Laurie L. Malman

Introduction

Deferring inclusion in gross income of advance receipts—a perennial hope of accrual basis taxpayers—has been rekindled by the recent decision of *RCA Corp. v. United States.* The issue dealt with in *RCA* by the United States District Court for the Southern District of New York has, in one form or another, been directly addressed by the Supreme Court on three separate occasions. Yet it is still largely unresolved.

The issue arises when an accrual basis taxpayer enters into an agreement obligating the taxpayer to perform over a number of taxable years. The performance typically will be to provide goods, services or capital. Under the terms of the agreement, the taxpayer either receives or is entitled to receive its fees in advance of the year of its performance. The question, in its most basic form, is whether the taxpayer must report as income all of the fees it receives in that first year, or whether the taxpayer may defer recognition of this income until it actually performs its contractual obligations and finally earns the income.

In resolving this issue, the courts and commentators have long struggled with the inconsistencies between the appropriate treatment of advance payments under financial accounting principles, which permit deferral of such receipts, and the apparent need for a different treatment for taxing accounting, which, unlike financial accounting, reflects the need to raise revenue.

Despite the Code's acceptance of financial accounting principles, and its requirement that a taxpayer who uses the accrual method of accounting for financial purposes compute taxable income on the accrual

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*Laurie L. Malman* is an Assistant Professor of Law, New York University School of Law. The author wishes to thank Robert J. Peroni, Assistant Professor of Law at Tulane University, and Joshua D. Rosenberg, Instructor in Taxation at New York University, for their assistance in the preparation of this article, and John L. Peschel, Professor of Law at New York University, for his criticism of a preliminary draft.

1 499 F. Supp. 507 (S.D.N.Y. 1980), rev'd, 81-2 U.S.T.C. ¶ 9783 (2d Cir. 1981). See the addendum at the end of this article.

method, the courts have, for the most part, diverged from accrual principles in the area of prepaid income. More often than not, the courts have agreed with the Commissioner that prepaid income should be taxed on receipt, regardless of the fact that such funds will be earned, and, pursuant to principles of financial accounting, should be reported in a subsequent taxable period.

This article will examine this divergence between the theory and the application of accounting principles, especially since the Supreme Court's decisions in the now famous trilogy: *Automobile Club of Michigan v. Commissioner*, American Automobile Association v. United States, and *Schlude v. Commissioner*. The article will indicate how the decisions of the trilogy have required taxpayers to adopt methods of accounting which may in fact distort income. Nevertheless, this article will suggest that the trilogy can be analyzed so that it does mesh the divergent principles of tax and financial accounting. Moreover, the article will show that out of such an analysis, post-trilogy case law has developed the basis of an appropriate framework for understanding the treatment of the advance receipts problem and for analyzing future developments.

**Accounting Methods**

To understand the development of the tax rules for prepaid income, it is critical to compare the underlying purposes of financial accounting with those of tax accounting. As the Supreme Court has stated:

The primary goal of financial accounting is to provide useful information to management, shareholders, creditors and others properly interested; the major responsibility of the accountant is to protect these parties from being misled. . . . [F]inancial accounting has as its foundation the principle of conservatism, with its corollary that "possible errors in measurement [should] be in the direction of understatement rather than overstatement of net income and net assets."  

The financial accountant strives to report a conservative estimate of a taxpayer's net worth and income. Financial accountants reflect assets at the lower of their purchase price or actual value, as opposed to merely their historical cost. More important to this discussion, the financial

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3 Section 446(a) provides: "Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books."


accountant reports gross receipts or expenditures at their real net cost—by matching and recording in the same period income together with all of the expenses related to its production. Hence, financial accounting requires present recognition of revenue which has been earned but not yet received, and present recognition of expenses which have been incurred but not yet paid. Financial accounting also requires deferral of certain future revenues received but not earned, as well as deferral of expenditures paid but not yet incurred.  

This matching tends to reduce present income by deferring present receipts which will be earned only with future expenses. Also, present income is reduced by deductions of future expenses related to present transactions. It is this matching which distinguishes the accrual method from the cash receipts and disbursements method of tax accounting, since there is no particular correlation between the actual flow of cash and the determination of net income.

Unlike financial accounting, tax accounting is concerned not with conservatively reflecting the net worth of a taxpayer at a given time, but

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8 Accrual principles have been summarized as follows:

1. Revenues are recognized as entering into the determination of income when sales are made or services are rendered.

2. The mere receipt of money or the promise of another person to pay money for goods or services does not represent revenue which should be recognized in the period of receipt if it is burdened with an obligation to deliver goods or render services in the future. Items of this nature are treated as resulting in liabilities or deferred credits until they are earned through the fulfillment of the required performances.

3. Costs and expenses directly identifiable with revenues are chargeable against the income of the period in which the revenues are recognized. Expenses, such as insurance, rent, property taxes and interest, which are for particular periods of time are chargeable over those periods. Other expenses incurred in the general conduct of the business are chargeable against the income of the period in which they are incurred unless it is clearly evident that they are for the benefit of future periods and there is a reasonable basis, both as to amount and time, for allocating them to future periods, in which event they should be deferred and charged to those periods.

4. If the precise amount of any costs or expenses is not determinable at the time they are chargeable against income, they should be recognized on the basis of reasonable estimates.

5. Accounting recognition of costs and expenses which cannot be determined with a reasonable degree of accuracy at the time they would otherwise be charged against income of a particular period should be deferred until that determination is possible.


with protecting the public fisc, that is, establishing an amount of income which can be credited to the taxpayer and which generates a corresponding tax. "In view of the Treasury's markedly different goals and responsibilities, understatement of income is not destined to be its guiding light."\(^{10}\) The argument follows that because revenue must be raised annually,\(^{11}\) tax accounting is not intended to present a picture of net worth. Its purpose is, instead, to present a picture of income and deductions generated within each particular taxable year. Tax accounting does not simply follow transactions and allow reporting of income at the conclusion of each transaction; it requires reporting in each taxable year, regardless of the stage of completion of a particular transaction.\(^{12}\) Thus, where income has been received from a transaction that is not completed at the end of the taxable year, tax accounting may require current reporting of taxable income, even though there has been no real increase in the taxpayer's actual net worth, due to offsetting future obligations.

It is within this basic framework that the tax law on prepaid income has developed.

The Tax Statute

Originally, taxing statutes provided only for the cash receipts and disbursements method of determining income. This method provides that income is reported in the year received and expenses are reported in the year actually paid. In 1909, the Treasury found it necessary to adopt regulations which recognized accrual concepts.\(^{13}\)

But it was not until 1916 that the income tax statute recognized an accrual method of accounting. The Revenue Act of 1916 authorized a corporation to "make its return upon the basis on which its accounts are kept," subject both to the condition that it "clearly reflect income" and to the Commissioner's regulations.\(^{14}\) In 1926, the Supreme Court saw the adoption of the accrual method as enabling "taxpayers to keep their


\(^{11}\) Section 441 provides that "taxable income shall be computed on the basis of the taxpayer's taxable year."


\(^{13}\) In 1909, the Treasury found it necessary to adopt "a regulation which provided that the term 'actually paid' as used in the law did not necessarily contemplate that there should have been an actual disbursement of cash or even of its equivalent, but that under the law an item would be deemed to be paid as soon as the taxpayer recognized that it had to be paid by recording it as a liability," May, Financial Accounting 68 (1946).

books and make their returns according to scientific accounting principles, by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period." 16 Hence, the basis of determining taxable income appeared to be the standard of "scientific accounting principles." 16

The current Code and regulations similarly recognize financial accounting principles. Section 446(a) provides that "taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books," 17 and the Code and regulations specifically envision the accrual method. 18 Even though the tax law has apparently accepted financial accounting principles, in the area of prepaid income the courts have for the most part supported the government's contention that such amounts should be taxed on receipt.

**Early Case Law**

Judicial analysis of the treatment of prepaid income is based on two theories. Early case law relied on the claim of right doctrine. Modern cases have focused on the Code's requirement that a taxpayer's method of accounting must "clearly reflect income." 19

**Claim of Right Doctrine**

The claim of right doctrine was established by the Supreme Court in *North American Oil Consolidated v. Burnet*. 20 In that case, the taxpayer operated oil and gas producing lands that produced a net profit in 1916.

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16 United States v. Anderson, 269 U.S. 422, 440 (1926). The regulations promulgated in 1919 provided that "each taxpayer shall adopt such forms and systems of accounting as are in his judgement best suited to his purpose." Reg. 45, § 212, Art. 24 (1919).


18 Section 1.446-1(a)(2) of the regulations provides:

A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expenses are treated consistently from year to year.

19 Section 451(a) provides:

*[The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.]*

See also Reg. § 1.451-(1)(a).

19 I.R.C. § 446(b).

20 286 U.S. 417 (1932).
Because of litigation concerning ownership of the land, profits earned in 1916 were impounded and held by a receiver until the following year. In 1917, the monies were released to the taxpayer, although a possibility still existed that the taxpayer would have to refund the monies if it lost the still pending litigation. The litigation finally terminated in the taxpayer's favor in 1922. At issue was whether the income was to be reported in 1916, when it was earned, in 1922, when the litigation was finally settled, or in 1917, when it was released to the taxpayer.

Holding that the income should have been reported in 1917, the Court described the claim of right doctrine:

If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return [report as gross income], even though it may still be claimed [by others] that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.\(^1\)

The Court stressed that the money at issue was income in 1917 because it had been both earned and actually received by the end of that year.\(^2\) The Court expressed no opinion regarding the reporting of unearned receipts, for the facts in *North American Oil* did not occasion that inquiry.

Another early Supreme Court decision in this area was *Brown v. Helvering*.\(^3\) There the taxpayer, an insurance agent, received commissions on insurance policies he had sold during the year. Since he might have been required to refund portions of these commissions if the policies were cancelled prior to their intended expiration, the taxpayer established a reserve for these possible future expenses and deducted the amount of the reserve from gross income. The Commissioner argued that since the taxpayer had earned and received the commissions when he sold the policies, the deduction of a reserve for possible cancellations (the effective equivalent of excluding a portion of the commissions from income) before they actually occurred was inappropriate. The Supreme Court agreed with the Commissioner. It required inclusion of the commissions in the year they were received and earned. If an obligation to repay the money arose in a later year, the taxpayer would be entitled to a deduction in that later year when the actual obligation became due and was paid.

In both *North American Oil* and *Brown*, the taxpayers argued that although they had received funds and had completed whatever work was

\(^1\) *Id.* at 424.
\(^3\) 291 U.S. 193 (1934).
necessary, at least a portion of their receipts had not yet risen to the status of "income," because, due to events beyond their control (an adverse result on appeal in North American Oil or cancellation of the policies in Brown), the amounts might have to be returned. But as noted, the Court disagreed, holding in both cases that the total amount of funds earned and received was to be included in gross income. While the Brown decision may have foreshadowed subsequent analysis of the treatment of prepaid income, neither Brown nor North American Oil dealt with prepaid income. Each held only that funds which were both received and earned could not be characterized as something other than income simply because of the mere possibility that a portion would have to be returned.

Despite the fact that the claim of right doctrine arose only with respect to earned receipts, for many years the Commissioner successfully relied on the doctrine to persuade the courts that accrual method taxpayers must immediately include in gross income unearned receipts. The resulting discrepancy between the tax and financial accounting treatment of advance receipts caused taxpayers and their auditors a great deal of confusion. Taxpayers were effectively required to keep two sets of records, one for financial purposes, the other for tax purposes.

In response to this confusion, in 1954 Congress enacted section 452.

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24 Brown v. Helvering is most accurately described as a reserve case, in that it disallowed a present deduction for a reserve—the amount which represented the taxpayer's estimate of its future liabilities. However, it should also be viewed as foreshadowing the issues raised in modern litigation concerning deferral of prepaid receipts; namely, that courts have been reluctant to allow deferral unless the taxpayer can demonstrate that its future obligations of performance are fixed and certain. See the text accompanying N. 176 infra.


26 Section 452 was added to bring tax and financial accounting principles into closer harmony. The report of the Senate Committee on Finance stated:

Present law provides that the net income of a taxpayer shall be computed in accordance with the method of accounting regularly employed by the taxpayer, if such method clearly reflects the income, and the regulations state that approved standard methods of accounting will ordinarily be regarded as clearly reflecting taxable income. Nevertheless, as a result of court decisions and rulings, there have developed many divergencies between the computation of income for tax purposes and income for business purposes as computed under generally accepted accounting principles. The areas of difference are confined almost entirely to questions of when certain types of revenue and expenses should be taken into account in arriving at net income.

The changes embodied in the House bill and in your committee's bill are designated to bring the income-tax provisions of the law into harmony with
which permitted accrual basis taxpayers to defer prepaid income until the year the income was earned, subject to a maximum deferral of five years. Congress repealed the section one year later.\textsuperscript{27} The only reason articulated for the repeal was the Department of Treasury's estimate of large revenue losses, and no other reason should necessarily be inferred.\textsuperscript{28}

**Clear Reflection of Income**

In the same year, 1955, the Tenth Circuit presented the Commissioner with a major setback in the area of prepaid income in *Beacon Publishing Co. v. Commissioner*.\textsuperscript{29} The taxpayer, a newspaper publisher, received prepaid subscriptions for periods of 30 days to five years and reported the amounts received ratably over the applicable subscription periods.

The Tax Court had rejected the argument that an accrual method taxpayer must report income only when earned, and sustained the Commissioner’s position that the claim of right doctrine requires inclusion upon receipt.\textsuperscript{30} On appeal, however, the Tenth Circuit reasoned that the claim of right doctrine has nothing to do with a taxpayer's accounting method; rather, that the doctrine determines only whether an amount which has been clearly earned, but whose ownership is disputed, is income to the recipient, and not when such income must be reported.\textsuperscript{31} The court found that the case presented no issue of ownership, since there was no question that the prepaid subscriptions belonged to the taxpayer without restriction. The only issue presented in *Beacon* was when that income was to be reported, and this, according to the court, was to be determined by the taxpayer's accounting method. The Tenth Circuit then went on to reject the Commissioner's proposal for taxation on receipt on the basis that such a proposal required the taxpayer to report its prepaid items on the cash method (on receipt) and to accrue deduc-

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\textsuperscript{28} See H.R. REP. No. 293, 84th Cong., 1st Sess. 2–3 (1955); S. REP. No. 372, 84th Cong., 1st Sess. 3 (1955).  
\textsuperscript{29} 218 F.2d 697 (10th Cir. 1955).  
\textsuperscript{30} 21 T.C. 610, 615 (1954).  
\textsuperscript{31} 218 F.2d at 700. It is perhaps this very fragmenting of the issue between when and whether income has been earned which has caused much of the confusion in this area. See the text accompanying Ns. 182–83 infra.
tions, putting the taxpayer on a hybrid method which did not clearly reflect income. Moreover, the court pinpointed the basic problem with the Commissioner’s analysis by finding that the Commissioner’s method distorted the taxpayer’s income, since it failed to match income with related expenses.

