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PREPAYMENT FOR FUTURE SERVICES: TO WHAT EXTENT IS DEFERRAL ALLOWED?

by
Clare L. Garner, Jr. *

Introduction

If an objective observer, uninitiated into the vagaries and mysteries of tax accounting, were to read only the Internal Revenue Code provisions regarding allowable accounting methods and the Treasury Regulations enforcing these provisions, he would be surprised when he later discovered the rule that prepayments for services to be rendered beyond the current taxable year, received without restriction as to their disposition, are generally taxable to accrual basis taxpayers in the year of receipt regardless of when the expenses of earning the receipts are to be incurred. Such a rule of immediate inclusion flies in the face of traditional financial accrual accounting principles which seek an accurate portrayal of the financial picture of a business entity by matching revenues from services with the related expenses incurred in generating that income. This rule of immediate inclusion upon receipt of payment for future services was finally established, after a long and disjointed evolutionary process, in the celebrated "trilogy" of United States Supreme Court cases decided between 1957 and 1963.[1] Since the 1967 case of *Artnell Co. v. Commissioner*[2] was decided by the Seventh Circuit, there has been a noticeable judicial and even administrative trend creating exceptions to the general rule of immediate inclusion.

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1. Automobile Club of Michigan v. Commissioner, 353 U.S. 180 (1957); American Automobile Ass'n v. United States, 367 U.S. 687 (1961); Schlude v. Commissioner, 372 U.S. 128 (1963).

2. 400 F.2d 981 (7th Cir. 1968).

Recently, the U.S. District Court for the Southern District of New York's decision in *RCA Corp. v. United States*[3] broke new ground in the prepaid income area of tax law by holding that "a taxpayer is entitled to rely on reliable statistical projections of anticipated expenses in determining the extent to which prepaid amounts should be included in gross income in tax years other than that of their receipt, in accordance with the principles of accrual accounting."[4] This significant expansion of the trend creating exceptions to the general rule of immediate inclusion upon receipt was short lived, as the Second Circuit reversed the lower court's holding on appeal.[5]

This article will discuss the history and present state of the law concerning the proper taxable year of inclusion of prepayments for services to be rendered beyond the current taxable year by accrual basis taxpayers, with a special emphasis on *RCA Corp. v. United States*.

EARLY HISTORY OF PREPAID INCOME TREATMENT

In response to growing pressure from economists and businessmen, Congress enacted a provision in the Revenue Act of 1916 allowing taxpayers to compute annual taxable income on the basis of the method used to compute annual accounting income, unless the book method did not "clearly reflect income."[6] The United States Supreme Court stated in *United States v. Anderson*[7] that the purpose of this provision impliedly allowing the accrual method was "to enable taxpayers to keep their 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; . . . ."[8]

Presumably under the *Anderson* rationale, an accrual basis taxpayer would not include receipts for services in gross income until the year in which the receipts were "earned." This has not been the case. In a line of Tax Court cases beginning in 1930 with *Automobile Underwriters, Inc.*,[9] the Internal Revenue Service has managed to persuade the Tax Court that prepayments

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3. 499 F. Supp. 507 (S.D. N.Y. 1980).
4. *Id.* at 516.
5. 664 F.2d 881 (2nd Cir. 1981), *cert. denied*, ______ U.S. ______, 102 S. Ct. 2958 (1982).
6. Revenue Act of 1916, ch. 463, §§ 8(g) and 13(d), 39 Stat. 756, 763, 771 (current version at I.R.C. §446(b) (1976)).
7. 269 U.S. 422 (1926).
8. *Id.* at 440 (emphasis added).
9. 19 B.T.A. 1160 (1930).

for future services must be returned by accrual basis taxpayers in the year of receipt even if not yet earned.[10] The rationale for requiring immediate inclusion was originally the question-begging assertion that the prepayments "ripened into gross income" by mere reason of their receipt.[11]

In *North American Oil Consolidated v. Burnet,*[12] decided in 1932, the Supreme Court articulated the "claim of right doctrine" which was soon adopted as the underlying rationale justifying the rule requiring immediate inclusion of prepayments for future services for accrual basis taxpayers. It is interesting to note that *North American Oil* did not deal with the situation where receipts were "unearned" at the time of receipt.[13] All that *North American Oil* held was that taxpayers who received receipts which had already been earned, under a claim of right and without restriction as to disposition, must report them in the year of receipt.[14]

The Supreme Court expressly applied the claim of right doctrine to an accrual basis taxpayer in *Brown v. Helvering,*[15] but that case merely stands for the proposition that an accrual basis taxpayer who receives payments for services already rendered, where the payments are received under a claim of right without restriction as to disposition, must include those payments in gross income in the year of receipt, even if there is a contingent liability to return the payments in later years.[16] The case does not squarely apply to the situation where an accrual basis taxpayer has received unearned advances for services to be rendered in the future. In spite of these distinctions, the Tax Court continued to require accrual basis taxpayers to include prepayments for future services in the year of receipt, using the new-found claim of right doctrine as its justification.[17] Outside the Tax Court, there were few

10. *See* Bradstreet Company of Maine v. Commissioner, 23 B.T.A. 1093 (1931); Northern Illinois College of Optometry v. Commissioner, 2 T.C.M. 664 (1943); Your Health Club, Inc. v. Commissioner, 4 T.C. 385 (1944); and National Airlines, Inc. v. Commissioner, 9 T.C. 159 (1947).

11. *Automobile Underwriters,* 19 B.T.A. at 1165.

12. 286 U.S. 417 (1932).

13. *See* Behren, *Prepaid Income Accounting Concepts and the Tax Law,* 15 TAX L. REV. 343, 347 (1960).

14. The method of accounting in *North American Oil Consolidated* was not stated. In dicta, the Court stated that it was not material "for the purposes of this case, whether the company's return was filed on the cash receipts and disbursements basis or the accrual basis." 286 U.S. at 423.

15. 291 U.S. 193 (1934).

16. *See* Behren, *supra* note 13, at 347-48.

17. *See supra* cases cited note 10. Note that during this time the Tax Court distinguished prepayments for the sale of goods and land, allowing deferral. Sophie M. Garretson v. Commissioner, 10 B.T.A. 1381 (1928); Summit Coal Co. v. Commissioner, 18 B.T.A. 983 (1930); Veenstra & De Haan Coal Co. v. Commissioner, 11 T.C. 964 (1948); and Woodlawn Park Cemetery Co. v. Commissioner, 16 T.C. 1067 (1951); *But see* Wallace Moritz v. Commissioner, 21 T.C. 622 (1954).

cases dealing with the accrual basis taxpayer and prepayments for future services, at least until 1955.[18]

PREPAYMENT FROM SECTIONS 452 AND 462 Of The 1954 CODE TO THE SUPREME COURT TRILOGY

As part of the comprehensive revision of the Internal Revenue Code in 1954, Congress enacted sections 452 and 462 allowing deferral of prepaid income and deductions of reserves for estimated future expenses.[19] The reason for the statutes was a desire to harmonize tax accounting with accepted business accounting, so as to avoid "distortion" of income caused by not matching revenues and expenses relating to prepayments for sales of goods and services.[20]

Soon after the enactment of sections 452 and 462 in 1954, the Internal Revenue Service received major shocks when two Circuit Court cases, decided under pre-1954 Code tax law, came down. In *Beacon Publishing Co. v. Commissioner,*[21] the Tenth Circuit rejected the use of the Commissioner's favorite weapon in the prepaid income area, the claim-of-right doctrine. The court held that an accrual basis taxpayer who received prepaid newspaper subscriptions could defer income because of the fixed dates on which the subscriptions were to be satisfied.[22] In *Pacific Grape Products Co. v. Commissioner,*[23] the Ninth Circuit allowed a deduction for estimated future expenses of shipping merchandise to customers where there was a fixed obligation. These cases served to muddy the waters since they went against the presumed state of the law prohibiting deferral of unearned income and deduction of estimated expenses.

