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PREPAID INCOME FOR FUTURE SERVICES: WHEN MAY AN ACCRUAL BASIS TAXPAYER UTILIZE THE DEFERRAL TECHNIQUE?

INTRODUCTION

"It is essential that the income tax laws be brought into harmony with generally accepted accounting principles."[1]

This call for conformity of the rules governing tax and financial accounting ironically was made by the Senate Finance Committee in 1955 after retroactively repealing section 452, the first Code section to incontestably allow the standard financial accounting practice, deferral of inclusion in income, until earned, of payments for services to be rendered in the future by an accrual method taxpayer.[2] The Senate committee's goal of attaining the above conformity in the area of prepaid income has not been achieved. The Internal Revenue Service and the government have consistently attempted to treat payments for future services as income recognized at the time of receipt.[3] Conflict between these attempts and Congress' expressed goal of conforming tax accounting with standard financial accounting has involved the Supreme Court in a confusing battle. As a result of limitations set by three Supreme Court cases (the Trilogy),[4] the Commissioner has restricted availability of the deferral method by accrual method taxpayers. Recently, however, a federal district court narrowly interpreted the Trilogy to allow greater utilization of the deferral method.[5] Although reversed on appeal,[6] the district court's suggestions cast new light on the Commissioner's interpretation of the Trilogy.

This article discusses the accrual accounting method and its relation to in-

1. S. REP. No. 372, 84th Cong., 1st Sess. 6 (1955), *reprinted in* 1955-2 C.B. 858 [hereinafter S. REP.].

2. Section 452 came into law as part of the 1954 Internal Revenue Code. Congress recognized that "under present law" prepayments for future services were includible in the year of receipt, despite well-established accounting procedure that permitted income to be recognized as earned. Section 452 was enacted to allow the deferral of these prepayments until the years in which, under the taxpayer's deferral accounting method, the income is earned. However, the period over which the prepayments were allowed to be deferred could not exceed five years after the year of receipt. Where such "earning period" exceeded five years, taxpayers could elect to ratably defer the prepayment over the period of the taxable year of receipt and the five succeeding taxable years. S. REP. No. 1622, 83d Cong., 2d Sess. 62 (1954), General Report on § 452. Section 452, enacted in 1954, was retroactively repealed one year later by Congress in Pub. L. No. 84-74, 69 Stat. 134 (June 15, 1955). The effect of its repeal is discussed *infra* notes 106-16 and accompanying text.

3. RCA Corp. v. United States, 664 F.2d 881, 888 (2d Cir. 1981), *cert. denied,* 102 S. Ct. 2958 (1982).

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

5. RCA Corp. v. United States, 499 F. Supp. 507 (S.D.N.Y. 1980), *rev'd,* 664 F.2d 881 (2d Cir. 1981), *cert. denied,* 102 S. Ct. 2958 (1982).

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come deferral. Past treatment of deferral for tax purposes is reviewed, culminating in a discussion of the Trilogy's restriction of the deferral method. By examining the federal district court's interpretive suggestions, conclusions can be drawn as to the Trilogy's proper and most beneficial interpretation in light of the aims of tax accounting and, specifically, the deferral method.

ACCRUAL ACCOUNTING FOR FINANCIAL PURPOSES: DEFERRING PAYMENTS RECEIVED FOR FUTURE SERVICES

The accrual method of accounting recognizes and reports revenues as income in the period the expenses generating those revenues are incurred, or stated differently, as the revenues are "earned."[7] This "matching" procedure is the conceptual hub of accrual accounting.[8] Matching revenues and related expenses accurately reflects, for business purposes, net earnings for the period. Payments for future services are recognized as income when the services are rendered. The mere receipt of money for future services does not constitute income in the period of receipt, since such receipt is burdened with an obligation to render services in the future.[9] The accrual method therefore recognizes income only when it is earned or the right to receive it is fixed, irrespective of when the payment is ultimately received.[10]

The most common application of accrual accounting involves the deferral of income recognition. Prepayments received are allocated to a liability account, typically entitled deferred or unearned income, which reflects the taxpayer's obligation to perform future services. As the services are rendered and expenses incurred, a proportionate amount of the prepayment is deemed earned and recognized as income for that period with a corresponding decrease in the liability account. The costs of services generating the revenues are accounted for when the revenue is recognized, consistent with the matching concept. While the above procedure accurately describes standard financial accounting practice, deferred income recognition traditionally has been treated differently for tax purposes.

ACCRUAL ACCOUNTING FOR TAX PURPOSES: JUDICIAL AND CONGRESSIONAL ACCEPTANCE

Prior to the Revenue Act of 1916, income for tax purposes was reported solely by the cash receipts and disbursements accounting method.[11] The 1916 Act, however, expanded the section defining permissible accounting methods

6. 664 F.2d 881 (2d Cir. 1981), *cert. denied*, 102 S. Ct. 2958 (1982).

7. Treas. Reg. § 1.461-1(a)(2) (1960).

8. *See* Crumbley, *How Long Will the Commissioner and the Courts Ignore Accounting Standards On the Accrual of Prepaid Income?*, 22 NAT'L TAX J. 559, 559 (1969). *See also* AICPA, ACCOUNTING PRINCIPLES (CCH) § 1026.12-28 (1971).

9. Jacobs, *Changing Attitudes Toward Accrual Concepts*, N.Y.U. 16TH INST. ON FED. TAX 579 (1958).

10. Beacon Publishing Co. v. Commissioner, 218 F.2d 697, 699 (10th Cir. 1955). The Tenth Circuit's statement of the accrual concept's operation referred to accrual accounting for both financial and tax purposes.

11. *See generally* Revenue Act of 1913, ch. 16, § 11(B), 38 Stat. 114, 167.

to allow a taxpayer, with Treasury approval, to file a tax return on any accounting basis that "clearly reflects" the taxpayer's income.[12] Congress designed this revision specifically to permit accrual accounting for tax purposes.[13] Although the Revenue Act of 1918 subsequently removed the necessity of obtaining special approval to use the accrual method,[14] the general provision permitting accrual reporting remained otherwise unchanged for thirty-six years.[15] Finally, in 1954, the provision was changed to specifically permit the accrual method.[16]

In the historic 1926 case of *United States v. Anderson*,[17] the Supreme Court approved accrual accounting for tax purposes. The Court held that a munitions tax applicable to an accrual taxpayer's 1916 operations accrued and was required to be deducted in 1916, rather than in 1917 when actually paid.[18] In applying the accrual method for tax purposes, the Court accepted the matching concept as its guidepost, explaining that the 1916 statutory change enabled taxpayers to utilize scientific accounting principles by charging expenses against corresponding income earned during the taxable period.[19]

Clearly after *Anderson* no disparity existed between accrual accounting for financial purposes and for tax purposes. As the Court stated, the accrual method was a statutorily recognized accounting method.[20] At this stage in the

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12. Revenue Act of 1916, ch. 463, § 13(d), 39 Stat. 756, 771. The pertinent portion of the Act provides:

> [K]eeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect its income, may, subject to regulations made by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, make its return upon the basis upon which its accounts are kept. . . .

See also id. ch. 463, § 8(g), 39 Stat. 763.

13. *See* H.R. REP. No. 922, 64th Cong., 1st Sess. 4 (1916), *reprinted in* 1939-1 C.B. 22, 24.

14. Revenue Act of 1918, ch. 18, § 212(b), 40 Stat. 1057, 1064-65.

15. *See* Revenue Act of 1939, ch. 1, § 41, 53 Stat. 1, 24.

16. I.R.C. § 446(c) (1976) provides as follows:

> (c) Permissible Methods — Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting —
> (1) the cash receipts and disbursements method,
> (2) *an accrual method,*
> (3) any other method permitted by this chapter, or
> (4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary.

(emphasis added). Accrual accounting does not merely defer the timing of income recognition. Income recognition is determined by the right to receive and not the actual receipt of the income. United States v. Harmon, 205 F.2d 919, 920 (10th Cir. 1953). Therefore, if accrual taxpayer X renders services to Y in year one and bills him accordingly, but does not receive payment until year two, X recognizes income in year one, when the right to receive it first arises.

17. 269 U.S. 422 (1926).

18. *Id.* at 440.

19. *Id.*

20. *Id.* at 441.

relationship between accrual accounting and tax law, it appeared an accrual basis taxpayer could defer inclusion of income for future services until such services were in fact rendered.[21] What then happened to this apparent rapport between taxpayers and the Treasury in the application of generally accepted accounting principles? One commentator suggests the government simply adopted an opportunistic taxation philosophy of taxing as income whatever it could, whenever it could, irrespective of the taxpayer's method of accounting or any principle of consistency.[22] This new philosophy was reflected in the government's application of "claim of right" doctrine.

