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RCA Corp. v. United States: The Latest Round in the Controversy over Actrual Accounting for Prepaid Income

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CASE NOTES

RCA Corp. v. United States: The Latest Round in the Controversy over Accrual Accounting for Prepaid Income

RCA Corp. v. United States[1] is the most recent in a long line of cases originating before the 1954 Internal Revenue Code that discuss whether a corporate taxpayer which keeps its books and records using the accrual method of accounting may use that method to account for advance payments received for services to be rendered in future years.[2] In the *RCA* decision the United States Court of Appeals for the Second Circuit held that no matter how clearly accrual accounting reflects the taxpayer's income, the taxpayer is not permitted to defer reporting advance receipts as income until the receipts are earned.

I. The *RCA* Case

RCA Corporation, an accrual basis taxpayer, sold television service contracts in conjunction with its sales of television sets. The purchaser paid a lump-sum fee at the inception of the con-

1. 664 F.2d 881 (2d Cir. 1981), *cert. denied*, 102 S. Ct. 2958 (1982).

2. The Treasury Regulations provide that an accrual basis taxpayer normally includes revenues in its taxable income in the year in which "all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." Treas. Reg. § 1.451-1(a) (1957). In Spring City Foundry Co. v. Commissioner, 292 U.S. 182 (1934), the Supreme Court said, "Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the *right* to receive and not the actual receipt that determines the inclusion of the amount in gross income." *Id.* at 184 (emphasis in original). Under accrual accounting a taxpayer who receives payment in exchange for his agreement to perform services over a five-year period would normally include one-fifth of the payment in its income for each of the five years. The graduated federal income tax rates and the time value of money create serious disadvantages for the accrual basis taxpayer that is required to use the cash basis to account for income collected but not yet earned. All the income is bunched in the first year, and the taxpayer is taxed at that time. The offsetting expenses will not be incurred until later years when the taxpayer performs the required services. *See* Stewart & Woods, *Analysis of the Trend Toward Deferring Recognition of Prepaid Income*, 59 Taxes 400 (1981).

tract. RCA in return agreed to provide television repair service during a stated period of time ranging from three to twenty-four months. RCA took a portion of the advance receipts into income at the time of sale. This portion covered selling and processing costs, as well as a profit. The balance of the receipts was deferred and taken into income over the contract period using a statistically derived formula designed to include in income the portion of the advance receipts attributable to services performed each month.[3] This formula was based on RCA's past experience and reflected seasonal repair patterns, variations in average daily workload, and the number of working days in each month. RCA continually refined the statistical formula and used it for internal management as well as for tax accounting.

The Commissioner determined that the deferral of advance receipts did not clearly reflect RCA's income and required that the full amount of the advance payments be included in income in the year of receipt even though RCA was an accrual basis taxpayer.[4] RCA paid the Commissioner's assessment and filed a refund suit in the United States District Court for the Southern District of New York.[5] The district court found that the deferral clearly reflected income and decided in favor of RCA.[6] The Commissioner appealed.

The United States Court of Appeals for the Second Circuit reversed the district court and held that a court reviewing the Commissioner's exercise of discretion must not determine whether in its own opinion the taxpayer's method of accounting clearly reflects income. Rather, the reviewing court should determine whether there is an adequate basis in law for the Commissioner's determination. If the Commissioner's determination is adequately based in law, it must be sustained.[7]

The Second Circuit found the necessary basis in law in a

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3. RCA estimated the number of service calls that would be provided under the contracts sold each month. It also estimated the percentage of the total number of service calls that would be made during each month of the contract term. Using these estimates, RCA was able to determine the portion of the revenue from each group of contracts that had been earned each month. 664 F.2d at 883.

4. I.R.C. § 446 (1976) gives the Secretary of the Treasury the authority to prescribe a method of accounting for a taxpayer if, in the Secretary's opinion, the method used by the taxpayer does not clearly reflect income.

5. 499 F. Supp. 507 (S.D.N.Y. 1980), *rev'd*, 664 F.2d 881 (2d Cir. 1981), *cert. denied*, 102 S. Ct. 1976 (1982).

6. 499 F. Supp. at 518.

7. 664 F.2d at 886.

trilogy of Supreme Court decisions, which the court read as establishing that deferral was unacceptable for tax purposes because of the uncertainty inherent in estimating future customer demands for services. The court felt that because RCA could not predict with certainty the amount it would ultimately earn from the service contracts, the Commissioner was not required to subject the revenues to "the vicissitudes of RCA customers' future demands for services."[8] Accordingly, the court held that the Commissioner acted within his discretion in requiring RCA to report prepaid income at the time the income was received.[9]

II. Analysis

The *RCA* decision is the first time a federal appellate court has refused to allow an accrual basis taxpayer to defer reporting prepaid income despite a finding that the taxpayer's method of accounting clearly reflects income. The court's opinion is based on an excessively broad reading of Supreme Court decisions and a misinterpretation of the Internal Revenue Code provisions that deal with prepaid income. Further, the decision is inconsistent with the court's own prior decisions and is at odds with the decisions of other federal courts. Finally, policy considerations favor allowing deferral.

