

Q. And there are no artificial or allocations or estimates made in the method that is being used?

A. No.

Mr. Bauersfeld: No further questions.

[fol. 202] Recross examination.

By Mr. McCormick:

Q. Your testimony with respect to your opinion as to the accuracy of the returns in this case was based upon your conclusion that the books properly reflected the income according to accounting methods, is that not correct?

A. Not entirely, no.

Q. Would you explain that, please?

A. Well, I have yet to see anything in the income-tax statute that says that this isn't a proper accounting method and that by the application of this accounting method you can't arrive at a true income and an accurate income, an accurate income in accordance with the income-tax statutes.

Q. Are you familiar with the many cases in the Supreme Court dealing with the claim-of-right doctrine?

A. Yes, I am.

Q. Aren't those cases dealing with the income-tax statutes?

A. I think—Let me preface this remark by saying right off the bat that I'm not a lawyer but I don't think some of them are but there's a distinction here, too, when you have a memorandum accounts receivable I don't think you have an enforceable right to anything.

Mr. McCormick: I believe that's all.

The Court: All right, Mr. Miller. Thank you.

(Witness excused.)

COLLOQUY BETWEEN COURT AND COUNSEL

Mr. Bauersfeld: Petitioner rests.

The Court: Does the respondent have any testimony?

Mr. McCormick: No, sir.

The Court: I suppose the income-tax returns and so on are attached to the Stipulation?

Mr. Bauersfeld: Yes, Your Honor.

The Court: All right, gentlemen, what length of time would you like to have in which to file your simultaneous briefs in this case?

[fol. 203] Mr. Bauersfeld: Well, sir, I've tried a whole series of cases this spring. I was wondering if Your Honor would entertain 90 days?

The Court: Well, I think so. I think the Court will have plenty, he has already heard enough to keep him busy. Do you want 90 days, also, Mr. McCormick?

Mr. McCormick: Yes, sir.

The Court: All right, the Court will grant the parties until June 23, 1958, in which to file your opening briefs. I suppose you would want 30 days in which to file reply briefs?

Mr. Bauersfeld: Yes, sir.

Mr. McCormick: Yes, sir.

The Court: You may have that, until July 23, 1958, in which to file your reply briefs.

Mr. Bauersfeld: Thank you, Your Honor.

The Court: I think that concludes all that we have set for today and we'll recess now until 9:30 tomorrow morning.

(Whereupon, at 4-p. m., Monday, March 24, 1958, the hearing was closed.)

IN THE TAX COURT OF THE UNITED STATES

32 T. C. No. 124

Docket Nos. 62109, 69591, 69592, 69593

MARK E. SCHLUDE and MARZALIE SCHLUDE et al., Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

FINDINGS OF FACT AND OPINION IN DOCKET NOS. 62109, 69591,
69592 AND 69593—Filed September 28, 1959

The Studio, a partnership operating Arthur Murray Dance Studio, entered into contracts with students whereby [fol. 204] it agreed to furnish dancing lessons and the student agreed to pay therefor. The student would make a down payment and pay the balance in installments, sometimes giving a note therefor. The Studio, an accrual basis partnership, returned as gross income the pro-rata amount of the contract price based on the number of lessons taught during the year. Usually, by the end of the year, the balance of the contract price or some portion thereof had been paid by the student. The Commissioner determined that the entire contract price had to be returned as gross income in the year the contract was entered into on the ground that it had been received or accrued. *Held*, for the Commissioner. The entire contract price accrued at the time the contract was entered into since the Studio had a right to receive a fixed and determinable amount.

Carl F. Bapersfeld, Esq., and Einar Viren, Esq., for the petitioners.

William E. McCormick, Esq., for the respondent.

The following proceedings are consolidated herewith: Mark E. Schlude, Docket No. 69591; Marzalie Schlude, Docket No. 69592; and Mark E. Schlude and Marzalie Schlude, Docket No. 69593.