The "Claim of Right" Doctrine

The claim of right doctrine has its roots in *North American Oil Consolidated v. Commissioner*,[23] decided by the Supreme Court six years after *Anderson*. In *North American Oil*, the taxpayer in 1916 operated a section of oil land legally owned by the United States.[24] The government also claimed beneficial ownership of the land and, after the institution of legal proceedings, had a receiver appointed to operate the property and hold the net income. Pursuant to court decree, the receiver paid the net profits earned from 1916 operations to the taxpayer in 1917.[25] The government appealed, but lost at the circuit court of appeal.[26]

The income earned from 1916 operations was entered on the taxpayer's books in 1916 and included in an amended return for that year filed in 1918.[27] Upon audit, the Commissioner determined the income in question was taxable in 1917. The taxpayer alternatively contended the income was taxable in 1916, or in 1922 when ownership of the impounded property was awarded to the taxpayer.[28] The Court first held the net profits were not taxable in 1916, since the taxpayer had no right in that year to demand the receiver pay over the money.[29] The Court, noting uncertainty as to whether the taxpayer was on the cash or accrual accounting basis, held the particular method used ir-

21. The Service, in two early rulings, seemed to agree. In the first ruling, an accrual taxpayer sold tickets for tourist cruises and received payments therefore late in one taxable year. The expense incident to running the cruise was not incurred until the succeeding year. The Service determined that only the accrual method of accounting would clearly reflect income, and permitted deferral of the receipts from ticket sales until the succeeding taxable year. I.T. 2080, III-2 C.B. 48 (1924). In the second ruling, the Service permitted accrual basis publishers of periodicals to report prepaid subscription income over the subscription period, which extended beyond the taxable year of receipt, where publishers had consistently followed that practice. I.T. 3369, 1940-1 C.B. 46.

22. *See* Jacobs, *supra* note 9, at 583.

23. 286 U.S. 417 (1932).

24. *Id.* at 420.

25. *Id.* at 421.

26. Commissioner v. North Am. Oil Consol., 50 F. 752, 756 (9th Cir. 1921).

27. 286 U.S. at 421.

28. *Id. See* United States v. North Am. Oil Consol., 242 F. 723 (S.D. Cal. 1917), aff'd 264 F. 336 (9th Cir. 1920), *appeal dismissed*, 258 U.S. 633 (1922).

29. 286 U.S. at 422-24.

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relevant. The taxpayer was not liable in 1916 for income it had not yet received and might never receive.[30]

The Court responded to the taxpayer's argument that the amounts received in 1917 were not taxable until 1922 with the now famous claim of right doctrine.

> 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 report, even though it may 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.[31]

The Court labeled earnings received under a claim of right without disposition restrictions as recognizable income.[32] Even if later found not entitled to the earnings and compelled to restore its equivalent, the taxpayer must disclose the amount as income.[33] The claim of right doctrine formulated in *North American Oil* responded to the issue of whether amounts, otherwise includible as income in a particular year under the taxpayer's accounting method, should be recognized in that year when their ownership is disputed. The Supreme Court was not referring to prepayment for which future services were owed. The funds in question were admittedly income under the taxpayer's accounting method, not mere receipts.

After *North American Oil,* lower courts unfortunately applied the claim of right doctrine to force accrual basis taxpayers to include prepayments for future services in the year of receipt. The criterion for applying the doctrine became the presence or absence of a use restriction on the prepaid receipts. Courts overlooked the fact that under the accrual method the receipts were not yet income.[34] By so interpreting *North American Oil,* lower courts ignored the Supreme Court's reference to earnings and net profits, because payments for future services are neither when received by an accrual taxpayer. The better view would require the amounts in question to be otherwise includible under the taxpayer's accounting method as a precondition to the doctrine's application.[35]

These courts arguably misapplied the "restriction on use" test. Restrictions on disposition or use need not be specifically stated in a contract, nor must the receipts in question actually be set aside to be restricted. Common sense dictates a taxpayer receiving payment for future services must retain sufficient funds to pay the costs of rendering those services. As the Supreme Court

30. *Id.* at 424.

31. *Id.* (emphasis added).

32. *Id.*

33. *Id.* (emphasis added).

34. *See* Automobile Club of Mich. v. Commissioner, 230 F.2d 585 (6th Cir. 1956), *aff'd on other grounds,* 353 U.S. 180 (1957); Capital Warehouse Co. v. Commissioner, 171 F.2d 395 (8th Cir. 1948); Clay Sewer Pipe Ass'n v. Commissioner, 139 F.2d 130 (3d Cir. 1943); South Dade Farms v. Commissioner, 138 F.2d 818 (5th Cir. 1943); New Capital Hotel v. Commissioner, 28 T.C. 706 (1957); Andrews v. Commissioner, 23 T.C. 1026 (1955); Your Health Club, Inc. v. Commissioner, 4 T.C. 385 (1944).

35. *See* Gelfand, *The "Claim of Right" Doctrine,* 33 TAXES 726, 728 (1955).

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stated in 1934, for receipts to be taxable the taxpayer must be "under no restriction, contractual *or otherwise,* as to its disposition, use or enjoyment."[36] This statement indicates that practical business requirements may constitute a restriction sufficient to prevent the claim of right doctrine from forcing inclusion of prepayments in income when they must be earned by future services.

Beginning in 1955, courts began to recognize that the claim of right doctrine did not support the Commissioner's argument against deferred reporting of prepayments by accrual taxpayers. The Tenth Circuit in *Beacon Publishing Co. v. Commissioner*[37] held the doctrine only applies when determining the treatment of an amount *otherwise includible in income* whose ownership is disputed.[38] The court recognized that the doctrine does not address the different issue of whether amounts undisputably owned by the taxpayer may be reported in other than the taxable year of receipt under the accrual method.[39] Because the doctrine's application would destroy the matching concept which is intrinsic to the accrual method, the court allowed prepaid sums received for newspaper subscriptions to be reported over unexpired subscription periods.[40] Within five years of *Beacon Publishing,* three other circuits[41] used the same rationale to reject the government's application of claim of right to payments for future services to be rendered by an accrual taxpayer.

The Supreme Court's Trilogy of decisions concerning deferral of prepayments settled the issue of claim of right's applicability to an accrual taxpayer's prepaid receipts.[42] In all three cases the Court, although referring to claim of right, turned to the statutory guidance of section 446(b) in determining the validity of a deferral system.[43] As the Trilogy developed, fueled by an enthusiastic rejection of the doctrine by legal commentators,[44] it became apparent claim of right had been replaced by section 446(b)'s clear reflection of income test.

"Clearly Reflects" Income — Section 446(b)

The 1916 Revenue Act, which first permitted accrual accounting, limited

36. Brown v. Helvering, 291 U.S. 193, 199 (1934).

37. 218 F.2d 697 (10th Cir. 1955).

38. *Id.* at 699-700.

39. *Id.* at 700.

40. *Id.* at 701-02.

41. *See, e.g.,* Schlude v. Commissioner, 283 F.2d 234 (8th Cir. 1960), *rev'd on other grounds,* 372 U.S. 128 (1963); Bressner Radio, Inc. v. Commissioner, 267 F.2d 520 (2d Cir. 1959); Schuessler v. Commissioner, 230 F.2d 722 (5th Cir. 1956).

42. The dissent in American Auto. Ass'n v. Commissioner, 367 U.S. 687 (1961), characterized the majority's failure to rely on the doctrine in Automobile Club of Mich. v. Commissioner, 353 U.S. 187 (1961), and *AAA* as a rejection of the doctrine's applicability to prepaid receipts of accrual taxpayers. 367 U.S. at 693. The majority's silence in *Michigan* and *AAA,* coupled with expressed reservations concerning the correctness of *Beacon Publishing,* support the dissent's conclusions. *See Michigan,* 353 U.S. at 189; *AAA,* 367 U.S. at 691. *See also infra* notes 53-82 and accompanying text.

43. *Schlude,* 372 U.S. at 136-37; *AAA,* 367 U.S. at 690; *Michigan,* 353 U.S. at 188.

44. *See, e.g.,* Gelfand, *supra* note 35; Jacobs, *supra* note 9; Wolder, *Deduction of Reserves for Future Expenses and Deferring of Prepaid Income,* 34 TAXES 524 (1956).

the deferral method's use. Accrual was statutorily permissible unless it did not clearly reflect income.[45] This statutory requirement was the forerunner of section 446(b). Because prior to *Beacon Publishing* and the Trilogy, the Commissioner consistently won deferral cases by applying the claim of right doctrine, courts found it unnecessary to determine whether deferral clearly reflected income. As a result, whether section 446(b) applied to the deferral area was unknown.

Read literally, section 446(b) is somewhat confusing. It expressly grants the Commissioner discretion to choose an alternative accounting method once the determination has been made that the taxpayer's method does not clearly reflect income.[46] The statute does not explicitly state who is to make the latter determination. While the regulations empower the Commissioner to make the decision,[47] this statutory ambiguity allows one to question if the Commissioner's discretion to determine whether an accounting method clearly reflects income is narrower than his authority to mandate a new accounting method.[48] The absence of pre-Trilogy case law applying section 446(b) to deferral accounting left in doubt the extent of the Commissioner's section 446(b) discretion.

THE TRILOGY

By applying section 446(b) to the deferral area, the Court's Trilogy hammered the last nail into the claim of right coffin and redefined the issue. The question became whether deferral accounting clearly reflects income. In each case the Court upheld the Commissioner's determination that each system did not clearly reflect income as a valid exercise of his section 446(b) discretion. Afterwards, the Commissioner asserted the Trilogy vested him with

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45. *See supra* note 13.

