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Comments

Prepayments: The Historical Tension Between Tax and Commercial Accounting

I. Introduction

It would be difficult to find another area in the tax field in which the Commissioner has had as much early success at the expense of good accounting practice, than in the area of prepaid income and estimated future expenses. Originally, prepayments for the performance of services or for the sale of goods were required to be reported by an accrual method taxpayer in the year of the prepayment, even though for purposes of non-tax accounting the amount might have been deferred and not accrued until the services which earned the payment were performed or the goods sold were delivered. In 1954, Congress in an attempt to reconcile the two positions, passed section 452 of the Internal Revenue Code of 1954,[1] which would have permitted deferral of prepaid income over a five year period, and section 462[2] which would have permitted reserves for certain estimated expenses. However, when it appeared that the one time revenue loss from the enactment of these sections might be in excess of one billion dollars,[3] largely because of unexpected reserves and lack of transitional rules, these sections were retroactively repealed later in the same year. Subsequently, the Supreme Court appeared to accept the traditional position held by the government concerning prepayments, viewing the repeal of sections 452 and 462 as a Congressional ratification of the Commissioner's long standing rule denying referral.[4]

1. I.R.C., Pub. L. No. 591, ch. 736, § 452, 68A Stat. 152 (1954), *repealed by* Act of June 15, 1955, § 1(a), Pub. L. No. 74, 69 Stat. 134.
2. I.R.C., Pub. L. No. 591, ch. 736, § 462, 68A Stat. 152 (1954), *repealed by* Act of June 15, 1955, § 1(b), Pub. L. No. 74, 69 Stat. 134.
3. *See infra* note 42 and accompanying text.
4. Schlude v. Comm'r, 372 U.S. 128 (1963); American Auto. Ass'n v. United States, 367 U.S. 687 (1961); Automobile Club of Michigan v. Comm'r, 353 U.S. 180 (1957).

More recent developments, however, indicated a possible weakening of the Government's approach. In *Artnell Co. v. Commissioner,*[5] the Seventh Circuit held that a taxpayer would be permitted to defer advance receipts where he could show with reasonable certainty that they were to be earned by the performance of a particular service on a specific future date. This decision made it clear that there were indeed situations in which deferral would be allowed, and that the intimations to that effect in earlier Supreme Court opinions were not merely meaningless dicta. *Artnell* prompted the immediate promulgation of Revenue Procedure 70-21,[6] allowing deferral of prepayments for services under limited circumstances, and Treasury Regulation 1.451-5,[7] permitting deferral of prepayments for the sale of goods according to the seller's regular method of accounting.

Despite an apparent current truce in the battle between tax and commercial accounting in the area of prepayments, many taxpayers still choose to avoid the issue of prepayments altogether by having any advance payments characterized as a loan or even as a security deposit. Taxpayers also avoid prepayment problems through the use of trusts or escrow accounts, artificial billing practices, or by adjusting their business cycle to coincide with their fiscal year. It is not clear at this point as to whether the current reconciliations in the struggle between tax and commercial accounting in the area of advance payments and deferrals are a permanent end to the hostilities or merely a temporary cease fire.

This comment will discuss the historical tension between tax and commercial accounting in the area of prepayments. This will be done by describing the development of the problem and Congress' attempt to deal with it legislatively in 1954. Next, the case law that resulted from the repeal of sections 452 and 462 will be examined. Finally, recent regulatory efforts in this area will be described, as well as some practical alternatives presently employed by taxpayers seeking to defer accrual of prepaid income.

II. TRADITIONAL APPROACH

The traditional rule has been that prepayments for goods or for

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5. 400 F.2d 981 (7th Cir. 1968).
6. 1970-2 C.B. 501.
7. Treas. Reg. § 1.451-5, T.D. 7397, 1976-1 C.B. 115.

the performance of services must be reported by an accrual method taxpayer in the year of the prepayment even though for purposes of non-tax accounting the amount might be deferred and not accrued until the goods are delivered or the services which earned the payment are performed. The purpose of deferring prepaid income is to attribute that income to the period in which it is earned. Similarly, the purpose of establishing reserves for estimated future expenses is to match these expenses against the revenues to which they relate. Both the deferral of prepaid income and the establishment of reserves for estimated future expenses conform with generally accepted accounting principals.[8]

The courts have recognized that since the underlying purpose for deferring income and establishing future expenses is the same, *i.e.*, the matching of revenues against expenses, the two concepts should be governed by the same legal principles. Although it can be argued that there are technical distinctions in deferring prepaid income and deducting estimated future expenses, the net result is the same[9] and for purposes of this comment all discussions concerning the deferring of prepaid income will be applicable equally to the related concept of reserving future expenses, unless otherwise noted.

The Internal Revenue Code requires that taxable income be computed using the method of accounting used by the taxpayer in keeping his books.[10] The purpose of the accrual method of accounting is to match income and expenses in the period during which they are earned and incurred, respectively.[11] Actual receipt of income or payment of expenses is generally irrelevant.[12] Under this system, income is recognized when "earned" by the perform-

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8. *See* Rev. Proc. 71-21, 1971-2 C.B. 549 § 2.

9. Simplified Tax Records, Inc. v. Comm'r, 41 T.C. 75, 79 (1963). *Accord*, Field Enters. Inc. v. United States, 348 F.2d 485 (Ct. Cl. 1965).

10. I.R.C. § 446(a) (1976). The accrual method of accounting is recognized by the Internal Revenue Code as a permissible method. *Id.* at § 446(c).