The respondent determined deficiencies in income tax as follows:

Docket No.	Petitioner	Year	Deficiency
62109	Mark E. Schlude and Marzalie Schlude	1950	\$15,819.14
69591	Mark E. Schlude	1952	9,264.69
69592	Marzalie Schlude	1952	8,971.55
69593	Mark E. Schlude and Marzalie Schlude	1953	83,395.82
		1954	11,544.32

Respondent on brief concedes that the proceeding for 1950 (Docket No. 62109) is barred by the statute of limitations. Therefore, findings of fact as to the partnership fiscal year 1950 will in the main be omitted. No deficiency for the fiscal year 1951 was determined.

In the remaining proceedings the deficiencies are based on a number of adjustments, only one of which (for each year) is in issue. The adjustment in issue relates to the income of a partnership known as Arthur Murray Dance Studio in which the petitioners were equal partners. This [fol. 205] adjustment was the adding to the income of the partnership the yearly increases in an account entitled "Deferred Income" on the ground that such amounts represented taxable income.

For the fiscal year 1950, the respondent, in his deficiency notice, explained this adjustment as follows:

Explanation of Partnership Adjustments

1—Income is increased by the amount of prepaid income received during the fiscal year. Income is also increased by the amount of the accounts receivable and notes receivable that are attributable to the fiscal year.

The prepaid income was unrestricted as to use. It clearly represented income to the partnership in the year it is received.

As for the accounts and notes receivable, these are income to an accrual basis taxpayer for the period in which they arise.

All the similar adjustments for the taxable years, in this respect, are the same as above except as to amounts.

FINDINGS OF FACT

Some of the facts have been stipulated; they are incorporated herein by this reference.

Petitioners Mark E. and Marzalie Schlude, husband and wife, are residents of Omaha, Nebraska, and filed their returns on the cash basis for the years involved with the now director of internal revenue for the district of Nebraska.

On June 18, 1946, the petitioners formed a partnership known as Arthur Murray Dance Studio, hereinafter sometimes referred to as the Studio, in which they were equal partners, for the purpose of conducting dance studios in territories authorized by various franchise agreements received from Arthur Murray, Inc., New York, New York.

The franchise agreements required the partnership to pay Arthur Murray, Inc., a royalty of 10 per cent of the gross receipts of such dancing school or schools. In addition, the agreements required the partnership to pay Arthur Murray, Inc., 5 per cent of its gross receipts to be held in escrow by Arthur Murray, Inc., and to protect and indemnify Arthur Murray, Inc., from any and all claims that may be made against it as a result of granting the franchise to the partnership. The payments to the escrow fund were to continue until the partnership had deposited the total sum of \$20,000 with Arthur Murray, Inc. Thereafter, no further payments were to be made to the fund unless the fund was depleted by payments therefrom, in which case payments were to be continued or resumed until the fund amounted to the sum of \$20,000. These amounts were required to be paid weekly. The franchise agreement gave Arthur Murray, Inc., control and supervisory powers over many phases of the conduct of the business of the Studio. It also required the Studio to honor the unused portion of paid courses of lessons of students enrolled in any other studio licensed by Arthur

Murray, Inc., by giving lessons to such students. Arthur Murray, Inc., also required other studios to do the same. The sum of \$1.50 per hour was to be paid by the studio holding the contract to the studio giving the lesson.

Pursuant to the franchise agreements, the partnership operated studios for the teaching of private ballroom dancing to individual students. The location of the various studios being operated by the partnership and the date of their formation is as follows:

Location	Date of Formation
Omaha, Nebraska	June 18, 1946
Lincoln, Nebraska	September 20, 1948
Sioux City, Iowa	October 1, 1949
Sioux Falls, South Dakota	June 1, 1952
Grand Island, Nebraska	October 3, 1953

When a student engaged the Studio to teach dancing lessons, the student and the Studio executed one of the six forms of written contracts entitled as follows:

(a) Enrollment Agreement and Contract With Student for Instruction.

[fol. 207] (b) Extension Agreement and Contract With Student for Instruction.

(c) Renewal Agreement and Contract With Student for Instruction.

(d) Deferred Payment Enrollment Agreement and Contract With Student for Instruction.

(e) Deferred Payment Extension Agreement and Contract With Student for Instruction.

(f) Deferred Payment Renewal Agreement and Contract With Student for Instruction.