46. I.R.C. § 446(b) (1976) reads as follows: "(b) Exceptions – 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." *Id.*

47. Treas. Reg. § 1.446-1(a)(2) (1960) ("[N]o method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income.").

48. For an excellent discussion concerning the extent of the Commissioner's discretionary power over taxpayers' accounting methods, see Goodhue, *Claim of Right and Changes in Accounting Method,* N.Y.U. 18TH INST. ON FED. TAX 209, 216-21 (1960). Although this article predates two-thirds of the Trilogy, the author's conclusion seems to still have merit:

> It is probably too late to deny that the Commissioner has considerable discretion in laying down rules for determining when specific items of income should be reported and specific deductions should be allowed. It is probably also too late to deny that the Commissioner, where the taxpayer has chosen an accounting method which does not conform to his rules, has discretion to require a much higher degree of proof from the taxpayer that his method does clearly reflect income, than might be the case where no specific rules or regulations have been laid down. *There remains considerable force to the argument that if the taxpayer can sustain such a burden and prove convincingly that its method clearly reflects income, it is an abuse of the Commissioner's discretion to require the taxpayer to abandon his method* in favor of the Commissioner's method, unless the latter's is demonstrably better.

Id. at 221 (emphasis added).

sufficiently broad discretion to reject *any* deferral accounting method. Later courts have debated whether this represents an accurate interpretation of the Trilogy.[49] From these cases, three competing viewpoints have evolved. First, section 446(b) and the congressional intent evidenced by the repeal of pro-deferral section 452 vest the Commissioner with sufficiently broad discretion to reject any deferral method.[50] Second, deferral accounting clearly reflects income via the performance of services on fixed future dates.[51] Third, the existence of fixed future performance dates is a significant, but not determinative, factor in deciding whether "accurate matching" is achieved. Statistical projections of the customer demand for future services, if reasonably precise, are sufficient to achieve the requisite "accurate matching."[52] The decisions promoting these viewpoints must be closely examined to determine which viewpoint best characterizes the Supreme Court's intent.

Michigan

The Supreme Court first addressed the validity of deferral by accrual taxpayers in 1957 in *Automobile Club of Michigan v. Commissioner*.[53] The petitioner in *Michigan* received membership dues paid one year in advance. The club then recognized the prepaid dues as income ratably over the twelve month membership period. To the extent the membership period extended into the next taxable year, taxation on a portion of the prepayment was deferred.[54] The Service contended that payments received under a claim of right without disposition restrictions should be reported as income in the year of receipt.[55]

Ignoring the claim of right doctrine, the Court analyzed the particulars of the deferral system and decided it did not clearly reflect income.[56] Accordingly, the Commissioner was held to have acted within the bounds of his section 446(b) discretion in rejecting the system.[57] The Court found that the pro rata allocation of prepaid dues was purely artificial and bore no relation to future services that may or may not be rendered.[58]

On this basis alone, the Court might have appeared to reject the taxpayer's deferral method because it did not achieve the accurate matching of revenues and related expenses that is basic to accrual accounting. This interpretation implies the Court would be receptive to a realistic deferral method that accurately matched revenues and expenses. The Court, however, in foot-

49. *See, e.g.,* Mooney Aircraft, Inc. v. United States, 420 F.2d 400 (5th Cir. 1970); Morgan Guaranty Trust Co. v. United States, 585 F.2d 988 (Ct. Cl. 1978); Boise Cascade Corp. v. Commissioner, 530 F.2d 1367 (Ct. Cl.), *cert. denied,* 429 U.S. 867 (1976).

50. *See supra* note 2.

51. *See infra* notes 83-95 and accompanying text.

52. RCA Corp. v. United States, 499 F. Supp. 507 (S.D.N.Y.), *rev'd,* 664 F.2d 881 (2d Cir. 1981), *cert. denied,* 102 S. Ct. 2958 (1982).

53. 353 U.S. at 180.

54. *Id.* at 188.

55. *Id.* at 188-89.

56. *Id.* at 189.

57. *Id.* at 189-90.

58. *Id.* at 189.

note twenty[59] reserved comment on the correctness of two cases[60] permitting deferral based on fixed future dates of service performance. Distinguishing those cases, the Court recognized that in the instant case performance of services remained contingent on a member's demand and therefore was not related to fixed future dates.[61] This footnote may have meant the Commissioner could reject any method that defers recognition of prepaid income for services not to be rendered on fixed future dates without abusing his discretion.

The question left unclear by *Michigan* was whether the Court required a deferral system to achieve accurate or exact matching of revenues and related expenses in order to clearly reflect income. Did the Court intend for its textual requirement that deferral "bear a relation" to future services to control? Such a requirement is satisfied when revenues are accurately matched with the expenses incurred incident to generating those revenues. Or did the Court's footnote modify the textual passage so as to require that the services be performed on fixed future dates? If this is the proper interpretation, no uncertainty as to the extent of future services is tolerated; revenues are exactly matched with related expenses due to the specificity of time and extent of future services. Rendition of services solely upon customer demand would not constitute a sufficient basis for deferral under the latter interpretation, as the extent of future services to be rendered is uncertain.

Bressner Radio, Inc. v. Commissioner[62] was the first post-*Michigan* case to consider this question. In *Bressner Radio*, the taxpayer received prepayments on television service repair contracts covering a twelve-month period. The payments were included in monthly income in pro rata fashion, consistent with statistical data illustrating a reasonably uniform demand for services under the contract.[63] The Second Circuit held that if the taxpayer demonstrated its method clearly reflected income, the Commissioner would not have discretion under section 446(b) to reject the method.[64] The court recognized the difficulty of determining whether the method adopted clearly reflected income,[65] and used the generally accepted accrual accounting principle of matching as its analytical starting point.[66]

The court had no difficulty in determining that as a financial accounting matter, the deferral method clearly reflected income because the taxpayer accurately matched revenues and related expenses. The real issue was whether the taxpayer's deferral clearly reflected income or was instead purely artificial

59. *Id.* at 189 n.20.

60. Schuessler v. Commissioner, 230 F.2d 722 (5th Cir. 1956); Beacon Publishing Co. v. Commissioner, 218 F.2d 697 (10th Cir. 1955).

61. 353 U.S. at 189 n.20. The Court stated that, unlike facts in the instant case, in *Beacon Publishing* performance on subscriptions was usually deferred until the publication dates after the tax year in question; and in *Schuessler* services were to be rendered on specified dates. *Id.*

62. 267 F.2d 520 (2d Cir. 1959).

63. *Id.* at 521.

64. *Id.* at 522-23. The court relied on I.R.C. § 41 (1939), forerunner of § 446(b). *See also* Goodhue, *supra* note 49.

65. 267 F.2d at 522-23.

66. *Id.* at 525.

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in light of *Michigan*.[67] The Second Circuit distinguished *Michigan* as dealing with a truly artificial system, because the club in *Michigan* failed to prove the services were actually rendered uniformly so as to justify the matching of related earnings via the ratable monthly allocation of revenues.[68] The Second Circuit stated that *Michigan* contemplated a realistic deferral would be permissible.[69] The court then held the taxpayer's system did in fact clearly reflect income for tax purposes.[70]

Bressner Radio therefore allowed a taxpayer to use statistically based estimates of both the time and extent of future services to defer and allocate prepaid income when services are to be rendered solely upon customer demand. The *Bressner Radio* court ignored footnote twenty of *Michigan* and the fixed future date controversy in favor of financial accounting principles of accurate matching as the standard for its clear reflection analysis. The Supreme Court's second Trilogy decision, *American Automobile Association v. United States (AAA)*,[71] placed the validity of this approach in serious doubt.

AAA

The facts in *AAA* were essentially the same as those in *Michigan*, however, in *AAA* the taxpayer supported its monthly pro rata allocation of prepaid membership dues with statistics evidencing a correlation between ratable recognition and actual incidence of expenses incurred in rendering service to members.[72] The taxpayer argued this statistical evidence distinguished him from the taxpayer in *Michigan*, who had failed to prove the requisite matching.[73] Agreeing with *Bressner Radio*, the taxpayer stated the *Michigan* Court allowed for a realistic deferral method that accurately matched revenues and related expenses.[74]

The *AAA* Court, however, did not characterize *Michigan* as a failure of proof case. Instead, the Court said its holding in *Michigan* that the taxpayer's deferral was purely artificial was based on its finding that the performance of services was contingent on a member's demand and was not related to fixed future dates.[75] In so characterizing *Michigan* and citing footnote twenty as support, the Court indicated exact matching and fixed future dates were necessary for deferral to clearly reflect income. It follows that the Commissioner would always be within the bounds of his section 446(b) discretion in rejecting deferral systems relying on statistical data other than fixed future performance dates to project customer demand and accurately match income with expenses. Commenting on the lower court's finding that AAA's deferral system agreed with generally accepted financial accounting principles, the Court ap-

67. *Id.* at 529.
68. *Id.*
69. *Id.* at 526.
70. *Id.* at 529.
71. 367 U.S. 687 (1961).
72. *Id.* at 690.
73. *Id.* at 691.
74. *Id.* at 692.
75. *Id.* at 691.

parently prohibited use of statistics when it found them "without determinate significance" and based on inherently undependable "average experience."[76] The only rationale offered, however, for flatly prohibiting the use of estimates and statistics was that actual individually incurred expenses varied from month to month even when averaged, while the recognition of income remained ratably constant.[77]

Some courts[78] and commentators[79] have limited the Court's apparent prohibition on statistics to the narrow facts of the case. They argue *AAA* did not absolutely reject the use of statistics, but that, as in *Michigan*, the facts indicated the pro rata allocation of prepaid revenues did not accurately match revenues and expenses, since expenses were not incurred ratably. AAA's statistics failed because the prepaid revenues were not allocated so as to accurately match revenues with expenses.