Later in 1955, the Congress retroactively repealed sections 452 and 462 of the 1954 Code.[24] There was Congressional apprehension that the transitional rules phasing in the new statutes were inadequate in that the revenue losses in the phase-in year

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18. *See* Virginia Iron Coal & Coke Co. v. Commissioner, 99 F.2d 919 (4th Cir. 1938); South Dade Farms, Inc. v. Commissioner, 138 F.2d 818 (5th Cir. 1943).

19. I.R.C. §§ 452 and 462 (1954). Although there are some technical distinctions between deferring prepaid income and deducting estimated future expenses, the underlying principles are similar. Both are methods for matching future expenses of earning prepayments against the prepayments themselves. *See* the discussion by Judge Drennen in Simplified Tax Records, Inc. v. Commissioner, 41 T.C. 75, 79 (1963). However, it is important to remember the greater risk of loss of tax revenues inherent in deferral. *See* Mooney Aircraft, Inc. v. United States, 420 F.2d 400, 407 (5th Cir. 1969). *See also,* Comment, 42 NOTRE DAME LAW. 511 (1967).

20. *See* Austin, Surrey, Warren, and Winkour, *The Internal Revenue Code of 1954: Tax Accounting,* 68 HARV. L. REV. 257, 273 (1954).

21. 218 F.2d 697 (10th Cir. 1955).

22. *Id.*

23. 219 F.2d 862 (9th Cir. 1955).

24. Pub. L. No. 84-74, 69 Stat. 134 (1955).

were thought to be alarmingly higher than anticipated.[25] It is widely agreed that Congress intended to withdraw sections 452 and 462 and restore this area of tax law to what it would have been had the statutes never been enacted, while working on a better statute.[26] Indeed, it is clear that when Congress repealed sections 452 and 462, it was fully aware of the pro-taxpayer holdings earlier in 1955 by the Tenth and Ninth Circuits in *Beacon Publishing* and *Pacific Grape Products,* and intended no positive or negative interferences in judicial interpretation of the tax law in the area.[27]

The Tax Court, meanwhile in *Curtis R. Andrews v. Commissioner,*[28] thought that the claim-of-right doctrine rejected in the prepaid income area in *Beacon Publishing* was as valid as ever, and required immediate inclusion of prepayments for future services. However, the Fifth Circuit in *Schuessler v. Commissioner*[29] allowed a deduction for estimated future expenses involving a fixed service obligation, following the reasoning of *Beacon Publishing.*[30]

THE SUPREME COURT TRILOGY

When *Automobile Club of Michigan v. Commissioner*[31] was decided by the Supreme Court in 1957, the law concerning prepayments for future services was unclear, since *Beacon Publishing* seemed to clearly demolish the use of the claim of right rationale to tax prepaid income immediately. The Service, aware of the vulnerability of the claim of right doctrine in the prepaid income context, came up with a new rationale for taxing prepaid income currently: Internal Revenue Code §446(b). Section 446(b) gives the Commissioner discretion to change the taxpayer's method of tax accounting if it does not "clearly reflect income."[32]

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25. *See* H.R. Rep. No. 293, 84th Cong., 1st Sess. 2-5 (1955); S. Rep. No. 372, 84th Cong., 1st Sess. 4-5 (1955); Hearings Before the Senate Finance Committee on H.R. 4725, 84th Cong., 1st Sess. 6 (1955).

26. *See* Justice Stewart's dissent in American Automobile Ass'n v. United States, 367 U.S. 687, 703-11 (1961); Alvin, *'Prepaid Income': How the Commissioner Turned Liabilities Into Income Under the 1954 Code,* 11 WAYNE L. REV. 482, 484 (1965); Behren, *supra* note 13 at 355-56; Cromatarie, *Advance Payments: Income Yes, But When?, 24th* TUL. TAX INST. 238, 387-88 (1972).

27. H.R. Rep. No. 293, 84th Cong., 1st Sess. 4-5 (1955); S. Rep. No. 372, 84th Cong., 1st Sess. 5-6 (1955), wherein it was stated concerning *Pacific Grape:* "An extension of the principles laid down in this case might well lead the courts in the future to permit the accrual of most estimated expenses which would be covered by section 462 even though this section is repealed."

28. 23 T.C. 1026, 1032 (1955).

29. 230 F.2d 722 (5th Cir. 1956).

30. *Id.* at 725.

31. 353 U.S. 180 (1957).

32. I.R.C. §446(b)(1976) provides: "If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income."

In *Automobile Club of Michigan,* the Supreme Court had its first opportunity to decide a case dealing with prepayment for future services to an accrual basis taxpayer. In this case, the taxpayer received prepayment of membership dues covering a one-year period during which the taxpayer promised to render services at the member's request. The accrual basis taxpayer used the payments without restriction as to disposition, and for tax and book purpose arbitrarily prorated the dues on a monthly basis, causing a deferral of "unearned" dues remaining at the end of the year.

The *Automobile Club* Court heard the Commissioner's assertion of the claim of right doctrine, but seemingly ignored it and focused on the wide discretion given the Commissioner under section 446(b).[33] The Court upheld the exercise of the Commissioner's discretion in disallowing the deferral here on the basis of Code section 446(b), reasoning as follows: "The pro rata allocation of the membership dues in monthly amounts is *purely artificial* and bears no relation to the services which petitioner may in fact be called upon to render for the member."[34] It was the "artificiality" of the taxpayer's pro rata tax accounting method of deferral that caused it to not clearly reflect income, leaving the Commissioner room to reject the method and impose a method requiring immediate inclusion. Justices Harlan, Burton and Clark registered dissents to the rule of immediate inclusion there.

Two years after the Supreme Court decided *Automobile Club of Michigan,* its first case of what was to become a "trilogy" of cases, the Second Circuit decided *Bressner Radio, Inc. v. Commissioner.*[35] The *Bressner* court viewed *Automobile Club of Michigan* as having turned on the fact that the pro rata monthly deferral method used there was "purely artificial," and as having assumed that a more realistic deferral method would have been permissible.[36] The *Bressner* court found the pro rata equal monthly deferral method used by the taxpayer in the case at bar did a reasonably accurate job in deferring revenues until they were

33. *Automobile Club of Michigan,* 353 U.S. at 189.

34. *Id.* (emphasis added). In a footnote, the Court carefully distinguished *Beacon Publishing Co.* where there were fixed dates for the future services and specifically indicated that they expressed no opinion on those two cases. *Id.* at 189 n.20.

35. 267 F.2d 520 (2nd Cir. 1959). *Compare* Streight Radio & Television, Inc. v. Commissioner, 280 F.2d 883 (7th Cir. 1960), *cert. denied,* 366 U.S. 965 (1962), disallowing deferral because the taxpayer failed to show that the deferral method sufficiently matched revenue and related expenses.

36. *Id.* at 528.

earned and matching them with foreseeable related expenses, since the historical experience of the taxpayer demonstrated a reasonably uniform demand for services it had an obligation to render on demand. The Service soon issued a Revenue Ruling [37] announcing that it would not follow *Bressner Radio,* citing the misapplied claim of right doctrine and *Automobile Club of Michigan.*

In 1961, the Supreme Court decided *American Automobile Association v. United States,*[38] the second case in the Supreme Court trilogy involving prepaid income, and perhaps the most important case in the area. In a five to four decision,[39] the Supreme Court again rejected a pro rata equal monthly deferral method used by an accrual method taxpayer to report income arising from one year membership dues received in advance.[40]

The *AAA* Court based its rejection of the taxpayer's deferral method on the "artificiality" of the method of pro rata monthly deferral used here, the same section 446(b) ground it used in *Automobile Club of Michigan.* The problem which, in the Court's view, caused a distortion of income was that deferring the prepaid dues in pro rata equal monthly amounts did not properly match the revenues with the related expenses which in fact actually varied from month to month. The Court reasoned that since the services were to be performed only upon a member's demand and without relation to fixed future dates, the use of a pro rata equal monthly deferral method was "purely artificial."[41]

The taxpayer in *AAA* used a substantially identical pro rata equal monthly deferral method as the taxpayer in *Automobile Club of Michigan.*[42] The only difference the Court faced in *AAA* was the fact that unlike the taxpayer in *Automobile Club of Michigan,* the taxpayer in *AAA* offered evidence that its deferral method was in harmony with generally accepted accounting principles, and that statistics compiled on average monthly costs showed that the deferral method used happened to correlate roughly to the average costs.[43] The Court found the offered evidence insufficient to wipe

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37. Rev. Rul. 60-85, 1960-1 C.B. 181. The Commissioner later partially relaxed his view against *Bressner Radio* in Rev. Rul. 71-299, 1971-2 C.B. 218 to harmonize with Rev. Proc. 71-21, 1971-2 C.B. 549.