Shortly after Beacon, the Fifth Circuit, in Schuessler v. Commissioner,32 permitted the analogue of deferring prepaid receipts by allowing the present deduction of a reserve for future expenses.33 In Schuessler, the taxpayer sold furnaces for $20 to $25 more than his competition: in return for his higher price, the taxpayer agreed to turn the furnaces on and off for each of the next five years. The taxpayer set up a reserve for the estimated future costs of this service. In computing his income for the year of sale, the taxpayer reported the total profit and then deducted the amount of the reserve. By treating the reserve as a presently deductible item, the taxpayer effectively deferred inclusion in income of an amount equal to those future expenses. The court stated that not only was the taxpayer’s method of computing taxable income reasonable, but that present inclusions of amounts which were attributable to, and which would be offset by, future deductions would, in fact, distort income.

On the heels of Beacon, Schuessler and similar taxpayer victories34 came the first of the trilogy—Automobile Club of Michigan v. Commissioner.35 There, the taxpayer received membership dues which were paid in advance for one year. In return, the club agreed to provide certain repair services as needed by the paid-up members. When received, the dues were placed in a deferred account and taken into income ratably for each of the 12 months following receipt. While the Commissioner relied, once again, on the claim of right doctrine, the Supreme Court effectively bypassed this argument and grounded its decision on Section 41 of the 1939 Code. Section 41 provided that if the taxpayer’s method of accounting “does not clearly reflect . . . income, the computation shall be made in accordance with such method as in the opinion of

32 230 F.2d 722 (5th Cir. 1956).
33 Id. at 725. In arriving at its decision, the court noted that by permitting the present deduction of future expenses attributable to present and unearned income, it was applying a basic premise of accrual accounting embodied in the regulations, namely, that “when all facts have occurred which determine that the taxpayer had incurred a liability in the tax year, and neither the fact nor the amount, although not definitely ascertained, of the liability is contested, and the amount is susceptible of estimate with reasonable accuracy in the tax year, deduction thereof from income may be taken by a taxpayer on an accrual basis.” Id. at 724 (citation omitted).
34 E.g., Pacific Grape Prods. Co. v. Comm’r, 219 862 (9th Cir. 1955); Harrold v. Comm’r, 192 F.2d 1002 (4th Cir. 1951).
of the Commissioner does clearly reflect income." 36 The Court found that the taxpayer's pro rata method of inclusion of membership dues in monthly amounts was "purely artificial," 37 and thus the Commissioner had not abused his discretion under section 41 in rejecting the taxpayer's system.

While the Court engaged in little analysis of the issues involved, it did note (albeit in a footnote) that both Beacon and Schuessler were distinguishable from the case before it, because in reach of those cases the taxpayer had received payments for particular services which it was bound to perform at specified times in the future. On the other hand, the automobile club had no fixed obligation to perform any particular services for its members. 38 Since the club had no fixed liability to meet at specific times in the future, the Court reasoned that the club's pro rata deferral of prepaid dues (which at least in theory should have represented an attempt to match its dues income with the future expenses of performance) represented no more than an arbitrary estimate of what its performance and related expenses might be. While the estimate was not far from what in fact resulted, the Court concluded it was still only an arbitrary ("purely artificial") estimate of future expenses, and not a reflection of fixed future liabilities. Although the Supreme Court in Automobile Club of Michigan specifically declined to express an opinion as to the correctness of Beacon and Schuessler, its distinguishing of these cases hinted that the real basis for its decision in Automobile Club of Michigan was that the taxpayer's performance was conditioned on customer demand.

Two years later, the Second Circuit gave the Commissioner a temporary setback in Bressner Radio, Inc. v. Commissioner, 39 by upholding the taxpayer's method of deferring advance receipts as clearly reflecting income. In that case, the taxpayer sold television sets which were accompanied by service contracts pursuant to which Bressner was required to provide repair services over a 12-month period. The taxpayer sold the service contracts to a bank for cash, and, allocating 15 percent of the contract price as payment for installation of the sets and the remainder to the service contract, reported this remaining 85 percent ratably over the 12-month contract period. The court rejected the Commissioner's

36 I.R.C. § 41 (1939). While the Supreme Court noted that the Commissioner's argument was based on the claim of right doctrine, its holding did not make it clear whether the Court refused to apply the claim of right doctrine as inapplicable, or simply decided it was unnecessary to reach a discussion of that doctrine.
37 353 U.S. at 189.
38 353 U.S. at 189 n.20.
39 267 F.2d 520 (2d Cir. 1959).
application of the claim of right doctrine, and instead focused on whether the taxpayer's method of accounting clearly reflected income. In deciding that question affirmatively, the court noted that the taxpayer's experience demonstrated that expenses incident to its performance under thousands of contracts were ratably incurred over the contract period. Thus the taxpayer's method deferred revenues until they were earned and complied with the purpose of accrual accounting by matching receipts with related expenditures.

The decisions in *Automobile Club of Michigan* and *Bressner Radio* raised the following question: What evidence must a taxpayer produce in order to meet the burden of proving that its method of deferral clearly reflects income? More particularly, in light of *RCA*, the cases raise the issue of what kind of statistical evidence, if any, is acceptable.

The Supreme Court attempted to respond to these issues in the second case of the trilogy, *American Automobile Association v. United States*, which the Court agreed to hear because it determined that the decision of the Court of Claims in *AAA* conflicted with *Bressner Radio*. The only issue before the Supreme Court was whether the AAA's method of accounting clearly reflected income. While the taxpayer in *AAA* used the same basic method for deferring advance receipts as had the Automobile Club of Michigan, this time the AAA came forward with sta-

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40 Id. at 523. The court specifically noted that the claim of right doctrine did not concern the propriety of deferring unearned receipts. Id. at 525.

41 Id. at 528. The Second Circuit, in holding for the taxpayer, distinguished *Automobile Club of Michigan* on the following three grounds, only one of which, however, is evident from the Supreme Court's opinion in that case:

1. Although the Automobile Club reported all of its income on a pro rata deferred basis, a significant percentage of the dues it received was for services other than car repairs and was, in effect, earned on receipt, and not with the performance of later services.

2. The Automobile Club actually could have elected not to perform many of the future services which it had contended justified deferral without affecting its right to keep the prepaid dues.

3. The Automobile Club had deferred income on the basis of its purely arbitrary pro rata allocation, while Bressner deferred its prepaid income based on an allocation formula derived from a careful analysis of its past performance requirements and a prediction of future obligations.

Only the last of these three distinctions is apparent from the facts appearing in the Supreme Court's opinion in *Automobile Club of Michigan*. Id. at 528, 529.

42 367 U.S. 687 (1961) (herein cited as *AAA*).

43 The club in *AAA* originally included yearly dues ratably (that is, if paid in April, seventeen twenty-fourths would be included in the year of payment; if paid in December, one twenty-fourth would be included in the year of payment and the rest the following year), but it changed its method of deferral in 1954 and thereafter included one half of all dues paid in the year of receipt and one half of the dues in the following year, regardless of the month in which the dues were paid.
istical evidence indicating that, on a group basis, the taxpayer's method of ratably including prepaid membership dues over the 12-month membership period matched actual costs and revenues for the club as a whole. However, the Court once again distinguished Beacon Publishing and Schuessler 44 and rejected the AAA's proof, holding that the AAA's method was no less artificial than that of the Automobile Club of Michigan. The Court focused on the fact that the taxpayer's pooled data did not indicate whether any of the prepayments for services would ever in fact be earned through performance. In so doing, the Court reasoned that statistics reflecting average monthly costs per member on a group basis were not sufficient to establish that fixed liabilities had accrued for purposes of tax accounting:

The Code exacts its revenue from the individual member's dues which, no one disputes, constitute income. When their receipt as earned income is recognized ratably over two calendar years, without regard to correspondingly fixed individual expense or performance justification, but consistently with overall experience, their accounting doubtless presents a rather accurate image of the total financial structure, but fails to respect the criteria of annual tax accounting and may be rejected by the Commissioner. 45

The opinion in AAA seems to imply that the concept of the annual accounting period requires that no deferral is appropriate absent a specific obligation which fixes the date of the taxpayer's performance requirement or the date of related costs.

The Court also contended that the taxpayer's pro rata inclusion of income did not result in matching that income to related expenses, because while income was consistently recognized each month, expenses to be matched against that income were not consistently incurred, since the AAA's performance was uneven. The implication that uneven performance means that expenses are unevenly incurred is misleading. In fact, major expenses such as rent or salaries may be incurred ratably over the taxpayer's income earning period regardless of when performance is actually required; thus the Automobile Club's ratable inclusion of prepaid income may have reasonably matched income against its major expenses. The Court may have been shortsighted in failing to distinguish between two broad categories of expenses—fixed and variable. A taxpayer will incur fixed expenses like rent or salaries as long as it anticipates that it will be required to perform its contractual obligations dur-
ing the relevant period. Fixed expenditures are not necessarily incurred on the dates of actual performance, but are incurred because the taxpayer expects that it will perform and is holding itself in readiness to do so. Variable expenditures, however, can be incurred only on or about the date of anticipated actual performance.

Apparently the Supreme Court disallowed deferral in *AAA* and *Automobile Club of Michigan* as a means of preserving the integrity of the annual accounting system. Given the fact that the taxpayer's method in each of those cases resulted in a deferral of only one year, it is unlikely that deferral resulted in any real distortion. In fact, subsequently the Commissioner accepted certain short-term deferrals. Nevertheless, the Supreme Court’s decisions in *Automobile Club of Michigan* and *AAA* proved for many years to be the death knell for taxpayers’ attempts at reasonable methods of deferral.

Another basis given by the Court for its holding in *AAA* was the legislative history of the repeal of section 452 and the passage of section 455, which, it stated, indicated Congress’ recognition of the problems concerning the treatment of prepaid income and refusal to create more than limited deferral in the area of prepaid subscriptions. The Court stated that section 452 would have specifically declared AAA’s accounting system (that is, pro rata inclusion of income) to be acceptable, but that the repeal of that section reinstated the “long-standing position of the Commissioner and the courts” that such accounting methods were not acceptable. Even though the Court in *AAA* recognized that section 452 was repealed only because of the Treasury’s estimates that the section would have had a disastrous impact on revenues, the Court concluded that repeal of section 452 was a clear mandate from Congress that the Automobile Club’s method of accounting was not acceptable for tax purposes. Such a conclusion is subject to question.

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47 367 U.S. at 694–97. In response to the specific issue raised in *Beacon Publishing*, Congress enacted section 455, which allows deferral of certain prepaid subscription income. In response to the problem posed by *AAA* and *Automobile Club of Michigan*, Congress subsequently added section 456, which provides for the deferral of prepaid dues to certain membership organizations.
48 367 U.S. at 695.
49 *Automobile Club of New York Inc. v. Comm*r*, 304 F.2d 781 (2d Cir. 1962), was pending in the Second Circuit when *AAA* was decided. As in *AAA*, the taxpayer, who admittedly could not estimate in advance the requirements of its members for emergency road service or any of the expenses which might be incurred in rendering service, attempted to defer prepaid annual dues. While the court held that *AAA* controlled the case before it, it also took pains to distinguish *Bressner Radio* from the automobile club cases, stating that, unlike those cases, in *Bressner Radio*, “the taxpayer’s statistics showed a definite monthly business
In *Schlude v. Commissioner*, the last of the Supreme Court trilogy, and the one that for some time appeared to seal the deferral coffin, the Court once again attempted to deal with the issue of which method of accounting more clearly reflected income. In *Schlude*, the taxpayer ran a dance studio. Dancing lessons were offered under two basic plans: the cash plan contract (which required a cash down payment with the balance due in installments) and the deferred payment plan (which required only a portion of the down payment to be paid in cash, the balance of the down payment being due in installments, and the remainder of the contract price represented by a negotiable promissory note which provided for specified payments). Under both plans, the contracts were noncancellable and provided for no refunds. Each contract provided for a specific number of lesson hours and a designated period during which the lessons had to be given, but there was no schedule of specific dates for lessons.

The studio was an accrual basis taxpayer. For each student, it reported as gross income an amount equal to the number of hours actually taught during the fiscal year multiplied by a designated hourly contract rate determined by dividing the total contract price by the total number of hours of lessons to be provided under the contract. Similarly, the studio reported deductions on the accrual basis, except that royalty payments and sales commissions on the dance instructors' contracts were deducted when paid, irrespective of when the related receipts were taken into income.

Since the Commissioner did not press a claim of right argument, the issue before the Supreme Court was whether the studio could be required under section 41 of the 1939 Code and section 446(b) of the 1954 Code to include as income advance payments of cash, negotiable notes and due but unpaid contract installments. The Court held that the taxpayer was required to include all three. The Court stated that the case expense and financial expectancy [so that its] method of accounting on an accrual basis and its deferral of income closely matched the corresponding expenses and clearly reflected income.” *Id.* at 784. The Second Circuit, in an opinion presaging the major opinions after *AAA* which have allowed deferral, seemed simply to disregard the Supreme Court's rejection in *AAA* of deferral based on overall or group predictions.

Section 41 of the 1939 Code provided:

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such
was squarely controlled by *AAA*, which had held that the enactment and subsequent repeal of section 452 justified the Commissioner's rejection of deferral of prepaid income as not clearly reflecting income. The Court in *Schlude* thus perpetuated the questionable conclusion in *AAA*, which had gone beyond the Treasury's statement that loss of revenue alone required repeal of Section 452.

The Court then stated that an "additional ground" controlling the case was that Schlude's accounting method was "artificial" in that it sought to defer receipts on the basis of contracts which did not provide for performance on fixed dates in the future. Thus, while the taxpayer theoretically deferred inclusion of prepayments received until such payments were earned, the implication of the decision is that Schlude could predict neither when it would be required to render performance to earn the payments or whether it would ever be required to perform services to earn the income. In *Schlude* the Court seemed to be focusing on the performance justification for deferral. The Court also pointed out that although Schlude deferred inclusion of receipts, he presently deducted commissions paid on the dance contracts. The Court stated: "In view of all these circumstances, we hold the studio's accrual system vulnerable under § 41 and § 446(b) with respect to its deferral of prepaid income."  