One year later the Second Circuit, in *Automobile Club of New York v. Commissioner*,[80] characterized *AAA* as decided simply on the taxpayer's failure to establish an accurate matching of income and expenses and opined that *AAA* in no way impaired the vitality of *Bressner Radio*.[81] *Bressner Radio*, the Second Circuit stated, was distinguishable because the allocation of prepaid revenues in accordance with the taxpayer's statistics closely matched expenses with revenues.[82] Most courts and commentators, however, understandably interpreted *AAA* as flatly prohibiting all use of estimates and statistics.

Schlude

The third decision of the Trilogy, *Schlude v. Commissioner*,[83] breathed new

76. *Id.* at 693. The Court stated:

> This is only to say that in performing the function of business accounting the method employed by the Association is in accord with generally accepted commercial accounting principles and practices. It is not to hold that for income tax purposes it so clearly reflects income as to be binding on the Treasury. Likewise, other findings merely reflecting statistical computations of average monthly cost per member on a group or pool basis are without determinant significance to our decision that the federal revenue cannot, without legislative consent and over objection of the Commissioner, be made to depend upon average experience in rendering performance and turning a profit.

Id.

77. *Id.* The Court observed:

> Indeed, such tabulations themselves demonstrate the inadequacy from an income tax standpoint of the *pro rata* method of allocating each year's membership dues in equal monthly installments *not in fact related* to the expenses incurred. Not only did individually incurred expenses actually vary from month to month, but even the average expense varied — recognition of income nonetheless remaining ratably constant.

Id. (emphasis in original).

78. *E.g.*, RCA Corp. v. United States, 499 F. Supp. 507 (S.D.N.Y. 1980), *rev'd*, 664 F.2d 881 (2d Cir. 1981), *cert. denied*, 102 S. Ct. 2958 (1982).

79. *See, e.g.* Seago, *What Chance for Prepaid Income Deferrals Based on Statistical Estimates After* RCA *Decision*, 54 J. TAX. 16 (1981).

80. 304 F.2d 781 (2d Cir. 1962).

81. *Id.* at 784.

82. *Id.*

83. 372 U.S. 128 (1963).

life into the accurate matching argument and the availability of statistics to prove such matching. In *Schlude,* a dance studio sold prepaid dance lesson contracts for a specified number of hours. Although the contracts designated the period over which the lessons would be taken, there was no schedule of specific dates. The studio credited a deferred income account for the amount prepaid on a particular contract.[84] At the close of each year, the number of hours taught on a contract was multiplied by a designated hourly rate and the resulting sum was reported as income for that period. If no lessons were taught on a contract for over a year, an entry would be made cancelling that contract and recognizing the unearned prepayment as cancellation gain income in that year.[85]

The Court, in holding the Commissioner properly exercised his section 446(b) discretion, rejected the taxpayer's deferral system as not clearly reflecting income.[86] As in *AAA,* the taxpayer's deferral system deferred income for services to be performed on customer demand, rather than on fixed future dates.[87] Apparently relying on the exact matching concept, the Court held that when services are not to be performed on fixed future dates, the Commissioner always acts within his discretion in rejecting the deferral system.[88]

A closer reading of *Schlude,* however, indicates the absence of fixed future dates may not have been determinative and a system relying on estimates to accurately match revenues and expenses might clearly reflect income. The *Schlude* Court's concern was not the matching of revenues and expenses relating to hours actually taught under the contract, but instead was the absence of expenses matching the cancellation gains.[89] Under financial accounting principles, when additional services need not be rendered nor expenses incurred to earn income, income should be recognized immediately.

The fatal flaw of the taxpayer's system in *Schlude* was that at the end of each period the "studio was *uncertain* whether none, some, or all of the remaining lessons would be rendered."[90] The Court's primary concern was not that exact matching be achieved, but that any income deferred actually be earned in the future. The Court found the studio's arbitrary decision of when to cancel a particular contract objectionable because income could be reported in a period subsequent to receipt, which bore no economic relationship to the income reported.[91] The solution, the Court stated, would have been to report income from "estimated cancellations" in the year of receipt, since no additional expenses had to be incurred to earn those cancellation gains.[92] The deferral system's failing could be remedied by the use of accurate statistical projections of the extent to which contracted-for lessons would actually be taught.

84. *Id.* at 130.
85. *Id.* at 131-32.
86. *Id.* at 135-36.
87. *Id.* at 135.
88. *Id.* at 136-37.
89. *Id.* at 136.
90. *Id.*
91. *Id.* at 136, n.9.
92. *Id.*

The Trilogy's conflicting statements on the use of statistics to clearly reflect income end in confusion. According to *AAA*, the use of statistics to project when prepaid revenues should be matched to future expenses is inappropriate.[93] In *Schlude*, the Court approved the use of statistical projections as a valid means of accurately determining the extent of performance of future services, thereby legitimizing the deferral system.[94] The Court in *AAA* and *Schlude* arguably did not intend fixed future performance dates to be an absolute prerequisite to clear reflection of income. The Court's primary concern was uncertainty as to the extent of future services that inheres in a deferral system relying solely on customer demand to allocate prepaid revenues. This is evidenced by the Court's statement in both *AAA* and *Schlude* that the particular deferral systems unacceptably deferred income recognition of prepayments to a taxable period in which "no, some, or all the services paid for may or may not be rendered."[95] The Court's adoption of fixed future dates as an instance in which deferral clearly reflects income merely manifests its concern over the above uncertainty. Where services are to be performed on fixed future dates, there is no uncertainty: clearly, the entire prepayment will be earned through future performance.

The Court's focus reflects a concern that the matching concept underlying accrual accounting be followed. As the degree of certainty attending the rendition of future services increases, the allocation of revenues to future periods in which those services are increasingly certain to be rendered achieves a closer matching of revenues and expenses. Fixed future dates of performance provide absolute certainty and exact matching, whereas services to be rendered solely on customer demand, without any statistical projection of the extent of such demand, results in inaccurate matching due to an impermissible degree of uncertainty as to whether future services will be rendered.

The issue arguably left unanswered by the Trilogy is the validity of a deferral system whose uncertainty falls somewhere between the two extremes of fixed future dates and solely on customer demand. More specifically, the issue is whether a deferral system that, in allocating prepaid revenues to future periods, relies on accurate statistical projections of customer demand for services, clearly reflects income. To answer this question, the development of the law after the Trilogy must be reviewed.

SERVICE ASSERTS ABSOLUTE ANTI-DEFERRAL RULE

The *AAA* and *Schlude* decisions clearly imply that deferral based on the performance of services on future fixed dates clearly reflects income for tax purposes. In both cases, however, the Court relied on a broader alternate ground in upholding the Commissioner's rejection of deferral — Congress' enactment and subsequent retroactive repeal of section 452, the only Code section to incontestably allow deferral.[96] In the post-Trilogy years, the Service contended

93. 367 U.S. at 693.
94. 372 U.S. at 135-36.
95. 372 U.S. at 136; 367 U.S. at 692.
96. *See supra* note 2.

that this legislative "rejection" of deferral meant the Commissioner could reject *any* deferral method as a sound exercise of section 446(b) discretion.[97]

The majority in *AAA* viewed the passage of section 452 as the first legislative declaration specifically permitting deferral accounting for tax purposes. Congress' repeal of section 452 one year later "was just as clearly a mandate from the Congress that petitioner's [deferral] system was not acceptable for tax purposes."[98] The Court noted that the enactment of section 455 in 1958, permitting publishers to defer inclusion in income of prepaid subscriptions, and Congress' express refusal at that time to allow deferral of prepaid automobile club membership dues, was an indication that Congress was aware of the deferral problem but chose to limit its permissibility to publishers.[99] Such congressional awareness, along with the fact that by repealing section 452 Congress eliminated the only law incontestably permitting the deferral method, required the Court to "leave to the Congress the fashioning of a rule which, in any event, must have wide ramifications."[100] Thus, because of the repeal of section 452 and Congress' limited authorization of deferral thereafter,[101] the Court concluded the Commissioner did not abuse his section 446(b) discretion in rejecting the taxpayer's deferral system.

The Commissioner rested his broad proposition that deferral is never a valid method for tax purposes upon the *AAA* majority's interpretation of congressional action in the deferral accounting area. The Commissioner contended that in light of the clear congressional mandate emanating from the repeal of section 452, rejecting the deferral method always lies within his

97. *See, e.g.,* RCA Corp. v. United States, 664 F.2d 881, 889 (2d Cir. 1981) (reserving comment on this proposition); Hagen Advertising Displays, Inc. v. Commissioner, 407 F.2d 1105 (6th Cir. 1969); Decision, Inc. v. Commissioner, 47 T.C. 58 (1966); Cox v. Commissioner, 43 T.C. 448 (1965); Popular Library, Inc. v. Commissioner, 39 T.C. 1092 (1963).

98. 367 U.S. at 695.

99. Ironically, five weeks after *AAA* came down Congress enacted § 456, permitting deferral of prepaid membership dues by membership organizations such as those in *Michigan* and *AAA*. Section 456 permits the prepaid dues to be reported on a pro rata basis over the period in which the services to which the dues relate are required to be performed. However, the reporting of the dues cannot be deferred over a period of more than 36 months. I.R.C. § 456 (1976).