11. United States v. Anderson, 269 U.S. 422 (1926); FINNEY & MILLER, PRINCIPLES OF ACCOUNTING INTERMEDIATE 9-10 (1965).

12. Under the regulations, the timing of income and deductions are governed by the "all events" test. Income is includable in gross income "when all events have occurred which fix the right to receive income and the amount thereof can be determined with reasonable accuracy." Treas. Reg. § 1.451-1(a), T.D. 7397, 1976-1 C.B. 115. Expenses are deductible when "all events have occurred which determine the fact of liability and the amount thereof can be determined with reasonable accuracy." Treas. Reg. § 1.461-1(a)(2), T.D. 6917 1967-1 C.B. 108.

ance of services or delivery of goods, regardless of when payment is actually received, and expenses are reported in the year in which corresponding income is "earned," regardless of when the expenditures are actually made.[13] The matching of income and expenses avoids the distortion that invariably arises under the simpler cash receipts and disbursements method of accounting. Assume for example, that a corporation received $10,000 in November, 1980, for services to be performed, half in 1980 and half in 1981. Assume further that the corporation incurred expenses of $8,000 in performing these services and that all of these expenses were paid in 1981. Under the cash method the corporation would show a $10,000 profit in 1980 and an $8,000 loss in 1981 even though its true profit on the transaction is $1,000 in 1980 and $1,000 in 1981.[14] Under the accrual method, the first half, or $5,000 earned in 1980 is included in income for that year and the $5,000 balance is deferred until 1981 when it is earned. In addition, although not paid until 1981, a reserve of $4,000 for expenses to be incurred is established in 1980. The remaining $4,000 of expense is deducted in 1981 when it is incurred. Thus, the accrual method presents a more accurate picture of the financial position of the corporation as of any given date and also of the results of its operations for any reporting period.

From the practical point of view, while both business and tax accounting principles are designed to yield an annual net income figure, their objectives are not identical. The business world wants a periodic net income figure for purposes of determining profitabil-

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13. There is much confusion concerning the use of the terms "earn," "realize," and "recognize" in income tax accounting. Properly speaking, income is "earned" over the life of a transaction by the continuing activity of performance of the contract; it is "realized" upon completion of the transaction; and ordinarily it is then "recognized" immediately or at a date depending upon the taxpayer's system of accounting. *See* Alvin, *"Prepaid Income": How The Commissioner Turned Liabilities into Income Under Section 446 of the 1954 Code*, 11 WAYNE L. REV. 482, 494-95 (1965).

According to the above definitions, prepayments have been neither earned nor realized at the time their receipt and should therefore not be considered income under § 61(a). However, the Commissioner contends that performance of the contract is not a condition precedent to the realization of income, that prepayments constitute realized income, and that they should therefore be recognized when received. *Id.* at 494-96. *See* Comment, *Accrual Accounting and the Clear Reflection of Income: Purity of Accounting Principals Forsaken and the Protection of Tax Revenues*, 42 NOTRE DAME LAW. 511 (1966). *See also* J. CHOMMIE, FEDERAL INCOME TAXATION § 83 at 236 (2d ed. 1973); 2 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 12.60 (rev. perm. ed. 1967).

14. FINNEY & MILLER, *supra* note 11, at 9-10.

ity for various accounting periods. On the other hand, Congress wants a steady flow of tax revenue and assurance that taxpayers, in fact, pay tax on all elements of gain, even if it may later be offset by related expenses.

There has been considerable divergence between tax accounting and commercial accounting in the treatment of advance payments for services and sales of goods, and the use of reserves for estimated expenses. The Commissioner of Internal Revenue has long taken the position that prepayments for services or for sales of goods are income in the year of receipt to an accrual basis taxpayer,[15] regardless of when the services are to be performed or when the delivery and passage of title to the goods is to take place. Commercial accounting, however, would report this income only in the year of performance or of delivery and passage of title.

For income tax purposes, the Commissioner and the courts have primarily employed two techniques to disallow the use of the accrual method of accounting to defer recognition of prepaid receipts to the year when the services are performed or goods delivered. These techniques are: (1) the "claim of right" doctrine, first propounded in *North American Oil Consolidated v. Burnet*[16] and (2) the "Commissioner's discretion" rule.[17] The claim of right doctrine, as enunciated by the Supreme Court in *North American Oil* provides:

> If a taxpayer received earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it might still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.[18]

Although the decision in *North American Oil* actually had noth-

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15. *See* Chief Counsel's Memorandum 20,021, 1938-1 C.B. 157. The bulletin dealt with the question of whether income received by the M Publishing Co. as payment for subscriptions to periodicals may be reported as income for the years on which earned rather that in the year of receipt. It was held that amounts received by the M Publishing Co. within the taxable year without restriction as to disposition, use, or enjoyment, for subscription service to be rendered in a succeeding year or years constitute income for the year in which received regardless of the fact that the taxpayer's books of account are kept on the accrual basis.

16. 286 U.S. 417 (1932).

17. I.R.C. § 446(b) (1976). This section provides, in effect, that if a taxpayer's method of accounting does not clearly reflect income, the computation shall be made in accordance with such method as in the Commissioner's opinion does clearly reflect income.

18. 286 U.S. at 424.

ing to do with advance payments and in fact involved money conceded by the taxpayer to be income,[19] the doctrine was soon lifted out of its limited context and was applied generally to characterize prepayments for services as income in the year of receipt, recognizable in that year for tax purposes, regardless of the taxpayer's accounting method.[20] The Commissioner's assertion of the claim of right doctrine as a theory for taxing prepaid sales of goods, as opposed to services, was generally less successful.[21] In 1955, the Court of Appeals for the Tenth Circuit[22] and in 1959, the Court of Appeals for the Second Circuit[23] expressly rejected the claim of right doctrine as a technique for disallowing the deferral of prepayments for services and the doctrine is now rarely found in decisions dealing with deferral of prepayments.

The second technique used to deny deferral of prepayments is the Commissioner's discretion rule. This is actually an exercise of limited judicial review of determinations made by the Commissioner that a taxpayer's accounting method does not "clearly reflect income."[24] A method of accounting means not only the overall method, "but also the accounting treatment of any item" of income or expense.[25] It has been the Commissioner's position for

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19. A section of oil land had been put into receivership while the right to its beneficial ownership was being litigated by the oil company and the United States. *Id.* at 420-21. After the district court had dismissed the government's petition, the income from the land previously held by the receiver was paid to the oil company. *Id.* at 421. The United States Supreme Court held that the income should have been recognized when paid by the receiver under a claim of right, despite the fact that the government was still contesting the ownership on appeal. *Id.* at 424.

20. *See, e.g.*, Brown v. Helvering, 291 U.S. 193 (1934); South Dade Farms, Inc. v. Comm'r, 138 F.2d 818 (5th Cir. 1943).

21. Veenestra & DeHaan Coal Co. v. Comm'r, 11 T.C. 964 (1948).

22. Beacon Publishing Co. v. Comm'r, 218 F.2d 697 (10th Cir. 1955) (court allowed deferral of prepaid newspaper subscriptions by an accrual basis taxpayer on the theory that application of the claim of right doctrine by the Commissioner would result in a "distortion of an accrual taxpayer's true income" by creating a hybrid bookkeeping system in which the accrual basis taxpayer reports all prepaid items on the cash receipts basis). *Id.* at 700-01.