A. The RCA *Court Read Supreme Court Decisions Too Broadly*

In 1957 the United States Supreme Court decided *Automobile Club of Michigan v. Commissioner*,[10] the first of three decisions dealing with the deferral of prepaid income by accrual basis taxpayers. All three cases were decided in favor of the Commissioner; all three were accompanied by strong dissents. The *Michigan* case dealt with an automobile club that collected annual dues in advance from its members. In return the association agreed to provide a variety of services such as road maps and highway service. The club did not report the dues as income in the year of receipt. As an accrual basis taxpayer, it took the dues into income over the period of time to which they related. One-twelfth of each member's annual dues was reported as income each month. The association made no attempt to antici-

8. *Id.* at 888.
9. *Id.* at 887-88.
10. 353 U.S. 180 (1957).

pate weather conditions or other seasonal fluctuations in demands for service. The dues were simply prorated in equal monthly amounts regardless of actual services rendered. The Supreme Court sustained the Commissioner in determining that this method of deferral did not clearly reflect the taxpayer's income. "The pro rata allocation of the membership dues in monthly amounts is purely artificial and bears no relation to the services which petitioner may in fact be called upon to render . . . ."[11]

The second decision, *American Automobile Association v. United States*,[12] was handed down in 1961. The taxpayer, another automobile club, also collected membership dues in advance. Like the taxpayer in *Michigan*, the association included the collections in income in equal monthly amounts over the membership periods. Unlike the *Michigan* taxpayer, the association presented expert accounting testimony at trial to show that its deferral method followed generally accepted accounting principles and that the correlation between the costs of member service and the period of time over which the dues were taken into income was justified by experience.[13]

The Supreme Court, relying on its *Michigan* decision, decided in the Commissioner's favor. The Court held that the association's pro rata allocation was inadequate for tax purposes since the allocation of income was not related to the expenses incurred. Income was deferred to a taxable year in which none, some, or all of the services might or might not be rendered. While actual expenses of providing services varied from month to month, the allocation of income remained constant.[14] That the association's method of accounting complied with generally accepted accounting principles apparently had no bearing on the outcome. The Supreme Court held that generally accepted accounting principles were not binding on the Treasury.[15]

As an alternate ground for its decision, the Court read the 1955 retroactive repeal of section 452 as a decision by Congress that deferral of prepaid income was not acceptable.[16] The Court

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11. *Id.* at 189.
12. 367 U.S. 687 (1961).
13. *Id.* at 691.
14. *Id.* at 692-93.
15. *Id.* at 693.
16. *Id.* at 695. When the Internal Revenue Code was first enacted, it contained § 452. Internal Revenue Code of 1954, Pub. L. No. 591, § 452, 68A Stat. 3, 152 (1954), *repealed by* Pub. L. No. 74, § 1, 69 Stat. 134 (1955). The section authorized accrual basis

noted that although it had been claimed that Congress did not intend to disturb prior law as it affected permissible accounting methods, "the cold fact is that it repealed the only law incontestably permitting the practice upon which the Association depends."[17] The Court went on to point out that Congress had been aware of the deferred income problem when it amended the tax accounting provisions of the Code in 1958, subsequent to the *Michigan* decision. Apparently applying a legislative reenactment theory, the Court read into Congress' action an intent to deny deferral of prepaid income to automobile clubs.[18]

The third case, *Schlude v. Commissioner*,[19] was decided in 1963. In *Schlude* an accrual basis taxpayer operated a dance studio and sold contracts for dancing lessons. Customers were required to pay in advance for a specified number of dance instruction hours, ranging from 5 to 1200. The contracts required that the lessons be completed within a stated time period, and individual lesson appointments were arranged by the customers. Like the *Michigan* and *AAA* taxpayers, the *Schlude* taxpayer used a deferral method of accounting for the advance receipts. Each year the taxpayer determined the number of lesson hours that had been taught under each contract. This number was multiplied by the contract rate per lesson hour to determine the amount of income to be reported for the year. The remaining advance payments were deferred. If there was no activity on a contract for a year or if a contract was cancelled, the collections