The House Ways & Means Committee, in its report accompanying the enactment of § 456, commented on the Supreme Court's decision in *Michigan*:

> The pro rata allocation of annual membership dues over the 12 months to which the dues relate may not precisely match the periods in which services are performed for individual members. Nevertheless, your committee believes that spreading dues income of these clubs in this manner will more clearly approximate the period in which the services are rendered than reporting the income for the year of the receipt of the membership dues.

H.R. Rep. No. 381, 87th Cong., 1st Sess. 2 (1961), *reprinted in* 1961-2 C.B. 390.

While § 456 effectively overrules the *AAA* decision insofar as it relates to membership organizations, the Court's decision still applies to all other "prepaid service" scenarios where deferral is not expressly permitted by statute.

100. 367 U.S. at 697.

101. *See supra* note 99.

broad discretion. For several reasons, the Commissioner's proposed absolute anti-deferral rule did not constitute a proper reading of the Trilogy.

While the majority in *AAA* relied on rules of statutory construction in analyzing section 452's repeal, the *AAA* dissent investigated the legislative history underlying section 452's enactment and subsequent retroactive repeal.[102] After close scrutiny, the dissent properly concluded the enactment and repeal of section 452 did not justify the majority's finding of a broad congressional mandate.[103] Congress' expressed purpose in enacting section 452 was to bring tax accounting more nearly into line with accepted business accounting by permitting deferral.[104] Congress felt that but for the improper application of the claim of right doctrine to accrual taxpayers, section 452 would have been unnecessary and a proper reading of the 1939 Code would have permitted deferral.[105]

The repeal of section 452 did not reflect a change in Congress' belief that deferral was proper.[106] The Secretary of the Treasury requested that Congress repeal the statute because, due to mechanical problems in the statute, a tremendous loss of revenue would have occurred in the provision's transition year.[107] Congress acceded to the Secretary's request but emphasized that the

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102. 367 U.S. at 706-08 (Stewart, J., dissenting). The effect of the repeal of a statute is to destroy its effectiveness and treat it as though it had never existed. 1A J. SUTHERLAND, STATUTORY CONSTRUCTION ¶ 23.33 (C. Sands, 4th ed. 1972). The Service's argument is that prior to § 452's enactment deferral was not permissible, and therefore repeal of § 452 signaled a return to the pre-§ 452 viewpoint.

103. 367 U.S. at 710.

104. *Id.* at 709. *See also* S. REP., *supra* note 1, at 3, quoting from the tax recommendation in the Presidential Budget Message of 1954.

105. 367 U.S. at 703 (Stewart, J., dissenting). Justice Stewart characterized Congress as being aware "that the difficulty lay, not with the statute, but with administrative and court interpretation." *Id.*

106. Congress also repealed § 462, the "flip side" of deferral, which allowed accrual of a current deduction for additions to reserves for estimated future expenses. Section 462 came in with § 452 under the 1954 Internal Revenue Code as part of the attempt to bring tax and financial accounting more into line. It permitted the "reserve accounting" method to be elected. More precisely, § 462 permitted an accrual basis taxpayer to deduct reasonable additions to reserves for various types of estimated expenses, where such expenses were related to income taxed during the year, thereby preventing the double tax benefit that otherwise would occur via use of § 452 and § 462. Prior to § 462, deductions were only allowed when all events had occurred which fixed the fact and the amount of the taxpayer's liability. The deductions newly permitted by § 462 previously were disallowed due to their "contingent" nature.

107. The mechanical problem referred to was strictly a one-year matter. In the transition year, 1954, there would have been a "telescoping" of deductions due to 1) the newly allowed deductions for additions to reserves for future estimated expenses, for those taxpayers electing the "expense reserve" method, and 2) the deductions for expenses actually incurred in 1954 by an accrual taxpayer, attributable to income earned in a prior period but not deductible under old law until the current year. When considering § 452 and § 462, Congress had contemplated a $45 million revenue loss for fiscal year 1955 as a result of their enactment. Due to the above "telescoping," however, the Secretary felt that losses could run into the billions of dollars. Further, he contended that through the manipulation of the nature and content of contracts, § 452 could be used to achieve the same result were § 462 alone repealed. S. REP., *supra* note 1, at 5. *See also* Wagman, *Sections 452 and 462: Stormy Past but a Bright Tomorrow*, 33 TAXES 711, 715-16 (1955).

repeal did not signify disapproval of the deferral method.[108] Indeed, the Senate Report closed with a renewed call for congruency between tax and business accounting.[109] The Senate Finance Committee implicitly approved the *Beacon Publishing* decision decided between the enactment and repeal of section 452, by suggesting that all publishers be entitled to defer prepaid subscription income consistent with *Beacon Publishing* and the Service's previous limited approval of deferral.[110]

The Court's discussion of the section 452 repeal in *AAA* and *Schlude* was unnecessary because in both cases the Court first found the deferral systems presented were purely artificial and did not clearly reflect income. Once the Court determined the Commissioner's action was a valid exercise of his section 446(b) discretion no further discussion was necessary. Indeed, *Michigan*, the

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The "telescoping" problem was brought to the attention of Congress during its consideration of § 462, and the statute was modified before being enacted into law. As modified, the Secretary was given broad discretionary power to control any excessive revenue loss, by requiring the deduction for current expenses actually incurred to be spread out over an extended period of years instead of being deducted entirely in the transition year. The Secretary, however, was dubious of exercising the authority Congress intended him to have and was fearful that prolonged taxpayer litigation would result from such exercise. As a result of the Secretary's apprehensions and his desire to have a fresh review of § 452 and § 462, the committee concluded:

> [Y]our committee (Senate Finance Committee) has reluctantly concluded to report out the House bill repealing these sections from the effective date of their enactment. Since the Secretary has not, by regulations, exercised the discretionary limitations which your committee delegated to him in the law, it is apparent that the loss in revenue under these provisions may be much larger than was anticipated last year.

S. REP., *supra* note 1, at 5.

108. In a letter from the Secretary of the Treasury to the House Ways and Means Committee, the Committee received the following assurance from the Secretary:

> Furthermore, the Treasury Department will not consider the repeal of § 452 as any indication of congressional intent as to the proper treatment of prepaid subscriptions *and other items of prepaid income, either under prior law or under other provisions of the 1954 Code* . . . . It is my understanding that the foregoing is consistent with the desires of your committee, with which I agree, that the repeal of § 452 and § 462 should operate simply to reestablish the principles of law which would have been applicable if § 452 and § 462 had never been enacted.

H.R. REP. No. 293, 84th Cong., 1st Sess. 5 (1955), *reprinted in* 1955-2 C.B. 852, 854-55 (emphasis added).

109. *See* S. REP., *supra* note 1, at 6.

110. In I.T. 3369, 1940-1 C.B. 46, 47, the Service stated: "[I]f the publisher uses the [deferral] . . . of reporting subscription income, all expenses incurred during the year in which the subscriptions are obtained, which are applicable to the obtaining of the subscriptions, or to the subscriptions themselves, shall be spread allocably over the subscription periods in the same manner as the subscription income." *Id.* At the conclusion of its report, the Committee made clear it expected to report out legislation that would provide proper substitutes for § 452 and § 462. True to its word, § 455 was enacted three years later permitting deferral of prepaid subscription income. I.R.C. § 455 (1976). Three years later, § 456 came into law, permitting deferral of prepaid membership dues income. *Id.* at § 456.

first Trilogy case, ignored the repeal of section 452, although the government briefed this point.[111]

Clearly, the congressional mandate the *AAA* majority drew from the repeal of section 452 was overly broad, and probably wholly incorrect. Congress believed that, but for the erroneous application of the "claim of right" doctrine, deferral was proper and enacted section 452 to reinforce that belief.[112] The section was later repealed for reasons unrelated to its professed validation of the deferral method.[113] It seems incongruous to interpret the section 452 repeal as a mandate from Congress that deferral is not valid for tax purposes. In light of the fact that Congress was aware of the *Beacon Publishing* decision when repealing section 452, its desire that the trend of judicial decisions be allowed to run its course without an inference of disapproval being drawn from the repeal of section 452 seems to be better read as anything but congressional disapproval of deferral.[114] At the very least, even if the legislative history of section 452 does not actually *approve* deferral, it clearly does not stand for the broad proposition for which the *AAA* and *Schlude* majority cite it.[115]

The Court's implication throughout the Trilogy that deferral clearly reflected income when based on fixed future dates further discredits the Commissioner's absolute anti-deferral argument. It is highly unlikely that the Court's reference to section 452's repeal was intended to prohibit all deferral, since footnotes in *Michigan* and *AAA* specifically refrain from overruling *Beacon Publishing* and *Schuessler*, two cases permitting deferral based on future fixed dates. A more reasonable interpretation would be that the Court felt section 452's repeal broadened the Commissioner's section 446(b) discretion, but not to the extent of permitting disallowance of deferrals clearly reflecting income.[116]

The Seventh Circuit's decision in *Artnell Co. v. Commissioner*[117] rejects

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111. Brief for Respondent at 64-65, Automobile Club of Mich. v. Commissioner, 353 U.S. 180 (1957).

112. In light of the fact that Congress was aware of the *Beacon Publishing* decision when repealing § 452, its desire that the trend of judicial decisions be allowed to run its course without any inference of disapproval being drawn from the repeal seems to be better read as anything but congressional disapproval of deferral. *See supra* note 104.

113. *Id.*

114. *See supra* note 108.

