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I. INTRODUCTION

The rule that an accrual basis taxpayer, engaged in the performance of service contracts, may not defer income recognition of advance payments to the period when the services are to be rendered has perhaps been among the most controversial in the field of tax law. Though writers and judges have vehemently opposed the prepaid income rule, the majority of courts have gone along with the Commissioner of Internal Revenue in extending it to the point where now only legislation can change it. As a result of three recent cases, the rule is now applicable to taxpayers engaged in the sale of goods.

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1. E.g., Alvin, "Prepaid Income": How the Commissioner Turned Liabilities into Income under Section 446 of the 1954 Code, 11 WAYNE L. REV. 482 (1965); Behren, Schlude Holds Prepaid Income Taxable on "Receipt"; Rationale is Uncertain, 18 J. TAXATION 194 (1963); Gelfand, The "Claim of Right" Doctrine, 33 TAXES 726 (1955).


From a commercial accounting viewpoint of income recognition there is no real difference between rendering services and selling goods. In both situations, the income is earned at the time of performance. From a tax accounting viewpoint, however, there is an inherent distinction due to the "return of capital" concept embodied in our system of income taxation. Although this distinction gives rise to constitutional considerations, up to now they have been brushed aside on the theory that the rule laid down by the United States Supreme Court pertaining to prepaid income for future services is equally applicable to amounts received in advance for the future delivery of goods.

This comment will analyze the constitutional aspects which should be considered when applying the prepaid income rule to the sale of goods. Some practical ways of dealing with the problem will also be explored.

II. Historical Analysis

A. Statutory

1. THE CONFLICT: SECTION 446

The root of the conflict over the proper tax treatment of prepaid income between the accounting profession and the taxpayer on one side against the Commissioner and the courts on the other lies in the interpretation of section 446 of the Internal Revenue Code of 1954. That section provides that "taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." An exception is provided where the method used by the taxpayer does not "clearly reflect income," in which case "the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income." The Code specifically provides that the cash receipts and disbursements method and the accrual method are both permissible in computing tax-

7. See cases cited note 4 supra.
8. For a detailed discussion of the history of the prepaid income rule, see Alvin, supra note 1, at 483-493 and Behren, supra note 1, at 194-200.
9. All references are to the Int. Rev. Code of 1954 unless otherwise indicated.
10. Int. Rev. Code of 1954, § 446(a). The prior sources for this section are §§ 8(g) and 13(d) of the Revenue Act of 1916 which indirectly authorized the use of the accrual basis for tax purposes.
13. The primary distinction between the accrual and the cash methods of accounting is that the accrual method identifies revenues and expense with specified periods of time such as a month or year; whereas in the cash method, revenue and expense are recorded in the books of account when received and paid without regard to the period to which they apply. Wixson & Kell Accountant's Handbook, § 5.10 (4th ed. 1962). Reduced to its simplest meaning as applied to income recognition, the accrual basis recognizes income when
able income. The Code further clarifies which method of accounting is to be used in recognizing income for tax purposes by providing that "any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period."¹⁴

At first blush it would appear that the taxpayer has the right to report taxable income in the same manner that his accountant used to set up his books and prepare his financial statements. The accountant, however, in interpreting the above provisions, does so in light of what has been termed "generally accepted accounting principles." While these "principles" do not represent any set of rigid rules, they do provide basic standards which are used as guidelines by the accounting profession for purposes of commercial accounting. ¹⁵ The "principle" which is of particular importance in determining when advance payments should be taken into income is the one which requires that there be a periodic matching of costs and revenues. ¹⁶ Basically, this means that revenues should be matched as closely as possible against the expenses incurred in earning them. Where this is not done, a distortion occurs in that income is reported in one year and the corresponding expenses are reported in another year. The net result, however, is the same when the operations are viewed over the long run rather than isolated to one particular year.¹⁷ In terms of income recognition of advance payments for goods or services, this periodic matching would require that the advance payments be deferred until the period when the costs of earning them are incurred. Ideally, that would be when the goods are delivered or when the particular service is performed.