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taxpayers to include advance receipts in income over the shorter of two periods of time: the period in which the income would be reported under the taxpayer's method of accounting, or six years. The year after it was enacted, however, Congress retroactively repealed the section. The repeal was not intended to be an expression of congressional disapproval of deferral, but was occasioned only by the fear of a temporary revenue loss that some thought would occur in the year that taxpayers who had not previously deferred prepaid income elected to defer. H.R. REP. No. 293, 84th Cong., 1st Sess. 3 (1955); S. REP. No. 372, 84th Cong., 1st Sess. 4-5 (1955); *see also* American Auto. Ass'n. v. United States, 367 U.S. at 703-04 (Stewart, J., dissenting). The Secretary of the Treasury indicated before the repeal that the Treasury Department would not interpret the repeal as a congressional rejection of deferral. H.R. REP. No. 293, 84th Cong., 1st Sess. 3 (1955); S. REP. No. 372, 84th Cong., 1st Sess. 5 (1955).

17. 367 U.S. at 695. Justice Stewart points out in his dissent that the "legislative history shows that Congress made every effort to dissuade the courts from doing exactly what the Court is doing in this case—drawing from the repeal of § 452 an inference of Congressional disapproval of deferred reporting of advances." 367 U.S. at 708 (Stewart, J., dissenting).

18. 367 U.S. at 696-97. I.R.C. § 456 (1976) now permits certain membership organizations such as automobile clubs to defer prepaid membership dues.

19. 372 U.S. 128 (1963).

on the contract that had not previously been reported were taken into income. These contract cancellation gains were reported in the year of cancellation. The taxpayer made no attempt to estimate each year the percentage of its contracts that would be cancelled.

The Supreme Court upheld the Commissioner in rejecting the taxpayer's method of accounting. The Court held that since the taxpayer provided services only upon a customer's demand, the deferral was subject to the same defect as the methods used by the *Michigan* and *AAA* taxpayers. An examination of the opinion reveals the reason for the Court's holding. The method of accounting was not found to be artificial merely because the precise time of performance of each individual customer was uncertain, but because the taxpayer made no attempt to estimate the extent to which it would be required to perform under the contracts. Since some customers failed to use all the lesson hours they had purchased, "the studio was uncertain whether none, some or all of the remaining lessons would be rendered."[20] The Court indicated in a footnote that "[t]he studio made no attempt to report estimated cancellations in the year of receipt, choosing instead to defer these gains to periods bearing no economic relationship to the income recognized."[21] As Justice Stewart pointed out in dissent, the inadequacy could have been remedied if the taxpayer's deferral method had incorporated statistical estimates of contract cancellations. The majority's reference to estimated cancellations shows that the Court did not intend to bar adequately supported statistical estimates.[22]

In *RCA* the Second Circuit relied on these three Supreme Court cases in its rejection of prepaid income deferrals. A taxpayer that receives an advance payment for services to he rendered later cannot know with certainty the exact amount of service the customer will require. This uncertainty, the Second Circuit held, was the basis for the Supreme Court decisions.[23] However, close reading of this trilogy of cases reveals that the Supreme Court did not intend this broad construction.

In *Michigan* the Court held that the pro rata inclusion of

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20. *Id.* at 136.

21. *Id.* at 136 n.9.

22. *See id.* at 142 (Stewart, J., dissenting). The viewpoint taken by the dissenting Justices was adopted by the Fifth Circuit in Mooney Aircraft, Inc. v. Commissioner, 420 F.2d 400 (5th Cir. 1969).

23. 664 F.2d at 887-88.

membership dues in equal monthly amounts was purely artificial and bore no relation to the services the taxpayer might be called upon to render.[24] The Court found that since the method of deferral did not relate the income recognized to the services performed, the deferral did not clearly reflect income. The Court in a footnote expressly distinguished on their facts earlier decisions in which deferral had been found to clearly reflect income.[25] The Court thus did not disapprove of all prepaid income deferrals. The *Michigan* decision can be said to stand for the proposition that, under the particular facts presented, a simple pro rata deferral was inadequate.

The *AAA* decision can be said to stand for the rule that generally accepted accounting principles are not binding on the Treasury.[26] Even though a taxpayer's accounting system is in harmony with accepted commercial practice, it might not clearly reflect income for tax purposes. The method used by the *AAA* taxpayer was identical to the one used by the taxpayer in *Michigan*. The Supreme Court held, as it did in *Michigan*, that a simple pro rata allocation of membership dues in equal monthly installments not related to expenses incurred was inadequate for tax purposes.[27]

In *Schlude* the Supreme Court again found that the taxpayer's method of accounting failed to clearly reflect income. The taxpayer's method of accounting was artificial because it deferred contract cancellation gains to accounting periods that were unrelated to the period of time over which income from the contracts was realized.[28] The Court implied that if the taxpayer's method of deferral had taken into account these contract cancellation gains, it would have been adequate.[29] *Schlude* stands for the rule that in order to clearly reflect income, a deferral method must incorporate an estimate of the total per-

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24. 353 U.S. at 189.