23. Bressner Radio, Inc. v. Comm'r, 267 F.2d 520 (2d Cir. 1959) (court allowed deferral of prepayments for future servicing of television sets by an accrual basis taxpayer, saying that the claim of right doctrine did not apply to "unearned receipts" and that taxpayer's matching of receipts and expenditures clearly reflected income). *Id.* at 528. *But see* American Auto. Ass'n v. United States, 367 U.S. 687, 689 (1961).

24. I.R.C. § 446(b) (1976).

25. Treas. Reg. § 1.446-1(a)(1), T.D. 7285, 1973-2 C.B. 163. In Treas. Reg. § 1.446-1(e)(2)(ii)(a), T.D. 7285, 1973-2 C.B. 163, the definition of "method of accounting" is refined to include only treatment of any material item which involves the proper time for inclusion of the item in income or the taking of a deduction.

some time that amounts received for services to be performed in the future must be fully included in gross income in the year of receipt in order to reflect income clearly, despite the fact that this treatment is not in accord with generally accepted accounting principles.[26] The Supreme Court has employed this device three times to uphold the Commissioner's assessment: *Automobile Club of Michigan v. Commissioner*,[27] *American Automobile Association v. United States*,[28] and *Schlude v. Commissioner*.[29] Although the Commissioner had argued that the claim of right doctrine[30] should be applied in these cases, the Court carefully avoided reliance upon that theory and instead upheld the Commissioner's position by virtue of the Commissioner's authority under section 446(b) to determine whether the taxpayer's accounting method clearly reflected income,[31] and found that the Commissioner had not abused this discretion.

Although the Supreme Court was consistently able to rely on the Commissioner's discretion pursuant to section 446 to determine that a prepayment for services to be rendered in the future should be accrued immediately and included in gross income in the year of receipt, it is also section 446, as interpreted by the regulations, which ironically offers the taxpayer the most direct authority for deferring prepayments, particularly in a situation dealing with a prepayment on the sale of goods.[32] However, in *Hagen Advertising Displays, Inc.*,[33] the Tax Court held, and was later affirmed by the Sixth Circuit,[34] that advance payments for the sale of goods would be considered income when received. This was held despite the

26. *See supra* note 14.

27. 353 U.S. 180 (1957).

28. 367 U.S. 687 (1961).

29. 372 U.S. 128 (1963). *See infra* notes 51-63 and accompanying text.

30. *See supra* note 19 and accompanying text.

31. *See supra* notes 24, 25 and accompanying text.

32. Treas. Reg. § 446-1(c)(1)(ii), T.D. 7285, 1973-2 C.B. 163. This regulation states that "the method used by the taxpayer in determining when income is to be accounted for will be acceptable if it accords with generally accepted accounting principles, [and] is consistently used by the taxpayer from year to year . . . ." *Id.* The regulation further states, by way of example, that "a manufacturing business may account for sales of his product when the goods are shipped, when the product is delivered or accepted, or when title to the goods passes to the customer, whether or not billed depending upon the method regularly employed in keeping his books." *Id.*

33. 47 T.C. 139 (1966), *aff'd*, 407 F.2d 1105 (6th Cir. 1969).

34. *Id.*

taxpayer's contention that the advance payments constituted gross receipts only and could not be considered gross income until the cost of goods sold had been determined and deducted from gross receipts.[35]

It was against this background of discrepancies between the treatment of prepaid income under generally accepted principles of accrual accounting and under tax accounting rules, as interpreted by the court, that Congress, in an attempt to achieve some certainty in this area, incorporated sections 452 and 462 into the Internal Revenue Code of 1954.[36]

III. Sections 452 and 462

The enactment of sections 452 and 462 of the 1954 Internal Revenue Code was an attempt by Congress to bring tax accounting concepts into line with generally accepted commercial accounting concepts in cases of prepayments for goods or services (section 452) and the use of reserves for estimated expenses (section 462).[37] Section 452, which applied to an accrual basis trade or business that received prepaid income in connection with a liability to render services or furnish goods, permitted the prepaid income to be included in the year in which it was received and in each of the five succeeding taxable years.[38] The section defined prepaid income as "any amount (includable in gross income) which is received in connection with, and is directly attributable to a liability which extends beyond the close of the taxable year in which such amount is received."[39] The term prepaid income, however, did not expressly include any amounts that were "treated as gain from the sale or other disposition of a capital asset,"[40] whether long term or short

35. *Id.*

36. S. Rep. No. 1622, 83d Cong. 2d Sess. 62 (1954).

37. *Id.*

38. I.R.C., Pub. L. No. 591, ch. 736, § 452, 68A Stat. 152 (1954), *repealed by* Act of June 15, 1955, § 1(a), Pub. L. No. 74, 69 Stat. 134 provided:

> In the case of any prepaid income to which this section applies, if the liability . . . is . . . to end before the first day of the sixth taxable year in which such income is received, then such income shall be included in gross income for the taxable year in which it is received, and for each of the five succeeding taxable years, to the extent proper under the method of accounting used under section 446 in computing taxable income for such year.

39. *Id.* § 452(e)(1).

40. *Id.*

term. A liability was defined as "a liability to render services, furnish goods or other property, or allow the use of property."[41]

Although the enactment of sections 452 and 462 was looked upon with favor by most tax practitioners,[42] critics pointed out that the revenue to be lost as a result of the enactment of the sections might be astronomical. The original estimates, made in 1954, of the loss in revenue from the provisions of sections 452 and 462 was $45,000,000 for the fiscal year 1955. In the early part of 1955, however, revised estimates indicated that the revenue loss might be as high as several billion dollars.[43] It also appeared that the two sections were being interpreted by taxpayers as extending far beyond the operation intended and expected by the Treasury at the time of their adoption. In response to this anticipated revenue loss and the Treasury Department's belief that the two sections as they were enacted could not be corrected by regulations, the Treasury strongly recommended that Congress retroactively repeal both sections.[44]

The Secretary of the Treasury in a letter to the House Committee on Ways and Means indicated "that the repeal of sections 452 and 462 should operate simply to re-establish the principles of law which would have been applicable if sections 452 and 462 had never been enacted."[45] However, the Senate Finance Committee, in reporting on the repeal of these sections expressed their concern that the repeal of these sections would not solve the problems in this area:

> Your committee desires to make its position clear that it expects to report out legislation dealing with prepaid income and reserves for estimated expenses at an early date . . . . [T]he existing rulings of the Treasury Department and the court decisions dealing with estimated expenses and prepaid income are now in such a state of confusion and uncertainty that in the opinion of your committee legislative action is required on these subjects. In addition, your committee believes that it is essential that the income tax laws be brought into harmony with generally accepted accounting principles

41. *Id.* § 452(e)(2).