It has been argued, however, that the *Schlude* decision itself has caused the real distortion in this area of tax accounting. If the Supreme Court's decision in *Schlude* and the rest of the trilogy is read as requiring that income be taxed on receipt, regardless of when earned, the Supreme Court has prescribed a method of accounting that at least in an economic sense distorts income. And while the tax laws may appropriately require a performance justification for deferral, if the Supreme Court has decreed that deferral is appropriate only where the dates of future

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53 372 U.S. at 134.
54 372 U.S. at 135, 136.
55 372 U.S. at 136.
56 Ibid.
performance are set forth in a contract, the Court may have imposed a burden on taxpayers which is not only too harsh in an economic sense, but one which is unnecessarily harsh in view of the goals of tax accounting.  

Moreover, while the Supreme Court found that Schlude's method of deferral did not clearly reflect income, it did not make clear whether the Commissioner can reject any method of deferring prepaid income because deferral per se precludes clear reflection of income. Because of this ambiguity, even the final case of the trilogy left open many of the same questions which existed before the first of these cases was decided.  

See the text accompanying Ns. 176-83 infra. Consider also this example:

An accrual method, calendar year taxpayer enters into a contract on December 1 to perform services ratably over a 12-month period. The taxpayer receives in advance, on December 1, the full contract price of $120. The taxpayer estimates that it will incur $60 of expenses in performing under the contract, or a net profit of $60. Theoretically, there are three alternatives for computing income: (1) Taxpayer reports the full $120 of income in year one and accrues only $5 dollars of expenses, resulting in $115 of income in year one and $55 of deductions in year two; (2) taxpayer reports the full $120 in year one and deducts the full $60 in year one, resulting in $60 of net income in year one, and no income or deductions in year two; or (3) taxpayer accrues only $10 of income and $5 of deductions in year one, leaving $110 of income and $55 of deductions to be reported in year two, resulting in $5 of net income in year one and $55 of net income in year two. The method which most clearly distorts the reporting of income as earned is the first. Yet that is the method of which seems to have been mandated in the trilogy.  

Schlude raised additional questions. The first of these dealt with the inclusion of due but unearned income. In addition to amounts actually prepaid, the Court required Schlude to include in income the amounts of those contract installments which were due but had not yet been received or earned on the basis that "it is the right to receive and not the actual receipt," that determines the accrual basis taxpayer's inclusion in gross income. 372 U.S. at 137 (emphasis in original; citation omitted). While it had been assumed prior to Schlude that the right to receive payments arises when the related services are performed, regardless of whether payments are due before or after that performance, Schlude did not make clear whether this general rule was being changed in all circumstances, so that time of performance was no longer relevant, or whether it was changed only in situations where the time and the certainty of actual performance were not known.

In addition, the Court held that the Commissioner was justified in requiring the inclusion of prepayments in the form of negotiable notes as well as cash. While upholding the lower court's determination that the face amount of the notes was includable, the Court stated that "negotiable notes are regarded as cash receipts to the extent of their fair market value for purposes of recognition of income." 372 U.S. at 136 n.10.

Since, under traditional tax concepts, negotiability is relevant only to the cash method taxpayer and, similarly, only cash method taxpayers include notes at their fair market value, whereas accrual method taxpayers include notes, whether negotiable or not, at face value, it became unclear whether one who receives payment for services prior to performance is deemed to be on the cash receipts method of accounting for all purposes or for purposes of valuation only, or whether the Court simply erred in describing the amount included in gross income by an accrual basis taxpayer. On remand, the Tax Court held that the taxpayer had to
Nevertheless, for a number of years following the Supreme Court's decision in Schlude, the lower courts, without analysis, were unanimous in upholding the Commissioner's exercise of discretion under section 446(b) and in requiring the inclusion of advance payments for future services, sales or loans in the year of receipt.

Post-Trilogy Litigation

Prepaid Services Income

In the year following the Schlude decision, the Second Circuit dealt with advance membership fees in Parkchester Beach Club Corp. v. Commissioner. After noting that "there was obviously no way to ascertain or estimate with reasonable accuracy . . . how much the taxpayer would be required to expend in the next fiscal year to furnish the services and facilities previously paid for" (implying that deferral might be proper if the expenses were established with reasonable certainty), the court held, in light of AAA and Schlude, that deferral was properly rejected as not clearly reflecting income.

In Popular Library, Inc., the Tax Court began what has become a hard line upholding the Commissioner's exercise of a discretion under section 446(b), stating that the trilogy established the principle "that, in the absence of statutory provisions to the contrary, accrual-basis taxpayers which have received unrestricted cash for services or benefits before performance must report such payments as income for the year of receipt."

include the face amounts of the notes "[s]ince it uses the accrual method," stating that the language of the Supreme Court's footnote to the contrary was merely "illustrative dicta." Mark E. Schlude, 22 T.C.M. 1617, 1620 (1963). See also Gunderson Bros. Engineering Corp., 42 T.C. 419 (1964), where the Tax Court concluded that Schlude stands for the proposition that the fair market value of negotiable notes constituted payment, but that nonnegotiable notes would not constitute payment for they would not be cash equivalents, once again implying that the accrual method taxpayer is deemed to be on the cash method with respect to advance receipts.

59 335 F.2d 478 (2d Cir. 1964).
60 Id. at 480.
62 Id. at 1099. Accord, Wide Acres Rest Home, Inc., 26 T.C.M. 391 (1967); Paul B. Heubner, 25 T.C.M. 406 (1966); Decision Inc., 47 T.C. 58 (1966), acq.; E. Morris Cox, 43 T.C. 44 (1965). In Heubner, a lawyer's unrestricted fees were held to be includable on receipt, despite the following facts: (1) The services for which the fees were paid were not to be performed until a later period; (2) some portion of the fees were potentially refundable; and (3) the fees were in any event subject to court approval. In Cox, the taxpayer unsuccessfully sought to distinguish its facts from those in Schlude by contending that: (1) the services
The first exception to the Commissioner's post-trilogy sweep of successes, and a reexamination of the clear reflection of income test, came in the Seventh Circuit's decision in *Artnell Co. v. Commissioner.*\(^6\) The Artnell Company acquired all the stock of Chicago White Sox, Inc., which operated the White Sox baseball team, and subsequently liquidated the corporation. Before the acquisition, the White Sox had received advance revenues from the sale of season tickets and single admissions for future games, from radio and television broadcasting rights to future games and from season parking passes.

As of the date of its liquidation, the White Sox had deferred as unearned income that portion of the amounts received for season tickets, advance single admissions, radio and television broadcasts and season parking books which was allocable to games to be played after the date of liquidation. As these future games were played, Artnell took into income the amount of deferred receipts allocable to each game. The Commissioner asserted that the established rule disallowed deferral absent specific statutory authority, and, not surprisingly, the Tax Court agreed.\(^6\) In the court of appeals, the Commissioner reasserted this position, and the taxpayer countered that section 446 sanctions the method of accounting regularly used by the taxpayer unless that method "does not clearly reflect income."\(^6\) The taxpayer claimed that the White Sox' method did in fact clearly reflect income.

The Seventh Circuit agreed that the Commissioner would not abuse his discretion by requiring the inclusion of advance receipts if the extent and time of future services were uncertain. However, the court questioned whether the Supreme Court had decided in the trilogy to give the Commissioner unlimited discretion to reject deferral of prepaid income where no statutory provision exists (as the Tax Court's decision stated), or whether it had left an opening for a decision that under the facts of a particular case, the time and extent of future performance might be so certain, and the matching of income and expenses so demonstrable, that deferral would clearly reflect income. The court concluded that such an opening was left, and remanded the case to the Tax Court in order to

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\(^{63}\) 400 F.2d 981 (7th Cir. 1968).

\(^{64}\) 48 T.C. 411 (1967).

\(^{65}\) 400 F.2d at 983. The Commissioner asserted that inclusion of the advance receipts was required by the annual accounting principle of tax accounting.
determine whether the accounting method used by the taxpayer did, in fact, clearly reflect income.\(^6\)

Because in *Artnell* the Commissioner relied on an assumption that deferral of prepaid receipts was per se invalid, the specific deferral mechanism employed by *Artnell* was not directly attacked by the Commissioner in the court of appeals. In spite of the Supreme Court's implication in *AAA* that there could be no deferral without "correspondingly fixed individual expense or performance justification,"\(^67\) the Seventh Circuit seemed untroubled by the fact that it was probably impossible for *Artnell* to do more than pool all of its expected expenses and simply allocate a percentage to each payment received based upon their relation to the total payments received. It seems clear that *Artnell* could not meet the evidentiary burden imposed by *AAA*, if that case is read as allowing deferral only where individual receipts are matched against the individual expenses specifically incurred to earn those receipts. Since *Artnell* was bound by its contract with the American Baseball League to play scheduled games at specific times and places, it probably incurred little additional expense (other than perhaps some additional personnel) by selling tickets, parking books and broadcasting rights to these games. Finally, just as in *Schlude*, while many season ticket holders might well not come to many of the games and thus not ever demand performance, contrary to the *Schlude* Court,\(^68\) the *Artnell* court seemed untroubled by the taxpayer's failure to report estimated cancellations (in this case, estimated no-shows) in the year of receipt.

In part, the decision in *Artnell* was based on the court's view that *Beacon Publishing* remained a viable precedent. The court relied on the Supreme Court's footnote in *Automobile Club of Michigan*, which distinguished *Beacon Publishing* on the ground that *Beacon* had involved fixed dates of performance, as establishing the continued vitality of *Beacon*. Without analysis of the other possible conflicts between its decision and the reasoning in *Schlude* and *AAA*, the court in *Artnell* focused on performance and effectively decided that where the extent and time of future performance are fixed, deferral of prepaid receipts until that time may be appropriate, regardless of a taxpayer's apparent inability to treat expenses individually rather than as a pool.

While *Artnell* focused on the factual distinction between the trilogy, where there were no fixed dates of performance, and the White Sox'
fixed schedule, the significance of this distinction is questionable. *Artnell* held that where the exact dates of performance are known, deferral of income until those dates may more clearly reflect income than does inclusion at the date of payment. What should have been more persuasive than foreknowledge of the exact dates of performance was that performance would be rendered sometime after the close of the current taxable year. League rules and history indicated that a certain number of games would be played, with thousands of spectators at each game, thus insuring the necessity of performance; unlike the trilogy, this performance was not subject to customer demand.69

Despite the Seventh Circuit's reasoning in *Artnell*, the Tax Court continued to reject the theory that prepaid service income is not taxable until earned,70 and to insist that absent a specific statutory exception, prepaid service income is includable in gross income in the year of receipt.71

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69 In *AAA*, the Court disallowed deferral where income was "recognized ratably over two calendar years without regard to correspondingly fixed individual expense or performance justification." 367 U.S. at 692. *AAA* relied on Automobile Club of Michigan v. Comm'r, 353 U.S. 180 (1957), which disallowed deferral where "substantially all services [were] performed only upon a member's demand and the taxpayer's performance was not related to fixed dates after the tax year." 367 U.S. at 691. However, the focus of both cases seems not to have been on whether specific fixed dates had been set, but on whether there was reasonable certainty that each individual expense would be incurred (and thus each payment would be earned) at some time after the tax year during which deferral was sought. Indeed, it may be argued that even if Schlude had scheduled dance lessons for each student on specific days of each month for the next 20 years, he would be no more certain of performance, since students might cancel or drop out, and he still would have been unable to defer his prepaid income for the lessons.

At least one commentator casts doubt on the utility of the *Artnell* reasoning, arguing that the courts in *Artnell*, as well as in *AAA* and Schlude, have based their holdings on a misconstrued concept of income deferral. Poole, *The Taxation of Prepaid Sales of Goods*, 24 Tax L. Rev. 375, 400 (1969). The author states that income is to be deferred because it is not yet earned, not because it will be earned at some specified time in the future. In each of these cases there was certainty that as yet the income had not been earned in the accounting sense. Knowledge of when it would be earned in the future (because of some fixed schedule of performance) would not make the fact that the payments were unearned any more true. In an accounting sense, this is absolutely true and demonstrates the condition in which the area of prepaid income was left after the trilogy. It may be argued, however, that if, as the Court feared in the trilogy, income might be received without ever being earned, because no services would ever be demanded, for tax purposes it would be inappropriate to defer gross income simply because it is not yet earned. See the text accompanying Ns. 175–183 infra.


Boise Cascade

While taxpayers made limited inroads into the Commissioner's almost limitless discretion, they did not gain another major source of support for deferral until the Court of Claims' decision in *Boise Cascade Corp. v. United States*. Once again the question posed was whether the taxpayer's method, which deferred advance receipts, clearly reflected income. The taxpayer, Ebasco, entered into contracts to do engineering work, pursuant to which it received substantial advance payments. Although Ebasco did not defer its deductions resulting from costs incurred in obtaining the contracts, it did defer inclusion of advance receipts until the time it actually performed the required services. It also included in income amounts earned but not yet received. As distinguished from the facts in *Artnell*, the contracts in *Boise* for the most part did not establish fixed dates for performance, but stated simply that Ebasco was to perform "expeditiously." In spite of this, Ebasco deferred inclusion of signifi-

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72 In *Petroleum Heat & Power Co. v. United States*, 405 F.2d 1300 (Ct. Cl. 1969), the taxpayer, in connection with its principal business of selling oil, entered into contracts with its purchasers to service their burners. The taxpayer usually billed customers in advance for the full service contract price. On its books, advance receipts for services were taken into income in the month in which they were earned by performance (and the expenses were incurred in servicing the oil burners). Since all contracts were completed within the year in which payment was received, all income prepaid in a given year was earned in the same year and no deferral resulted. However, when all of the taxpayer's stock was sold to members of a consolidated group, the taxpayer was required to file a return for a period of six months ending with the stock sale. On this six-month return, the taxpayer took into income only enough of the contract payments received to offset expenses for the period of January 1 through June 30. The deferral was permitted because the deferral arose only as a result of the requirements of a short period return mandated by the regulations, and because the period of consolidation was transitional and resulted in a one time deferral of income, as opposed to the continuous use of deferral by taxpayers like Schlude. The taxpayers had based their arguments on broader grounds, citing *Schuessler, Artnell* and *Beacon Publishing*. The court's narrow reasoning, namely that any distortion which might have resulted from deferral was limited, foreshadowed the Service's administrative allowance of deferral in Revenue Procedure 71-21, 1971-2 C.B. 549, and section 1.451-5 of the regulations. In *Automated Marketing Systems, Inc. v. United States*, 74-2 U.S.T.C. ¶ 9711, *aff'd*, No. 74-1678 (7th Cir., Jan. 9, 1975), the court permitted deferral of prepaid receipts for future marketing services. As the court failed to either discuss or even cite any authority for or against its holding, the decision is of little precedential value.


