; *Commissioner* v. *Hansen,* 360 U.S. 446; *American Automobile Assn.* v. *United States,* 367 U.S. 687. Even accounting methods prescribed by federal regulatory agencies to insure compliance with other federal statutes are not determinative of tax

[30] See also fn. 5 (p. 15) of taxpayer's brief.

liability under the Revenue Acts. *Old Colony R. Co.* v. *Commissioner,* 284 U.S. 552, 562; *Mine Hill & Schuylkill Haven R. Co.* v. *Smith,* 184 F. 2d 422 (C.A. 3d), certiorari denied, 340 U.S. 932; *Kansas City Southern Ry. Co.* v. *Commissioner,* 52 F. 2d 372, 378 (C.A. 8th), certiorari denied, 284 U.S. 676. What constitutes a fair and accurate statement of a taxpayer's income in a report to creditors or stockholders, or even for purposes of complying with some other statute, does not necessarily coincide with what must be reported as income under the taxing statute; each report is designed to serve discrete needs and objectives. "Many reserves set up by prudent business men are not allowable as deductions". *Brown* v. *Helvering, supra,* 291 U.S. at 202. As the Court stated in *Weiss* v. *Wiener,* 279 U.S. 333, 335: "The income tax laws do not profess to embody perfect economic theory. They ignore some things that either a theorist or a business man would take into account in determining the pecuniary condition of the taxpayer. * * *"[31]

In *Spring City Co.* v. *Commissioner,* 292 U.S. 182, the Court held that an accrual basis taxpayer who sold

[31] The amicus points (Br. 27-28) to a provision in the Treasury Regulations under the 1954 Code (Section 1.446-1(a)(2)) that "generally accepted accounting principles in a particular trade or business * * * will ordinarily be regarded as clearly reflecting income". This is hardly an unqualified approval of all commercial accounting practices. Moreover, the Regulations proceed to explain that an accounting method used by the taxpayer will be acceptable only "if it accords with generally recognized and accepted *income tax accounting principles* and is consistently used by the taxpayer from year to year". (Emphasis added.) Regulations Section 1.446-1(c)(ii), Appendix, *infra*, pp. 88-89.