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Federal Income Taxation -- Deferral of Prepaid Income

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NOTES AND COMMENTS

Federal Income Taxation—Deferral of Prepaid Income

In *American Auto Ass'n v. United States*,[1] the United States Supreme Court held that a taxpayer on the accrual basis may not defer prepaid membership dues over the period of membership, but must include such receipts as income in the year of receipt. The Association received membership dues for a twelve month period, payable in advance. Membership commenced or might be renewed in any month of the year. For many years, the Association had employed an accrual method of accounting and the calendar year as its taxable year.[2] The dues were treated on the Associations' books of account as income received ratably over the twelve month membership period. In the year of receipt the Association reported as income only that portion of the dues applicable to the calendar year during which the dues were collected. The balance was recognized as income in the ensuing calendar year.[3]

The Commissioner, acting pursuant to section 41 of the Internal Revenue Code of 1939,[4] rejected the Associations' method of accounting and substituted a method of his own. He claimed that the Associations' method did not properly reflect its income for tax purposes. Section 41 required a taxpayer to compute his income on an annual basis in accordance with the method of accounting which he regularly employed, but provided that if no method was regularly used, or if the method used did not clearly reflect income, the computation would be made in accordance with such method as in the opinion of the Commissioner clearly reflected his income. Section 42 of the Internal Revenue Code of 1939[5] required all items of income to be included in the gross income for the taxable year in which they were received by the taxpayer, unless, under section 41, they were to be properly accounted for as of a different period.

When sections 41 and 42 are read together, it seems clear that

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[1] 367 U.S. 687 (1961).

[2] The Association had used the accrual method since 1932.

[3] During the years of 1952 and 1953, the Association reported as income one-twelfth of the dues received for each month of membership occurring in the year of receipt.

[4] 53 Stat. 24 (now INT. REV. CODE OF 1954, § 446).

[5] 53 Stat. 24 (now INT. REV. CODE OF 1954, § 451).

the Commissioner is given no discretion to reject a taxpayer's regularly employed accounting method so long as it clearly reflects his income. Therefore, the critical question to be determined in a case such as the present one is whether the taxpayer's method clearly reflects income. But in the principal case the Court seems to have brushed aside this question and proceeded to decide when the income in question should be reported for tax purposes without regard to the taxpayer's accounting system or accepted accounting practice.

In disallowing the deferral of income, the Commissioner has traditionally taken the position that such a method is in conflict with the "claim of right" doctrine. This doctrine was first announced in *North American Oil Consol. v. Burnet.*[6] The Court in that case said,

> If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, 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.

The cases relying on this doctrine, with the exception of *Automobile Club of Michigan v. Commissioner,*[7] have dealt with *earned* rather than *unearned* income, and the only question was when this earned income should be reported for tax purposes.[8] The case announcing the doctrine had nothing to do with the determination of whether a method of accounting was valid or invalid and it should have no weight in deciding a case of the present type.

Four circuits have held that the claim of right doctrine may not be used to compel a taxpayer to report unearned income in the year of receipt. The tenth circuit held, in *Beacon Publishing Co. v. Commissioner,*[9] that a magazine publisher could defer prepaid subscription income over the duration of the subscription period. In 1956

[6] 286 U.S. 417 (1932).

[7] 353 U.S. 180 (1957).

[8] In the case announcing the claim of right doctrine, there was no dispute but that the income was already earned. No case was found, except *Automobile Club of Michigan,* in which the Supreme Court relied on the doctrine to reject a taxpayer's method of accounting, and it is not clear that it was relied on in that case.

[9] 218 F.2d 697 (10th Cir. 1955). INT. REV. CODE OF 1954, § 455, now provides that publishers may defer prepaid subscription income when the subscription period extends beyond the taxable year of receipt.

the fifth circuit had occasion to decide whether prepaid income from contracts to service heating furnaces sold by the taxpayer must be reported in the year of receipt. That court found, in *Schuessler v. Commissioner*,[10] that the accrual method of accounting more accurately portrayed the taxpayer's income than the one selected by the Commissioner because it matched income against expenses of the period in which the income was earned and was incident to earning that income, rather than against expenses of the period in which the income was received and without regard to when the income was earned. More recently, the second circuit held, in *Bressner Radio, Inc. v. Commissioner*,[11] that prepaid income from television servicing contracts could be deferred over the length of the obligation to furnish service. In 1960 the eighth circuit, in *Schlude v. Commissioner*,[12] held that a taxpayer who operated a dancing school could defer prepaid tuition over the period of instruction covered by the contract where the obligation to furnish instruction extended beyond the taxable year of receipt. In upholding the taxpayers deferral, all four circuits noted that the taxpayer was deferring unearned income until a period in which it could be matched with expenses incurred incident to earning the income.[13] Since this is the objective to be achieved by any sound accrual accounting system, it seems that these courts were on sound footing.

In the present case the government had successfully relied upon the claim of right doctrine in the Court of Claims.[14] Upon appeal to the Supreme Court, the government switched its argument to the annual accounting requirement found in section 41 of the Internal Revenue Code of 1939.[15]

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[10] 230 F.2d 722 (5th Cir. 1956).