74 *Id.* at 1370. An average of over 94 percent of the deferred amounts were received by Ebasco under contracts which either required services to be performed by a specific date or required that the services be performed "with all reasonable dispatch and diligence," as "expeditiously as possible," or some comparable requirement. All of the deferred amounts were earned through the performance of services in the next succeeding year and were then reported as income.
cant amounts which had been received, because they had not been earned by performance.

In Boise, as in Artnell, the court was presented with a taxpayer's method of deferral which the court wanted to sustain, since the taxpayer's method more clearly reflected income than did the Commissioner's proposed method. To do this, the court had to circumvent the language of the trilogy. Thus, in analyzing the prepaid receipts problem, the Court of Claims focused on the performance justification for deferral and suggested that what the Supreme Court had referred to as an "additional ground" for its decisions in AAA and Schlude, namely, that services were rendered on demand rather than on fixed dates, was the only basis for its holding in those cases. In this respect, Boise appropriately found that the Supreme Court, in spite of its language, was not as concerned with fixed dates of performance as it was with the certainty of performance. The court reasoned that although not all of Ebasco's contracts provided for fixed performance dates, the evidence established that Ebasco was in fact required to perform; and therefore its contractual obligations were fixed and definite rather than subject to customer demand. Thus, the court concluded that Ebasco's deferral of prepaid receipts clearly reflected income within the meaning given that phrase by the Supreme Court.

As to the Supreme Court's statement in Schlude to the effect that the repeal of section 452 reinstated the "long-standing administrative and lower court rulings that accounting systems deferring prepaid income could be rejected by the Commissioner" (a conclusion subject to dispute), the Boise court concluded that this language meant only that the Commissioner should be given broad discretion to disallow deferral and that it did not mean that deferral of prepaid receipts was invalid per se. Additionally, the Boise court concluded that although it did not so appear from the opinion in Schlude, the Supreme Court's discussion of legislative history was itself only dicta.

The court further supported its holding that the taxpayer's method clearly reflected income by rejecting the Commissioner's proposed method as a "hybrid" system combining elements of the cash and accrual methods. The combination arose because the Commissioner would have had the taxpayer include advance payments for unperformed services as well as accrue amounts attributable to performed services, even though the taxpayer was not yet entitled to bill or receive payments for

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75 353 U.S. at 187; 372 U.S. at 135.
76 372 U.S. at 134 (citation omitted).
77 530 F.2d at 1376.
78 Ibid. The Boise court supported its conclusion with the reasoning of Mooney Aircraft v. United States, 420 F.2d 400, 408–09 (5th Cir. 1969).
79 530 F.2d at 1378.
the latter. Rejection of the Commissioner's approach on this basis seems
to fly in the face of the Supreme Court's tacit approval of such hybrid
systems in *Automobile Club of Michigan, AAA* and *Schlude*.
Unlike the Supreme Court in *Schlude* and *AAA*, which seemed to place no
burden on the Commissioner with respect to his exercise of discretion
under section 446(b), the Court of Claims in *Boise* indicated that to
prevail, the Commissioner must prove that his proposed method of ac-
counting would more clearly reflect income than would the method em-
ployed by the taxpayer.

Even though the Seventh Circuit in *Artnell* and the Court of Claims
in *Boise* set forth bases for the deferral of advance receipts, the Tax
Court has remained steadfast in its denial of deferral, except where the
case involves fixed dates of performance and is appealable to the Seventh
Circuit.

**RCA**

In the most recent of the service cases, *RCA Corp. v. United States*,
the United States District Court for the Southern District of New York
interpreted the trilogy quite liberally. For the first time since the trilogy,
a court permitted deferral of advance receipts despite the fact that the
taxpayer did not establish when, nor even whether, it would be required
to perform services under any particular contract.

*RCA*, more than any post-trilogy case, demonstrates the underlying
weakness in the reasoning of the trilogy. In addition, the court's analysis
of the trilogy is an instructive lesson in the extent to which courts may
go to read what they believe is a reasonable rationale into opinions
which fight against such reason.

The case involved service contracts entered into between RCA and
certain purchasers of its television sets. RCA received payment at the

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80 In each of those cases, in effect, the taxpayer was required to be on the cash
method with respect to advance receipts and on the accrual method in other
respects. However, it is arguable that all that was at issue in those cases was the
proper treatment of advance receipts under the accrual method. Of course, if that
was true of those prior cases, the same rationale should apply to Ebasco's treat-
ment of advance receipts.
81 Speaking of the Commissioner, the court stated: "Judging both by what he
has rejected and what he would impose he has abused his discretion." 530 F.2d
at 1378 (emphasis added).
82 See, e.g., *T.F.H. Publications Inc.*, 72 T.C. 623 (1979); *Allied Fidelity
Corp.*, 66 T.C. 1068 (1976), *aff'd*, 572 F.2d 1190 (7th Cir.), *cert. denied*, 439
83 See *Collegiate Cap & Gown Co.*, 37 T.C.M. 960 (1978).
1981). See the addendum at the end of this article.
time of sale, and in return agreed to service the sets over a specified period of from three to 24 months, as and when service was needed by customers. In computing its taxable income for the years at issue, RCA included in income only that portion of the advance receipts that covered the costs of selling and processing the service contract, plus a profit. The remainder was deferred and taken into account over the life of the contracts. Although RCA failed to establish with reasonable certainty when or if any individual service contract would require the performance of future services, it did demonstrate that it deferred income on the service contracts according to its statistical estimates made on a group or pool basis. Thus, the critical issue was whether deferral based on group or pool statistics was proper.

In what may be regarded as an example of utter judicial reasonableness, the court held that the Commissioner could not reject RCA’s method of accounting “simply because the deferred revenues relate to services to be performed at unspecified times in tax years subsequent to that of receipt.” Moreover, the court stated that to demonstrate that its method did clearly reflect income, RCA had only to prove that “its accounting method, as a whole, matched revenues and expenses well,” the controlling factor being not whether RCA’s projections and accompanying deferral “matched revenues and expenses from month to month, but whether they did so from year to year.”

But to arrive at its conclusion, the RCA court had to convince itself that in the trilogy the Supreme Court meant to hold that deferral of prepaid service income is appropriate (1) if there is evidence that, on a group or pool basis, a taxpayer can predict with reasonable certainty the extent and cost of future performance that will be required, and (2) if the taxpayer then defers only the income attributable to those future services. Any such reading of the trilogy is stretched, at best.

RCA based its interpretation of the trilogy on a very narrow reading of *AAA*. The court supported its narrow reading with two conclusions, both of which are subject to some dispute. First, it found that the *AAA*

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85 RCA estimated, with respect to the group of television sets and service contracts sold in a given month, the percentage of the total number of calls expected to be made during each month over the life of the group of service contracts. RCA then accrued as income in a given year that percentage of the amount received on the contracts which was equal to the estimated percentage of monthly volume. Hence, if the company estimated that 30 percent of all service calls for the group would be made in year number one of a two-year contract, RCA would accrue 30 percent of the contract receipts in year number one and 70 percent in year number two.

86 499 F. Supp. at 516 (emphasis in original).

87 499 F. Supp. at 522 (emphasis in original).

88 Ibid.
decision had not overruled the Second Circuit's decision in Bressner Radio Inc. v. Commissioner, which, it will be recalled, specifically allowed deferral on the basis of the taxpayer's statistical evidence. Second, it concluded that in Schlude the Supreme Court itself had narrowed the scope of AAA. The court came to this conclusion despite its observation that the Supreme Court granted certiorari in Schlude expressly to consider the scope of AAA and then squarely rejected Schlude's method of deferral under AAA.

The RCA court looked first to the AAA decision for precedent authorizing deferral on the basis of overall averages. The following excerpt from AAA would seem to make the search futile:

It may be true that to the accountant the actual incidence of cost in serving an individual member in exchange for his individual dues is inconsequential, or, from the viewpoint of commercial accounting, unessential to determination and disclosure of the overall financial condition of the Association. That "irregularity," [in performance of services on an individual basis], however, is highly relevant to the clarity of an accounting system which defers receipt, as earned income, of dues to a taxable period in which no, some, or all the services paid for by those dues may or may not be rendered. The Code exacts its revenue from the individual member's dues which, no one disputes, constitute income. When their receipt as earned income is recognized ratably over two calendar years, without regard to correspondingly fixed individual expense or performance justification, but consistently with overall experience, their accounting doubtless presents a rather accurate image of the total financial structure, but fails to respect the criteria of an annual tax accounting and may be rejected by the Commissioner.

The court, however, quoted a different and ambiguous passage that allowed room for the conclusion that the Supreme Court's rejection of pool or group projections should be narrowly construed.

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89 267 F.2d 520 (2d Cir. 1959).
90 It has also been suggested that the Supreme Court's decisions in the trilogy effectively overruled Bressner Radio. See Seago, What Chance for Prepaid Income Deferrals based on statistical estimates after RCA Decision?, 54 J. Tax. 16 (Jan. 1981).
91 499 F. Supp. at 514.
92 367 U.S. at 692 (emphasis added).
93 The court in RCA quoted the following passage from AAA:

[O]ther findings merely reflecting statistical computations of average monthly cost per member on a group or pool basis are without determinate significance to our discussion that the federal revenue cannot, without legislative consent and over objection of the Commissioner, be made to depend upon average experience in rendering performance and turning a profit. Indeed, such tabulations themselves demonstrate the inadequacy from an income tax standpoint of the pro rata method of allocating each year's membership dues in equal monthly
The RCA court also had to contend with the language of the trilogy where the Supreme Court twice specifically stated that the taxpayer’s accounting method was artificial, because in each case “substantially all services [were] performed only upon a member’s demand and the taxpayer’s performance was not related to fixed dates after the tax year.” However, the RCA court stated that in the trilogy the taxpayers’ accounting methods were artificial, not for the reasons which the Supreme Court had stated, but because the taxpayers in the trilogy did not adequately account with their statistics for the fact that services might never be performed. The RCA court explained that, as opposed to AAA, the statistics employed in RCA were reliable and were proven to be accurate on an annual basis. The RCA court seemed to disregard the fact that the statistics used in AAA seemed equally accurate on an annual basis, and were noted as being accurate reflections of the group average by the Supreme Court.

RCA’s conclusions were also based on a misreading of the following, somewhat unclear statement in AAA, which the court referred to as presaging Schlude:

Although the findings below seem to indicate that it would produce substantially the same result as that of the system [of ratable monthly recognition] employed, we consider similarly unsatisfactory, from an income tax standpoint, allocation of monthly dues to gross monthly income to the extent of actual service expenditures for the same month computed on a group or pool basis.47

installments not in fact related to the expenses incurred. Not only did individually incurred expenses actually vary from month to month, but even the average expenses varied—recognition of income nonetheless remaining ratably constant.

499 F. Supp. at 513 (citation omitted).


46 The RCA court stated that the problem with Schlude’s method of deferral with respect to services which had no fixed dates of performance “was not that the time of performance was not specified, but rather that the extent of performance was not specified and consequently there was no assurance that including receipts in gross income to the extent of actual expenses incurred each year was the equivalent to including receipts in gross income in proportion to that year’s share of total expenses to be incurred over the life of the contract.” 499 F. Supp. at 515 (emphasis in original).

RCA apparently interpreted Schlude as resting on the theory that deferral was inappropriate because Schlude failed to statistically project anticipated cancellations and to include income from estimated cancellations (that is, contracts on which no performance would be required to earn the payments already received) upon receipt. The RCA court stated that Schlude “makes clear” that “the use of such projections is essential.” 499 F. Supp. at 516.

40 367 U.S. at 692.

The RCA court interpreted this statement to mean that prepaid income could not be deferred until the related actual expenditures were incurred, because some income would be due to cancellations and thus would be earned without incurring any expenditures (which, of course, presupposes that income can or should be matched to individually incurred expenses\(^98\)). There is no indication that this reasoning had anything to do with the AAA Court's statement, however, especially since that Court had conceded that the AAA's method of accounting did indeed present an "accurate image of the total financial structure."\(^99\) Nevertheless, based on its tortuous interpretation, RCA concluded that had the AAA been able to support its method of accounting by adequate statistical projections, albeit on a group basis, AAA's system would have been upheld.

The problem to which the Supreme Court was referring in its decision in AAA and which the RCA court failed (perhaps intentionally) to note, is quite different from that articulated by RCA. It is a problem inherent in the use of group statistics.\(^100\) By requiring "individual expense or performance justification,"\(^101\) AAA appears to require that unless a taxpayer can demonstrate that an individual contract will require a reasonably ascertainable amount of service in each year, it cannot

\(^98\) See the text accompanying Ns. 45-46 supra.

\(^99\) 367 U.S. at 692.

\(^100\) Assume that X Corp. is engaged in widget maintenance and repair and enters into ten five-year service contracts on January 1, 1982. X receives $10 for each contract (a total of $100). X can demonstrate with reasonable certainty, based on its past experience, that pursuant to these ten contracts, it will be required to perform a total of $20 worth of service a year for five years. Thus, X argues that in the year of receipt it should be required to include only $20 of income, deferring the remaining $80.

On a group or pool basis, this appears reasonable. However, when looked at on an individual basis, as the Supreme Court has apparently required, the problem becomes clear. Assume that widget A is a lemon and requires $20 worth of repair in 1982 and another $20 worth of repair in 1983. Further, assume that (1) widgets B and C each require $10 worth of service in 1984, (2) widget D requires $20 worth of service in 1985 and 1986 and (3) the remaining widgets require no service. Looking at the amount earned on each individual widget, as AAA seems to require, as to widgets E through J, no work was ever required to be performed, so that all of the advance receipts attributable to these widgets should be included on receipt. As to widget A, half of the $10 received by X Corp. was earned in 1982 and half was earned in 1983. As to B and C, all $10 attributable to these was earned in 1984, when the services on these were required. As to D, $5 (half of the total income on this widget contract) was earned in 1985 and $5 more was earned in 1986.

While X Corp.'s prediction that the ten contracts would require the performance of $20 worth of service per year for five years was accurate, such a prediction was quite different from an estimate of the amount of expense X Corp. would incur with respect to each individual widget or of when it would incur expenses on each such widget.

\(^101\) 367 U.S. at 692.
defer prepayments received under that contract. Thus, RCA's holding that an average or pool approach to deferral is permissible if the taxpayer can establish with reasonable certainty that services will be required to be performed in the future seems to bend AAA to an almost unrecognizable shape.

Even though the holding of RCA may not be consistent with the trilogy, one must consider the basic problem to which it is addressed, namely, the appropriate basis for determining whether the deferral of prepaid income clearly reflects the taxpayer's income. In this regard RCA probably presents a reasonable approach. The court's failure to find firm judicial precedent may be interpreted as the weakness of the trilogy rather than the weakness of RCA.