42. *See* Bierman & Helstein, *Accounting for Prepaid Income and Estimated Expenses Under the Internal Revenue Code of 1954*, 10 TAX L. REV. 83 (1954).

43. *Id.*

44. H. REP. No. 293, 84th Cong. 1st Sess. (1955) [hereinafter H. REP. No. 293], *reprinted in* 1955-2 C.B. 852; S. REP. No. 372, 84th Cong. 1st Sess. (1955) [hereinafter S. REP. No. 372], *reprinted in* 1955-2 C.B. 858.

45. H. REP. No. 293, *supra* note 44, at 855.

. . . . [D]efinite rules must be written into the income tax laws.[46]

Congress acted in 1955 to repeal both sections 452 and 462 on a retroactive basis,[47] and included provisions as to the steps taxpayers had to take with respect to returns in which they had elected the benefits of either section 452 or section 462 or both and were now faced with increased tax liability due to their retroactive repeal.[48] Despite the fact that the Secretary of the Treasury, who proposed the repeal of these sections,[49] and the report of the Senate Finance Committee[50] both made it explicitly clear that no inference of disapproval of accrual accounting principles was to be drawn from the repeal of these sections, it will be seen in the next section of this comment that the Supreme Court of the United States would take the position that the enactment and subsequent repeal of sections 452 and 462 evidenced a Congressional intent to which the Court would defer, *i.e.*, that any deferral of prepaid income was precluded unless specifically authorized by Congress.

IV. Case Law

The starting point for an examination of the current treatment of advance payments for services and for sales of goods would have to be those cases referred to collectively as the "trilogy" of Supreme Court cases: *Automobile Club of Michigan v. Commissioner*,[51] *American Automobile Association v. United States*,[52] and *Schlude v. Commissioner*.[53]

In *Automobile Club of Michigan v. Commissioner* (*Auto Club*) the taxpayer kept its books on the accrual basis and deferred prepaid annual dues to each of the twelve succeeding months, al-

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46. S. Rep. No. 372, *supra* note 44.
47. Act of June 15, 1955, Pub. L. No. 74, 69 Stat. 134.
48. *Id.* § 4 entitled "Saving Provisions" applied when the repeal of either section 452 or section 462 increased the tax of a taxpayer and when: (1) the tax was for a taxable year ending on or before June 15, 1955 (the date of the enactment of the repealing act); and (2) the last date prescribed for the payment of the tax or installment thereof was before December 15, 1955. The taxpayer had to file, on or before December 15, 1955, a statement showing the increase in the amount of tax. If the taxpayer filed the required statement and also paid in full that portion of the increase in tax which was due before December 15, 1955, the taxpayer would not be liable for the payments of interest on the increase in tax. *Id.*
49. *See supra* note 45.
50. *See supra* note 46.
51. 353 U.S. 180 (1957).
52. 367 U.S. 687 (1961).
53. 372 U.S. 128 (1963).

though it used the payments without restriction. The dues entitled the member to various services provided by the club on the members' demand.[54] Although the Commissioner argued for rejection of the deferral under the claim of right doctrine,[55] the Court carefully avoided relying on that theory and eventually upheld the Commissioner's position using the Commissioner's discretion rule.[56] The Supreme Court observed that the auto clubs were unable to show precisely when the receipts from each member would be earned. Even though general accounting principles would have permitted deferral on the basis of an estimate or a statistical analysis of member utilization of the organization's services, the lack of precision in matching income and expenses led the Court to sustain the Commissioner.[57]

In *American Automobile Association v. United States* (*A.A.A.*) under similar circumstances the Court again upheld the Commissioner, despite expert testimony that the method used to allocate the dues receipts to the months of the membership was in accord with generally accepted accounting principles. The Court found, with four dissents, that the matching of revenues and the corresponding expenses of performing services was imprecise and therefore not permissible.[58] The Court could not say that the Commissioner had abused his broad discretion by rejecting the taxpayer's system. Also, the Court in *A.A.A.* relied on the legislative history of sections 452 and 462.[59] It believed that since these sections had sanctioned precisely what these taxpayers were asserting, and since they were retroactively repealed only one year after enactment, Congress had rejected the method of accounting utilized by these

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54. 353 U.S. at 189-90.

55. *See supra* note 19 and accompanying text.

56. *See supra* note 24 and accompanying text.

57. The Court noted:

> 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,' 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 of the services paid for by those dues may or may not be rendered.

367 U.S. at 692.

58. *Id.* at 693-98.

59. *Id. See supra* notes 38-48 and accompanying text.

taxpayers.[60] Moreover, the Court noted that after the decision in *Auto Club*, Congress enacted section 455[61] which permits deferral of prepaid subscription income and rejected a section which would have permitted deferral of prepaid dues to non-profit service organizations pending further study.[62] The decision is a reaffirmation of the decision in *Auto Club* based on the Commissioner's discretion rule and the notion, based on the legislative history of sections 452 and 462, that if Congress has not expressly sanctioned deferral, then it is precluded.

The third part of the trilogy, *Schlude v. Commissioner*, concerned the attempt by partners in a dance studio to defer prepayments for dancing lessons. The Supreme Court, again with four dissents, held that the taxpayer could not defer recognition of income on prepaid receipts for dancing lessons since "services were rendered solely on demand in the fashion of the *American Automobile Association* and *Automobile Club of Michigan* cases."[63]

It seems clear that this trilogy of Supreme Court cases stands for the principle that prepaid income may not be deferred and estimated expenses deducted in those situations where the basis for deferral or deduction is purely artificial, *i.e.*, where the time when the income will be earned or the expenses incurred cannot be precisely determined. In these situations the Commissioner is fully authorized under section 446(b) of the code to adjust the taxpayer's

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60. 367 U.S. at 695. The court in *A.A.A.* stated:

> [T]he fact is that § 452 for the first time specifically declared petitioner's system of accounting to be acceptable for income tax purposes, and overruled the long-standing position of the Commissioner and courts to the contrary. And the repeal of the section the following year, upon insistence by the Treasury that the proposed endorsement of such tax accounting would have a disastrous impact on the Government's revenue, was just as clearly a mandate from the Congress that petitioner's system was not acceptable for tax purposes.