115. It is likely the Court's discussion of the § 452 repeal was dicta in *AAA* and *Schlude*. In both cases the Court found the deferral systems presented were purely artificial and not clearly reflective of income, due to the lack of accurate matching of revenues and expenses. *Schlude*, 372 U.S. at 135-36; *AAA*, 367 U.S. at 691.

116. The viewpoint of the Fifth Circuit, for example, follows:

> It seems, then, that the Court is for the present taking a middle ground pending Congressional reform and clarification in this extremely confused area of the law. While the repeal of sections 452 and 462 *does not absolutely preclude* deferrals and accruals, it indicates that the Commissioner should have very broad discretion to disallow such techniques when there is any reasonable basis for his action.

Mooney Aircraft, Inc. v. United States, 420 F.2d 400, 408-09 (5th Cir. 1969) (emphasis added).

117. 400 F.2d 981 (7th Cir. 1968).

the Commissioner's absolute anti-deferral rule. In *Artnell,* customers bought season tickets for the Chicago White Sox baseball team admitting them to all scheduled home games.[118] This factual scenario resembled the fixed future dates situation, which the Supreme Court earlier implied would clearly reflect income. The Service argued that absent specific statutory authorization, deferral accounting as a rule must be disallowed.[119] The Tax Court agreed,[120] holding that in light of Congress' limited approval of deferral, the Commissioner had unreviewable discretion under section 446(b) to reject deferral accounting where Congress made no contrary provision.[121]

On appeal, the Seventh Circuit interpreted the Trilogy more narrowly than the Tax Court. Because section 446(b) provides the only statutory authority for the Commissioner's rejection of deferral accounting, the asserted absolute anti-deferral rule necessarily presumed that no deferral system could ever clearly reflect income. Unwilling to read the Trilogy as granting the Commissioner such unbridled discretion, the Seventh Circuit concluded that rather than a blanket prohibition, the Court had rejected deferral only when the time and extent of performance of future services was uncertain.[122] Even allowing for the Supreme Court's deferral to Congress to fashion an appropriate rule for deferral accounting, the Seventh Circuit held that "there must be cases where deferral accounting so clearly reflects income that the Commissioner's rejection thereof would be an abuse of his discretion."[123] The court then remanded to the Tax Court to determine whether the taxpayer's deferral method clearly reflected income.[124]

The *Artnell* decision makes three important points. First, no absolute rule of law prohibiting deferral exists, because the Commissioner does not have unreviewable discretion to reject all deferral systems.[125] Second, in the fixed future dates scenario deferral clearly does reflect income.[126] Third, when reviewing the Commissioner's section 446(b) discretion, a court must determine whether

118. *Id.* at 982.
119. *Id.* at 983.
120. Artnell Co. v. Commissioner, 48 T.C. 411 (1967).
121. *Id.* at 418.
122. 400 F.2d at 983-84.
123. *Id.* at 985.
124. On remand, the Tax Court took a rather radical approach:

> As we understand the opinion of the Court of Appeals, we are to examine the White Sox' method of accounting and to determine whether such method clearly reflects its income, without any consideration of those reasons which led to the adoption of a different rule for tax accounting. In other words, we are to judge the White Sox' method by the *standards commonly used for financial* or commercial accounting purposes.

29 T.C.M. 403, 405 (1970) (emphasis added). The Tax Court found that while the taxpayer's method did not perfectly match income with expenses, it did so better than the Commissioner's proposed method, and held for the White Sox. *Id.* at 406. No other court has followed this approach and relied exclusively on financial accounting notions in reviewing the Commissioner's exercise of his § 446(b) discretion.

125. 400 F.2d at 984.
126. *Id.* at 984-85.

the system in question clearly reflects income.[127] Most importantly, the *Artnell* decision implied that a deferral system not based on fixed future dates might be acceptable if it clearly reflects income.[128]

Other courts have subsequently concurred with *Artnell* in rejecting the Commissioner's proposition that, absent specific congressional authorization, deferral is per se invalid. To date, the Tax Court,[129] Court of Claims,[130] and the Third[131] and Fifth Circuits[132] all agree no absolute prohibition against deferral exists, while only the Sixth Circuit[133] concurs with the Service's viewpoint.

Indeed, the Service seems to recognize the fallacy of its own argument, as demonstrated by its limited acceptance of deferral in Revenue Procedure 71-21.[134] That Revenue Procedure permits a limited two-year deferral of prepayments for future services, provided certain conditions ensuring time and extent of future performance are met.[135] Revenue Procedure 71-21 blatantly contra-

127. *Id.* at 985.

128. *Id.* at 984-85.

129. Prior to a recent decision, the Tax Court clearly recognized the *Artnell* exception. "Since *Artnell Co.*, this Court has indicated that it will not follow the rationale of that case *unless* the facts present a certainty, of performance or fixed dates, such as was presented in *Artnell Co.*" T.F.H. Publications, Inc. v. Commissioner, 72 T.C. 623, 644 (1979), *aff'd by unpublished opinion,* Docket No. 79-2486 (3d Cir., May 27), *cert. denied,* 101 S. Ct. 320 (1980). The Tax Court in *T.F.H.* contrasted, and impliedly disassociated itself from, its prior opinions citing the Trilogy as establishing a rule of nondeferral. *See, e.g.,* Angelus Funeral Home v. Commissioner, 47 T.C. 391, 399 (1967); William O. McMahon, Inc. v. Commissioner, 47 T.C. 58, 62 (1966); Cox v. Commissioner, 43 T.C. 448, 455-56 (1965).

A recent decision, however, Chesapeake Financial Corp. v. Commissioner, 78 T.C. 869 (1982), creates doubt as to the Tax Court's current stance. Since the facts of the decision did not merit deferral (the taxpayer did not provide a breakdown of when services were to be rendered), the court's rejection of the taxpayer's system as not "clearly reflecting" income was to be expected. In distinguishing the instant facts from those in *Artnell* and *Boise Cascade,* the Tax Court implied it was undecided as to whether it recognized the exceptions provided in those cases when it stated: "We need not decide whether to adopt the rationale of the Seventh Circuit and the Court of Claims . . . ." *Id.* at 881. Further evidence of the Tax Court's indecision is evidenced by the following:

> In contrast to *Artnell* and *Boise Cascade,* the present case does not provide the occasion to ask whether the Supreme Court trilogy "left an opening for a decision that under the facts of a particular case, the time and extent of future performance might be so certain, and the matching of income and expenses so demonstrable, that deferral would clearly reflect income."

Id. (quoting Malman, *Treatment of Prepaid Income — Clear Reflection of Income or Muddied Waters,* 37 TAX L. REV. 103, 120 (1981)).

130. Morgan Guaranty Trust Co. v. United States, 585 F.2d 988 (Ct. Cl. 1978); Boise Cascade Corp. v. United States, 530 F.2d 1367 (Ct. Cl. 1976).

131. *See* T.F.H. Publications, Inc. v. Commissioner, 72 T.C. 623 (1979), *aff'd in an unpublished opinion,* Docket No. 79-2486 (3d Cir., May 27), *cert. denied,* 101 S. Ct. 320 (1980).

132. Mooney Aircraft, Inc. v. United States, 420 F.2d 400 (5th Cir. 1970).

133. *See* Hagen Advertising Displays, Inc. v. Commissioner, 407 F.2d 1105 (6th Cir. 1969).

134. Rev. Proc. (71-21), 1971-2 C.B. 549.

135. Section 3.02 of Rev. Proc. 71-21, *id.,* provides that:

> An accrual method taxpayer who, pursuant to an agreement (written or otherwise), receives a payment in one taxable year for services, where all of the services under such agreement are required by the agreement as it exists at the end of the taxable year

dicts the Commissioner's argument that *AAA* stands for the per se invalidity of deferral absent specific congressional authorization, since the procedure was issued without such authorizations.

Limits on the Permissible Use of the Deferral Method

Artnell's interpretation of the Trilogy established that no absolute rule prohibiting deferral absent congressional authorization exists, and deferral based on rendition of services on fixed future dates clearly reflects income and is therefore acceptable for tax purposes. The next logical question is how much further can the deferral method validly be extended? As stated in *Michigan,* deferral based not on fixed future dates but solely on customer demand is clearly unacceptable due to inadequate matching of revenues and related expenses. An acceptable middle ground, however, between the fixed future dates and solely on customer demand extremes may exist. For example, where services are to be rendered on customer demand, but the time and extent of such demand is projected through the use of statistical forecasts with reasonably precise accuracy, the deferral system could clearly reflect income.

Whether such a deferral method is acceptable for tax purposes depends on how the Trilogy is interpreted. As discussed above, a narrow reading of *AAA* and *Schlude* indicates the Court did not intend fixed future dates to be wholly determinative of a deferral system's validity, but rather to exemplify the accurate matching required for deferral accounting to clearly reflect income. The Court's footnote reference in *Schlude* to the taxpayer's failure to project estimated contract cancellations indicates the *AAA* Court did not intend to prohibit the use of statistics to accurately match revenues and expenses.[136] The Service broadly interpreted *AAA* and *Schlude* as rejecting all use of statistics to achieve accurate matching and clear reflection; only deferral based on fixed future dates is sufficient to achieve clear reflection of income. Recently, the Federal District Court for the Southern District of New York, and the Second

> of receipt to be performed by him before the end of the next succeeding taxable year, may include such payment in gross income as earned through the performance of the services .... However, if the inclusion in gross income of payments received is properly deferred under the preceding sentence and for any reason a portion of such services is not performed must be included in gross income in such next succeeding year, regardless of when (if ever) such services are performed.