38. 367 U.S. 687 (1961).

39. Interestingly, Mr. Justice Clark wrote the *AAA* majority opinion, yet dissented in *Automobile Club of Michigan* on the prepaid income issue. *Automobile Club of Michigan* was a 5 to 3 decision.

40. 367 U.S. at 688-89.

41. *Id.* at 691.

42. *Id.*

43. *Id.*

away the charge that the deferral method was "purely artificial." First, the Court noted that the criteria of annual tax accounting were not always satisfied by financial accounting standards.[44] Second, the Court rejected the attempted after-the-fact justification of the pro rata equal monthly deferral method which compared the pro rata equal monthly method used to the actual way the average cost per month turned out.[45] Presumably the taint of "artificiality" could have been removed if the taxpayer had been able to predict before-the-fact, with reasonable accuracy, the future expenses related to the prepaid dues.[46] The court seemed to reject *AAA*'s hit-and-miss deferral method which by chance happened to come close (but not close enough) to the actual related expenses of rendering the promised services.

The *AAA* Court rested its rejection of the deferral method on the grounds that the enactment and repeal of Code sections 452 and 462 by Congress, coupled with the enactment of Code section 455 allowing deferral for publishers having prepaid subscriptions and the rejection of a similar statute allowing deferral for prepaid auto club membership dues, indicated that the Court should defer to Congress "in this case."[47] The Court immediately concluded as follows: "*[We] find only that, in light of existing provisions not specifically authorizing it, the exercise of the Commissioner's discretion in rejecting the Association's accounting system was not unsound,* we need not anticipate what will be the product of further 'study of this entire problem.' "[48]

In the dissenting opinion Mr. Justice Stewart correctly pointed out that the enactment and repeal of sections 452 and 462 was only intended to restore the status quo and not to rule out all deferral not specifically permitted by Congress.[49] In all probability, the Court did not intend to outlaw all deferral methods not specifically allowed by Congress.[50] This probability is supported by the following facts: the Court in *AAA* specifically refrained

44. *Id.* at 692. *See also* Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979) for a recent reaffirmation of this point.

45. The *AAA* Court noted that the pro-rata equal monthly deferral did not square closely enough with the after-the-fact average monthly costs computed on a "group or pool" basis. 367 U.S. at 693. The *AAA* Court further stated in dicta that had an after-the-fact deferral system actually been used by the taxpayer, it would flunk tax accounting standards. 367 U.S. at 693. The *AAA* Court did not discuss before-the-fact deferral systems.

46. *See* Automobile Club of New York v. Commissioner, 304 F.2d 781 (2nd Cir. 1962), which viewed *Bressner Radio,* as having survived *AAA* since the before-the-fact predictions closely matched the actual expenses.

47. 367 U.S. at 697.

48. *Id.* at 697-98 (emphasis added). Note the restrictive wording here.

49. *Id.* at 703-11 (Stewart, J., dissenting).

50. See the excellent discussion of this question in Mooney Aircraft, Inc. v. United States, 420 F.2d 400, 402-09 (5th Cir. 1969).

from overruling *Beacon Publishing*;[51] the fact of the restrictive nature of the *AAA* holding;[52] and the fact that Congress had refused to allow deferral for prepaid auto club dues by specific statute.

In 1963, the Supreme Court decided *Schlude v. Commissioner*,[53] the third case in the Supreme Court trilogy dealing with prepayment for future services. *Schlude* rejected a deferral method which allocated prepayments for future services on the basis of the actual services rendered under the contract as of the end of each accounting period, a type of after-the-fact allocation which the *AAA* Court had rejected in dicta.[54] The taxpayer in *Schlude* had entered into non-cancellable contracts allowing no refunds, under which the taxpayer agreed to provide dance lessons at unspecified future dates. At the close of each tax accounting period, the taxpayer recognized income to that date on the basis of the number of dance lessons given thus far. The *Schlude* Court rejected the deferral method as being "artificial" since, as in *Automobile Club of Michigan* and *AAA*, "the advance payments related to services which were to be performed only upon customers' demands without relation to fixed dates in the future."[55]

In a footnote,[56] the *Schlude* Court attempted to illustrate the reason why deferral methods based on experience each year were fatally "artificial." The taxpayer in *Schlude*, by an arbitrary rule of thumb, recognized "gains from cancellations" when the customer actually happened to demand no services during the year.[57] The *Schlude* Court complained that: "The studio made no attempt to report *estimated cancellations in the year of receipt*, choosing instead to defer these gains to periods bearing no economic relationship to the income recognized."[58] It seems clear that reasonably accurate statistical methods of estimating, before-the-fact, the services that would actually be rendered in the future were sanctioned by the *Schlude* Court as an acceptable substitute for the after-the-fact deferral method used by the taxpayer.[59] Only by such a before-the-fact estimation of future services could there be a proper

51. 367 U.S. at 691 n.4.
52. *See supra* note 48 and accompanying text.
53. 372 U.S. 128 (1963).
54. *See supra* note 45.
55. 372 U.S. at 135.
56. *Id.* at 136 n.9.
57. *Id.* at 131-32.
58. *Id.* at 136 n.9 (emphasis added).
59. See Justice Stewart's dissenting opinion in *Schlude v. Commissioner*, 372 U.S. at 142-43. Note here that Justice Stewart incorrectly failed to distinguish between a deferral system based on before-the-fact statistical estimates suggested as a "cure" by the majority in *Schlude*, and the after-the-fact statistical deferral system rejected in dicta by the majority in *AAA*. *See supra* note 45.

matching of revenues and expenses in a situation where the taxpayer was obligated to render future services, solely upon demand, without relation to fixed future dates. An annual after-the-fact deferral system in such a situation is flawed because of lack of demonstrable certainty, at the end of each tax year which the contract covers, as to whether more services would have to be rendered in the future periods remaining until the contract expired.[60] The concern seems to have been that demonstrably definite assurance be given that the deferred income is reported as the related costs do in fact occur under the deferral system.

The *Schlude* Court also discussed as an additional ground for its rejection of the deferral system involved, the policy expressed in *AAA* of viewing the enactment and repeal of Internal Revenue Code §452 as indicative of Congressional intent of "reinstating long-standing administrative and lower court rulings that accounting systems deferring prepaid income *could* be rejected by the Commissioner."[61] Even though this could be read as a carte blanche for the Commissioner to reject any deferral system not specifically authorized by statute, it seems clear that the Court only meant to give the Commissioner wide, but not absolute, discretion to reject deferral systems not specificlly allowed by statute.[62]

Schlude, decided in 1963, was the last word the Supreme Court has spoken on the prepaid service income issue, and it is clear that any case which would allow deferral of prepaid service income today must first hurdle the difficult, yet not insurmountable, barriers set up by the Supreme Court in its *Automobile Club of Michigan, AAA,* and *Schlude* "trilogy" of cases.[63]

FROM THE TRILOGY TO *RCA Corp. v. United States* IN 1980

Soon after the last installment of the Supreme Court trilogy in *Schlude,* the Tax Court, speaking through Judge Drennen in *Simplified Tax Records, Inc. v. Commissioner,*[64] had an opportunity to assess the impact of the trilogy on the prepaid income area of the tax law. Although the case dealt with the accrual of

60. This failure is crucial since without an estimation as to the amount of service to be performed in the following period, it is impossible to determine whether the right amount is being deferred.