[11] 267 F.2d 520 (2d Cir. 1959).

[12] 283 F.2d 234 (8th Cir. 1960), *rev'd per curiam*, 367 U.S. 911 (1961). The reversal was based upon the decision in the principal case.

[13] The Association had a more difficult task in proving its system of accounting properly matched future expenses with deferred income than did the taxpayers in these cases. Substantially all services provided by the Association were performed only on demand and were not limited to any fixed dates, but were performed at any time requested by its members.

[14] 181 F. Supp. 255 (Ct. Cl. 1960). The government did not rely on the claim of right doctrine probably because four circuits had previously denied that such ground may be used as a basis to deny a taxpayer the right to defer prepayments. The Second, Fifth, Eighth and Tenth Circuit Courts of Appeal had previously held that the claim of right doctrine had no application in determining *when* to report prepaid unearned income, and allowed accrual basis taxpayers to defer unearned income in accordance with their regularly employed method of accounting.

[15] 53 Stat. 24 (now INT. REV. CODE OF 1954, § 446).

The annual accounting requirement demands that neither income nor deduction items be accelerated or postponed from one year to another in order to reflect the long-term economic result of a particular transaction or group of transactions. However, as noted by the dissent, most of the cases relied upon by the government as a basis for this argument, involved cash basis taxpayers and none of the decisions cited pertain to deferred reporting of wholly unearned income.[16] Apparently this interpretation of the annual accounting requirement stems from a rule laid down by the Tax Court in *Automobile Club of New York*[17] to the effect that, "an item of income cannot accrue for tax purposes *after* it has in fact been received subject to the unrestricted use by the taxpayer."

The Supreme Court in the principal case did not base its decision solely upon the annual accounting requirement. It seems to have placed considerable weight on the fact that the Internal Revenue Code of 1954, as originally passed, contained specific provisions allowing taxpayers to defer unearned, prepaid income to a tax period later than that of receipt,[18] and to accrue expenses and deduct them in the period during which they actually became due.[19] The Supreme Court said that section 452 of the Internal Revenue Code of 1954, was not merely a statement of prior existing law, but that it was the first specific acceptance of the deferral of prepaid, unearned income for tax purposes. It further said that this provision was contrary to existing law, and that its repeal was an indication that Congress intended to restore the law to its status prior to the enactment of this section and not to allow this type deferral. As the income in question was for 1952 and 1953, it seems that action taken by Congress in 1954 and 1955 should have no bearing on the decision in the present case. The Court did not mention section 446 of the Internal Revenue Code of 1954 which specifically recognizes the accrual method of accounting as acceptable for computing income for tax purposes.

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[16] In Burnet v. Sanford & Brooks Co., 282 U.S. 359 (1931), the Court took note that the taxpayer had not attempted to take advantage of the accrual method under which system the treatment in question would have been allowed. In Security Mills Flour Co. v. Commissioner, 321 U.S. 281 (1944), the taxpayer had not applied consistently either a cash or accrual method; Brown v. Helvering, 291 U.S. 193 (1934), involved an attempt by an accrual basis taxpayer to accrue an expense that was highly contingent.

[17] 32 T.C. 906, 913 (1959). (Emphasis is by the court.)

[18] INT. REV. CODE OF 1954, ch. 1, § 452, 68A Stat. 152.

[19] INT. REV. CODE OF 1954, ch. 1, § 462, 68A Stat. 158.

The Supreme Court also placed some reliance on *Automobile Club of Michigan.* In that case the sixth circuit relied on the claim of right doctrine in affirming the Commissioner's disallowance of the taxpayer's deferral of prepaid membership dues. The Supreme Court did not specifically rely on the doctrine, but said, in affirming the circuit court in that case, that the taxpayer's method of accounting was "purely artificial" so far as the record before the Court showed. Apparently this was because there was no proof that the Automobile Club's method of accounting properly matched income with the expenses incurred which were incident to the earning of the income. This would seem to indicate that the Supreme Court would be willing to allow a taxpayer to defer income if he could show that his method of accounting clearly reflected income. In the instant case, there was expert accounting testimony that supported the Association's method, and the hearing commissioner found that the taxpayer's method clearly reflected income,[20] yet the Supreme Court still refused to allow the deferral.

The courts have been, until recently, more favorable to the accrual basis taxpayer who accrued expenses and deducted them in a period prior to the tax period in which they were actually paid. This situation is analogous to the deferral of unearned income and it was also controlled by section 41 of the Internal Revenue Code of 1939. An early case in which the Supreme Court considered this problem is *United States v. Anderson.*[21] That case involved an accrual basis taxpayer who attempted to deduct munitions taxes in the taxable period during which they actually were assesed and became due. The basis of the tax was sales made by the taxpayer in the previous tax period. The Court held that the taxes accrued as the sales were made and could not be deducted in the following period because the true income could not have been determined without deducting from gross income for the year the total cost and expenses attributable to the production of that income during the year. In construing sections 12(a) and 13(d) of the Revenue Act of 1916,[22] which were similar to section 41 of the Internal Revenue Code of 1939, the Court said of the purpose of the act,

> It was to enable taxpayers to keep their books and make their returns according to scientific accounting principles, by charg-

[20] American Auto. Ass'n v. United States, 367 U.S. 687, 693 n.5 (1961).
[21] 269 U.S. 422 (1926).
[22] Rev. Act of 1916, ch. 463, §§ 12(a) & 13(d), 39 Stat. 767, 771.