There are basically two types of contracts entered into between the partnership and students, i. e., the cash plan contracts (contracts (a), (b), and (c)), and the deferred payment plan contracts (contracts (d), (e), and (f)). Each plan has three categories. The first sale of a dance course

represents an original sales contract (contracts (a) and (d)). After the student has contracted for an original course, he has the privilege prior to the fifth hour of instruction on the original course of enlarging that course at a lesser rate by entering into an "extension" agreement course (contracts (b) and (e)). A renewal course (contracts (c) and (f)) is one sold to a student after his completion of the original and extension courses.

Under contracts (a), (b), and (c) a portion of the contract price was paid in cash at the time of signing the agreement and the balance was to be paid in deferred installments. Under contracts (d), (e), and (f) a portion of the down payment was paid in cash at the time of contracting. The balance of the down payment was to be paid in installments and the remaining balance of the contract price was to be paid in the manner set forth in a negotiable note which accompanied the contract.

All of the contracts provided that (1) the student should pay tuition for lessons in a certain amount, (2) the student should not be relieved of his obligation to pay the tuition agreed upon in the contract, (3) no refunds would be made, and (4) the contract is noncancelable. The contracts provided for a specific number of hours of lessons ranging [fol. 208] from 5 hours to 1,000 and 1,200 hours. Some of the contracts were for lifetime courses which, in addition to 1,200 specified hours, the student is entitled to 2 hours of lessons per month plus 2 parties a year for life. Under many of the contracts the lessons extended beyond the fiscal year in which the contract was entered into. Most of the lessons which extended beyond the fiscal year in which the contract was entered into were taught in the fiscal year immediately succeeding the year in which the contract was entered into. At the time of contracting, the student and the Studio did not agree upon a schedule for performance of the lessons upon fixed dates. The dates for instruction were arranged from time to time as lessons were given.

Notes accompanying deferred payment contracts received by the Studio were negotiated with a local bank. At the time a student's note was negotiated with the bank, the

bank would deduct its interest charges and give approximately 50 per cent of the balance of the note to the partnership and set up a reserve account for the other 50 per cent of the note which the partnership could not use until after the note was paid in full by the student. After the note was paid, the balance in the reserve account was transferred to the partnership's general bank account. The notes were transferred to the bank because it was felt that the student (maker of the note) would be more likely to pay the bank than the partnership. The bank made no credit investigation of the student because it had complete recourse against the partnership.

Cash payments received by the partnership directly from students, the amounts received by the partnership at the time notes were transferred to the bank, and the amounts received by the partnership when notes transferred to the bank were fully paid were either deposited or credited to a partnership general bank account without segregation from other partnership funds.

Although the contract stated that they were noncancelable, the Studio frequently rewrote contracts, reducing the number of lessons for a smaller sum of money. Also, despite the fact that the contract provide that no refund will be made, and despite the fact that the Studio dis- [fol. 209] couraged refunds, occasionally a refund would be made on a canceled contract.

The Studio paid Arthur Murray, Inc., of New York, in weekly payments on Friday of each week, 10 per cent of the gross cash receipts of the Studio for the preceding calendar week. Commissions for selling lessons were, in general, paid at the time cash payments were received by the Studio.

When the partnership was organized in 1946, a public accountant employed by a firm of certified public accountants installed a complete double entry bookkeeping system. An accrual method and a fiscal year ending March 31 were employed. This accounting system was used continually and consistently from 1946 throughout the years in question. The public accountant (who became a certified

public accountant in 1948) installed the accounting system, kept the Studio's books and prepared its partnership income tax returns in conformity with the books.

In addition to the books, individual student record cards were maintained. On these cards are recorded the name and address of the student, the type of contract, the hours involved, the total contract price, and a history of the lessons taught and payments made under the contract.

Under its system of accounting all of the transactions affecting each contract were recorded on individual record cards at the time they occurred. On its books the various transactions were recorded as follows:

(1) When a contract was entered into: *Accounts Receivable* is charged for the total contract price and *Deferred Income* is credited for a like amount.

(2) When a cash payment, down payment or otherwise, on a contract is received: *Cash* is debited and *Accounts Receivable* is credited.