61. 372 U.S. at 134 (emphasis added).

62. *See* Artnell Co. v. Commissioner, 400 F.2d 981 (7th Cir. 1968).

63. The precise nature of these barriers to deferral after the trilogy will be discussed later in this paper.

64. 41 T.C. 75 (1963).

estimated future expenses, the "flip side" of deferral of prepaid income, Judge Drennen spoke of the impact of the trilogy generally on this problematic area of tax law.

> Whether these more recent decisions of the Supreme Court will lay these problems to rest is problematical because the Court speaks in broad terms and it is not always clear just what the fundamental bases for the decisions are—hence other cases may be distinguished. See *Automobile Club of New York v. Commissioner,* 304 F.2d 781 (1962), wherein the Court of Appeals for the Second Circuit, while relying upon *American Automobile Assn. v. United States, supra,* to hold against the taxpayer, distinguished its own prior decision in favor of the taxpayer in *Bressner Radio, Inc. v. Commissioner,* 267 F.2d 520 (1959) . . . .[65]

In a footnote, the court continued,

> We suspect, because of its repeated emphasis on the Commissioner's discretion under sec. 41 of the 1930 Code and sec. 446 of the 1954 Code, and the legislative history of secs. 452 and 462, that the majority of the Supreme Court stand for the principle that, absent statutory sanctions for it, *unless the taxpayer can show that the Commissioner clearly abused his discretion in disallowing deferral of prepaid income or accrual of estimated expenses,* this exercise of the Commissioner's discretion will not be disturbed by the Court even though the taxpayer's method of accounting is in accord with generally accepted principles of commercial accounting. We also suspect that this principle, if such it be, will be met with some resistance in the courts.[66]

This assessment of the trilogy proved to be a prophetic hint as to what the future would eventually hold for the prepaid income area.

The bulk of the early post-trilogy decisions dealing with deferral of prepaid income came out of the Tax Court. In 1963, the Tax Court formulated its response to the Supreme Court trilogy. In the case of *Popular Library, Inc. v. Commissioner,*[67] the Tax Court held that the trilogy had laid down a rule of law absolutely and unequivocally disallowing any deferral of prepaid service income absent a specific statute permitting deferral in a given situation.[68] This hardline "fundamentalist" view of the trilogy was soon surprisingly extended by the Tax Court to cases involving

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65. *Id.* at 81.
66. *Id.* n.6 (emphasis added).
67. 39 T.C. 1092 (1963).
68. *Id.* at 1099.

customer advances for the sale of goods,[69] and for the next decade the Tax Court clung rigidly to its absolutist no-deferral philosophy.[70]

Outside the Tax Court, the earliest post-trilogy decisions were split.[71] In *Parkchester Beach Club Corp. v. Commissioner,*[72] decided in 1964, the Second Circuit Court of Appeals disallowed deferral of prepaid service income, citing the trilogy as authority. The court was careful to distinguish its earlier decision in *Automobile Club of New York v. Commissioner* which had in turn viewed *Bressner Radio, Inc. v. Commissioner* as surviving the Supreme Court's *AAA* decision.[73] Apparently, the Second Circuit would have allowed deferral on the basis of *Bressner Radio* had there been a way to match revenues and expenses by estimating before-the-fact "with reasonable accuracy" the costs of future services due under the contract and deferring prepayments on that basis.[74]

From a historical perspective, the most important post-trilogy case dealing with the prepaid service income issue was *Artnell Company v. Commissioner*[75] decided by the Seventh Circuit in 1968. In *Artnell,* the taxpayer owned a professional baseball team and received prepayments for services in the form of season tickets. The *Artnell* court, in allowing deferral on the basis that there was a "fixed" schedule of baseball games to be played, made analogies to *Beacon Publishing*[76] which the Supreme Court had

69. Chester Farrara v. Commissioner, 44 T.C. 189 (1965); Hagen Advertising Displays v. Commissioner, 47 T.C. 139 (1966); S. Garber, Inc. v. Commissioner, 51 T.C. 733 (1969). *See also* Fifth and York Co. v. United States, 234 F. Supp. 421 (W.D. Ky. 1964). This resulted despite earlier contrary authority in Veenstra & De Haan Coal Co. v. Commissioner, 11 T.C. 964 (1948) and Woodlawn Park Cemetery Co. v. Commissioner, 16 T.C. 1067 (1951), holding the general no-deferral-of-prepaid-income rule inapplicable to sales of goods.

70. *See* Cox v. Commissioner, 43 T.C. 448 (1965); William O. McMahon, Inc. v. Commissioner, 45 T.C. 221 (1965); Decision, Inc. v. Commissioner, 47 T.C. 58 (1966); and Angelus Funeral Home v. Commissioner, 47 T.C. 391 (1967).

71. *Compare* James M. Pierce Corp. v. Commissioner, 326 F.2d 67 (8th Cir. 1964) *with* Parkchester Beach Club Corp. v. Commissioner, 335 F.2d 478 (2nd Cir. 1964) *and* Franklin Life Insurance Co. v. United States, 399 F.2d 757 (7th Cir. 1968).

72. 335 F.2d 478 (2nd Cir. 1964).

73. *Id.* at 480. On the issue of whether *Bressner Radio* was overruled by *AAA, see also* Smith Motors v. United States, 61-2 U.S.T.C. para. 9627 (D.C. Vt. 1961) (*Bressner* alive), and National Bank of Fort Benning v. United States, 44 A.F.T.R.2d para. 79-6061, 79-6070 (M.D. Ga. 1979) (*Bressner* alive). Franklin Life Insurance Co. v. United States, 399 F.2d 757, 763 (7th Cir. 1968), *cert. denied,* 393 U.S. 1118 (*Bressner* dead). *Compare also* Bell Electric Co. v. Commissioner, 45 T.C. 158, 166 (1965) (*Bressner* must be consider "in the light of" the trilogy).

74. *Parkchester Beach Club Corp.*, 335 F.2d at 480.

75. 400 F.2d 981 (7th Cir. 1968), *remanded* 29 Tax Ct. Mem. (CCH) 403 (1970). *See Franklin Life Insurance Co.*, 339 F.2d at 763 in which the Seventh Circuit had forshadowed its result in *Artnell. See also* Automated Marketing Systems, Inc. v. United States, 74-2 U.S.T.C. para. 9711 (D.C. Illinois 1974) affirmed by the Seventh Circuit in unpublished opinion January 9, 1975, in which deferral was allowed on the basis of reliable estimates of cost arising under the service contract.

76. *Beacon Publishing*, 218 F.2d 697.

specifically refrained from overruling in the trilogy. The court reasoned that:

> It is best judgment that, although the policy of deferring where possible, to congressional procedures in the tax field will cause the Supreme Court to accord the widest possible latitude to the Commissioner's discretion, *there must be situations where the deferral technique will so clearly reflect income that the Court will find an abuse of discretion if the Commissioner rejects it.*[77]

The "certainty" of the fixed schedule of baseball games have allowed the court to allow a deferral technique based on the schedule despite the Commissioner's objections.[78]

As one authority puts it, "the *Artnell* case delivered a major jolt to long-standing and generally accepted policy requiring taxpayers, whether on the cash or accrual method, to include amounts received for goods and services to be furnished in a later year in income in the year of receipt."[79] As will be discussed, since *Artnell,* a significant number of courts considering the problem in light of the trilogy have adopted a somewhat relaxed rule concerning deferral of prepaid income. Indeed, even the Service decided to recant partially as will be discussed.