25. *Id.* at 189 n.20.

26. 367 U.S. at 690-91.

27. *Id.* at 693. The Court used broad language that could be interpreted as a blanket rejection of the use of "statistical computations" made on a "group or pool basis." But the Court stopped short of such a holding. It limited itself to a finding that a simple pro rata allocation unrelated to actual expenses incurred was unsatisfactory. It left open the question whether a statistical deferral method, under which the income recognized would be related to the actual expenses incurred, would be adequate for tax purposes. *Id.*

28. 372 U.S. at 135-36.

29. Justice Stewart discussed this point in his dissent. *Id.* at 141-42 (Stewart, J., dissenting).

formance that will be required of the taxpayer.

In none of the three Supreme Court cases did the Court reject all deferral of prepaid income. The decisions leave open the possibility that a deferral method which is not artificial and that incorporates an estimate of the total performance required of the taxpayer would be upheld. The Court of Appeals for the Fifth Circuit expressed this view of the trilogy in *Mooney Aircraft, Inc. v. Commissioner*:[30] "All that *Schlude* and *AAA* would seem to require is that the deferred income is reported as the related costs do in fact occur."[31]

The deferral method used by RCA cannot be said to suffer from the weaknesses of the methods rejected by the Supreme Court trilogy. RCA's method is easily distinguishable from the simple pro rata allocation rejected in *Michigan* and *AAA*. As the Second Circuit stated, RCA's deferral "matched service contract revenues and related expenses with reasonable accuracy."[32] RCA's method took into account factors such as seasonal repair patterns, variations in average daily workloads, and the number of working days each month. Furthermore, RCA's method included an estimate of the total number of service calls that would be required by each customer. The allocations of prepaid income reflected the extent of the taxpayer's total performance under the contracts.[33] RCA's deferral is also distinguishable from the method rejected in *Schlude*. RCA's method incorporated an estimate of the total performance that would be required under the contracts. Therefore, the Supreme Court trilogy need not be construed to compel a rejection of RCA's method of accounting.

B. The RCA *Decision Is Based on Misinterpretations of Applicable Internal Revenue Code Provisions*

Congress first authorized the use of accrual accounting for tax purposes in the Revenue Act of 1916. The Act provided that a corporation which kept its books on an accounting method other than the cash basis could use that method for tax purposes as long as the method clearly reflected income.[34] The Supreme

30. 420 F.2d 400 (5th Cir. 1969).

31. *Id.* at 408. The Seventh Circuit agrees. Artnell Co. v. Commissioner, 400 F.2d 981, 984 (7th Cir. 1968), *acq.* 1968-2 C.B. 1.

32. 664 F.2d at 883.

33. *Id.*

34. Revenue Act of 1916, Pub. L. No. 64-271, § 13(d), 39 Stat. 756, 771 (1916).

Court stated that the purpose of the provision was to enable taxpayers to determine their taxable income "according to scientific accounting principles, by charging against income earned during the taxable period, the expenses incurred in . . . earning income during that period."[35] Section 446 of the current Internal Revenue Code contains a similar provision. It expressly authorizes a taxpayer that keeps its books using the accrual method of accounting to use that method for tax purposes.[36]

Section 446 is also the statutory basis for the Commissioner's disallowance of accounting methods. The section provides that "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."[37] The plain language of the statute gives the Commissioner the authority to disallow an accounting method only if it does not clearly reflect income.

Furthermore, the clear weight of judicial authority concerning section 446 is that the Commissioner may disallow a taxpayer's method of accounting only if it does not clearly reflect the taxpayer's income.[38] The courts that have found a taxpayer's method to clearly reflect income have refused to allow the Commissioner to require a change of accounting method. In *RCA* the district court expressly found that RCA's method of accounting clearly reflected its income. In spite of this finding the Second Circuit permitted the Commissioner to impose another method of accounting. The court held that the district court acted improperly in making its finding.[39] In this respect the Second Circuit's decision is at odds with the plain language of the statute, which gives the Commissioner such authority only when the taxpayer's method of accounting fails to clearly reflect income.