(3) The record does not show the entries which are made when the installment notes are transferred to the bank but it appears that the Studio treated the amounts withheld by the bank, viz., the Reserve Fund, as an Account Receivable.

[fol. 210] (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.)

(5) At the close of each fiscal year all of the individual student's record cards were analyzed and the total number of hours taught and remaining untaught were determined. The total number of taught hours was multiplied by the designated rate per hour of each contract. (This rate is apparently arrived at by dividing the total number of contract hours into the total contract price.) The amounts arrived at (taught hours times rate per hour)

for each contract are totaled and this total is regarded as earned income. This amount is then charged to *Deferred Income* and credited to *Earned Income*.

(6) If there had been no activity in a course under a contract for a period of over a year entries would be made canceling the course and contract. In the event a course was canceled or reduced in amount, the following entries would be made: *Deferred Income* would be charged with the amount of deferred income applicable to the canceled portion. (Untaught hours canceled times rate per hour equals amount of deferred income applicable.) *Accounts Receivable* would be credited for the amount due on the canceled hours, if any, and any other amount due which would not be paid because of the cancellation or reduction. The difference between the amount charged to *Deferred Income* and the amount credited to *Accounts Receivable* would be debited or credited to *Gain or Loss on Cancellations*. (There would be a gain if the amount charged to *Deferred Income* exceeded the amount credited to *Accounts Receivable*, and a loss if the latter exceeded the former.)

The following schedule reflects the number of untaught hours (of lessons) at the end of the following fiscal years:

[fol. 211]

	March 31, 1952	March 31, 1953	March 31, 1954
Balance—Beginning	15,091½	17,486	31,168
Additions			
Sales	28,975	52,649½	54,128
Deductions	44,066½	70,135½	85,296
Hours taught—transferred to earned income	17,436½	28,436½	39,159
Hours untaught—canceled due to inactivity	9,144	10,531	14,459½
Total deductions	26,580½	38,967½	53,618½
Balance—ending—of untaught hours	17,486	31,168	31,677½

The following schedule reflects a history of the *Deferred Income* account for the fiscal years ended March 31, 1952, 1953 and 1954:

	March 31, 1952	March 31, 1953	March 31, 1954
Contract Amount of Deferred Inc.			
Balance—beginning	\$106,541.70	\$131,143.92	\$235,942.33
Additions during Year Contract amount of sales	235,396.68	430,293.65	452,040.70
Deductions	\$341,938.38	\$561,437.57	\$687,983.03
Contract amount transferred to earned income	\$143,949.63	\$243,277.46	\$325,266.97
Contract amount unearned and canceled due to lack of ac- tivity	66,844.83	82,217.78	113,975.76
Total deductions	\$210,794.46	\$325,495.24	\$439,242.73
Balance—ending—of contract Amount of deferred income	\$131,143.92	\$235,942.33	\$248,740.30

The following schedule reflects the beginning and ending balance in the *Deferred Income* account (as shown above) and the net change therein for the following fiscal years:

	March 31, 1952	March 31, 1953	March 31, 1954
Contract Amount of Deferred In- come			
Ending Balance	\$131,143.92	\$235,942.33	\$248,740.30
Beginning Balance	106,541.70	131,143.92	235,942.33
Increase	\$ 24,602.22	\$104,798.41	\$ 12,797.97

[fol. 212] The following schedule reflects the composition of the beginning balance, ending balance, and the net change of the *Deferred Income* account for the following fiscal years:

	March 31, 1952	March 31, 1953	March 31, 1954
Students Accounts Receivable (Installment Contracts Carried by Studio, Notes Not Yet Processed Through the Bank, and Unpaid Balances on Planned Cash Courses)			
Ending Balance	\$ 63,627.23	\$ 86,698.33	\$ 85,177.10
Beginning Balance	55,241.99	63,627.23	86,698.33
Increase or Decrease	\$ 8,385.24	\$ 23,071.10	\$ (1,521.23)
Reserve Fund Held by Bank on Students Notes Financed			
Ending Balance	\$ 7,943.74	\$ 37,747.61	\$ 34,533.22
Beginning Balance	8,112.28	7,943.74	37,747.61
Increase or Decrease	\$ (168.54)	\$ 29,803.87	\$ (3,214.39)
Deferred Income Collected— (Considering Reserve Fund Held by Bank as Not Collected Until Funds Are Released and Made Available for With- drawal by Bank)			
Ending Balance	\$ 59,572.95	\$111,496.39	\$129,029.98
Beginning Balance	43,167.43	59,572.95	111,496.39
Increase	\$ 16,385.52	\$ 51,923.44	\$ 17,533.59