The early judicial reaction to the Seventh Circuit's analysis of the trilogy in *Artnell* was mixed. The First Circuit was not sure what to think of *Artnell,*[80] and the Sixth Circuit seemingly declined to follow *Artnell,*[81] while the Ninth Circuit acknowledged the correctness of *Artnell* though distinguishing it factually from the case before it.[82]

The building conflict between the circuit courts since *Artnell* symbolized an inner conflict within the Internal Revenue Service

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77. 400 F.2d at 984-85 (emphasis added).

78. *Id.* at 985.

79. Freeland, Lind, and Stevens, *Fundamentals of Federal Income Taxation,* 577 (2nd ed. 1977).

80. New England Tank Industries of New Hampshire, Inc. v. Commissioner, 413 F.2d 1038 (1st Cir. 1969). *Cf.* Wilkinson-Beane, Inc. v. Commisioner, 420 F.2d 352, 358 (1st Cir. 1970) dealing with a cash method taxpayer.

81. Hagen Advertising Displays, Inc. v. Commissioner, 407 F.2d 1105, 1109 n.7 (6th Cir. 1969) (sale of goods). This case might be criticized because, in arriving at its "absolutely-no-deferral" result, the court apparently missed the fact that in *AAA* the Supreme Court had specifically distinguished *Beacon* and *Schuessler,* as it had done previously in *Automobile Club of Michigan. (Compare* 407 F.2d 1105, 1109 n.5 *with* 367 U.S. 687, 691 n.4.) *See also* Grinder, Taber, & Grinder, Inc. v. United States, 75-2 U.S.T.C. para. 9546 (D.C. Tenn. 1975).

82. Angelus Funeral Homes v. Commissioner, 407 F.2d 210 (9th Cir. 1969), *cert. denied,* 396 U.S. 824 (1969). A "trust fund" was not really involved here since the prepayments could be used for the taxpayer's benefit subject to some limits.

over the precise meaning of the Service's victory in the trilogy. It is interesting to note that the government did not petition for certiorari in *Artnell*,[83] perhaps out of fear that the Supreme Court would have limited the reach of the trilogy. In what one authority calls "a remarkable volte-face,"[84] the Internal Revenue Service decided in two Revenue Procedures[85] issued in 1970 and 1971 and a regulation[86] amended in 1971 to allow limited deferral of prepayments for future services and sales of goods in carefully defined circumstances.

Revenue Procedure 70-21,[87] as superseded by substantially identical Revenue Procedure 71-21,[88] was designed to reconcile the tax and financial accounting treatment of prepayments for services in a "large proportion" of the cases, by allowing a limited one year[89] deferral in carefully defined circumstances for accrual method taxpayers.[90] The deferral treatment was allowed only where the service contract covered periods lasting no longer than the end of the next taxable year,[91] and the limited deferral privilege was stated not to include amounts received under guaranty or warranty contracts or to prepaid rent or to prepaid interest.[92]

In a parallel development in 1971, Treas. Regs. Section 1.451-5 came out, allowing accural method taxpayers receiving "substantial" advance payments for goods includible in inventory to defer the prepayments up to two years following the year in which the substantial advance payments are received.[93] Advance payments for noninventoriable goods could be deferred until the taxable year in which the goods are shipped.[94]

The Fifth Circuit got its chance to respond to *Artnell* in its well written opinion in *Mooney Aircraft, Inc. v. United States*[95] decided in 1970. This case involved an attempt to accrue estimated

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83. Freeland, Lind, and Stevens, *supra* note 79, at 579.

84. BORRIS BITTKER, 4 FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS 105-63 (1981).

85. Rev. Proc. 70-21, 1970-2 C.B. 501; Rev. Proc. 71-21, 1971-2 C.B. 549.

86. Treas. Regs. § 1.451-5 (1971).

87. 1970-2 C.B. 501.

88. Rev. Proc. 71-21, *supra* note 85. *See also* Rev. Rul. 71-299, *supra* note 37, relaxing the Service's anti-*Bressner Radio* stance "to the extent" inconsistent with Rev. Proc. 71-21 (repealed Pub. Law No. 84-74, 169 Stat. 134).

89. Contrast I.R.C. § 452 (1954) (*repealed by* Pub. L No. 84-74, 69 Stat. 134) which allowed five year deferral. The Service can hardly be accused of being generous here.

90. Rev. Proc. 71-21, § 2, *supra* note 85.

91. *Id.* at §§ 3.02, 3.03.

92. *Id.* at § 3.08.

93. Treas. Regs. § 1.451-5(c).

94. Treas. Regs. § 1.451-5(b).

95. 420 F.2d 400 (5th Cir. 1970). *See also* National Bank of Fort Benning v. United States, 44 A.F.T.R. 2d para. 79-6061 (M.D. Ga. 1979).

expenses rather than defer prepaid receipts. Since the principles involved are generally similar, the opinion comprehensively surveyed the history of the law on prepaid income. The court viewed the trilogy as having taken a "middle ground" in the area, the repeal of sections 452 and 462 having served to vest the Commissioner with very wide (yet not absolute) discretion to disallow deferral or reserve systems pending Congressional reform and clarification in this extremely confused area of law. The Fifth Circuit quoted dicta from the early post-trilogy Tax Court *Simplified Tax Records* case as support for its "middle ground" view that the trilogy created no absolute bar to deferral.[96]

The Tax Court, which prior to *Artnell* had rigidly held to a view of the trilogy as setting up an absolute bar to deferral absent specific statutory authorization,[97] seemed to retreat a little in *Standard Television Tube Corp. v. Commissioner*[98] decided in 1975. There the court while seemingly recognizing *Artnell* as authority, distinguished it because of the lack of certainty of performance or fixed future service dates. In *Allied Fidelity Corp. v. Commissioner*[99] decided in 1976, the Tax Court again acknowledged *Artnell* as authority yet distinguished it factually. However, here the case was appealable to the Seventh Circuit.[100]

The Court of Claims got its chance to hop on the *Artnell* bandwagon in 1976, when it decided *Boise Cascade Corp. v. United States.*[101] The court allowed deferral of prepaid service income where the engineering services to be performed related to the construction of an electric power plant. Deferral was based on continually revised estimates of the service hours needed to complete the contract. In following *Artnell* and *Mooney Aircraft,* the court found sufficient "certainty" of dates of performance to justify deferral.[102]

The Court of Claims quickly extended the deferral rationale of *Boise Cascade* to prepaid interest in *Morgan Guaranty Trust Co. of New York v. United States*[103] decided in 1978. The opinion

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96. 420 F.2d at 408, 409. Note that from 1963 to 1967 the Tax Court had consistently ignored its own *Simplified Tax Records* dicta, instead viewing the trilogy as an absolute bar. See cases cited *supra* note 70.

97. *Supra* note 70.

98. 64 T.C. 238 (1975).

99. 66 T.C. 1068 (1976), *aff'd,* 572 F.2d 1190 (7th Cir. 1978).

100. The rule of *Jack E. Golsen,* 54 T.C. 742 (1970), would thus apply requiring the Tax Court to recognize as controlling a rule set out by a Court of Appeal in the circuit to which a case at bar was appealable.

101. 530 F.2d 1367 (Ct. Cl. 1976), *cert. denied,* 429 U.S. 867 (1976).

102. *Id.* at 1377-78, 1378 n.8.