The conflict arises because as a general rule, accounting principles are absorbed into the law of federal income taxation only where they are found to fit within the general framework of the taxing statute, or where they aid in securing uniformity of application.¹⁸ Subject to certain modifications, taxable income does follow commercial accounting principles

it is "earned" in contrast to the cash basis which recognizes income only upon its actual or constructive receipt.

¹⁴. Int. Rev. Code of 1954, § 451(c) (emphasis added). The "method of accounting used in computing taxable income" refers to the accrual basis or any other method permitted by section 446(c). Section 461(a) sets out the general rule for the taking of deductions by providing that "the amount of any deduction or credit ... shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing income."


¹⁶. Id., § 1.

¹⁷. The largest distortion occurs in the first and last years of existence since the first year contains large income and little expense whereas the last year contains large expense and little income.

to a large extent. It should be understood, however, that income for tax purposes is to be determined by the statute and not by accounting principles. Authority for this proposition may be found in the Code itself which provides the Commissioner with broad discretion in determining whether the accounting method used by the taxpayer does, in fact, "clearly reflect income." As to a periodic matching of costs and revenue, it has been noted that the Code does not lay down any broad principle that deductions are to be related in all cases to the income earned by their expenditure. "Any such principle would inevitably lead to hopeless confusion and to the destruction of the basic general concept that there should be an annual reckoning on the basis of the method of accounting used by the Taxpayer."

Another reason for the conflict between accounting principles and tax accounting lies in the fact that sound accounting favors a conservative approach to the inclusion of income and of deductions, whereas the policy of Congress and the Internal Revenue Service is, ordinarily, to accelerate income and defer deductions.

2. SECTIONS 452 AND 462

In an effort to resolve the conflict by bringing tax accounting more into line with accepted business accounting, Congress enacted sections 452 and 462 in the 1954 Code. These sections provided expressly for deferral of "prepaid income" and for allowances for estimated future expenses. The accountants had won a major victory since the accrual method of accounting, as generally used for financial reporting purposes, now had Congressional approval for use in computing taxable income. Unfortunately, the victory was short-lived, because once the Treasury re-estimated the

19. Id.
20. Id.
21. INT. REV. CODE of 1954, § 446(b). For the limitations placed on the Commissioner's discretion see MERTENS, supra note 18, at § 12.14:
   The taxpayer's method of accounting is not controlling unless it clearly reflects income. But the discretion of the Commissioner in changing the method claimed by the taxpayer is not unlimited. While the Code leaves much to the discretion of the Commissioner, he is not free to act capriciously or arbitrarily, and he may not, in deciding what clearly reflects income, sacrifice the facts to theory or fiction.
   In Treas. Reg. § 1.446-1(b) (1957), the Commissioner apparently adopts generally accepted accounting principles as the standard for determining whether a method of accounting "clearly reflects income."
22. J. MERTENS, supra note 18, at § 12.23.
23. Id.
24. Id. The author notes that in an "ideal" accounting system it might well be that taxable income would be determined by deducting from gross income the expenses actually incurred in earning it. He points out, however, that niceties of accounting must frequently yield to the need of revenue and a workable system of determining each year the amount of taxable income.
25. INT. REV. CODE of 1954, § 452.
initial first year loss of revenue, Congress accepted their recommendation to retroactively repeal the sections.\textsuperscript{27}

The legislative intent behind the repeal has had an astounding impact upon the subsequent shaping of the prepaid income rule by the courts. In two of the leading Supreme Court cases\textsuperscript{28} the majority opinions relied very heavily on an interpretation of the Congressional intent behind the repeal, \textit{i.e.} that the Commissioner could reject any accounting system which deferred prepaid income. The dissenting opinions in these cases, in consonance with other courts\textsuperscript{29} and writers,\textsuperscript{30} have interpreted the repeal only as a Congressional intent to "re-establish the principles of law which would have been applicable if sections 452 and 462 had never been enacted."\textsuperscript{31} Subsequent to the repeal of these sections, Congress has made piecemeal attempts to reinstate section 452 of the 1954 Code by passing legislation which allows deferral of prepaid income from subscriptions\textsuperscript{32} and membership dues.\textsuperscript{33} As one writer has pointed out, this "fragmentary approach to 'prepaid income' not only creates inconsistencies in tax treatment among accrual basis taxpayers, but also falls short of decisively resolving the problem."\textsuperscript{34}