> ing against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period; and indeed, to require the tax return to be made on that basis, if the taxpayer failed or was unable to make the return on a strict receipts and disbursements basis.
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> The appellee's true income for 1916 could not have been determined without deducting from its gross income for the year the total cost and expenses attributable to the production of that income during the year.[23]

The Court there held that the tax must be deducted in 1916 or not at all. It said that this was true regardless of the fact that the tax was assessed and paid in 1917, since it was based on sales made in 1916, and that it made no difference that the taxpayer did not know until the assessment the amount of the munitions tax.

If a taxpayer's books are to clearly reflect his income, as required by section 41 of the Internal Revenue Code of 1939, he must record and report his expenses and income according to the same method of accounting. Therefore, if a taxpayer is required to deduct expenses only in the year of accrual, it seems that he should be required to recognize his income only in the year during which it is earned. But the Supreme Court seems to have a double standard in requiring an expense to be accrued and deducted regardless of whether it has been paid, and at the same time refusing to allow a deferral of prepaid income. It follows that a taxpayer may be required to keep two different sets of books, one for income tax purposes, and another for reporting to stockholders and governmental agencies. The Tax Court in *National Airlines, Inc.*[24] recognized that the requirement of keeping two different sets of books may constitute a hardship on the taxpayer, but that court said the remedy was not to be furnished by the judiciary.

Congress has in effect overruled the decision in the present case as applied to certain membership organizations which are organized without capital stock. In 1961 Congress passed a statute[25] which allows qualified organizations to spread prepaid membership dues income ratably over the period during which there is a liability to

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[23] 269 U.S. at 440.
[24] 9 T.C. 159, 162 (1947).
[25] INT. REV. CODE OF 1954, § 456.

perform services. The period of such liability must extend beyond the year of receipt, but must not be in excess of three years. Those taxpayers who cannot qualify under this statute may still be able to defer reporting of prepaid unearned income by proving that there is a reasonable correlation between the income deferred and future expenses. Such a conclusion seems to be justified as the Supreme Court in the principal case placed considerable reliance upon the *Automobile Club of Michigan* case.

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Pleadings—Cross-Claim for Contribution

In *Greene v. Charlotte Chem. Labs., Inc.*,[1] plaintiff sued to recover damages for personal injuries, joining *A* and *B* as alleged joint tort-feasors. *A* filed a cross-claim against *B* setting up a plea for contribution. *B* moved to strike the cross-claim. The trial court allowed the motion. On appeal this was affirmed in a four to three decision.[2]

The most obvious and severe consequence of this decision is to preclude an original defendant in such an action from holding another original defendant in to defend against his contribution claim should plaintiff take a voluntary or suffer an involuntary nonsuit against him at any time prior to judgment.[3] It thereby adds yet another complexity to an already intricate and still evolving pattern of rules in our multiple party pleading practice.[4]

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[1] 254 N.C. 680, 120 S.E.2d 82 (1961).

[2] Justice Moore wrote the majority opinion in which Chief Justice Winborne, Justices Denny and Higgins concurred. Justice Bobbitt dissented, joined by Justices Parker and Rodman. Subsequently, in Bass v. Lee, 255 N.C. 73, 120 S.E.2d 570 (1961), the court reaffirmed this position with only Justice Bobbitt dissenting.

[3] This consequence was frankly recognized by the majority opinion which stated the question presented and answer in this form: "In an action against two defendants, as joint *tort-feasors,* may one defendant set up a plea for contribution against the co-defendant and thereby preclude dismissal of the co-defendant during the trial and before judgment. . . . The answer is 'No.' " 254 N.C. at 691, 120 S.E.2d at 90.

[4] See Brandis & Graham, *Recent Developments in the Field of Permissive Joinder of Parties and Causes in North Carolina,* 34 N.C.L. REV. 405, 419-22, 425-29 (1956); BRANDIS, *A Plea for Adoption by North Carolina of the Federal Joinder Rules,* 25 N.C.L. REV. 245, 260-68 (1947); BRANDIS, *Permissive Joinder of Parties and Causes in North Carolina,* 25 N.C.L. REV. 1 (1946). In these articles the authors review the decisions of the North Carolina Supreme Court in an effort to formulate the rules regarding multiple party pleading. From the cases discussed therein and more recent decisions of the court, the rules pertaining to cross-claim for contribution prior to *Greene* appear to be as follows: (a) Prior to the enactment of G.S. § 1-240