Unpaid balances on notes held by the bank for the fiscal years ended March 31, 1952, through March 31, 1954, were as follows:

	March 31, 1952	March 31, 1953	March 31, 1954
Ending Balance	\$ 9,618.00	\$ 40,627.96	\$ 23,440.75
Beginning Balance	1,842.10	9,618.00	40,627.96

* By composition we mean the debits corresponding to the credits in the *Deferred Income* account. For example, the balance in the *Deferred Income* account at March 31, 1952, is \$131,143.92. This amount is represented by the following ended balances at March 31, 1952:

Uncollected—	
Student Account Receivable	\$ 63,627.23
Reserve Fund—Bank	7,943.74
Collected	59,572.95
	\$131,143.92

In order to check the composition of any of the balances or net changes in the *Deferred Income* schedule the same computation must be made.

[fol. 213] The following schedule reflects the amount of sales canceled, the uncollectible accounts receivable on the canceled sales, and the gain on cancellations on the Studio's books and returns for the years involved:

	Fiscal Years Ended March 31		
	1952	1953	1954
Sales Canceled	\$ 66,844.87	\$ 82,217.78	\$ 113,975.70
Uncollectible Receivable on Cancellation	39,983.43	62,734.42	85,527.15
Gain on Cancellation	\$ 26,861.40	\$ 19,483.36	\$ 28,448.55

The following schedule reflects ordinary gross income and deductions on the Studio's books and returns for the following fiscal years:

	March 31 1952	March 31 1953	March 31 1954
Gross Income			
Contract Amts. transferred			
Earned Income	\$143,949.63	\$243,277.40	\$325,266.90
Gains from cancellation	26,861.40	19,483.36	28,448.55
Other Income	4,041.21	11,426.23	16,987.31
Total	\$174,852.24	\$274,187.00	\$370,702.76
Deductions	137,267.91	223,390.64	301,609.76
Ordinary Net Income	\$ 37,584.33	\$ 50,796.36	\$ 69,093.00

The respondent, in his notices of deficiency, increased the ordinary net income of the partnership for the fiscal years ended March 31, 1952, 1953, and 1954, by the amount of the increases in the *Deferred Income* account in those years, viz., \$24,602.22 for 1952, \$104,798.41 for 1953, and \$12,797.97 for 1954. (See schedule of income in *Deferred Income* account, supra.)

A supplemental stipulation of facts was filed April 5, 1958, which reads as follows:

It is hereby stipulated that the tuition paid to other studios during the taxable years ending March 31, 1950 to March 31, 1954, inclusive, is as follows:

* The respondent also disallowed certain expenses of the Studio, which are not in issue, and added to each partner's distributive share of partnership income his respective share of the additional income.

[fol. 214]

Taxable year ended March 31, 1950	\$ 592.00
Taxable year ended March 31, 1951	751.10
Taxable year ended March 31, 1952	825.00
Taxable year ended March 31, 1953	1,328.43
Taxable year ended March 31, 1954	1,955.32

OPINION

Black, Judge: The petitioners are equal partners in the Studio, a partnership which owns and operates five Arthur Murray Dance Studios under franchise agreements with Arthur Murray, Inc. In dispute is the amount of the Studio's gross income. Specifically, the dispute relates to the manner in which the receipts from contracts for dancing lessons are to be reported.

The problem may best be explained by the following illustration: On August 1, 1952, the Studio enters into a contract with a student whereby the Studio agrees to teach the student 24 1-hour dancing lessons and the student agrees to pay \$240 in four \$100 down and \$20 per month for the next 7 months. (In some cases the student gives a negotiable note for the installment payments.) Lessons are arranged from time to time and at the end of 1952 the Studio has given the student 10 lessons and the student has paid \$180, the \$100 down and four \$20 installments. By March, 1953, the Studio gives the student 10 additional lessons and the student pays \$40, two more installments. The student loses interest in the course and does not take the remaining four lessons and the Studio is unable to collect the remaining \$20.