3. GROSS INCOME AND GROSS RECEIPTS DISTINGUISHED: SECTION 61(a) AND THE RETURN OF CAPITAL CONCEPT

If section 446 were the only Code provision involved, there would be no doubt that advances received by the taxpayer for either goods or services should be treated equally. The broad discretion given to the Commissioner by that section would obviously enable him to require that all advances, whether for goods or services, be included in gross income and thus be given income recognition in the year of receipt. This approach, however, which is the one that has been used by the courts to justify equal treatment,\textsuperscript{35} completely ignores section 61(a) of the Code which defines what is to be included in gross income.

\textsuperscript{29} Schuessler v. Commissioner, 230 F.2d 722 (5th Cir. 1956).
\textsuperscript{30} Alvin, \textit{supra} note 1; Behren, \textit{supra} note 1; Sporrer, \textit{The Past and Future of Deferring Income and Reserving for Expenses}, \textit{34 TAXes} 45 (1956).
\textsuperscript{31} See \textit{H.R. 293}, 84th Cong., 1st Sess. 3 (1955); \textit{S. 372}, 84th Cong., 1st Sess. 3 (1955); \textit{1955-2 CUR. BULL.} 852, 859.
\textsuperscript{32} \textit{INT. REV. CODE} of 1954, § 455.
\textsuperscript{33} \textit{INT. REV. CODE} of 1954, § 456. This section, in effect, nullifies the decisions in the automobile club cases.

\textsuperscript{34} Alvin, \textit{supra} note 1, at 485.
\textsuperscript{35} See cases cited note 4, \textit{supra}. 
From the outset it should be noted that there is a distinction between gross receipts and gross income. Gross receipts corresponds to the total sales price received for an item sold. Gross income, on the other hand, represents the excess, if any, remaining after the cost of the item sold is subtracted from the gross receipt. The subtraction of the cost enables the vendor to recover his capital investment in the item sold, thereby leaving a residue which constitutes his gross income. From this gross income, deductions are made for other expenses incurred in making the sale, leaving "taxable income" upon which the tax rate is then imposed. Thus, while a taxpayer engaged in the sale of goods must deduct from gross receipts his cost of goods sold to arrive at gross income, a taxpayer who performs services does not have to make any deductions to arrive at gross income. To him, gross receipts and gross income are synonymous.86

Another distinction that should be observed is that between costs of goods sold and "ordinary and necessary" business expenses. The latter may be described as those expenses which are usually incurred as a result of doing business. Good examples of these are the selling and administrative expenses which are incurred by nearly any business engaged in the sale of goods or services. While the deduction for cost of goods sold has been described as an essential one since it preserves the return of capital concept,87 the deduction for "ordinary and necessary" expenses of doing business has been said to be a matter of legislative grace which Congress could either allow or disallow as it sees fit.88

In the context of a tax on income, the reason for the return of capital rule is clear. If an amount sufficient to restore the taxpayer's capital investment in the property sold is not allowed as a deduction from gross receipts in arriving at gross income, then the tax is not one on income but rather one imposed on both capital and income. Where a taxpayer receives money in advance of the date when the goods are to be delivered and attempts to defer income recognition by excluding it from gross income, the Commissioner, by exercising his discretion, may require him to include it in gross income for the taxable year in which it was received. If the taxpayer was also allowed to deduct the cost of the items sold, he would then be receiving the same treatment as one performing service contracts who is required to include an advance payment in gross income in the year of receipt. The justification for equal application of the prepaid income rule is clear in this situation since both taxpayers are being taxed only on their gross income. Although a distortion takes place in that the expenses incurred in earning the income will not be deducted until a later period, it is not really significant when considered from the

36. For a detailed discussion see J. Mertens, supra note 18, at § 5.10.
37. E.g., Commissioner v. Weisman, 197 F.2d 221 (1st Cir. 1952); Davis v. U.S., 87 F.2d 323 (2d Cir. 1937).
38. E.g., Commissioner v. Sullivan, 356 U.S. 27 (1958); Davis v. United States, 87 F.2d 323 (2d Cir. 1937).
standpoint that Congress could conceivably disallow these deductions altogether and apply the tax entirely on a gross income theory.\textsuperscript{9}

Assume, however, that no deduction were allowed for cost of goods sold. Here the equal treatment theory breaks down, and the question presents itself whether the income tax can constitutionally be imposed on gross receipts and thus on capital. The answer involves a determination of the definition of the word “income” in the sixteenth amendment and whether it sanctions an unapportioned tax on gross receipts. Before delving into the constitutional problem, however, a brief analysis of the judicial background of the prepaid income rule will be helpful.