Id.

61. I.R.C. § 455 (1976). Prepaid subscription income was defined as "any amount which is received in connection with, and is directly attributable to, a liability which extends beyond the close of the taxable year in which such amount is received, and which is income from a subscription to a newspaper, magazine, or other periodical." *Id.* at § 455(d)(1).

62. After the decision in *American Auto. Ass'n*, Congress enacted I.R.C. § 456 (1976) permitting deferral of prepaid dues by certain membership organizations and thus strengthened the legislative history argument against deferral.

63. 372 U.S. at 136. *See* Behren, *Schlude Holds Prepaid Income Taxable on "Receipt"; Rationale is Uncertain*, 18 J. TAX'N 194 (1963). The Court also stated that it regarded the retroactive appeal of § 452 "as reinstating long-standing administrative and lower court rulings that accounting systems deferring prepaid income could be rejected by the Commissioner." 372 U.S. at 134.

method of accounting in order to "clearly reflect income." It should also be noted that these decisions dealt only with situations involving prepayments for the rendition of future services and did not consider the situation presented by the prepayment of part or all of the purchase price of goods to be sold and delivered in the future. However, the decisions were eventually extended well beyond their original scope and were used to disallow deferral of advance payments for the sale of goods, too.[64]

In the face of such consistent success by the Commissioner in rejecting deferral of prepaid income, the Seventh Circuit rendered its decision in *Artnell Co. v. Commissioner,*[65] and permitted deferral. There, the taxpayer owned a professional baseball team and received advance payments for tickets, parking books and broadcasting rights for the ensuing baseball season. When owned by Chicago White Sox Incorporated, the taxpayer had used the accrual method of accounting and the tax year normally would have ended on October 31, 1962. However, because of the liquidation following the purchase of all of the White Sox stock by Artnell Company, the tax year ended on May 31, 1962, when only thirty-one percent of the scheduled home games had been played. The White Sox balance sheet showed as deferred "unearned income"[66] that part of the advance receipts allocable to later games. Artnell included in its tax return for May 31, 1962, only the receipts shown as "earned income" on its books. The Commissioner assessed a deficiency and the Tax Court upheld it.[67]

Relying on its own prior decisions[68] and those reached earlier by

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64. Hagen Advertising Displays, Inc. v. Comm'r, 47 T.C. 139 (1966), *aff'd,* 407 F.2d 1105 (6th Cir. 1969); Farrara v. Comm'r, 44 T.C. 189 (1965); Modernaire Interiors, Inc. v. Comm'r, 27 T.C.M. 1334 (1960); Fifth & New York Co. v. United States, 234 F. Supp. 421 (W.D. Ky. 1964).

65. 400 F.2d 981 (7th Cir. 1968).

66. Chicago White Sox, Inc., had established a system of accounting where prepayments were put into an "unearned income" account, a portion of the payments being transferred to an "earned income" account as each game was played. In this way receipts were consistently matched with revenues. *Id.* at 982-83.

67. Artnell Co. v. Comm'r, 48 T.C. 411 (1967), *rev'd,* 400 F.2d 981 (7th Cir. 1968).

68. 48 T.C. at 416. The Tax Court in discussing the three Supreme Court decisions regarding deferral of prepaid income stated that: "Notwithstanding the Court's criticism of the methods of accounting used by the taxpayers in those cases, we believe that the Court would reach the same result without regard to the method used by the taxpayer for deferring prepaid income." *Id.*

the Supreme Court,[69] the Tax Court determined that the Commissioner had not abused his discretion under section 446(b) in rejecting the deferral of prepaid income by Artnell, regardless of the method used by Artnell Company to defer it.[70] On appeal, the Seventh Circuit reversed the Tax Court, stating that there was no rule of tax law which required automatic inclusion of prepaid income. Rather, it must first be determined that the taxpayer's method of accounting does not clearly reflect income, and only in that event may the Commissioner recompute according to his own discretion.[71] Because the Tax Court had denied deferral to Artnell Company without first determining whether their accounting method clearly reflected income, the case was remanded.[72] On remand, the Tax Court observed that the schedule of baseball games permitted an exact forecast of Artnell's earnings and held that while the taxpayer's accounting method was not ideal, the taxpayer did act properly in deferring income allocable to games played after the end of the tax year.[73]

As a result of the case law in the area of deferring prepaid income, an accrual method taxpayer was required to include advance payments in income when received unless he either fell within a specific statutory exception or was able to predict precisely the time when the earning event would occur.[74] It was against this background that on August 6, 1970, the Internal Revenue Service published News Release 1055, which announced that comprehen-

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69. *See supra* notes 51-63 and accompanying text.

70. A careful reading of I.R.C. § 446(b) (1976) indicates that the court had erroneously interpreted the extent of the discretionary authority conferred upon the Commissioner. That secton provides: "[I]f the method of accounting 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." *Id.* The clear import of the section is that the Commissioner's discretion attaches only after the method of accounting has been determined not to clearly reflect income.

71. I.R.C. § 446(b) (1976). *See supra* note 70.

72. Artnell Co. v. Comm'r, 400 F.2d 981 (7th Cir. 1968). *See Artnell Co., on remand,* 29 T.C.M. (CCH) 403 (1970).

73. *Auto Club., A.A.A.* and *Schlude* are distinguishable from *Artnell,* for in those cases it had been determined that income was not clearly reflected due to the taxpayer's inability to match precisely income and the services by which the income was earned. *See supra* notes 51-63 and accompanying text.