103. 585 F.2d 988 (Ct. Cl. 1978).

remarked that "where there is no distortion of income or potential for distortion under a method of tax accounting because the date income is earned is easily ascertainable, it is an abuse of the Commissioner's discretion to switch a taxpayer's method of tax accounting to a different method."[104] Nonetheless, the court noted that the *de minimis* amount of prepaid interest income, compared with total interest income raised a serious question as to the existence of even the potential for a "material income distortion." In addition, the daily nature of interest earnings and the fact that the interest prepayment was not a condition for the loan decided the court in favor of allowing deferral.[105]

The Tax Court toyed around with *Artnell* again in 1978, when it decided *Collegiate Cap & Gown Co. v. Commissioner,*[106] a case appealable to the Seventh Circuit. Here the Tax Court allowed deferral where there was certainty of future performance dates, citing *Artnell* as controlling although quipping that this did not "necessarily impl[y] that we accept the Seventh Circuit's approach in comparable cases not appealable to that circuit."[107] In *T.F.H. Publications, Inc. v. Commissioner*[108] decided in 1979, in a case affirmed by the Third Circuit, the Tax Court speaking through Judge Drennen (author of the *Simplified Tax Records* dicta)[109] explicity recanted from its earlier absolute rule of nondeferral, and instead said that nondeferral is not a rule of law but only a "general rule of thumb."[110] While accepting the *Artnell* rationale of allowing deferral where there is a certainty of performance or fixed dates, the court disallowed deferral in the case at bar because of just such a lack of certainty or fixed dates.[111]

It would seem that as of 1980 the trend of judicial authority supported the *Artnell* analysis of the trilogy. Although the repeal of sections 452 and 462 of the 1954 Internal Revenue Code requires the courts to give the "widest possible latitude" to the Commissioner's discretion under Code section 446(b) to reject accounting systems not clearly reflective of income, where the facts show

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104. *Id.* at 997.

105. *Id. But see* Bjornsen Investment Corp. v. United States, 81-1 U.S.T.C. para. 9258 (D.C. Iowa 1981), which refused to allow deferral of prepaid interest since, although it acknowledged *Morgan Guaranty,* the "de minimis amount" and "regulatory requirement" factors were not present.

106. 37 T.C.M. 960 (1978).

107. *Id.* at 965.

108. 72 T.C. 623 (1979), *aff'd* by the Third Circuit in unpublished opinion May 27, 1980, *cert. denied,* 449 U.S. 921 (1980).

109. *See supra* note 65 and accompanying text.

110. *T.H.F. Publications*, 72 T.C. at 641.

111. *Id.* at 644.

a certainty of performance on fixed dates in the future, deferral of prepayments on the basis of the schedule of performance is allowable.

RCA v. United States: THE DISTRICT COURT OPINION

On August 14, 1980, *RCA Corp. v. United States*[112] was decided by Judge Lasker for the Southern District of New York, allowing deferral of prepaid income. A flurry of optimistic articles greeted this bold case as infusing new life into the deferral doctrine.[113]

In *RCA,* the taxpayer received prepayments for service contracts of periods varying from three to twenty-four months whereby, upon the customer's demand, it would render television repair service on television sets it had just sold to the customer. The taxpayer was on the accrual basis for both tax and book purposes. The prepayments were allocated between "revenue immediately recognized" to cover the costs of processing and selling the contract plus a profit, and "unearned revenue" treated as a liability. Each month throughout the life of the service contracts, the unearned revenue account was credited to earned revenue, based on statistically derived schedules designed to take into account as revenue each month that portion of the prepayments attributable to the services performed that month under such contracts. A graph was stipulated into evidence showing that for the tax years in question the unearned revenue credited to earned revenue monthly on the basis of the schedules achieved a remarkably close correlation with the related direct service expenses actually incurred during each month of the tax years in question.[114]

The district court began its legal analysis by quoting *United States v. Anderson*[115] wherein the Supreme Court in 1926 had explained that the purpose of the provision of the Revenue Act of 1916 which first permitted the accrual method for tax accounting purposes was "to enable taxpayers to keep their books and make their returns according to scientific principles, by charging against

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112. 499 F. Supp. 507 (S.D. N.Y. 1980), *rev'd,* 664 F.2d 881 (2nd Cir. 1981).

113. Raabe, *New Case Permits Use of Statistical Evidence to Justify Deferral of Tax on Prepaid Income,* TAXATION FOR ACCOUNTANTS 280 (November 1980); Seago, *What Chance for Prepaid Income Deferrals Based on Statistical Estimates After RCA?,* 54 J. TAX'N 16 (January 1981); Thieves, *Revenue Recognition Help in RCA v. United States,* 33 TAX EXECUTIVE 216 (April 1981); Ehrlick, *Deferring Prepaid Income,* 12 TAX ADVISER 294 (May 1981); and Stewart and Woods, *Analysis of the Trend Toward Deferring Recognition of Prepaid Income,* 59 TAXES 400 (June 1981).

114. 499 F. Supp. at 519-21.

115. 269 U.S. 422 (1926).

income earned during the taxable period, to expenses incurred in and properly attributable to the process of earning income during that period."[116] Then the district court went into the section 446(b) clear-reflection-of-income issue, by taking a close look at the trilogy. The district court viewed the trilogy in a new light:

> In our view, the teachings of the trilogy can be briefly summarized as follows: *Michigan* and *AAA* establish that a taxpayer may not simply prorate recognition of receipts as revenue over the period in which the service covered by those receipts is to be rendered, because there is no assurance that those services will be rendered ratably over that period. *Schlude,* on the other hand, establishes that a taxpayer may not, automatically each year, recognize revenue to the extent of actual expenses incurred that year, because there is no assurance that this amount will accurately reflect the portion of the total expenses to be incurred under the contract attributable to that year. In each of these cases the Court found the taxpayers' method of accounting for prepaid receipts "artificial" not, as the Government contends here, because those receipts related to services to be performed at unspecified times in tax years subsequent to that of their receipt, but rather, as *RCA* argues, because in each case the taxpayers' accounting method failed to account properly for that fact through the use of adequately supported statistical projections.[117]

The district court found a justification for its views by noting that the Supreme Court in *Schlude* had rejected after-the-fact deferral systems but had suggested that before-the-fact statistical projections of anticipated expenses would have been satisfactory.[118] The court disposed of arguments based on *Thor Power Tool Co. v. Commissioner,*[119] where the Supreme Court in 1979 had emphasized the fundamentally different objectives of financial and tax accounting, by noting that *Thor Power Tool* itself had suggested the use of hard statistical evidence to write down inventories, rather than "reasonable" assumptions based on general business experience or well-educated guesses.[120] Then the court expressed its holding as follows: "In our view, a taxpayer is entitled to rely on reliable statistical projections of anticipated expenses in determining the extent to which prepaid amounts should be included in gross income in tax years other than that of their receipt, in accordance with the principles of accrual accounting."[121]

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116. *Id.* at 440.
117. 499 F. Supp. at 515-16.
118. *Id.* at 516.
119. 439 U.S. 522 (1979).
120. 499 F. Supp. at 516.
121. *Id.*

The district court rejected the argument that the trilogy viewed the legislative history of section 452 as setting up an absolute nondeferral rule absent specific statute allowing deferral. The court in dicta noted that the government's case was "undercut" to some extent here due to the Commissioner's partial recantation in Rev. Proc. 71-21.[122]

Finally, the district court found that taxpayer here had carried its burden of proving that its deferral technique "operated with reasonable precision" and concluded that the Commissioner had abused his discretion under section 446(b).[123]

RCA v. United States: THE SECOND CIRCUIT OPINION

When the *RCA* case was appealed to the Second Circuit early in 1981, it appeared probable that the court would affirm the lower court holding in favor of the taxpayer, because of the Second Circuit cases of *Bressner Radio, Automobile Club of New York* and *Parkchester Beach Club* allowing deferral on the basis of accurate statistical predictions.[124] Also, the Tax Court in *Southern Pacific Transportation Co. v. Commissioner,*[125] decided in 1980, approvingly cited *RCA in a "cf."* footnote dealing with the validity of statistical studies for tax purposes.[126]

On November 13, 1981, the Second Circuit surprisingly reversed the district court's holding in *RCA v. United States.*[127] After briefly reviewing the district court's opinion, the Second Circuit concluded that the lower court gave too little weight to the goals of tax accounting and to the Commissioner's wide discretion in implementing those objectives.