In 1952 the Studio, which reports on an accrual basis, returns as gross income \$100, representing 10 lessons taught at \$10 per lesson. During 1953 the Studio returns as gross income \$100 representing 10 lessons taught at \$10 per lesson. After the contract has been inactive for a year the Studio cancels it, computing a gain or loss thereon. Here the gain would be \$20. (Four lessons untaught at \$10 per lesson equals \$40, less contract price unpaid of \$20 equals \$20 gain.) This \$20 gain on cancellation would be returned as gross income in 1954.

[fol. 215] The Commissioner determined that the entire \$240, the contract price, should be returned in 1952 when the contract was entered into and the amount of the contract was paid or agreed to be paid. We agree.

The Studio, being on an accrual basis, must return items of gross income in the year in which they accrued. Section 42. "Items must be accrued as income when the events occur to fix the amount due and determine liability to pay." *Spring City Foundry Co. v. Commissioner*, 292 U. S. 182 (1934). When the contracts were entered into the amounts due thereunder were fixed and the students were "liable to pay." It is true that a payment of a portion of the contract price was deferred but that does not affect the fixed and unconditional right of the Studio to receive the amount. Nor does the fact that the Studio was required to perform future services under the contract alter the Studio's right to receive since the deferred payments were in many cases due prior to the rendering of the services. And the record shows that in most instances substantial payments were received prior to the performance of the services for which the payments were made.

The exception to the rule stated above is where there is a real uncertainty as to whether the taxpayer will ever receive the amount in question; cf. *San Francisco Stevedoring Co.*, 8 T. C. 222. Here the Studio actually received substantial cash or negotiable notes under each contract. The contracts themselves provided that they were non-cancellable and that no refunds should be made. Despite this provision in the contract some contracts were canceled. The facts show that the cancellations were considerable in amount. These amounts, according to the Studio's records, were about 17 per cent, 15 per cent, and 19 per cent of sales for the respective years. Assuming that the rate of cancellation was about 17 per cent of sales that fact still would not provide a sufficient basis for a finding that there was a real uncertainty that the amounts due under any one or all of the contracts would be uncollectible (and therefore not accruable) at the time the contract(s) were entered into. The normal manner of providing for this type of contingency is through the use of a bad debt reserve. We

have no issue in the instant case as to any addition to a [fol. 216] bad debt reserve nor do we have any issue concerning debts of the partnership which became worthless in the taxable year.

It seems to us that the instant case is controlled by our decision in *Curtis R. Andrews*, 23 T. C. 1026, on the first point decided in that case. That first point decided in the *Andrews* case was essentially the same as the main issue we have in the instant case. While it is true that the facts in the *Andrews* case are not precisely the same as the facts in the instant case, nevertheless we do not think that such differences in facts as do exist would justify a holding in the instant case different from what we held in the *Andrews* case. For example, in the *Andrews* case, according to the Findings of Fact, the Arthur Murray Studios in that case did not have any accounts receivable but they did take notes receivable from their dancing students. In the instant case, apparently the Studio had accounts receivable as well as notes receivable. This difference, it seems to us, is not sufficient to make a valid distinction between the *Andrews* case and the instant case. To an accrual taxpayer, accounts receivable must be taken into income just the same as notes receivable. We know of no authority to the contrary. Petitioners, in their brief, argue that their accounts receivable for dancing lessons contracts were not true accounts receivable but were what they term "memorandum account's receivable." Their argument on this point is, in part, stated in their brief as follows:

The record shows that at the time the contract is executed and the entries made to the deferred income account, the so-called students accounts receivable at that time are not true, earned receivables. True accounts receivable are entered after a product has been delivered or services have been rendered.

In other cases before our Court we have not made the distinction in accounts receivable which petitioners seek to draw. See *Your Health Club, Inc.*, 4 T. C. 385, which we will discuss more at length later.