C. The RCA *Decision Is Inconsistent with the Second Circuit's Prior Decisions*

Two years after the Supreme Court's *Michigan* decision, but before *AAA* and *Schlude*, the Court of Appeals for the Second Circuit decided *Bressner Radio, Inc. v. Commissioner*.[40] The

35. United States v. Anderson, 269 U.S. 422, 440 (1926).
36. I.R.C. § 446(c)(2) (1976).
37. *Id.* § 446(b); *see also* Treas. Reg. § 1.446-1(b)(1) (1957).
38. *See infra* notes 50-64 and accompanying text.
39. 664 F.2d at 889.
40. 267 F.2d 520 (2d Cir. 1959), *nonacq.* Rev. Rul. 60-85, 1960-1 C.B. 181. Rev. Rul.

taxpayer in *Bressner* entered into twelve-month service contracts with customers in conjunction with its business of selling television sets. The taxpayer agreed to provide repair service as needed for a flat fee. The fees were collected in advance. Using a method similar to the one used by RCA, the *Bressner* taxpayer allocated one-fourth of the contract price to the costs of installation and immediately took this amount into income. The balance was deferred and was recognized ratably over the contract term. The taxpayer was able to justify this deferral method by demonstrating that it was subject to a relatively uniform demand for services.[41] The Commissioner determined that the deferral did not clearly reflect the taxpayer's income. The Court of Appeals for the Second Circuit, agreeing with the trial court, upheld the taxpayer's deferral. The court distinguished *Michigan*, stating that the Supreme Court's decision was based on the narrow ground that the particular method of deferral adopted was unsatisfactory. A more realistic method of deferral—one that more accurately matched revenues with costs—would have been satisfactory.[42]

In its *RCA* decision the court did not feel bound by *Bressner*. The Second Circuit expressed a belief that the Supreme Court in *AAA* had intended to overrule *Bressner*.[43] It is true that when the Supreme Court granted certiorari to review the conflict between the Court of Claims' *AAA* decision and the Second Circuit's *Bressner* decision, the Supreme Court chose to affirm the Court of Claims. Nevertheless, a closer look at the *AAA* decision shows that the Court did not necessarily intend to overrule *Bressner*. The *AAA* Court decided that generally accepted accounting principles are not binding on the Treasury and that a method of accounting that is artificial is not acceptable for tax

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71-299, 1971-2 C.B. 218, modified the Commissioner's nonacquiescence about the time of inclusion of prepaid income from service contracts to the extent that it was inconsistent with the provisions of Rev. Proc. 71-21, 1971-2 C.B. 549.

41. 267 F.2d at 528. The court pointed out that the method proposed by the Commissioner would distort the taxpayer's income. The taxpayer had sustained losses on the service contracts. The Commissioner's method would show a taxable gain in the first year, followed by an increased loss in the second year. Further, since the taxpayer would have to use some of the money received to pay the first-year tax, less money would be available in the second year to fulfill the taxpayer's service obligations. *Id.* at 524.

42. *Id.* at 526. In Automobile Club of New York, Inc. v. Commissioner, 304 F.2d 781 (2d Cir. 1962), the Second Circuit again referred to its *Bressner* decision, stating that the deferral method used in *Bressner* clearly reflected the taxpayer's income, and that the method was not "purely artificial." *Id.* at 784.

43. 664 F.2d at 888.

purposes.[44]

As an alternate ground for its invalidation of *Bressner*, the Second Circuit held that *AAA* and *Schlude* had established that it was "not simply the 'artificiality' of a taxpayer's method of deferring recognition of income from services performable on demand that offends the clear reflection principle of § 446(b), but rather the uncertainty inherent in any method that relies on prognostications and assumptions about the future demand for services."[45] Since *Bressner* relied on assumptions, the court refused to invoke it to invalidate the Commissioner's exercise of his discretion.[46]

The *RCA* court's holding that *Bressner* is invalid is a reversal of the Second Circuit's position. In 1962, the year after the *AAA* decision, the Second Circuit decided *Automobile Club of New York, Inc. v. Commissioner*,[47] in which the court stated that the Supreme Court in *AAA* had "only affirmed the power of the Commissioner . . . to prescribe a method of accounting which clearly reflects income when the method used by the taxpayer does not do so."[48] The Second Circuit distinguished *Bressner* on the ground that the taxpayer had shown that its method of accounting clearly reflected income. "[I]ts method and the statistical material supporting its figures were not 'purely artificial.' "[49] Thus, in 1962, the court considered *Bressner* to be viable. By 1980, however, the court had decided to reverse itself and hold that *Bressner* had been overruled.[50]

D. The RCA *Decision Is at Odds with the Weight of Judicial Authority*

In a 1955 Tenth Circuit case, *Beacon Publishing Co. v. Commissioner*,[51] a publisher reported prepaid subscription income ratably over the subscription periods. The court held that