First, the court thought that the lower court used the wrong standard in reviewing the Commissioner's exercise of discretion, *i.e.*, the question is not whether the taxpayer's method of accounting "clearly reflected income" but whether there is an adequate

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122. *Id.* at 519. The court apparently felt that it was hypocritical for the I.R.S. to in one breath sanction to the limited use of statistical deferral methods in Rev. Proc. 71-21, *supra* note 88, at § 3.06, while in the next breath attacking RCA's statistical deferral method in the case at bar as not "clearly reflecting income."

123. 499 F. Supp. at 522-23.

124. *See supra* note 35 and 75 and accompanying text. *See also* Bayshore Gardens, Inc. v. Commissioner, 267 F.2d 55 (2nd Cir. 1959).

125. 75 T.C. 497 (1980). Judge Drennen, author of the decision in T.F.H. Publications, Inc. v. Commissioner, 72 T.C. 623 (1979) wrote the voluminous opinion touching tangentially on the *RCA* opinion.

126. *Id.* at 792 n.349.

127. 664 F.2d 881 (2nd Cir. 1981), *rev'g* 499 F. Supp. 507 (S.D. N.Y. 1980).

basis in law for the Commissioner's conclusion that it did not.[128]

Next, the court reviewed the Supreme Court prepaid income trilogy to extract the underlying policy considerations. The Second Circuit thought these policy considerations to be "quite clear":

> When a taxpayer receives income in the form of prepayments in respect of services to be performed in the future upon demand, it is impossible for the taxpayer to know, at the outset of the contract term, the amount of service that his customer will ultimately require, and, consequently, it is impossible for the taxpayer to predict with certainty *the amount of net income, i.e.*, the amount of the excess of revenues over expenses of performance, that he will ultimately earn from the contract. For purposes of financial accounting, this uncertainty is tolerable; the financial accountant merely estimates future demands for performance and defers recognition of income accordingly. Tax accounting, however, "can give no quarter to uncertainty." *Thor Power Tool, supra* 439 U.S. at 543, 99 S. Ct. at 786. The entire process of government depends on the expeditious collection of tax revenues. Tax accounting therefore tends to compute taxable income on the basis of the taxpayer's present ability to pay the tax, as manifested by his current cash flow, without regard to deductions that may later accrue.[129]

The court then went on to reason that since the RCA contracts created obligations dependent only upon the customer's demand for services, which were impossible to predict with complete certainty, the Commissioner acted within his discretion in requiring RCA to report its prepaid service contract income upon receipt.

After brushing aside its own *Bressner Radio* decision (which allowed deferral based on reasonably accurate predictions of future services) as having been expressly and impliedly overruled by *AAA* and *Schlude*,[130] the Second Circuit went on to stress its view that no "prediction," no matter how accurate, could serve as a permissible basis for deferral without the Commissioner's approval.[131]

The Second Circuit's opinion that *AAA, Schlude*, and *Thor Power* effectively negate the use of any statistical predictions, regardless of how accurate they may be, is doubtful on at least

128. 664 F.2d at 886. This criticism seems to focus on the semantics rather than the substance of the district court's opinion which acknowledged the Commissioner's extremely wide discretion in the prepaid income area, yet viewed that discretion as exceeding permissible limits on the basis of the facts before it.

129. *Id.* at 887-88.

130. *Id.* at 888. This is a disputed issue. See the conflicting views concerning the current viability of *Bressner Radio*, note 73 *supra*.

131. 664 F.2d at 889.

two grounds. First, the Supreme Court in *AAA* and *Schlude* dealt only with the after-the-fact use of descriptive statistics as opposed to before-the-fact use of statistical inference.[132] This is underlined by the Supreme Court's apparent suggestion in footnote nine of *Schlude* that the use of before-the-fact statistical estimates would have cured the defect in the taxpayer's deferral method.[133]

Second, a close analysis of the Supreme Court's recent tax accounting decision in *Thor Power Tool Co. v. Commissioner*[134] sharpens the principle expressed in footnote nine of *Schlude* concerning the use of estimates for tax accounting purposes. In *Thor Power Tool,* as in footnote nine of *Schlude,* the Supreme Court criticized the taxpayer for failing to present statistically evidenced estimates.[135] What the Supreme Court did reject expressly in *Thor Power Tool* and by implication in *Schlude* was the use of accounting methods based on relatively artificial assumptions such as general business experience or well-educated guesses, methods which are reasonable enough for financial accounting purposes yet too imprecise for tax accounting purposes.[136]

RESTATEMENT OF PREPAID SERVICE INCOME TAX LAW

Having completed the task of tracing the evolution of the tax law concerning accrual basis taxpayers who receive prepayments for future services, it is now possible to come to some conclusions as to what the tax law requires for one to properly defer the prepayments. The remaining discussion attempts to arrive at a restatement of the prepaid service income tax law in the area outside the safe harbor of Revenue Procedure 71-21, which covers probably the majority of cases in the area.

The starting point today is I.R.C. § 446(a) which 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."[137] This section has its origins in sections 8(g) and 13(d) of the Revenue Act of 1916,[138] the pur-

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132. *See supra* note 45 and *supra* note 54 and accompanying text. Only before-the-fact use of statistical inference concerning the extent of future services to be rendered under the contract can adequately "match" expenses against prepayments where services are to be rendered only upon the customer's demand without relation to fixed future dates.

133. The Second Circuit did not mention footnote 9 of *Schlude* in its opinion.

134. 439 U.S. 522 (1979).

135. *Thor Power Tool,* 439 U.S. at 528-29 and *Schlude,* 372 U.S. at 136 n.9.

136. *Id.*

137. I.R.C. § 446(a) (1976).

138. Revenue Act of 1916, ch. 463, §§ 8(g), 13(d), 39 Stat. 763, 771.

pose of which was to relieve the distortions caused by the strict application of the cash receipts and disbursements method, by enabling "taxpayers to keep their 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."[139] Note two key principles. First, income must be "earned" during the taxable period in which it is to be recognized and second, expenses related to earning the income must be offset against the income in the same period.[140]

Internal Revenue Code § 451(a) currently states that "[t]he 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 in a different period."

Treas. Regs. Section 1.451-1(a) helps out here by stating that: "Under an accrual method of accounting, income is includible in gross income when *all the events have occurred which fix the right to receive such income* and the amount thereof can be determined with reasonable accuracy."[141] This of course is the "all events test" originating in *United States v. Anderson,*[142] which, as previously discussed, also dealt with the original statute allowing accrual method for tax accounting purposes.

The "all events test" is a key to determining when an accrual method taxpayer should include prepayments for future services in gross income. Under the "all events test," it is not the actual receipt of a payment but the *right to receive* payment that determines the taxable year of inclusion.[143] Furthermore, substantially *all events* must occur which fix the right to receive payment. It seems clear that there is no legal "right" to receive payment until the payments have been earned by discharging "the liability to perform services under the contract."[144]

Up to this point in the concluding analysis, it would appear that the tax accounting principles on prepaid service income re-

139. *Anderson*, 269 U.S. at 440 (emphasis added).

140. These are the "revenue realization" and "matching" principles of financial accounting. *See* KIESO & WYEGANDT, INTERMEDIATE ACCOUNTING 32-36 (3rd ed. 1980).

141. Treas. Regs. § 1.451-1(a) (emphasis added).

142. 269 U.S. at 440.

143. *See* Spring City Co. v. Commisioner, 292 U.S. 182, 184 (1933) and Commissioner v. Hansen, 360 U.S. 446, 449 (1958), *cited in Schlude*, 372 U.S. at 137. *See also Mooney Aircraft*, 420 F.2d at 403.