Moreover, despite its misreading of AAA's position on the use of group statistics, the RCA court was clearly correct in some of its interpretations, and as such is helpful in structuring an appropriate framework for the treatment of prepaid income. Both the AAA and Schlude decisions based their denial of deferral, at least in part, on the assertion that services in those cases were to be performed on customer demand, not on fixed dates of performance. RCA read this to mean that it was not the time of performance which was critical to the Supreme Court but the certainty of performance, so that as long as the taxpayer could demonstrate that it would be required to perform, and thus earn the advance receipts, deferral of those receipts would be appropriate. RCA's reading of the trilogy is supported by at least one other prepayment case, Boise Cascade, which also concluded that there is ample justification under the trilogy for deferral where future performance is certain, despite the fact that the date of that performance is not contractually fixed.

Prepaid Sales Income

Except for Artnell Co. v. Commissioner, the courts have consistently held in favor of the government's position that all prepayments for goods should be treated in the same manner as prepayments for services—income in the year of receipt. While some decisions rest on the claim of right doctrine, each court which has considered the question seemed to believe that, absent a specific statutory exception, no deferral of prepaid receipts was permissible. Courts have neither discussed nor

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102 400 F.2d 981 (7th Cir. 1968). As previously indicated, Artnell can also be viewed as dealing with prepaid service income.
103 Hagen Advertising Displays, Inc. v. Comm'r, 407 F.2d 1105 (6th Cir. 1969); Fifth & York Co. v. United States, 234 F. Supp. 421 (W.D. Ky. 1964); S. Garber, Inc., 51 T.C. 733 (1969); Modernaire Interiors, Inc., 27 T.C.M. 1334 (1968); Chester Farrara, 44 T.C. 189 (1965). For a more extensive discussion
thought it relevant that performance was assured, either because goods would in fact have to be provided at a later date in return for the prepayments, or because the taxpayer's performance was not conditioned on customer demand.

In *Hagen Advertising Displays, Inc. v. Commissioner,* the Tax Court and the Sixth Circuit for the first time squarely dealt with the question of whether prepaid income from the sale of goods should be treated differently from prepaid service income. In that case, the taxpayer manufactured and sold signs. In accordance with the regulations, it computed income by subtracting from its gross receipts the cost of goods sold, and it determined the cost of goods sold by subtracting its year-end inventory from the sum of its beginning inventory plus its inventory costs for the year. In some cases, the taxpayer received payments for signs prior to their delivery. The Commissioner required that all such payments be reported in the year of receipt. The taxpayer argued, in both the Tax Court and the court of appeals, that the differences between tax accounting for goods and tax accounting for services were so significant that the trilogy could not sensibly be extended to cover advance receipts for goods.

Generally, if a taxpayer accrues payment for services, all of the payment received is includable in gross income and any expenses accrued by the provider of services are independently deductible. However, if a taxpayer accrues receipts for goods sold, only the excess of the receipts accrued over the cost of goods sold is ever includable in gross income; receipts not in excess of the cost of goods sold simply represent a return of capital. Since Hagen included in its year-end inventory (and thus did not take as a cost of goods sold) all the signs and work done on the signs attributable to the orders for which advance payments had been received, inclusion in gross income of the advance payments would require the taxpayer to include a substantial amount of what was merely a return of capital. The Tax Court was untroubled by this argument, however, and held the prepaid receipts to be gross income, restating its position that whenever “there is actual receipt and the funds are at the unrestricted disposal of the taxpayer, all events have already occurred that call for accrual.”

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104 Chester Farrara, 44 T.C. 189 (1965).
106 407 F.2d 1105 (6th Cir. 1969).
On appeal, the Sixth Circuit rejected this apparent application of the claim of right doctrine to unearned prepayments, but nevertheless required such amounts to be included in gross income when received. The court perpetuated the faulty reasoning of the Supreme Court by reading AAA’s analysis of the history of section 452 as holding that prepaid income is always includable when received, absent specific statutory authority to the contrary. Rather than distinguishing Artnell as a case which allowed deferral to specific dates of performance, as had other courts, the Hagen court specifically rejected Artnell, to the extent that it was inconsistent with its own decision. Although Hagen rejected deferral of prepaid sales receipts, it did acknowledge that an advance payment for goods to be provided in the future consisted not only of income but also of a return of capital, and that where the taxpayer could meet its burden of proving how much of the payment was merely a return of capital, that amount would not have to be included in income.

In a more recent Tax Court decision, the taxpayers tried to distinguish Hagen by arguing that the advance payments which they received (for fur coats to be made and delivered in the future) were refundable and therefore not income in any event. The court was unimpressed by this distinction, and found the prepayments to be income when received, again reverting to the claim of right doctrine.

Prepaid Interest

Another fertile ground for litigation has been the treatment of prepaid interest. In four similar cases involving life insurance companies, the Seventh, Fourth, Fifth and First Circuits held that unearned abatable interest which was due and paid in advance on policy loans was includable in the income of accrual basis taxpayers in the year received.

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109 E.g., Chester Farrara, 44 T.C. 189 (1965).
110 407 F.2d at 1110.
111 S. Garber, Inc., 51 T.C. 733, 735–36 (1969). In addition, the Tax Court in Garber explicitly denied a deduction for costs attributable to the goods to be supplied, based on its conclusion that the taxpayer still owned those goods, even though it was bound to deliver them to its customers. Id. at 737.
or charged to the principal balance of the policy loan. In each case, the insurance company took the advance interest into income only as it was earned.\textsuperscript{116}

In the first of these cases, \textit{Franklin Life Insurance Co. v. United States},\textsuperscript{117} the district court had held for the taxpayer on the basis that the Commissioner's position, which required inclusion of the prepaid interest when received or charged to the policy holder's account, would put the taxpayer on a hybrid method of accounting. Such a method is precluded by the special provisions of subchapter L, which require life insurance companies to adopt the accrual method of accounting for tax purposes.\textsuperscript{118}

The Seventh Circuit, however, reversed and held that the advance interest was includable on receipt, basing its decision on a tortuous view of the claim of right doctrine. Although the court recognized that the claim of right doctrine requires the inclusion of earnings received without restriction, it presented a somewhat novel concept of earnings. The court reasoned that the prepaid interest received pursuant to the binding obligation of the policy holder, a portion of which might have to be returned, was sufficiently earned to justify application of the claim of right doctrine. The court apparently confused the concept of earned with that of received, and disregarded the fact that abatable interest is earned only over time, as the loan principal remains outstanding.\textsuperscript{119}

\textsuperscript{116}The facts of the four cases were essentially the same. Under policies issued by the insurance companies, a policy holder was entitled to obtain a loan up to the cash surrender value of the policy. Annual interest on the loan was payable in advance. If the policy holder did not pay the interest in advance in cash, the insurance company would charge the annual interest in advance from the date of the loan until the next anniversary date of the policy by adding the interest to the loan balance on its books. If the policy loan were repaid during the policy year, the exact amount of interest ratably earned would be retained and the remainder returned to the borrower or to his account. Similarly, if the policy holder surrendered his policy for the cash value during the year, then only the amount of prepaid interest ratably earned was retained by the taxpayer, and the remainder was returned to the policy holder.


\textsuperscript{118}Section 818(a) provides:

All computations entering into the determination of the taxes imposed by this part shall be made—

(1) under an accrual method of accounting, or

(2) to the extent permitted under regulations prescribed by the secretary, under a combination of an accrual method of accounting with any other method permitted by this chapter (other than the cash receipts and disbursements method).

\textsuperscript{119}The Service itself has long taken the position that nonabatable interest (which is not actually paid in advance) is earned over time. \textit{See}, \textit{e.g.}, Rev. Rul.
The Fourth and Fifth Circuits followed the Seventh Circuit's decision in *Franklin*, but the Tax Court, in *Bankers Union Life Insurance Co.*\(^{120}\), held in similar circumstances that interest amounts which the insurance company added to the principal of the loan balance were neither earned nor received, but merely resulted in the taxpayer reallocating funds it already had. Therefore, these amounts were not required to be included until actually earned. Although the reallocation of funds resulted in their being transferred from accounts required to be held for the policies to unrestricted accounts, the court apparently chose to label the transfer a reallocation in order to avoid a head-on confrontation with the previous circuit court decisions.\(^{121}\) The Tax Court stated, gratuitously, that the case was distinguishable from *Schlude*, since Banker's Union "was not entitled to retain whatever might even be considered as prepayments without an obligation to refund."\(^{122}\) The decision's ambiguity on whether an obligation to refund validates deferral makes it of little value in formulating an analytical framework.

In the last of these insurance company cases, *Union Mutual Life Insurance Co. v. United States*, the First Circuit also acknowledged that "the real difference between *Schlude* and the present case is that the dance company could retain all of the income it received from customers whether it performed the requisite services or not, while the prepayment of a loan required plaintiff to refund interest to its customers."\(^{123}\) Nevertheless, the court decided that such a difference was irrelevant and, reverting to the claim of right doctrine, decided that mere prepayment, even though possibly refundable, was sufficient to require present inclusion.\(^{124}\)

**Morgan Guaranty**

The insurance company cases were distinguished and deferral was permitted by the Court of Claims in *Morgan Guaranty Trust Co. v.*

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\(^{120}\) 62 T.C. 661 (1974).

\(^{121}\) The court's reliance on the distinction between interest which is actually paid by the borrower in advance and a discounted loan, where the borrower merely promises to pay the interest in the future, seems to be consistent with *Schlude*, where the government decided not to argue in the Supreme Court that installments which were neither presently due nor paid by cash or negotiable note were includable by *Schlude*. 372 U.S. at 133. See also Gunderson Bros. Engineering Corp., 42 T.C. 419 (1964); Luhring Motor Co., 42 T.C. 732 (1964).

\(^{122}\) 62 T.C. at 681.

\(^{123}\) 570 F.2d at 385-86.

\(^{124}\) 570 F.2d at 386 n.2.
In a case which may be of limited utility, the court permitted the bank to defer the inclusion of prepaid interest where (1) the deferred amounts, in proportion to Morgan's total interest receipts, were *de minimis*, (2) Morgan's accounting method was mandated by the Federal Reserve Board and (3) the prepayments were all voluntarily made. The bank was required by the Federal Reserve Board to be on the accrual method of accounting for interest; accordingly, except where collection seemed unlikely, the bank credited interest to income as earned, regardless of the time of receipt. Although prepayment of interest was not required, occasionally borrowers voluntarily paid interest in advance of the specified due date, and that interest was similarly included by Morgan in income ratably as earned. Where all of the prepaid interest was not earned, because the loan was paid early, the bank refunded unearned interest to the borrower. The amounts at issue were small. The bank did not include in its 1964 return approximately $165,000 of interest received in advance in 1964 and to be earned in 1965, which amount constituted .13 percent of accrued interest and discount included in plaintiff's income for 1964.

Not surprisingly, the government argued that immediate inclusion of all prepaid interest was necessary to avoid distortion of income. The Court of Claims, in holding for the taxpayer, essentially adopted the taxpayer's arguments. Citing *Boise* and *Artnell*, the court first stated that the Commissioner would be abusing its discretion under section 446(b) by rejecting Morgan's accounting method, since there was no distortion or potential for distortion of income, because the date the income was to be earned was easily determinable. Essentially, the court appeared to be reverting to the *Artnell* concept that if there are fixed dates of performance, deferral of advance receipts until those dates is appropriate. In addition, the court noted that deference should be paid to the taxpayer's method of accounting since a regulatory body—in this case, the Federal Reserve Board—required such a method, especially where the taxpayer's accounting practices were consistently applied. The court also noted the *de minimis* amount of income deferred, which, as argued by the bank, disproved the Commissioner's contention that the bank's method of accounting distorted its income.

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125 585 F.2d 988 (Ct. Cl. 1978).
126 *Id.* at 992.
127 *Id.* at 997.
129 It has been suggested that the *de minimis* factor alone may have been suffi-
The court distinguished the insurance company cases on the basis that in Morgan the borrowers voluntarily prepaid the advance interest, whereas the policy loan contracts in the insurance company cases required that the annual interest be paid in advance. Morgan argued that in the insurance company cases, even if the interest was not actually paid in advance, interest was accruable in the year of the loan because it was due at that time, citing the proposition that income is accruable for tax purposes when the taxpayer has a legal right to it. In Morgan, however, the taxpayer argued that since the prepaid interest was not due in advance, accrual of the payments was not required. In fact, the insurance company cases are based on the proposition that the right to income is fixed when due, and therefore accruable at that time. The Court of Claims followed this line of reasoning and, in line with Schlude, implied that if the interest in Morgan had been due in advance, even if it had not yet been received or earned, it would have been taxable immediately.

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180 As will be recalled, Schlude required the inclusion of not only cash prepayments but, also of the face amount of installment obligations due but unpaid and as yet unearned, on the basis that it is “the right to receive and not the actual receipt that determines the inclusion of the amount in gross income.” 372 U.S. at 137 (emphasis added), citing Spring City Co. v. Comm'r, 292 U.S. 182, 184 (1934). In Spring City, the Court was dealing with an accrual basis taxpayer which during a tax year sold goods to a buyer that subsequently became insolvent during that same year. The Court held that upon the sale the taxpayer was required to accrue the sales price, despite the buyer's subsequent insolvency, essentially because the taxpayer had fully performed and therefore earned the sales income. Such a holding is completely consistent with financial accounting and the rule that income is accrued as earned, regardless of payment. Spring City, however, cannot stand for the proposition that funds due but as yet unearned are accruable. These simply were not the facts. Nevertheless, relying on Spring City, both Schlude and Morgan would require the inclusion of due but unreceived and unearned funds. Similarly, it has been the consistent position of the Internal Revenue Service to require the accrual of income on the earlier of the date funds are due, paid or earned. See, e.g., Rev. Rul. 80-308, 1980-2 C.B. 102; Rev. Rul. 79-292, 1979-2 C.B. 288; Rev. Rul. 79-195, 1979-1 C.B. 177; Rev. Rul. 74-607, 1974-2 C.B. 149.