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44. 367 U.S. at 693.
45. 664 F.2d at 888.
46. *Id.* at 888-89.
47. 304 F.2d 781 (2d Cir. 1962).
48. *Id.* at 783.
49. *Id.* at 784 (quoting *Bressner*, 267 F.2d at 529).
50. 664 F.2d at 888-89.
51. 218 F.2d 697 (10th Cir. 1955). *Beacon* was decided before the repeal of § 452. The Secretary of the Treasury indicated that the Treasury Department would not consider the repeal as either the acceptance or the rejection by Congress of the *Beacon* decision or any other judicial decision. H.R. REP. No. 293, 84th Cong., 1st Sess. 5 (1955); S. REP. No. 372, 84th Cong., 1st Sess. 5 (1955).

the Commissioner had abused his discretion in disallowing the taxpayer's method of accounting. The court pointed out that "[w]here a taxpayer keeps his books and files his returns on an accrual basis, income is accounted for in the year in which the amount is earned . . . irrespective of when the payment is received."[52] The court held that the "discretion of the Commissioner does not empower him to add to the taxpayer's gross income for a given year, an item which rightfully belongs in another year."[53]

The Fifth Circuit reached a similar conclusion in *Schuessler v. Commissioner*.[54] After concluding that the taxpayer's deferral method of accounting was more accurate than the Commissioner's proposed inclusion of all amounts in the year of receipt, the court adopted the reasoning and conclusion of *Beacon*. The court pointed out that what the Code seeks is the accounting method that most accurately reflects the taxpayer's income.[55]

Both *Beacon* and *Schuessler* predated the Supreme Court's *Michigan* decision. In a footnote to *Michigan* the Supreme Court distinguished *Beacon* and *Schuessler*, stating that in *Beacon* performance of the subscription was necessarily delayed until after the end of the tax year. In *Schuessler* the taxpayer was requested to perform services at specified times in years subsequent to the tax year. The *Michigan* Court noted that the taxpayer performed services only upon demand, and that performance was not necessarily delayed until after the end of the year in which membership dues were received.[56]

In the period since the Supreme Court trilogy, several courts have considered whether deferral clearly reflects income for tax purposes. One court apparently has upheld the position taken hy the Commissioner.[57] The others have rejected it.

A leading case allowing the deferral of prepaid income is the

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52. 218 F.2d at 669.

53. *Id.* at 702. I.R.C. § 455 (1976) now expressly authorizes deferral of prepaid subscription income.

54. 230 F.2d 722 (5th Cir. 1956).

55. *Id.* at 723-24.

56. 353 U.S. at 189 n.20.

57. In Hagen Advertising Displays, Inc. v. Commissioner, 407 F.2d 1105 (6th Cir. 1969), the Sixth Circuit refused to allow a sign manufacturer to defer advance payments received from customers for signs to be manufactured. However, the court did indicate that the taxpayer would have been permitted to deduct an estimate of its manufacturing costs in the year it was required to report the advance receipts as income if such an estimate had been made.

Seventh Circuit decision in *Artnell Co. v. Commissioner*.[58] The case involved a major league baseball team that filed tax returns on a May 31 fiscal year. The team sold season tickets and single admissions for future games. The team also sold season parking books and received payments for broadcast and television rights. These advance receipts were not reported as income in the year of receipt. Rather, as each game was played, the allocable advance receipts were taken into income. The balance was deferred. Although the taxpayer used the accrual basis, the Commissioner determined that the deferral did not clearly reflect income. The Commissioner based his argument on the theory that any system in which prepaid income is deferred does not clearly reflect income. He asserted that the Supreme Court trilogy established that the Commissioner may reject any deferral of prepaid income.[59] The Seventh Circuit disagreed. It read the trilogy as holding "upon consideration of the particular facts, that the commissioner did not abuse his discretion in rejecting a deferral of income where the time and extent of performance of future services were uncertain."[60] Acknowledging the Commissioner's wide discretion, the court held that "there must be situations where the deferral technique will so clearly reflect income that the Court will find an abuse of discretion if the commissioner rejects it."[61]

The United States Court of Appeals for the Fifth Circuit examined the trilogy in *Mooney Aircraft, Inc. v. Commissioner*.[62] In that case the Commissioner contended that the repeal of section 452 constituted a congressional decision that deferral of income was not acceptable for tax purposes. The court noted that although the Supreme Court had discussed the repeal in dicta in its opinions, it had in each case restricted its holding to a finding that the Commissioner had not abused his discretion in rejecting the taxpayer's accounting system. The Supreme Court specifically had refrained from overruling the *Beacon* and *Schuessler* decisions, which had permitted deferral, distinguishing them on the ground that performance was certain. The Fifth Circuit stated its belief that the Supreme Court had taken a middle ground pending congressional clarification. The