144. *See Bressner Radio, Inc.*, 267 F.2d at 523.

ceived by accrual method taxpayers are identical to the financial accounting principles of "revenue recognition" and "matching."[145] That is precisely the result mandated by the Supreme Court in *Anderson,* except for the fact that Code section 446(b) contains the following language also originating in the Revenue Act of 1916: "If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary does *clearly reflect income.*"[146] This clearly-reflect-income exception to tax accounting principles othewise applicable is a "safety valve"[147] for the Commissioner, a statutory overlay on otherwise valid tax accounting rules.

In *Anderson* the Supreme Court in 1926 seemed to view the clear-reflection-of-income exception as conditioning accrual accounting for tax purposes on the tax return reflecting "true *net* income."[148] The Supreme Court trilogy of cases on prepaid service income, *Automobile Club of Michigan, AAA,* and *Schlude,* allowed the Commissioner to use the clear-reflection-of-income safety valve to reject accounting systems deferring prepayments for future services which were "artificial" for tax purposes even though based on generally accepted accounting principles.[149] The artificiality arose from the fact that in all three trilogy cases the nonrefundable prepayments for future services were to be performed "only upon customers' demand without relation to fixed dates in the future."[150] The concern was that as each tax year closed, there was a real possibility that a good portion of the nonrefundable prepayments received that year would never be "earned" in later tax years because the customer might fail to demand services and hence would have been really "earned by default" in the year of receipt yet not reported in the year of receipt. This significant potential for distortion of "true net income" justified the Commissioner's use of Code section 446(b) to reject the deferral system in the trilogy of cases.

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145. *Supra* note 140.
146. I.R.C. § 446(b)(1976).
147. Austin, Surrey, Warren, and Winkour, *supra* note 20, at 260.
148. 269 U.S. at 439.
149. Note here that although generally accepted accounting principles are "ordinarily" sufficient, United States v. Anderson, 269 U.S. 422 (1926), and Treas. Regs. § 1.446-1(a)(2), they are not conclusively clearly reflective of true net income for tax accounting purposes. Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979).
150. *Schlude,* 367 U.S. at 136.

Where there is no significant *potential* for distortion of true net income in a deferral system, it would seem that Code section 446(b) is no barrier to deferral. If the accrual basis taxpayer can demonstrate that there is a *substantially certain basis* upon which he can predict the timing of the actual rendition of services he must render under the service contracts, there is no significant distortion potential, and deferral of the prepayments is permissible. Either a fixed performance schedule for future services[151] or a statistically reliable projection of future services[152] will provide such a "substantially certain basis." Anything less than a substantially certain basis will cause the deferral system to be exposed to the Commissioner's ability to use the clear-reflection-of-income safety valve to strike the system down.

The Code section 446(b) clear-reflection-of-income safety valve, has obtained added significance since *AAA* and *Schlude* were decided. These two decisions were not only based on the "artificiality" ground, but also upon the effect of the Congressional enactment and repeal of Code section 452, the only statute "incontestably permitting"[153] deferral generally. It seems clear that *AAA* and *Schlude* viewed this as being intended to give the Commissioner added room to exercise his already wide discretion in using the Code section 446(b) safety valve, pending Congressional study of the entire prepaid income problem.[154] Since the promised reform of the prepaid income area[155]—perhaps reenactment of Code sections 452 and 462 with appropriate transitional rules to slowly phase in the reform—has not been forthcoming, it is clear that this element of *AAA* and *Schlude* is still in effect giving an extra measure of discretion to the Commissioner in using section 446(b) to reject deferral systems not clearly reflecting true net income.

As a result, it appears that accrual basis taxpayers desiring to defer prepayments for future services must be prepared to demonstrate convincingly that there is in fact a "substantially certain basis" upon which they can predict the timing of the actual rendition of services under the contract. Absent a clear showing of a fixed performance schedule or statistically reliable projec-

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151. *See* Beacon Publishing Co. v. Commissioner, 218 F.2d 697 (10th Cir. 1955), and Artnell Co. v. Commissioner, 400 F.2d 981 (7th Cir. 1968).

152. *See* Bressner Radio, Inc. v. Commissioner, 267 F.2d 520 (2nd Cir. 1959), and RCA Corp. v. United States, 499 F.Supp. 507 (S.D. N.Y 1980)

153. *American Automobile Ass'n.*, 367 U.S. at 694.

154. *See RCA Corp.*, 499 F. Supp. 507, *T.F.H. Publications, Inc.*, 72 T.C. 623; *Boise Cascade Corp.*, 530 F.2d 1367; *Mooney Aircraft, Inc.*, 420 F.2d 400; and *Artnell Co.*, 400 F.2d 981.

155. S. REP. No. 372, 84th Cong., 1st Sess. 3 (1955).

tion of future services, the exercise of the Commissioner's wide discretion in using the Code section 446(b) safety valve will be viewed as being within permissible limits.

Although the majority of taxpayers will probably not be able to make such a clear showing,[156] there are perhaps many taxpayers in a position to do so. In the prepaid rent[157] and prepaid interest[158] areas, it seems that taxpayers could qualify for deferral since the reasonably certain basis would be supplied by the "fixed performance schedule" nature of rent and interest. In the guaranty and warranty areas, it likewise seems that many taxpayers could qualify for deferral since the reasonably certain basis could be demonstrated in many cases by "statistically reliable projections" based on past experience.

CONCLUSION

A close reading of the Supreme Court trilogy on prepaid income reveals that there are probably cracks in the dike, allowing taxpayers deferral privileges where it is clearly shown that there is no significant potential for distortion of true net income. However, it is by no means a settled question, as the Second Circuit's recent opinion in *RCA* demonstrates.

The taxpayer has applied for certiorari to the Supreme Court in *RCA*. The conflict between those courts seeing cracks in the Supreme Court trilogy[159] and those seeing virtually none[160] could

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156. Outside, of course, the safe harbor of Rev. Proc. 71-21, *supra* note 85.

157. Note that Rev. Proc. 71-21, *supra* note 85, specifically excepts rent from its protection. *See* Treas. Regs. §§ 1.61-8(a), (b). For traditional result, *see generally* South Dade Farms, Inc. v. Commissioner, 138 F.2d 818 (5th Cir. 1943); New Capital Hotel, Inc. v. Commissioner, 261 F.2d 437 (6th Cir. 1958), *aff'g* 28 T.C. 706 (1957); Kohler-Campbell Corp. v. United States, 298 F.2d 911 (4th Cir. 1962). *See also* New England Tank Industries of New Hampshire, Inc. v. Commissioner, 413 F.2d 1038, (1st Cir. 1969) for prepaid rent case flirting with *Artnell* and then disallowing deferral on the basis of Treas. Regs. §§ 1.61-8 (a), (b).

158. Note that Rev. Proc. 71-21, *supra* note 85, specifically excepts interest from its protection. *But see Morgan Guaranty Trust Co.*, 585 F.2d 988 (allowing deferral of prepaid interest.) *See also Bjornsen Investment Corp.*, 81-1 U.S.T.C. para. 9258, (disallowing deferral of prepaid interest on different facts).

159. Fifth Circuit:
Mooney Aircraft, Inc., 420 F.2d 400.
Seventh Circuit:
Artnell Co., 400 F.2d 981; *Automated Marketing Systems, Inc.*, 74 U.S.T.C. para. 9711.
Court of Claims:
Bosie Cascade Corp., 530 F.2d 1367; *Morgan Guaranty Trust Co. of New York*, 585 F.2d 988.
Tax Court:
T.F.H. Publications, Inc., 72 T.C. 623; *Southern Pacific Transportation Co.*, 75 T.C. 792 n.349.

160. Second Circuit:
RCA Corp., 664 F.2d 881.
Sixth Circuit:
Hagen Advertising Displays, Inc., 407 F.2d 1105.

be resolved if the Supreme Court decides to take the *RCA* case on appeal. The fact that the Supreme Court trilogy was each time closely decided, the change in the composition of judges on the Supreme Court since then, and the trend in favor of the narrow view of the trilogy in *Artnell* all point to the probability that, were the Supreme Court to take on *RCA*, the taxpayer would prevail.