74. *See* Boise Cascade Corp. v. United States, 530 F.2d 1367 (Ct. Cl. 1976), *cert. denied* 429 U.S. 867 (1976), in which the Court of Claims allowed an accrual method taxpayer in the construction business to defer prepaid income for services where the services were to be rendered at taxpayer's, not recipient's, discretion. The result is of questionable validity.

sive rules would be issued recognizing an accrual basis taxpayer's right to defer the reporting of advance payments as income. The release stated that this represented a change from the Service's past position. The new rules regarding advance receipts for services were published in Revenue Procedure 70-21,[75] and those relating to advance payments received for sales of goods for future delivery were contained in Proposed Regulation 1.451-5.[76]

V. Revenue Procedure 70-21 and Treasury Regulation 1.451-5

The government did not petition for certiorari in *Artnell.* Moreover, since that decision, the promulgation of Revenue Procedure 70-21 concerning prepayment for services, and Regulation 1.451-5, relating to prepayments for goods, reflect a kind of hesitant and creeping move toward the adoption of business accounting principles.

Deferral of advance payments received for services will be permitted under Revenue Procedure 70-21, if the services are required by written or oral agreement to be performed completely by the end of the following taxable year. The payment is to be included in income in the taxable year in which it is earned, *i.e.*, the service actually performed, but in no case will it be included later than the taxable year following the year of receipt. Even if the services are not in fact performed within the period required, all prepaid income allocable to the unperformed services must be included in gross income in the year following the year of receipt, although a portion of the payment is still unearned.[77] If under the terms of the agreement any portion of the services are to be performed after the year following the year of receipt of an advance payment, or if there is no specified date for the completion of services, then all advance payments must be included when received.[78]

The revenue procedure contains provisions intended to prevent

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75. 1970-2 C.B. 501, *superseded by* Rev. Proc. 71-21, 1971-2 C.B. 549 which provides essentially the same rules.

76. 35 Fed. Reg. 12,612 (1970).

77. Rev. Proc. 70-21, 1970-2 C.B. 501, § 3.02.

78. *Id.* § 3.03. It appears also that an existing agreement may be modified to meet the requirements of Rev. Proc. 70-21. Whether an agreement satisfies the provisions of Rev. Proc. 70-21 is determined by examining the agreement "as it exists at the end of the taxable year of receipt." *Id.* § 3.02.

taxpayer avoidance of its limitations. The requirement that all the services pursuant to an agreement must be performed before the end of the taxable year following receipt of an advance payment may not be avoided by dividing an agreement which spans a number of taxable years into several shorter agreements. The revenue procedure provides that the term "agreement" includes other agreements between the taxpayer and the person for whom the services are to be performed if such other agreements "provide for the rendition of substantially similar performance over a period of time that is substantially consecutive to that of the first agreement."[79] Nor can the limitations of the revenue procedure be avoided by having an affiliate perform services and obtain deferral when the taxpayer could not have obtained such treatment. The revenue procedure states that the term "taxpayer" includes another person "if the taxpayer and such other person are owned or controlled directly or indirectly by the same interests . . . ."[80]

The newly permitted deferrals will be treated as an acceptable method of accounting under section 446 as long as the method is consistently used by the taxpayer. Taxpayers may change to the new method for either goods or services for any taxable year by filing form 3115 within 180 days after the beginning of the year,[81] and obtaining the consent of the Commissioner. Taxpayers already using this method may continue to do so without the Commissioner's consent.[82] By treating the new rules as a method of accounting, the Treasury has sought to avoid the large transitional revenue losses envisioned under repealed section 452. If an accrual basis taxpayer had been including advance payments in income as they were received and now desires to change to one of the new methods under either Revenue Procedure 70-21 or Treasury Regulation 1.451-5 permitting limited deferrals, such amounts must be included in income again under the new method as they are earned. This duplication results in an increase in taxable income in the year of change which may be deducted ratably over the year of

79. *Id.* § 3.07.

80. *Id.* § 3.08. Control here has the same meaning as in I.R.C. § 482 (1976), *i.e.*, de facto control. *See* Eustice, *Tax Problems Arising From Transactions Between Affiliated or Controlled Corporations*, 23 TAX L. REV. 451, 486-89 (1968).

81. Treas. Reg. § 1.446-1(e), 3 T.D. 7285, 1973-2 C.B. 163.

82. Rev. Proc. 70-21, 1970-2 C.B. 501, § 3.12.

change and the next nine years.[83]

These transitional rules will minimize the impact of revenue losses from the new rulings.[84] However, this impact is still felt where a new taxpayer is involved, *i.e.*, one who has not previously included prepayments in income so as not to be liable for inclusion of a duplicate amount when earned under the new method of accounting. Possible avoidance of this duplicate tax has caused taxpayers to maneuver to become artifically equivalent to a new taxpayer. For instance, a taxpayer might endeavor to dispose of all his obligations under previous service contracts during year one prior to electing the new method for year two. This might be done by either renegotiating the contracts with customers so as to end liability on the old contract during the year, or by paying a third party to service the contract prior to electing. Under such circumstances the Service can refuse to consent to changes of method where the taxpayer has maneuvered to avoid the impact of the transition rule. Alternatively the Service might conditionally consent to the change of method upon inclusion of a phantom double-reported amount equal to that which would have resulted if the taxpayer had not assigned his obligations.[85]

Although the new rules regarding advance receipts for services were published in Revenue Procedure 70-21, the new rules relating to advance payments received for sales of goods for future delivery were contained in the Proposed Regulation 1.451-5. Under this section the taxpayer has an election to include the advance payments for sale of goods either in full in the taxable year of receipt or to include them in the year when they would otherwise be properly accruable under his method of accounting, *i.e.*, when the goods are shipped.[86] This latter option is often referred to as the "book"

83. *Id.* § 5 provides that the Commissioner would apply the principles of Rev. Proc. 64-16, 1964-1 (pt. 1) C.B. 677, when considering requests for consents to change to the accounting method permitted by the revenue procedure. Rev. Proc. 64-16 generally permitted a change of accounting method when the taxpayer agreed to spread the adjustments over a ten-year period. *Id.*

84. In another attempt to avoid a substantial revenue loss, Rev. Proc. 70-21 at § 3.06 specifically provides that it is not applicable to prepaid interest or prepaid rent. However, Morgan Guar. Trust Co. of New York v. United States, 585 F.2d 988 (Ct. Cl. 1978) allowed an accrual method taxpayer to defer the inclusion of prepaid interest from his gross income. It was argued that there was no distortion of income because of the de minimus nature of the prepaid interest deferred. *Id.* at 997.