As noted, the position of the Service and these courts is not supported by the case law cited. Nor is there any basis under financial accounting principles for the inclusion of either due (or paid) but unearned funds. See, e.g., Financial Accounting Standard Board, Statement No. 45, Accounting For Franchise Fee Revenue (March, 1981). The divergence between the Service's position and the precepts of financial accounting is far from critical. Tax accounting notions are not always in step with financial accounting rules, as witnessed by the cases which
The final reason given by the *Morgan* court for permitting deferral is one which, when combined with similar statements in *Boise*, may provide taxpayers with a justification for deferral in other circumstances. In both of these cases, the courts rejected the Commissioner's position, at least in part, because he proposed a hybrid method of accounting which would have placed the taxpayers on a cash method for reporting prepaid receipts and on an accrual method for reporting income earned but not yet received. These courts came to their conclusions despite the fact that in *AAA* and *Schlude* the Supreme Court appeared to favor a hybrid combination of the accrual and cash methods of accounting. Therefore, in light of *Morgan* and *Boise*, it may be argued that a hybrid method is acceptable only where the facts indicate that the taxpayer's method is sufficiently distorted to warrant rejection by the government, without regard to the method proposed by the Commissioner.

More recently, in *Bjornsen v. United States*, *Morgan* was distinguished and it was held that the Commissioner did not abuse his discretion by requiring prepaid interest to be included in the accrual basis taxpayer's income in the year of receipt, where (1) no portion of the prepaid interest was refundable, (2) no federal agency imposed the accrual method on the taxpayer and (3) the amount at issue was not *de minimis*. Unlike the insurance company cases, in *Bjornsen*, the court require the inclusion of prepaid income. But a rationale for the divergence where monies have actually been received in advance has been section 466(b), as well as the notion that tax accounting must protect the public fisc. Thor Power Tool Co. v. Comm'r, 439 U.S. 522, 542 (1979). Thus, taxpayers should be taxed on the receipt of unrestricted funds. While this bird-in-hand rationale for requiring the inclusion of cash prepayments can be understood, the rationale for including due but unpaid and unearned income is difficult to appreciate. There is hardly a bird in hand when funds are merely due but are as yet unpaid. Moreover, the claim of right doctrine is inapplicable on its face, since that doctrine only requires that funds actually received be reported as income. North American Oil Consol. v. Burnet, 286 U.S. 417, 424 (1932), it will be recalled, applies only where the "taxpayer receives earnings under a claimed right." Certainly, where no funds are paid, no earnings have been received.


It can be argued that one fact present in *Schlude* and which arguably distorted the taxpayer's accounting method was Schlude's present deduction of expenses allocable to the deferred prepaid income. Similarly, it might be argued that the methods used in both *Schlude* and *AAA* were sufficiently distorted because the facts in both of those cases indicated that income was presumably being deferred until earned, and yet that income might never be earned because the taxpayer might never be called upon to render the paid for services.

See the text accompanying N. 81 *supra.*

It can be argued that one fact present in *Schlude* and which arguably distorted the taxpayer's accounting method was Schlude's present deduction of expenses allocable to the deferred prepaid income. Similarly, it might be argued that the methods used in both *Schlude* and *AAA* were sufficiently distorted because the facts in both of those cases indicated that income was presumably being deferred until earned, and yet that income might never be earned because the taxpayer might never be called upon to render the paid for services.

81–1 U.S.T.C. ¶ 9258 (N.D. Iowa 1981). Interestingly, the court did not discuss the fact that the interest was due in advance.
did not confuse the concept of earned with received.\textsuperscript{136} The court in \textit{Bjornsen} specifically found that since the interest paid in advance was not abatable, it could not “be said that plaintiff earns that prepaid interest over the life of the contract so as to allow it to account for it under the accrual method.” \textsuperscript{137} Unlike the refundable interest at issue in \textit{Morgan} and the insurance company cases, it can be argued that nonrefundable prepaid interest is earned when the lender advances the funds, and therefore that deferral is inappropriate.\textsuperscript{138}

\section*{Alternative Theories}

While most attempts at deferral through a head-on confrontation with the trilogy have failed, taxpayers have employed several theories to successfully avoid the entire controversy provoked by the trilogy. Basically, these theories revolve around the concept that under certain circumstances the receipt itself does not constitute gross income. Rather than relying on a construction of the claim of right doctrine (that is, whether the doctrine applies only to earnings), these cases involve situations in which the courts find the doctrine inapplicable, since the receipts in question, whether or not earned, are simply not received under any claim of right. One can raise doubts as to the underlying soundness of the trilogy if taxpayers and courts can simply use different theories to avoid reporting current income where the taxpayers may be in essentially the same economic circumstances as those receiving prepaid income.

\subsection*{Trust or Conduit Theory}

Under the trust or conduit theory, taxpayers have successfully avoided present taxation on receipt of funds for future services by establishing that the funds were not received without restriction as to their use, but instead were subject to specific obligations enforceable in a court of equity. Accordingly, where prepaid funds are received pursuant to a legal obligation that they be used for a specific purpose, and the funds are required to be returned if not spent for that purpose, a taxpayer can successfully avoid their inclusion in gross income.\textsuperscript{139} Courts on occasion

\begin{footnotesize}
\textsuperscript{136} \textit{See}, e.g., Franklin Life Ins. Co. v. United States, 399 F.2d 757 (7th Cir. 1968).
\textsuperscript{137} §1–1 U.S.T.C. at 86,611.
\textsuperscript{138} \textit{See} 4 BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 105.34 (1981).
\textsuperscript{139} Modern precedent for this theory can be traced to Broadcast Measurement Bureau, Inc., 16 T.C. 988 (1951), \textit{nonacq}; and Seven-Up Co., 14 T.C. 965 (1950), \textit{acq}. \textit{See also} Greater Pittsburgh Chrysler Dealers Ass’n v. United States, 77–1 U.S.T.C. ¶ 9293 (W.D. Pa. 1977); Ford Dealers Advertising Fund, Inc.,

\end{footnotesize}
have upheld a taxpayer's argument that it holds funds merely as a trustee or conduit, despite the absence of specific words of trust and even though the funds so held are commingled with the taxpayer's general assets. Critical to a court's finding of a trust or conduit relationship is that the taxpayer enjoys no economic benefit from receipt of the funds. Thus, where the funds at issue may be used for the taxpayer's general corporate purposes, the trust argument will fail.140

As indicated by cases such as Angelus Funeral Home and P.F. Scheidelman & Sons, Inc., 141 the trust and conduit arguments are difficult to substantiate factually. It is also worth noting that the trust or conduit theory may be of limited economic aid to the taxpayer. The theory will help taxpayers primarily in those cases where the funds may be used only for a specific purpose and are not subject to general use by the taxpayers—situations where the taxpayer receives neither the present use of the receipts nor the assurance of their retention.

Deposit Theory

Another theory on which to exclude advance receipts from the taxpayer's gross income is based on the proposition that the funds received merely constitute a deposit or a contingent payment. The deposit argument has traditionally arisen in the context of sales or lease transactions.

In the earlier sales cases, taxpayers were successful in maintaining that funds received constituted deposits where retention of the funds was conditioned on the future delivery of goods which were not on hand and possibly not obtainable by the close of the taxable year.142 Courts dis-
tistinguished cases dealing with advance payments for services on the ground that in those cases the payments constituted gross income when received, whereas the deposits at issue in the sales cases would constitute gross income only when and if they would represent gains from closed and completed sales—sometime in the future, if at all.\textsuperscript{143}

One court viewed a purchaser's voluntary partial payments, made to help finance the seller's operations, as being in the nature of a loan.\textsuperscript{144} The amounts paid were not treated as received under a claim of right, since their retention was conditioned on delivery and acceptance of the goods.

The mere fact that advances are refundable does not provide the taxpayer with a sufficient basis for excluding the funds from gross income.\textsuperscript{145} Moreover, some of the courts which treated advance receipts as deposits apparently found it significant that the funds were advanced for goods rather than services. As a consequence, they believed that arguments such as claim of right were inapplicable.\textsuperscript{146} In light of more recent decisions which ignore this distinction,\textsuperscript{147} the precedential value of these sales deposit cases may be limited.

The deposit theory has also been used to avoid inclusion of advances under a lease. Since 1957, the regulations have provided that advance rentals constitute gross income in the year of receipt,\textsuperscript{148} and the courts have agreed.\textsuperscript{149} Where, however, the funds received constitute a security deposit, the funds will not be includable in gross income until the year they are applied as rent, if ever.\textsuperscript{150} Courts have applied a variety of fac-

\textsuperscript{143} In Veenstra & Dehaan Coal Co., 11 T.C. 964 (1948), the court viewed the funds received by the taxpayer as temporary advances by customers towards petitioner's working capital and held that such advances should be included in income only when deliveries were made.

\textsuperscript{144} Consolidated Hammer Dry Plate & Film Co. v. Comm'r, 317 F.2d 829 (7th Cir. 1963).

\textsuperscript{145} See id. at 832–33.

\textsuperscript{146} Ibid.

\textsuperscript{147} See the text accompanying Ns. 103–111 supra.

\textsuperscript{148} Reg. § 1.61-8.

\textsuperscript{149} E.g., Kohler-Campbell Corp. v. United States, 298 F.2d 911 (4th Cir. 1962); New Capital Hotel, Inc. v. Comm'r, 261 F.2d 437 (6th Cir. 1958).

\textsuperscript{150} E.g., Kohler-Campbell Corp. v. United States, 298 F.2d 911 (4th Cir. 1962); New Capital Hotel, Inc. v. Comm'r, 261 F.2d 437 (6th Cir. 1958); Gilken Corp.
tors in determining whether funds constitute a deposit rather than advance rental. Some of these factors are whether the funds are (1) labelled as a deposit, (2) segregated from the lessor's general assets and (3) to be returned to the lessee at the termination of the lease or bear interest which is remitted to the lessee. As with the trust concept, it is not fatal to the deposit argument that the recipient commingles the funds with its general assets. Apparently the most important factor which evidences a deposit is the obligation to return the funds at the termination of the lease. Since the deposit theory may be viewed as simply a variation of the loan theory discussed below, the repayment obligation seems appropriate.

Although cases employing the deposit theory traditionally arise in the context of sales or rental transactions, there is no reason why the theory should not apply to service contracts as well. Both sales and rental deposits are deposits against future performance. Similarly, a service provider could, for example, require a deposit on a warranty contract and, if the deposit were returnable in all events rather than applied against future earnings, the deposit argument could succeed simply on the basis that the taxpayer has no claim of right to the funds.

Loan Theory

In a similar line of cases, the taxpayer has argued that the amounts received constituted loans rather than gross income. As demonstrated by Consolidated-Hammer Dry Plate v. Commissioner, the argument that an amount received constitutes a deposit is closely linked to the argument that the deposit constitutes a loan, rather than gross income. Generally, the courts will not find that an advance constitutes a loan, unless there is a fixed obligation to repay at a specified date and the obligation arises solely from the passage of time.

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v. Comm'r, 176 F.2d 141 (6th Cir. 1949); Warren Serv. Corp. v. United States, 110 F.2d 723, 725 (2d Cir. 1940).

151 See the cases cited in N. 150 supra.

152 See, e.g., Warren Serv. Corp. v. United States, 110 F.2d 723 (2d Cir. 1940).

153 E.g., Kohler-Campbell Corp. v. United States, 298 F.2d 911 (4th Cir. 1962); New Capital Hotel, Inc. v. Comm'r, 261 F.2d 437 (6th Cir. 1958); Gilken Corp. v. Comm'r, 176 F.2d 141 (6th Cir. 1949); Warren Serv. Corp. v. United States, 110 F.2d 723, 725 (2d Cir. 1940).

154 Cf. LTR 8027012 (March 26, 1980); Rev. Rul. 72-519, 1972-2 C.B. 32.

155 317 F.2d 829 (7th Cir. 1963).

156 E.g., George Blood Enterprises, 35 T.C.M. 436 (1976); Robert Adams, 58 T.C. 42 (1972); New England Tank Indus., 50 T.C. 771 (1968), aff'd, 413 F.2d 1038 (1st Cir. 1969).

As in the trust or deposit theories, loan proceeds do not constitute gross income under the claim of right doctrine. Since the funds received are burdened by the obligation of repayment, they are not unrestricted. As such, the loan theory avoids the pitfalls of the trilogy and could be considered in structuring isolated service or sales transactions which involve an advance payment. For example, the taxpayer could enter into a loan transaction whereby it is unconditionally obligated to repay a sum certain. The transaction could provide that repayment may be made, at the option of the taxpayer-borrower, either in cash or in kind—the delivery of goods or the performance of services. While such a transaction in substance is no different from one which labels the advance payments as refundable prepayments, its form could provide the taxpayer with a viable argument for deferral on the basis that loan proceeds simply do not constitute gross income.

Although the structure of an advance payment as a loan, deposit or trust fund presents a possible avenue for deferral, any such structure may fail. If the papers are inartfully drafted or interpreted differently, the funds might then be viewed as an advance, in which case the taxpayer would be faced with the trilogy and its progeny. Further, the funds set aside under a loan, deposit or trust arrangement might be viewed as effectively constituting a reserve for future expenses. In that case the taxpayer will generally be denied a deduction for the reserve. The fact that artful drafting or different construction of similar economic situations could lead to different tax results should raise substantial questions about the underlying analysis in this whole area.

**Accrual of Expenses: Reserves**

A taxpayer required to include in current income prepayments for future services, goods or interest could escape substantial tax liability if it could presently deduct the future expenses attributable to those services, goods or interest for which payment has been received. It has long been established that expenses may be accrued and deducted in the year in which all events occur which fix the fact and the amount of

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158 The suggestion is made only with respect to isolated transactions, since it would be difficult to sustain this argument where the purported borrower is in the business of performing services or selling goods and consistently enters into agreements pursuant to which it performs the services or sells the goods, and argues, each time, that its performance or delivery constitutes merely the repayment of a loan.

159 While current inclusion of prepayments and deduction of future expenses leads to a present tax on the entire profit margin represented by the prepayment, as it did in Schuessler v. Comm'r, 230 F.2d 722 (5th Cir. 1956), it will leave a
the liability with reasonable certainty.\textsuperscript{160} Prior to the trilogy, taxpayers argued, generally without success, that even though their liabilities to third parties were not fixed, they could establish and deduct reserves that reflected reasonable estimates of what those future expenses would be.\textsuperscript{161}

After the trilogy, taxpayers have similarly been unsuccessful in their attempts to deduct reserves for future estimated expenses. In the first post-trilogy reserve case,\textsuperscript{162} the Supreme Court, in light of AAA, refrained from distinguishing deductibility of future expenses from accrual of prepayments. Similarly, the Tax Court has consistently found the reasoning of the trilogy to be dispositive of taxpayers' attempts to establish reserves for future expenses, holding that where a taxpayer's obligation to perform arises only on customer demand, a reserve for the future expense of that performance cannot be presently deducted.\textsuperscript{163}

The Service's position with regard to the deductibility of future expenses is clear—bare contractual liability to perform is not sufficient to establish a liability for tax purposes. Until the payee has performed, the payor's liability has not been established.\textsuperscript{164} But the Service's position is not free from doubt.\textsuperscript{165}

taxpayer with substantially less liability than if it were not to accrue any such deductions.