58. 400 F.2d 981 (7th Cir. 1968), *acq.* 1968-2 C.B. 1.
59. *Id.* at 983.
60. *Id.* at 983-84.
61. *Id.* at 985.
62. 420 F.2d 400 (5th Cir. 1969).

court found that "while the repeal of [section 452] does not absolutely preclude deferrals and accruals, it indicates that the Commissioner should have very broad discretion to disallow such accounting techniques when there is any reasonable basis for his action."[63]

The issue came before the Court of Claims in *Boise Cascade Corp. v. United States*.[64] In that case the Court of Claims reviewed the legislative and judicial history of deferral and took an approach similar to that taken in *Artnell* and *Mooney*. The court found that the taxpayer's method of accounting, under which income was recognized as services were performed, clearly reflected income. Accordingly, the court held that "the Commissioner is not authorized by § 446(b) to impose another method of accounting."[65]

In *RCA* the Second Circuit held that the task of a reviewing court is not to determine whether in its own opinion the taxpayer's method of accounting clearly reflects income. Rather, the reviewing court is to determine simply whether there is an adequate basis in law for the Commissioner's determination that it did not.[66] Even though the district court expressly found that RCA's method clearly reflected income,[67] the Second Circuit refused to allow deferral, holding that the district court's finding was "clearly erroneous."[68] Other courts that have considered the question have first determined whether the taxpayer's accounting method clearly reflected income in order to decide whether the Commissioner was entitled to impose another method of accounting.

Each of the Supreme Court decisions relied upon by the Second Circuit in *RCA* upheld determinations that the particular accounting method failed to clearly reflect income. In *Michigan* the Court found the taxpayer's method was "purely artifi-

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63. *Id.* at 408-09.

64. 530 F.2d 1367 (Ct. Cl.), *cert. denied*, 429 U.S. 867 (1976).

65. *Id.* at 1378. The Commissioner had contended that whenever the taxpayer received payment before the time services were rendered, the taxpayer should recognize income at the time of collection. The Commissioner further asserted that when services were rendered before payment was received, income should be recognized at the time the services were rendered. Thus, the Commissioner would have required accrual basis taxpayers to recognize income at the earlier of the time of collection or the time the income was earned. *Id.* at 1372.

66. 664 F.2d at 886.

67. 499 F. Supp. at 519.

68. 664 F.2d at 889.

cial," and therefore the Commissioner was authorized by the predecessor of section 446 to impose another method of accounting.[69] The *AAA* Court discussed the taxpayer's method of accounting and found it to be "unsatisfactory from an income tax standpoint."[70] The *Schlude* Court, after reviewing the taxpayer's accounting method, found it to be "vulnerable under . . . § 446(b) with respect to the deferral of prepaid income."[71] In each case in the trilogy, the Supreme Court upheld the Commissioner's disallowance of the taxpayer's method only after a finding that the taxpayer's method was inadequate for tax purposes.

Decisions subsequent to the trilogy have been even more explicit. In *Artnell* the Seventh Circuit addressed the proper scope of the Commissioner's discretion and rejected the assertion that the Commissioner has complete and unreviewable discretion to reject deferral. The court then ordered the Tax Court on remand to determine whether the taxpayer's method of accounting clearly reflected income.[72] Such a determination was necessary because the Commissioner had authority to impose another method of accounting only if the taxpayer's method did not clearly reflect income.

In its *Boise Cascade* decision the Court of Claims used a similar analysis. The court expressly found that the taxpayer's method of accounting "clearly reflect[ed] its income, and, accordingly, the Commissioner is not authorized by § 446(b) to impose another method of accounting."[73] The court went on to conclude that the hybrid method proposed by the Commissioner under which the taxpayer would use the cash method to account for advance receipts but would use the accrual method for everything else would distort income rather than clearly reflect it.[74] In *Morgan Guaranty Trust Co. v. United States*,[75] the Court of Claims under similar circumstances held that when there is no distortion of income under a taxpayer's accounting method, it is an abuse of the Commissioner's discretion to require the tax-

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69. 353 U.S. at 189-90.

70. 367 U.S. at 693.

71. 372 U.S. at 136.

72. 400 F.2d at 985. On remand the Tax Court found that the taxpayer's method of accounting clearly reflected income. Artnell Co. v. Commissioner, 29 T.C.M. (CCH) 403, 406 (1970).

73. 530 F.2d at 1378.