85. Rev. Proc. 64-16, 1964-1 (pt. 1) C.B. 677.

86. Treas. Reg. § 1.451-5(b)(1), T.D. 7397, 1976-1 C.B. 115.

method. The regulation contains an exception[87] to the otherwise unqualified option given taxpayers to report advance payments on their "book" method of accounting. This complex exception applies to a taxpayer who: (1) receives an advance payment with respect to an agreement for sale of goods held primarily for sale to customers; (2) by the last day of the tax year has received "substantial payments"; and (3) has, on hand, goods in sufficient quantity to satisfy the agreement in that year.[88] If these conditions are met, all advance payments received by the taxpayer by the last day of the second taxable year following the year of receipt of the substantial advance payments must be included in income in the second year. Unless the taxpayer falls within the "substantial advance payment/goods on hand" exception, the regulation permits substantially unlimited deferral of reporting of advance payments for the sale of goods until the time when the taxpayer would normally account for those advance payments under his regular book method of accounting.[89]

To prevent deferred amounts from escaping inclusion indefinitely, the regulation provides that any taxpayer using the "book" method who dies, ceases to exist in a transaction, or whose liability under the agreement otherwise ends, must include in the taxable year of the event so much of the advance payments as have not been included in all preceeding taxable years.[90] A taxpayer electing the "book" method is required to attach to his return for each taxable year in which he received advance payments a schedule reflecting: (1) the total amount of advance payments received in the year; (2) the total amount of advance payments received in prior taxable years not included in income in those years; and (3) the total amount of advance payments received in prior years which are included in gross income for the current year.[91]

If services are to be performed in conjunction with the sale of goods, the regulations still apply if the performance of the services

87. *Id.* § 1.451-5(c)(1)(i).

88. *Id.* § 1.451-5(c)(3). A taxpayer will be considered to have received substantial payments where advance payments received with respect to an agreement which together with all advance payments received prior to the taxable year with respect to the agreement, equal or exceed the total cost reasonably estimated as includable in inventory with respect to the agreement. *Id.*

89. *Id.* § 1.451-5(b)(1).

90. *Id.* § 1.451-5(f).

91. *Id.* § 1.451-5(d).

is an integral part of the sale.[92] If the amount allocable to payment for services is less than five percent of the total price, the service obligation will automatically be considered an integral part of the sale of the goods.[93]

Thus far, this comment has dealt primarily with the historical development of the concept of "deferring" advance receipts for goods or services. It will now examine other possible techniques or methods of avoiding or easing the problems of prepayments for goods or services.

VI. ALTERNATIVES

Despite Revenue Procedure 70-21, Treasury Regulation 1.451-5, and the ramifications of the *Artnell* decision,[94] there is only one sure method of avoiding the assertion of a tax on the receipt of prepaid sales—do not accept any prepayments. More often than not, though, not accepting prepayments is not a sound business practice. Often a taxpayer will find he is able to advantageously invest or otherwise beneficially utilize funds generated by prepayments, despite the tax problems associated with them. Further, many times a buyer is seeking an early deduction for his advance payment. This is particularly true where the buyer is a cash basis taxpayer. In the case of an accrual basis buyer, contracts should be drawn to fulfill the all-events test.[95] This will permit the buyer to accrue a deduction without the necessity of making a payment.

If sound business prudence should dictate that prepayments under a given set of circumstances are necessary, it may be possible to frame or characterize the transaction so as to avoid taxation of the prepayments. Often it will be possible for the taxpayer to characterize the prepayment as either a loan or a security deposit. Characterization as a loan is preferable to characterization as a deposit in that borrowed funds are not considered income and are not considered payment, even though the taxpayer has unrestricted use of the funds.[96] Characterization as a security deposit may be considered to avoid treatment as a prepayment if the tax-

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92. *Id.* § 1.451-5(a)(2).
93. *Id.* § 1.451-5(a)(3).
94. *See supra* note 65-70 and accompanying text.
95. *See supra* note 12.
96. Summit Coal Co. v. Comm'r, 18 B.T.A. 983 (1930). However, the I.R.S. may attempt to deny the reality of the loan. *See* Rev. Rul. 69-359, 1969-1 C.B. 140.

payer is willing to forego use of the funds and hold them in trust and not use them for his own benefit.[97]

In *Hagen Advertising Displays, Inc. v. Commissioner*,[98] a Sixth Circuit court declined to treat an advance receipt as a loan or deposit, as had been done in the earlier Tax Court decison of *Veenstra & DeHaan Coal Co.*,[99] and in the Seventh Circuit court decision in *Consolidated-Hammer Dry Plate & Film Co. v. Commissioner*.[100] The *Veenstra & DeHaan* case involved a coal company which received prepayments which were treated as a security deposit. The deposit was applied against the future purchase of coal. The price was to be the market price on delivery and the deposit was subject to refund if delivery could not be made for any reason. The taxpayer co-mingled the deposits with his general funds. The *Consolidated-Hammer* case involved a manfuacturer who received prepayments which were treated by the parties as a loan. The Air Force made advance payments for both completed and uncompleted work on the constructon of a special camera, and the manufacturer did not have any right to the advanced sums, *i.e.*, it was refundable to the Air Force. The advances were not required, but had been contemplated as a means of financing the taxpayer's small manufacturing operation. The court noted similarities to government small business loans. The fact that title passed as payments were made was viewed as though the government had a security lien. In both *Consolidated-Hammer* and *Veenstra & DeHaan*, the courts found that the monies advanced were not taxable when received.