Id. Rev. Proc. 71-21 most likely does not represent a trend towards the government recognizing that deferral in some instances "clearly reflects" income. Following hard on the heels of *Artnell,* the Rev. Proc. is more likely an attempt by the Service to minimize the damage done to its position by the Seventh Circuit in *Artnell.*

136. Inadvertently, the IRS in Rev. Proc. 71-21 lent support to this conclusion. In permitting a limited deferral or prepayments for future contingent services, the Service stated:

> In any case in which an advance payment is received pursuant to an agreement which requires the taxpayer to perform contingent services, the amount of an advance payment which is earned in a taxable year through the performance of such services may be determined (a) *on a statistical basis if adequate* data are available to the taxpayer.

Id. § 3.06, 1971-2 C.B. 549 (emphasis added).

Circuit, each tried to resolve this interpretive question, with widely disparate results.

RCA Corporation v. United States:[137] A New Approach

RCA, an accrual basis taxpayer, sold prepaid television service contracts to purchasers of new televisions. Under these agreements, the purchaser paid RCA a lump sum at the time of the purchase, and RCA agreed to service the television anytime trouble developed during a contract term from three to twenty-four months.[138] Because services were to be rendered upon customer demand rather than at regular intervals, the extent of future services was uncertain. RCA allocated the prepayment so that the portion attributable to the costs of selling and processing the contract, plus a profit, was recognized immediately as income. The remainder of the prepayment, the portion to be earned through future performance under the contract, was initially credited to a deferred income account.[139]

Based on past experience, RCA had developed statistical projections reflecting the percentage of service calls expected to be made each month under contracts of varying lengths. At trial, these projections were found to correlate to actual service calls with a very high degree of precision.[140] RCA utilized these projections to provide the basis for its monthly allocation to income of a portion of its prepaid receipts from the sale of contracts of each length. As a result, a portion of the prepayments were reported as income in tax years subsequent to their receipt.[141]

The Commissioner, after asserting that absent congressional authorization deferral is invalid, concluded RCA's deferral system did not clearly reflect income and rejected it under his section 446(b) authority.[142] At trial, the government argued the Trilogy establishes as a matter of law that deferral does not clearly reflect income when prepayments are received for services to be rendered at unspecified future dates, regardless of how accurately it matches revenues and expenses.[143] RCA contended the Trilogy, in conjunction with the *Anderson* case, simply requires that a deferral system achieve accurate matching of revenues and related expenses to clearly reflect income.[144]

The district court, limiting *AAA* and *Schlude* to their respective facts, rejected the government's position. The proper test under the statute, the court concluded, was whether the accounting method in question clearly reflects in-

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137. 499 F. Supp. 507 (S.D.N.Y. 1980), *rev'd*, 664 F.2d 881 (2d Cir. 1981), *cert. denied*, 102 S. Ct. 2958 (1982).

138. 499 F. Supp. at 508.

139. *Id.*

140. *Id.* at 518-19.

141. *Id.* at 508-09.

142. *Id.* at 509-10.

143. The government in such argument implicitly recognized the *Artnell* fixed future dates exception, but contended that such exception represents the furthest permissible extension of the deferral concept. *Id.*

144. *Id.* at 509.

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come.[145] That question is determined from how accurately the taxpayer's method matches revenues with the expenses of producing the revenue.[146] As to the fixed future date requirement, the court stated it was significant but not solely determinative in appraising whether revenues and related expenses are accurately matched.[147]

According to the district court, *Michigan* rejected a deferral system because the taxpayer failed to prove accurate matching,[148] but inferred that deferral could be upheld if there was evidence that the system accurately matched income with expenses. The court then focused on *AAA*'s apparent blanket proscription of the use of statistics and discredited it on two grounds. First, the Supreme Court's only rationale for the prohibition in *AAA* was that the particular taxpayer's pro rata deferral did not accurately match his revenues and expenses.[149] This enabled the *RCA* district court to limit *AAA*'s rejection of statistics to its facts.[150] Second, the Court noted in *Schlude* that if the dance studio had made an accurate statistical projection of estimated contract cancellations, the fatal uncertainty as to the extent of future services could have been remedied and accurate matching achieved.[151] The district court concluded the reference in *AAA* to estimated cancellations as a cure for the dance studio's uncertainty dispelled any notion that the Court intended to bar the use of such projections.

The district court's rationale for holding RCA's deferral method acceptable clearly was not novel. Although *RCA* was the first post-Trilogy case specifically allowing deferral based on statistics, the rationale applied by those post-Trilogy cases allowing deferral based on fixed future dates is equally applicable. Those decisions, consistent with the *RCA* district court, stress accurate matching as the cornerstone of clear reflection.[152] The Tax Court, on remand from the

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145. *Id.* at 516.

146. *Id.* at 518. The court observed:

> The proper test, under the statute, remains whether the accounting method in question "clearly reflects income"—that is, *in our view*, whether it ensures, with reasonable precision, that deferred revenues are included in gross income in tax years subsequent to that in which they are received only in proportion to the related services performed, and expenses incurred, during those tax years.

Id. (emphasis added).

147. *Id.* at 511-12. The court stated:

> In our view, the subsequent (post-*Michigan*) decisions of the Supreme Court establish that the fact that the services paid for are not to be performed on fixed dates is not in and of itself determinative, but is significant only insofar as it throws light on the question whether the challenged accounting method is "artificial" because it fails adequately to ensure that receipts are included in gross income in any tax year only in proportion to related expenses incurred during that year.

Id.

148. *Id.* at 512.

149. *Id.* at 512-13.

150. *Id.* at 513.

151. *Id.* at 515 (citing *Schlude*, 372 U.S. at 135-36).

152. *See infra* note 167.

Seventh Circuit in *Artnell* to determine whether the taxpayer's deferral system clearly reflected income, stated its duty was to determine whether the taxpayer's method achieved the matching of revenues and expenses required for financial accounting purposes.[153] Similarly, the Court of Claims found a taxpayer's deferral method clearly reflected its income because it achieved the "desideratum of accurately matching costs and revenues."[154] What is extraordinary about *RCA* was its willingness, in light of *AAA*, to allow the use of statistical projections to prove the required matching.

The government appealed *RCA* to the Second Circuit,[155] which had decided *Bressner Radio* twenty-two years earlier. Unfortunately for RCA, the Second Circuit's views on deferral had changed radically since that decision. Displaying an astonishing amount of deference to the Commissioner's judgment, the Second Circuit ruled the district court had misinterpreted its duty in *RCA*. The court concluded a reviewing court should not apply its own opinion in determining whether a deferral system clearly reflected income, but should defer to the Commissioner's decision unless it is without legal basis.[156] The Second Circuit concluded the lower court had given "too little weight to the objectives of tax accounting and to the Commissioner's wide discretion in implementing those objectives."[157]

After reviewing the Trilogy and its underlying policy consideration, the Second Circuit held the law adequately supported the Commissioner's action.[158] The primary policy consideration of the Trilogy, the court reasoned, was that deferral based on customer demand presents an impermissible degree of uncertainty as to the extent future services will in fact be rendered.[159] In light of such uncertainty, "the Commissioner was not required to subject the federal revenue to the vicissitudes of RCA customers' demands for service."[160] The court relied on *Schlude* and *AAA* in concluding that a deferral system relying on statistical projects and experiential assumptions was inherently uncertain to an impermissible degree. Although the Second Circuit found RCA's predictions more accurate than those in *AAA* and *Schlude*, "they were predictions nonetheless, and the Commissioner was not required to accept them as determinants of the federal revenue."[161] Accordingly, the court concluded the Commissioner did not abuse his discretion in ruling the projections did not evidence accurate matching and determining RCA's accounting method did not clearly reflect income.[162]

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153. 29 T.C.M. 403, 405 (1970).
154. 530 F.2d 1367, 1377 (Ct. Cl.), *cert. denied,* 429 U.S. 867 (1976). *See supra* note 49.
155. 664 F.2d 881 (2d Cir. 1981).
156. *Id.* at 886.
157. *Id.*
158. *Id.* at 888.
159. *Id.*
160. *Id.*
161. *Id.* at 889.
162. The Second Circuit withheld opinion on the government's "no deferral absent Congressional authorization" argument, in view of its disposition of the other issues before it. *Id.* at 889 n.10. The court's failure to dismiss this argument, long discredited by other courts, was certainly consistent with the remainder of its pro-government opinion.

District Court v. Second Circuit: Which Has the Better Analysis?

The conflicting analytical frameworks of the *RCA* district court and Second Circuit decisions reflect different interpretations of the judiciary's duty when reviewing an exercise of the Commissioner's section 446(b) discretion. The district court's approach requires the reviewing court to analyze the particular accounting method at issue. If the method matches revenues and related expenses with sufficiently precise accuracy, then it clearly reflects income. If the taxpayer's method clearly reflects income, the Commissioner is precluded from exercising his section 446(b) authority to reject it.[163] The validity of the Commissioner's exercise of discretion is determined by reference to whether the accounting method in question clearly reflects income.

In contrast, the Second Circuit determines whether the Commissioner has abused his discretion by reference to prior case law and policy considerations. This method totally bypasses investigation into the accuracy of the taxpayer's accounting method in favor of determining whether the Commissioner's action had an adequate basis in law. By upholding the Commissioner's rejection of RCA's highly precise statistical projections, the Second Circuit effectively established a rule of law that deferral based on statistical projections, no matter how accurately revenue and related expenses are matched, never clearly reflects income.