\textsuperscript{160} Section 1.461–1(a)(2) of the regulations provides, in pertinent part, that deductions can be accrued when "all the events have occurred which determine the fact of liability and the amount thereof can be determined with reasonable accuracy."


\textsuperscript{164} Rev. Rul. 80–182, 1980–2 C.B. 167. In this ruling, the taxpayer was obligated to remove offshore platforms and fixtures used in the taxpayer's drilling operation upon its abandonment of the wells or on termination of certain long-term oil and gas leases. Despite the fact that the taxpayer was contractually obligated to remove the platforms and fixtures, the Service held that the taxpayer's liability did not become fixed until it performed its removal obligation; hence, deductibility of the cost could not precede performance. See also World Airways, Inc., 62 T.C. 786 (1974), aff'd 564 F.2d 886 (9th Cir. 1977); Thriftimart, Inc., 59 T.C. 598 (1933), acq.; LTR 8014010 (Dec. 18, 1979).

\textsuperscript{165} See Aidinoff & Lopata, Section 461 and Accrual Method Taxpayers: The Treatment of Liabilities Arising From Obligations to be Performed in the Future, 33 Tax Law. 789 (1980). One issue involved in this analysis is the question of what is meant by the word "fixed" in the context of section 1.461–1(a)(2) of the regulations and, specifically, whether a contractual obligation is a fixed liability.

On the deduction side, the words of the regulations have been interpreted as
Revenue Ruling 80–230 indicates that the Service may allow taxpayers to accrue expenditures which are due even though not paid nor incurred through performance, thus taking a position analogous to its position requiring the accrual of due but unpaid and unearned receipts. The Service has stated, in dicta, that “under section 1.461-1(a)(2) of the regulations, all the events have occurred that determine the fact of the liability when (1) the event fixing the liability, whether that be the required performance or other event, occurs, or (2) payment therefore is due, whichever happens earliest.” The Service’s allowance of a deduction for payments at the due date regardless of payment seems to provide a significant opportunity for taxpayers with “friendly creditors,” those who either permit or fail to penalize late payment, to effectively defer substantial amounts of otherwise includable income.

The cases disallowing a deduction for reserves have relied in large measure on the trilogy. Conversely, one deduction case, Mooney Aircraft v. United States, was relied on in Artnell and RCA, dealing with the prepayment issues. Mooney sold airplanes and with each airplane issued a “Mooney Bond” redeemable for $1,000 when the airplane was retired. In the year of an aircraft’s sale, Mooney sought to deduct either the face amount of all Mooney Bonds sold that year or those Mooney Bonds which it estimated would be redeemed. Contrary to the Service’s contention, the court found that upon issuance of the bonds, the fact of Mooney Aircraft’s liability was fixed, even though there were no fixed dates of performance. The only contingency found by the court related to when that liability would arise.

The Fifth requiring a fixed obligation. A similar issue has also arisen on the income side, since Artnell, Boise, Morgan and RCA each allowed for the deferral of advance receipts, essentially because of offsetting expense obligations which were viewed as being fixed.

167 Id. at 170. The ruling involved the accrual on December 31 of a semiannual assessment required to be paid to the Comptroller of the Currency by national banks on or before the following January 31. The amount at issue, the assessment for the six-month period beginning on January 1, was due on January 31. Although the amount of the liability could be determined with reasonable accuracy as of December 31, since the amount was not due until January 31, and was for the six-month period beginning January 1, the Service held that all events that determined the fact of liability had not occurred as of December 31. See also Rev. Rul. 79–410, 1979–2 C.B. 213.
168 420 F.2d 400 (5th Cir. 1969).
169 Id. at 406, 408. The Service’s contention was consistent with its position that a liability becomes fixed when the obligation is performed, not when the taxpayer becomes contractually obligated to perform. See Rev. Rul. 80–182, 1980–2 C.B. 167.
Circuit distinguished Schlude and AAA, stating that in those cases the absence of fixed dates of performance was relevant because there was no certainty that performance would ever be required, so that deferral was inappropriate, whereas in Mooney there was no doubt that the airplanes would at some time be retired. Thus, Mooney Aircraft would clearly have to pay the $1,000 at some future date; the liability was no less fixed because the date was uncertain.\footnote{In fact, the court noted: "All that Schlude and AAA would seem to require is that the deferred income is reported as the related costs do in fact occur. If this were a deferral case, the taxpayer would report the 'income' represented by the bonds in the years they were redeemed and paid." \textit{Id.} at 408.}

Despite this finding, the court denied a present deduction because it found that the time between the bonds' issuance and the time for actual payment could be as long as 30 years. The court reasoned that this delay was simply too long to permit a present deduction without distorting the taxpayer's income. The court based its conclusion on two lines of reasoning: First, the court stated that where the income and the expense were separated by so much time, their relationship to each other was broken; monies received from the sale of planes could be disposed of freely by the taxpayer with no obligation to establish a bookkeeping reserve.\footnote{The court might not have been quite as concerned with the taxpayer's free use of funds for an extended period of time if it had considered the $1,000 received for each bond as no more than a loan. A taxpayer does not treat the receipt of borrowed funds as income, even if the taxpayer is not required to pay interest and even if the loan is for a long term. See the text accompanying N. 183 infra.} Second, the court stated that in light of the fact that even section 452, during its short life, permitted deferral of prepaid receipts for only five years, the Commissioner's rejection of Mooney's accounting method under section 446(b) was reasonable.\footnote{420 F.2d at 410.}

Assuming that the court was convinced that the bonds would be required to be paid (there was some question on this) and that the fact and amount of the liability had thus been determined with reasonable certainty, the court's holding that the deduction should be denied because the time of payment was too far in the future may simply reflect the court's perceived need to protect the public fisc. While the conclusions in Mooney have been criticized,\footnote{See Aidinoff & Lopata, \textit{Section 461 and Accrual Method Taxpayers: The Treatment of Liabilities Arising From Obligations to be Performed in the Future}, 33 \textit{Tax Law.} 789 (1980).} the case must serve as a warning to taxpayers that even if deferral is possible under Arinell, Boise, Morgan, RCA or any theory, courts may feel compelled to raise a question as to the length of time that deferral should be permitted.
Administrative and Legislative Concessions

In spite of its substantial judicial conquests, the Service, through rulings and regulations, has made limited concessions to taxpayers in receipt of prepayments for services and goods. In Revenue Procedure 71–21,174 the Service expressed its intention to permit deferral of prepaid income for services to be performed by the end of the taxable year succeeding the year of receipt. If the contract requires performance within the specified time period, a taxpayer can defer inclusion, on a pro rata basis, on the basis of the percentage of services not yet actually rendered, or on various statistical predictions, but only until the end of the year following payment, by which time all income must be reported. The Service, in enacting this revenue procedure, stated that it was doing so in order to reconcile tax and financial accounting, without permitting extended deferral.

In the area of prepaid sales income, the Treasury promulgated section 1.451–5 of the regulations, which permits substantial deferral on the sale of goods held primarily for sale to customers and certain manufactured goods. Taxpayers can generally defer advance receipts with respect to these goods until the year in which the funds must be included according to the method of financial accounting employed by the taxpayer. For inventory, however, this unlimited deferral applies only to goods not on hand at the close of the taxable year and not similar to inventory on hand. For this excepted class of inventory items, deferral is permitted only up to two years after the end of the tax year in which substantial prepayments are received.

More recently, Congress added section 458, which permits limited deferral of prepayments on sales of certain qualified magazines, paperbacks and records.

Analytical Proposal

Theory of the Trilogy

As indicated at the outset, this article proposes that post-trilogy case law has developed an appropriate framework for analyzing the treatment of advance receipts. The foundation of this framework is the trilogy itself. Thus, while the conclusions in the trilogy have required taxpayers to adopt methods of accounting which may distort income in an economic sense, appropriately analyzed, the reasoning of the Supreme Court can provide a basis for meshing the divergent goals of tax and financial accounting.

In Schlude and AAA the Court disallowed deferral of advance receipts because it found that the methods of deferral employed by AAA and Schlude each suffered from the same vice—performance was required only on customer demand, which might never occur. Therefore, deferral was held to be inappropriate. In both cases, the Supreme Court required certainty of performance as justification for deferral. The Court's conclusions are justifiable using the basic matching notion of financial accounting and the premises of tax accounting.

For financial accounting purposes, deferral of advance receipts is analytically appropriate because of the notion that the taxpayer is attempting to match revenues with the cost of producing those revenues; those costs are incurred when the revenues are to be earned or when performance is to occur. Thus, costs directly identifiable with revenues are matched or charged against those revenues. More generalized expenditures for particular periods of time are charged against the income generated over those time periods. For tax purposes, it is also appropriate to defer advance receipts on the basis of this matching notion, since deferral reflects the accrual method, and, equally important, deferral does not distort income. If a taxpayer receives an advance of $120 for the performance of a service which will generate $60 of expenses, the current inclusion of the full $120 without a corresponding current deduction of $60 distorts income in a very real sense.

But for tax purposes, the concepts of matching and distortion must be applied in the context of the annual tax period and the Treasury's role of protecting the fisc. Where future performance under a contract is fixed for some future date, and there is assurance that the income will be earned and the related expenses will in fact be matched, for tax purposes the income as well as the deductions attributable to that performance should be deferred until that later date.

The trilogy disallowed deferral of advance receipts because there was no certainty of performance. What seemed critical to the decisions in AAA and Schlude was the fact that under the contracts at issue, the taxpayers might never have earned the prepaid income through performance or incurred the related expenses. Also, there might never have been any taxable year in which matching would occur. Under these circumstances, the Supreme Court's conclusions can be justified. While the present inclusion of receipts for future performance might distort income, there might be no year of inclusion which offers less distortion. For example, if deferral were allowed and the taxpayer in fact performed none or only

a portion of the contracted services, then at least some of the advance receipts would be reported in the year in which the contract terminated. Arguably, inclusion in that year (where no related expenses would be generated) would be no less a distortion than inclusion in the year of receipt. Since the role of the Treasury is to exact its fair measure at some point, this analysis is merely looking for the most appropriate point in time. Where the taxpayer has not sustained the burden of proving that performance will occur, inclusion of advance receipts in the year of receipt may be at least as justifiable as inclusion in any other year.

If the Supreme Court's trilogy is correctly read as foreclosing deferral only where performance is uncertain, and consequently where the matching of receipts against expenses cannot be foreseen with reasonable certainty, the trilogy is basically sound. If this is a proper reading of the trilogy, the issue then becomes the appropriate method of determining reasonable certainty of performance. This method has been developed by the post-trilogy cases which have allowed deferral.

Schlude Progeny

Since Schlude, four cases have allowed the deferral of prepaid income: Artnell, Boise, Morgan and RCA. In contrast to the trilogy, the dates of future performance in Artnell and Morgan were fixed, and matching of income and expenses could be predicted with some certainty. In Boise, the court was convinced that the taxpayer would be required to perform, despite the fact that some of the contracts at issue did not specify the dates of that future performance. In RCA, however, the court was convinced by the taxpayer's statistical evidence, which proved only that as to a group of contracts a certain percentage of receipts would be earned through performance in given tax years.

These four decisions raise three analytical questions: (1) Are they in line with the Supreme Court's pronouncements in the trilogy? (2) Are they otherwise analytically sound? (3) Do they, along with an appropriate analysis, present the possibility of deferral under circumstances other than those presented by their particular facts?

Since the rationale of the trilogy implies that deferral is appropriate where performance is fixed, the conclusions of Artnell and Morgan easily find authority in the trilogy. Each allowed prepaid income to be deferred until fixed performance dates specified in a contract. Since the taxpayer could present evidence, based on performance dates specified in a contract, that matching of individual receipts with their related expenses would occur and therefore economic distortions would be avoided, nothing in the trilogy would preclude deferral. Evidence of specific performance dates was not present in any of the trilogy. But in Boise, even
though some of the contracts at issue did not specify dates of performance, the court allowed deferral, apparently because it was convinced by the taxpayer's evidence that performance would occur. Thus, arguably, Artnell, Morgan and Boise are consistent with the Supreme Court's primary concern.\(^{176}\)

Moreover, each of these three cases presents a viable basis for meshing divergent tax and financial accounting considerations. The accrual method of accounting provides that income is not to be reported until earned. Unless this method distorts the taxpayer's income, it should be followed. Put another way, for tax accounting, the rationale for deferring advance receipts should be that deferral prevents distortion. This occurs, however, only if matching can be predicted with reasonable certainty. Clearly, if, as in Artnell and Morgan, the time for performance is specified in the contract or if, as in Boise, the time for performance can be predicted with reasonable certainty, matching can be accomplished and deferral actually prevents distortion.\(^{177}\)

In RCA, however, the taxpayer did not produce evidence as to the certainty of its performance under any particular contract. It demonstrated only that as to a group of contracts, it could statistically project the percentage of the total performance which would be required in each future year under the contract. On this basis, deferral was allowed. Arguably, here too there was reasonable certainty of performance, at least on a group basis. However, while the RCA court's reasoning—the trilogy requires only certainty of performance—is correct, its specific conclusion flies in the face of AAA, which appears to preclude basing deferral on average or pooled statistics.

Even though RCA's reliance on group statistics departs from the Supreme Court's edicts, there is room for the use of statistics in a manner consistent with AAA. Even a strict reading of the trilogy would not prevent the use of statistics per se, but would simply limit the kinds of statistical analysis that can be used to justify the deferral of advance receipts. Moreover, there are many areas where the tax laws allow for the use of statistical data and estimates.\(^{178}\) Thus there is little room for the

\(^{176}\) Three courts have similarly concluded that the Supreme Court was more concerned with the certainty of performance than with the exact dates of that performance: RCA Corp. v. United States, 499 F. Supp. 507 (S.D.N.Y. 1980); Boise Cascade Corp. v. United States, 530 F.2d 1367 (Ct. Cl.), cert. denied, 429 U.S. 867 (1976); Mooney Aircraft, Inc. v. United States, 420 F.2d 400 (5th Cir. 1969).

\(^{177}\) As an example of the distortion which may be caused by the literal language of the trilogy, see N. 100 supra. Consider also the examples set forth in N. 57 supra, which indicate that the method of accounting proposed by the Supreme Court may, in fact, distort income.

\(^{178}\) See, e.g., Reg. § 1.451–3(c) (percentage of completion method of account-
argument that allowing taxpayers to defer on the basis of statistical estimates places too great an administrative burden on the government. If the government has assumed the burden of verification in other areas, it should be no less willing in this area.