In *Hagen*, however, the Tax Court held that the advance payments in question were taxable in the year of receipt. The taxpayer in *Hagen* was an accrual-basis manufacturer of identification signs for national advertisers. Its customers placed blanket orders for the number of signs which they estimated they would need for the ensuing year, and during that year, from time to time, directed the taxpayer to deliver signs. Although most of the customers did not normally make advance payments, some customers asked to be billed for their blanket order prior to delivery. Also, when a blanket order had been outstanding for an extended period of time, the

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97. Angelus Funeral Home v. Comm'r, 407 F.2d 210 (9th Cir. 1969).
98. 47 T.C. 139 (1966), *aff'd*, 407 F.2d 1105 (6th Cir. 1969).
99. 11 T.C. 964 (1948).
100. 317 F.2d 829 (7th Cir. 1963).

customer was billed to induce a request for delivery. The taxpayer recognized income from sales, including prepaid sales, only in the year of delivery, and there was no allocation of inventory costs between signs made for customers who made advance payments and customers who did not. Hagen argued that under its accrual method of accounting, it realized income only when a sale was completed, *i.e.*, when title or possession passed to the customer, and that although the advance payments might constitute gross receipts, they were not gross income until the cost of goods sold had been determined and deducted from gross receipts. The Tax Court, after finding that the advance payments were received by Hagen without restriction or disposition (a claim of right argument), held that the advance payments were taxable in the year of receipt. The court discounted the taxpayer's reliance on the gross receipts/gross income argument by pointing out that no records were kept of the cost of goods for which advance deposits had been received and that, therefore, no such deduction could be allowed.[101]

In *Hagen*, the prepayments were non-refundable and apparently the price was fixed or determinable with some accuracy. The condition of refundability would seem to be the significant difference between the cases. The possibility of repayments makes the transaction lack the finality that tends to be associated with the concept of includable income. Even so, to best come within the rule of *Veenstra & DeHaan*, it seems the more factors left contingent the better. Likewise, the rule of *Consolidated-Hammer* will require that the transaction involve a loan. *Hagen* seems properly distinguishable from *Veenstra & DeHaan* and *Consolidated-Hammer* in that there was no necessity for a refund, nor was there the appearance of a loan.

In light of these circumstances, it appears that in order to be more certain of characterization as a loan, such a transaction should be framed and labeled as a loan. Further, the loan should

101. In a well reasoned dissent, Judge Hoyt argued that taxpayer's method of accounting was in fact a more accurate reflection of its income than the Commissioner's adjustments, and that by failing to allow deferral in the advance payment for sales of goods area, the court was taxing gross receipts and not gross income. The dissent points out that the advance payments were not "gains" from sales until the cost of goods sold was deducted from the amounts received, and until such time, taxpayer realized no gross income, as defined in § 61. In addition, the dissent suggests that taxation of gross receipts would be an unconstitutional extension of the income tax, citing *Leba Sullenger*, 11 T.C. 1076 (1948). 47 T.C. at 152-53.

be subject to repayment whether the goods are delivered or not, if this is practical. The existence of at least nominal interest would go a long way towards establishing the substance of the transaction as a loan.

Characterizing a transaction as a security deposit is generally more uncertain and generally less desirable. The Internal Revenue Service's position is that a deposit that guarantees the customers "payment" of amounts owed to a creditor is not a deposit but an advance payment, while a deposit that secures someone's "property" is a true security deposit and not an advance payment.[102] The terms "deposit" and "advance" are so ambiguous that in many cases it will be difficult to identify the transaction as an advance or a deposit. For example, a security deposit may be characterized as an advance rental[103] and, as such, be taxable.[104] Most importantly characterizations can not be made in a vacuum, and the business needs of both the buyer and the seller must be satisfied in any commercial transaction. The buyer may need payment to get an early deduction or the seller may be fearful of leaving the buyer with an opportunity to back out of the deal with a refund by not characterizing the advance as a prepayment.

If under the surrounding circumstances it becomes absolutely necessary to accept a prepayment, one of the simplest devices for avoiding the inherent problems of receiving advance payments is to choose a fiscal year which coincides with the business cycle, so that payment, at the beginning of a season and the subsequent performance throughout the season all fall within one taxable year. Since prepayments are injurious to the taxpayer only when they are outstanding at the end of the year, an accounting period that matches revenue over the year avoids the problem. This device is particularly useful in a seasonal business. The *Artnell* case could have been avoided if a tax year corresponding to the end of the baseball season could have been arranged.[105] The selection of a proper accounting period is best solved in the initial year of a business. After that, the government's consent must be obtained before

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102. Rev. Rul. 75-519, 1972-2 C.B. 32.

103. Gilken Corp. v. Comm'r, 176 F.2d 141 (6th Cir. 1949).

104. New Capital Hotel, Inc., 28 T.C. 706 (1957), *aff'd per curiam,* 261 F.2d 437 (6th Cir. 1958).

105. *See supra* notes 65-71 and accompanying text.

a change in accounting is allowed.[106]

Another technique for avoiding the problems of prepayment is to adopt an artificial billing practice. The taxpayer should accept prepayments for services only through the end of the current tax year. Every customer should then be billed for a full year renewal on the first day of the next tax year. Under Revenue Procedure 70-21 this could be done in two year increments. The taxpayer could accept payments only for services to be rendered through the end of the next taxable year, soliciting renewals from each customer for two year contracts beginning on the first day of the tax year following expiration of their first agreement.[107]

Finally, the use of escrow devices to delay receipt of a prepayment is a possible solution, but the government seems opposed to allowing the use of escrows in this manner.[108] However, as mentioned earlier, a trust can be used to defer income if the taxpayer is effectively foreclosed from control of the funds. Such a device might not only delay receipt of the prepayment by the taxpayer, but will also allow his buyer an early deduction.[109]

It would appear that, with the passage of Revenue Proceduure 70-21 allowing deferral on advance payments for services for up to two years, and the passage of Treasury Regulation 1.451-5 allowing deferral on prepayments for goods consistent with the taxpayer's regular accounting method, there is finally a degree of certainty in this historically turbulent tax accounting area. However, it must be remembered that the tension in this area was presumably eased twice before only to be subsequently rekindled: once with the passage of sections 452 and 462 of the Internal Revenue Code and their almost immediate repeal, and later when the scope and applicability of the Supreme Court's decisions in *Auto Club, A.A.A.*, and *Schlude* were rendered uncertain by the decision in *Artnell*. In lieu of the tumultuous past in the area of advance payments, it is difficult to imagine that the current reconciliation in this area

106. I.R.C. § 442 (1976).

107. *See* Decisions, Inc. v. Comm'r, 47 T.C. 58 (1966).

108. Rev. Rul. 65-141, 1965-1 C.B. 210.

109. Angelus Funeral Home v. Comm'r, 407 F.2d 210 (9th Cir. 1968). The court noted that the outcome in each case will turn on the provisions of the particular trust involved. The control by, and the instrument of benefits to, the taxpayer are of prime importance. *Id.* at 212.

between tax and commercial accounting is anything more than the proverbial calm before the next storm.

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