74. *Id.*

75. 585 F.2d 988 (Ct. Cl. 1978).

payer to switch to a different method.[76]

According to the weight of judicial authority, the Commissioner may require a taxpayer to change its method of accounting only when the method used does not clearly reflect the taxpayer's income. Nevertheless, the *RCA* court held that such a determination was improper and permitted the Commissioner to reject an accounting method that had been found to clearly reflect the taxpayer's income. In this respect the *RCA* decision is contrary to the weight of judicial authority.

E. Policy Considerations Favor Deferral of Prepaid Income by Accrual Basis Taxpayers

Policy considerations favor allowing accrual basis taxpayers to use the accrual method to account for prepaid income. Among these considerations is that the federal income tax is levied not on gross income, but on net income.[77] If accrual basis taxpayers are taxed on advance receipts, they will be taxed on their gross income, since the expenses attributable to earning the receipts will not be incurred and deducted until subsequent years. In fact, such a taxpayer may be required to pay a tax when he has earned no net income at all. This was the situation in *Bressner*.[78] The taxpayer collected income in advance for its television service contracts, but incurred a net loss on the contracts. The method of accounting proposed by the Commissioner would have required the taxpayer to pay an income tax on its advance receipts. The taxpayer would have been left to report larger losses in later years with fewer funds available to meet its contractual obligations. Permitting accrual basis taxpayers to use the accrual method for advance receipts would prevent the imposition of a tax on gross income or on a net loss.

One of the basic tenets of taxation is that the tax should be levied at the point in time at which the taxpayer can most readily pay the tax and the IRS can most readily collect it.[79] Admittedly, the point at which the tax can most readily be paid and collected is the time the taxpayer collects cash. No doubt this is one of the reasons for the Commissioner's repeated insistence

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76. *Id.* at 997; *see also* Collegiate Cap & Gown Co. v. Commissioner, 37 T.C.M. (CCH) 960, 965 (1978), *aff'd in unpublished opinion*, (7th Cir. Jan. 9, 1975).

77. I.R.C. §§ 162, 212 (1976).

78. 267 F.2d 520.

79. Cohen, *Accounting for Taxes, Finance and Regulatory Purposes—Are Variances Necessary?*, 44 TAXES 780, 784 (1966).

that deferral of prepaid income is improper. It is, however, questionable whether this wherewithal-to-pay concept should control when its effect is to require a taxpayer using a proper accrual method of accounting to abandon that method for prepaid income. Several provisions in the Code require taxpayers to use particular methods to account for specified items of income and deduction,[80] but no Code provision requires use of the cash method to account for prepaid income. To the contrary, accrual accounting is specifically authorized by the Code.[81] Although wherewithal-to-pay is an important theory underlying the development of the tax law, this general policy should not be applied to override authorized accounting methods.

Nor can the Commissioner's position be supported by the proposition that use of the cash method to account for prepaid income is necessary to prevent manipulation and abuse. Accrual accounting is no more subject to abuse than is cash accounting. In fact, since businesses are probably more able to manipulate cash flow than their ongoing operations, accrual accounting is probably less susceptible to manipulation than cash accounting. In any event, the Commissioner has the statutory authority to disallow any method of accounting which, because of manipulation or otherwise, fails to clearly reflect the taxpayer's income.[82]

To require an accrual basis taxpayer to report prepaid income in the year of receipt is to require the taxpayer to use the cash method to account for prepaid income. In effect, such a taxpayer must report income at the earlier of the time cash is collected or the time the income is earned. The Treasury Department collects its revenue at the earliest possible point in time, and the taxpayer is placed in the worst possible position. The graduated federal income tax rates further compound the problems for the unfortunate taxpayer for whom this hybrid method of accounting produces a bunching of income. If accrual taxpayers were permitted to use accrual accounting for prepaid income, this unfairness would be eliminated.

Considerations of fairness and avoidance of taxation of gross income and net losses favor allowing accrual basis taxpayers to defer prepaid income. Requiring these taxpayers to use a hybrid method of accounting is not justified by wherewithal-to-

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80. *See, e.g.*, I.R.C. §§ 170 (charitable contributions), 213 (medical expenses), 461 (interest) (1976).

81. I.R.C. § 446(c)(2) (1976).

82. *Id.* § 446(b).

pay or by considerations related to prevention of abuse.

III. Conclusion

The *RCA* holding can be summarized as follows: Even though a taxpayer's method of deferral clearly reflects the taxpayer's income, a court must not overturn the Commissioner's determination that the method does not clearly reflect income as long as there is any basis whatsoever in the law for the Commissioner's action. This holding is contrary to the clear weight of judicial authority and the plain language of the statute. No federal court has ever before given such broad authority to the Commissioner. The Second Circuit should have held that a properly supported method of deferral may be used for tax purposes as long as it clearly reflects the taxpayer's income.

R. Glen Woods