The likely rationale for the Second Circuit's approach to deferral of prepaid service income is administrative convenience. The government strongly emphasized this factor in both *AAA* and *Schlude*.[164] Administrative considerations help explain the Trilogy's aversion to uncertainty in the performance of future services. Fixed future performance dates eliminate the need to verify statistical projections underlying deferral and thereby facilitate administration of the accounting method.[165] However, as one commentator has noted: "It is not at all clear that discrimination solely on the basis of what is administratively practicable could be supported by appeal to the only standard

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163. *See supra* note 48 and accompanying text.

164. *See* American Auto Ass'n v. United States, 367 U.S. at 692; Brief for Respondent at 42-43, Schlude v. Commissioner, 372 U.S. 128 (1963).

> There could be an enormous burden of evaluating and verifying complex statistical evidence submitted by millions of taxpayers in an endless variety of business contexts to prove they had reliably "related and matched" present income with estimated future expenses, or present expenses with estimated future income. Revenue agents could not only become involved in technical accounting problems in order to determine the validity and accuracy of the taxpayer's estimates in the first instance, but could be obliged to re-audit the taxpayer's accounts in later years to ascertain whether subsequent business experience corresponds with the taxpayer's previous estimates.

Id.

165. *See* Comment, RCA Corp. v. United States: *The Taxation of Income From Future Services*, 1 VA. TAX REV. 189, 206 (1981). This comment was written before the Second Circuit's decision in *RCA*; the Second Circuit's analysis bore uncanny resemblance to that of this comment, which concluded that the Commissioner should have the authority to reject the use of statistics simply on administrative convenience grounds.

made explicit in the statute — that accounting methods must 'clearly reflect income' for federal tax purposes."[166] Section 446(b) and the case law defining the bounds of the Commissioner's discretion focus on whether an accounting system clearly reflects income, rather than on whether the Commissioner will have a difficult time administratively making that same determination.

Review of earlier pro- and anti-deferral decisions supports the district court's analytical framework and reveals the Second Circuit's approach grants excessive deference to the Commissioner. In all three of its decisions, the Supreme Court, in determining whether the Commissioner had validly exercised his section 446(b) discretion, decided the accounting method in question was purely artificial and did not clearly reflect income because revenues and related expenses were not accurately matched. The Court therefore upheld the Commissioner's exercise of his section 446(b) discretion. The Court's determination of the validity of the Commissioner's exercise of section 446(b) discretion hinged on its own analysis of whether the taxpayer's accounting method clearly reflected income, which in turn depended on the accuracy with which the system matched revenues and related expenses.

Subsequent pro-deferral decisions have also focused on clear reflection and accurate matching as the cornerstone of their analyses of section 446(b) discretion. These cases[167] agree that section 446(b) calls for a factual determination of whether an accrual system employing the income deferral technique clearly reflects income. Once the taxpayer carries the burden of proving his method clearly reflects income, it necessarily follows that the Commissioner abused his section 446(b) discretion in rejecting it.

The Second Circuit's approach is very similar to that of courts in the post-Trilogy, pre-*Artnell* period. These courts, interpreting the Trilogy as establishing an absolute rule that deferral could not clearly reflect income, refused to examine a taxpayer's deferral system for clear reflection. *Artnell* corrected this analytical error. Recognizing the key to clear reflection was accurate matching, the Seventh Circuit held some deferral systems must so accurately match revenues and related expenses that to conclude such systems do not clearly reflect income would be an abuse of discretion. Deferral based on fixed future dates did accurately match revenues and expenses; thus, on remand the Tax Court held the Commissioner abused his discretion.

The rule of law established by the Second Circuit, that deferral based on statistical projections, regardless of how accurate, can never clearly reflect income, is analogous to the pre-*Artnell* rule. It attempts to preclude courts reviewing the Commissioner's exercise of his section 446(b) discretion from examining a deferral system to determine whether it accurately matches revenues and related expenses. If accurate matching, however, is truly the key

166. *See* Oberdorfer & Michelman, *A Commentary on Tax Administration and Accrual Accounting*, 12 AM. U.L. REV. 135, 146 (1963). Because Mr. Oberdorfer was Assistant Attorney General of the United States, in charge of the Tax Division of the Justice Department, and argued the government's case in *AAA* and *Schlude*, this article offers an excellent insight into the government's argument in those decisions.

167. *See Morgan Guaranty Trust*, 585 F.2d at 997; *Boise Cascade*, 530 F.2d at 1377-78; *Mooney Aircraft*, 420 F.2d at 406; *Artnell*, 400 F.2d at 983; *Bressner Radio*, 267 F.2d at 523.

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criterion in determining whether a deferral system clearly reflects income, the Second Circuit's blanket proscription cannot stand. To paraphrase *Artnell,* there must be situations where the deferral technique, relying on accurate statistical projections, will so clearly reflect income that it will be an abuse of discretion if the Commissioner rejects it.

CONCLUSION

The courts and the Service are in general agreement that the deferral technique is a valid derivative of accrual accounting in limited circumstances.[168] No appellate court, however, has yet accepted the *RCA* district court's proposition that statistically-based estimates of future services accurately allocate prepaid income when the services are rendered solely on customer demand. Whether such a system is valid for tax purposes depends on how the Trilogy is interpreted.

Fixed future performance dates ought not to be determinative of whether a deferral system clearly reflects income. Reading the Trilogy as requiring fixed future dates, and thus limiting the *Artnell* exception strictly to its facts, is an overly broad interpretation. A court reviewing the Commissioner's exercise of his section 446(b) discretion must determine whether the deferral system before it clearly reflects income. This inherently subjective inquiry precludes the imposition of absolute criteria such as fixed future dates. Courts should not state that, as a rule of law, deferral based on fixed future dates always clearly reflects income while deferral based on statistical projections never does. If the Supreme Court intended the Trilogy to pronounce this rule of law, it did so without congressional authorization. Section 446(b) only requires that a deferral system clearly reflect income; the Court should not engraft onto the statute additional requirements such as fixed future dates. Therefore, the better view of the Trilogy is that the Court intended fixed future dates be an indicia of, not a prerequisite to, clear reflection of income.

Post-Trilogy cases concur with this narrow interpretation of the Trilogy.[169] These cases demonstrate the Supreme Court's primary concern was the lack of

168. *See supra* note 48; *infra* note 169. The limited circumstances referred to are basically fixed future performance dates.

169. In addition to the *RCA* district court, the Court of Claims, the Tax Court, and the Fifth Circuit have indicated that they do not regard fixed future dates as a prerequisite to valid deferral accounting. In *Boise Cascade,* the Court of Claims permitted deferral where the taxpayer was contractually bound to render engineering services, and such obligation was fixed and definite. The Court of Claims emphasized that the taxpayer before it had a fixed obligation to perform its services without the uncertainty of performance so prominent in the Trilogy. In no way, the court concluded, was the taxpayer's performance of his services dependent solely upon customer demand. 530 F.2d at 1378.

In *T.F.H.,* the petitioner purchased the printing and publishing assets of a corporation, and as part of the purchase price gave the corporation a credit for future advertising in the petitioner's publication. After holding that the advertising credit was taxable income to the petitioner as a prepayment for future advertising, the Tax Court decided that the credit was immediately includible in the petitioner's income. In rejecting the petitioner's attempted deferral, the Tax Court noted that "*certainty of performance* is lacking as well as a predetermined schedule of performance." 72 T.C. at 645. For the Fifth Circuit's viewpoint, see *Mooney Aircraft,* 420 F.2d at 406.

certainty that prepaid services would in fact be rendered.[170] When future performance is secured pursuant to a fixed and definite contractual obligation, certainty of performance exists and deferral has been permitted.[171] It requires no great leap of faith by the courts to recognize that the requisite certainty can also be established by statistical projections of customer demand, provided these projections are shown by experience to predict with reasonable precision the extent of future performance. Systems such as that employed by RCA should be acceptable for tax purposes. Taxpayers, however, should be aware that no federal appellate court has yet accepted the above conclusion. Until the *RCA* district court's analysis is adopted, a taxpayer's knowledge that he is theoretically correct may be little solace.

GARY J. COHEN

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170. In *AAA*, the Court voiced its concern over "[a]n 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. In *Schlude*, "at the end of each period, . . . the studio was uncertain whether none, some, or all of the remaining lessons would be rendered." 372 U.S. at 136.

171. In *Boise Cascade*, the taxpayer had such a fixed contractual obligation, and the Court of Claims permitted the deferral. 530 F.2d 988, 991 (1976). In *T.F.H.*, the taxpayer's obligation to perform advertising services was subject to the customer's demand, and therefore deferral was denied. "Although the pertinent provision in the agreement refers to a monthly average of 10 pages of advertising, there is no requirement that Miracle (the party entitled to the services) place any advertising at all in petitioner's publications. Consequently, certainty of performance is lacking . . . ." 72 T.C. at 645.

The Tax Court, as evidenced by the above, appears to accept the *Boise Cascade* notion that certainty of performance is sufficient to permit deferral. The Tax Court, however, rejected the use of "monthly averages" to achieve such certainty; a requirement to perform, the Tax Court felt, was necessary to achieve the requisite certainty.