At most, the trilogy seems to forbid deferral of advance receipts on the basis of statistics that demonstrate (as did RCA’s) only that as to a group of contracts, on the average, a certain amount of performance will be required. The trilogy does not prohibit deferral based on estimates which demonstrate that, as to any individual receipt, it is reasonably certain that future performance will be required with respect to that receipt. Additionally, it should be noted that the AAA Court emphasized that in order to justify deferral, the taxpayer needs to show that performance will be required within a given future year. The taxpayer need not establish the time of performance with any more specificity than the year in which it will occur. Thus, if a widget maintenance company had maintained statistics sufficient to show only that, for 100 widget maintenance contracts, it would incur total expenses of $1,000, its data would be insufficient to delay inclusion of prepaid income on receipt. But, if the widget maintenance company data were to demonstrate that, as to any one widget, there was a 95 percent chance that the widget would require service in year five, it should be able to justify deferral of the income attributable to that service until year five. Where most of the service performed by the taxpayer is performed for a few contracts and most of the service contracts will in fact require no performance, as a practical matter statistics could not be developed which would justify deferral. However, with respect to a group of contracts, where most of the contracts will require some later performance, the taxpayer might well be able to statistically demonstrate reasonable certainty of performance with respect to each individual contract and thus justify deferral through the use of statistics.

Framework for the Future

Does the trilogy allow for the deferral of prepaid receipts under circumstances other than those specifically addressed in Artnell, Boise and Morgan? The answer should be “Yes.”

If appropriate analysis of the trilogy leads to the conclusion that

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179 357 U.S. at 692.

180 See N. 100 supra.
income cannot be deferred where performance is not assured, the im-
plication is that receipts can be appropriately deferred if future per-
formance is assured, and individual statistical evidence or fixed dates
of performance should not be the only kinds of evidence which can
be used to establish the relative certainty of future performance. Tax-
payers should be entitled to defer if it is reasonably certain that per-
formance under the contract will occur. The existence of fixed dates
of performance is neither necessary nor necessarily helpful to this
determination. Deferral should be allowed if the contract between
the parties requires performance and the facts and circumstances in-
dicate that performance is reasonably certain. For example, suppose
a contract provides for the taxpayer's obligation to clean and repair
a customer's widget five times in the course of the contract period.
The government would argue that deferral of prepaid receipts under
these circumstances would be improper because performance cannot
be assured in the absence of fixed dates of performance.\textsuperscript{181} But if the
company contracted to clean and repair the widgets on July 31 of each
year for the next five years, certainty of performance might nonetheless
be lacking despite the fixed dates; customers might leave, sell their
widgets or simply not want to have them cleaned and repaired on the
dates in question.

On the other hand, performance can be assured in the absence of
either fixed performance dates or statistical data. Suppose that the base-
ball club in \textit{Artnell} had won its league championship and was to play in
the World Series. Further suppose that the club's tax year ended on the
last day of the season and that shortly before that day it had sold 100,-
000 World Series tickets, even though the exact dates and locations of
the World Series games had not yet been established (the other league's
champion not having been determined). While there would be no dates
fixed for future performance by the end of the taxpayer's tax year, the
fact that the services would be performed during the next taxable year
could not be more certain,\textsuperscript{182} and deferral should be allowed.

In the cases involving fixed dates, the courts that would allow deferral
are relying on the terms of the contract and the assumption that the
parties will perform pursuant to their contractual commitment. Deferral
should similarly be allowed where the contract requires performance and
the surrounding facts and circumstances indicate certainty of perform-

\textsuperscript{181} Even with fixed dates of performance, deferral would not be sanctioned
under Revenue Procedure 71–21, 1971–2 C.B. 549, which does not permit de-
erral if, under the terms of the contract, the services may be performed after the
year following the year of receipt.

\textsuperscript{182} This proposition is premised on there being no baseball strike between the
end of the regular season and the World Series.
ance, even if specific dates of performance are not stated in the contract. Analytically, there is no substantial distinction between deferral where future performance (and therefore matching) is assured because dates of performance are specified in a contract between the parties, and where performance is assured because the contract and surrounding circumstances require performance at some point during its term. In both situations the courts are relying on the parties' compliance with the contract. Moreover, the contract terms and dates provide only some of the appropriate factors for determining whether and when future performances will occur.

Commentators might argue that Schlude prohibits the notion of deferral until performance, but such a blanket statement is erroneous. The Schlude Court found only that the deferral of prepaid income until actual performance would distort income where performance was not assured.

Additional criticism for the approach suggested here may revert to the assertion that income will simply be distorted. Taxpayers receiving funds free of any restrictions will not be required to report those funds as income until some unspecified year in the future. It is partially this fear which resulted in the expanded use of the claim of right doctrine. But it must be remembered that the claim of right doctrine, as established in North American Oil, dealt only with earned income. In the area of advance receipts, however, the receipts are not earned.

Indeed, the claim of right doctrine and notions of distortion are a subterfuge for the government's bird-in-hand approach to taxation. Arguments for immediate inclusion simply follow the reasoning that advance receipts are clearly income and to defer receipt for a protracted period would distort income. Once again, however, the proper concern seems to be that income should be reported on a basis which is consistent with the taxpayer's method of accounting. If there is reasonable certainty of performance, deferral until that performance fits both ends—consistency with the accrual method and reporting of income in an appropriate taxable period. Moreover, deferral under these conditions is not contrary to the mandate of the Supreme Court.

Commentators contend, however, that distortion arises because taxpayers receiving advance payments for future performance are receiving an economic benefit (measured by the value of the use of funds) and should be taxed on this benefit. They argue that the ability to defer such advances should not be extended beyond factual situations specifically dealt with in the enumerated cases. However, the economic benefit which results from the present use of funds in some cases may be no greater than the benefit enjoyed by a taxpayer who receives borrowed
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funds. Yet the tax laws have long held that no income results from the receipt of borrowed funds.

In the loan situation, the present economic benefit enjoyed by the borrower is offset by a present obligation to pay interest. However, not all loans bear interest, nor does every loan bear interest at a rate which adequately represents the taxpayer's economic benefit from the use of the funds. Similarly, if funds received are categorized as a deposit, the taxpayer is free to hold the funds without reporting them as income, despite the fact that the funds may not bear interest and may be unrestricted for a significant period of time.

But commentators might suggest that an analogy between prepayments on the one hand and loans or deposits on the other is fundamentally flawed. The treatment of a loan, security deposit, or for that matter a trust fund, has been analyzed under the claim of right doctrine; the issue is whether the receipts constitute gross income. Analysis of the treatment of advance receipts has been traditionally viewed as a question of timing—the when of taxation. But one should consider whether this fragmentation of the whether and the when of taxation has caused the real confusion in the area of advance receipts. Although this dichotomy may be technically accurate, it might serve a better end to view the advance receipt as a loan or deposit against future performance.

Consider the following case: a taxpayer has $120 of prepayments which are received under a contract obligating the taxpayer to perform in the future. The receipts will be offset by $60 of expenditures leaving $60 of net income. In the language of a loan, the taxpayer will effectively have to repay $60 of the advance receipts. The only accession to wealth then will be the net of receipts less expenses. The funds received may be no more unrestricted than loan proceeds. The economic criticism is that the obligation to perform, and therefore to incur expenses, is not as fixed as the obligation to return a loan. Such an argument is only partially valid. The amount of future expenses in some cases may be precisely determinable, and the obligation to incur these expenses may be as fixed as the obligation to repay a loan. Both are contractual obliga-

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183 One should consider the economic benefit enjoyed by a taxpayer who, for example, has an outstanding loan which bears interest at a rate of 5 percent. With current rates hovering around 20 percent, there is a clear financial benefit and, yet, the tax laws do not tax that benefit. The interest free loan analogy would suggest that interest be imputed to the recipient of advance receipts, whereas that part of the advance payment which would represent principle rather than interest should not be taxed. See Martin v. Comm'r, 649 F.2d 1143 (5th Cir. 1981); Suttle v. Comm'r, 625 F.2d 1127 (4th Cir. 1980); Charles E. Marsh II, 73 T.C. 317 (1979) nonacq.; Max Zager, 72 T.C. 1009 (1979); Herman M. Greenspun, 72 T.C. 931 (1979); J. Simpson Dean, 35 T.C. 1083 (1961), nonacq.
tions presumably enforceable in the courts. Commentators might argue that this analysis is inappropriate since there is a critical difference between the loan and the advance receipt. Loan proceeds simply do not constitute gross income because they do not represent a net accession to wealth; the offsetting obligation to return exists at the moment of receipt. As to the prepayment, however, the obligation to return (expend) arises in a future year. Thus, its receipt should be reported. An analysis of the issues on this basis, although perhaps technically precise, is misleading. The arguments for excluding loans or deposits from income would seem applicable to the deferral of prepaid receipts. In each case, the funds received are burdened by an offsetting obligation. In the case of the advance receipts, as long as future performance is reasonably assured, there is a preexisting, offsetting obligation—a contractual obligation as binding as that of repayment—and income should be reported at the time of that offsetting obligation.

Arguments as to the potential for distortion of income only obscure the appropriate reasoning. In any case where the taxpayer has received funds which are unrestricted as to their use for some time period, there is a preexisting, offsetting obligation—a contractual obligation as binding or smaller simply because the funds are called an advance rather than a loan.

If these arguments prevail, the next question is for how long deferral should be permitted. One should consider this question in light of a 20- or 30-year contract which requires performance at some point during its life. Under the Mooney reasoning, the very length of the period of deferral would be questioned. But in the end, arguments based solely on the length of the period of deferral would be nothing more than the government's age-old fear of allowing unrestricted funds to go unreported for a long time. As indicated previously, the reasoning of Mooney can be criticized and, as long as a date for reporting (based on performance) can be predicted with reasonable certainty, deferral would still seem to be appropriate.

As a final argument, commentators might suggest that if the expenditures mandated by future performance are viewed as an offsetting obligation, such an analysis provides an effective vehicle for avoiding the problems engendered by deducting a reserve for future expenses. In the first place, this article's analysis of prepaid receipts does not propose the allowance of a present deduction for future estimated expenses. More important, however, the argument itself demonstrates the inadequacy of fragmenting the analysis of prepaid income into issues of whether versus when. In fact, the very argument demonstrates that under present analysis artful drafting and proper labels may win the day.
In most cases, there is a discernible difference between deposited or borrowed funds and funds which constitute a reserve. These in turn are different from prepayments. This article does not suggest that those differences be obscured. However, where prepayments are received for the performance of an obligation and performance of that obligation can be predicted with reasonable certainty, those prepayments should be deferred.

Conclusion

At this point, it would be erroneous to suggest that all advance receipts can be deferred until earned. The Supreme Court has foreclosed that proposition and it is not being suggested. What is being suggested, however, is that where future performance under the contract between the parties is reasonably assured—on the basis of the contract terms, individual statistics or facts and circumstances—deferral of advance receipts until performance should be allowed. This is the teaching of Artnell, Boise, Morgan and, to some extent, RCA, and is consistent with a proper reading of the trilogy. This is an appropriate framework for future analysis, since the proposition reaches an accommodation between the divergent views of tax and financial accounting.
The decision of the district court in *RCA Corporation v. United States* was recently reversed by the Court of Appeals for the Second Circuit.\(^1\) In a decision which was predicated on the court's view of the objectives of tax accounting and "the Commissioner's wide discretion in implementing those objectives,"\(^2\) the court stated that its role was "not to determine whether in its own opinion RCA's method of accounting for prepaid service contract income 'clearly reflect[ed] income,' but to determine whether there is an adequate basis in law for the Commissioner's that it did not."\(^3\) And on the basis of its reading of the trilogy, the court concluded that the Commissioner had not abused his discretion in rejecting RCA's method of deferring prepaid service contract income.

The Second Circuit's position rested on its view of the policy considerations underlying the Supreme Court's decision in the trilogy.\(^4\) The court found that deferral was prohibited in each of those cases, where performance was based on customer demand, because in each such case it was impossible to know at the outset of the contract term the amount of services that would actually be demanded, and thus the taxpayer could not predict with certainty the amount of net income it would ultimately earn under the contracts. The Second Circuit observed that the Supreme Court's decisions reflect an underlying policy consideration, namely that the collection of federal revenues cannot rest on uncertainties, and therefore that tax accounting of necessity is hostile to financial accounting practices which defer the recognition of income, and thus the collection of taxes, on the basis of estimates or projections.

The court then noted that since RCA's service contracts required performance on customer demand, it too could not know with certainty the extent of its future performance and the amount of its ultimate earnings under the contracts. Thus the Second Circuit concluded, on the basis of its position that the "Commissioner was not required to subject the federal revenues to the vicissitudes of RCA customers' future demands for services," that the Commissioner did not abuse his discretion in disallowing RCA's method of deferral.\(^5\)

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2. *Id.* at 88,605.
3. *Id.* at 88,607.
4. *Id.* at 88,606.
5. *Id.* at 88,606. The Second Circuit's position is, in part, based on its view that *Schlude* requires that deferral be grounded on the certainty of a specific amount of performance. Arguably, however, *Schlude* requires only certainty as to the fact
The Second Circuit also made it clear that the decisions in *AAA* and *Schlude* invalidated its previous opinion in *Bressner Radio, Inc. v. Commissioner*. In addition, because the court concluded that *AAA* and *Schlude* invalidated not only a system of accounting which deferred recognition of income from services to be performed on demand, but any method of deferral that relies on "prognostications and assumptions about the future demand for services," it found any difference between RCA's method of deferral and those in other cases "immaterial." Thus while the Second Circuit could have reversed on the basis of RCA's use of group statistics and *AAA*’s prohibition against deferral based on group statistics, its decision is broader. It apparently held that deferral cannot be based on any estimates or predictions, including statistical evidence, whether group or individual.

The court noted, however, that because of its disposition of the issue, it did not have to address the government's argument that absent express legislative authorization or the Commissioner's consent, deferral is never permissible. Arguably, then, the decision of the Second Circuit may not be at odds with the decisions of the Court of Claims in *Boise Cascade v. United States* and *Morgan Guaranty Trust Co. v. United States*, and that of the Seventh Circuit in *Artnell Co. v. Commissioner*, all of which allowed deferral on the basis of contractual certainty of performance. Since even contractual certainty relies on the assumption that the parties will abide by the terms of the contract, and that services will actually be demanded, some question must remain as to the full impact of the court's statement that any method relying on "prognostications and assumptions about future demand for services" is inherently uncertain and thus invalid.
This issue of the Tax Law Review is dedicated to Charles S. Lyon