\section*{B. Judicial}

\subsection*{1. PRE “SERVICE” CASES}

Until recently the prepaid income rule had never been applied to cases where goods or property were sold. The courts had refused to apply the rule either on the basis that the advance constituted a form of loan,\textsuperscript{40} or that the contracts involved were executory contingent contracts for future sales.\textsuperscript{41} In the latter situations, the rationale applied was that gross income could arise only from a sale, and until the sale was completed, there could be no gross income. A careful reading of some of these cases indicates that what the court really meant was that until the cost of the goods or property sold could be determined and deducted from the advance payment, there was no gross income upon which to levy the tax.\textsuperscript{42} In other words, the courts were cognizant of the distinction between gross receipts and gross income, and would not permit the amount received to be taxed until the taxpayer was allowed to recoup his capital investment. But in all three of the recent cases\textsuperscript{43} which held that the prepaid income rule was applicable to goods, the courts completely brushed those cases aside on the theory that the “service” cases were controlling.

\subsection*{2. THE “SERVICE” CASES}

The first case in which the Supreme Court was squarely faced with the prepaid income issue was in \textit{Automobile Club v. Commissioner}.\textsuperscript{44} In

\begin{itemize}
  \item \textsuperscript{39} Id.
  \item \textsuperscript{40} \textit{E.g.}, Consolidated-Hammer Dry Plate & Film Co. v. Commissioner, 317 F.2d 829 (7th Cir. 1963) (financing agreements); Summit Coal Co. v. Commissioner, 18 B.T.A. 983 (1930) (loan).
  \item \textsuperscript{41} \textit{E.g.}, Lucas v. North Texas Co., 281 U.S. 11 (1930); Watkins v. United States, 287 F.2d 932 (1st Cir. 1961); Virginia Iron & Coke Co. v. Commissioner, 99 F.2d 919 (4th Cir. 1938); Consolidated Util. Co. v. Commissioner, 84 F.2d 548 (5th Cir. 1936); Bourne v. Commissioner, 62 F.2d 648 (4th Cir. 1933), \textit{cert. denied}, 290 U.S. 650 (1933); Aiken v. Commissioner, 35 F.2d 620 (8th Cir. 1929); Woodlawn Park Cemetery Co., 16 T.C. 1067 (1951); Veenstra & DeHaan Coal Co., 11 T.C. 964 (1948); Sophia M. Garretson, 10 B.T.A. 1381 (1928).
  \item \textsuperscript{42} Woodlawn Park Cemetery Co., 16 T.C. 1067 (1951); Veenstra & DeHaan Coal Co., 11 T.C. 964 (1948).
  \item \textsuperscript{43} \textit{See} cases cited note 4, supra.
  \item \textsuperscript{44} 353 U.S. 180 (1957).
\end{itemize}
that case, the accrual basis taxpayer reported membership dues received one year in advance ratably over the one year period of membership rather than in the year received. The Commissioner contended that the dues should be reported in the year of receipt, relying on the claim of right doctrine. The Court sustained the Commissioner's contention, but did so on the basis of the discretion given to the Commissioner by the Code to determine whether the taxpayer's method of accounting clearly reflects income.\textsuperscript{46} The Court found that the method of allocation of the membership dues used by the taxpayer was purely artificial and bore no relation to the services which it may have been called upon to render for the members. This finding was based on the fact that the services were to be performed solely on the demand of the members.

In \textit{American Automobile Association v. United States}\textsuperscript{46} the Court again held that an accrual basis automobile club must report membership dues paid in advance in the year of receipt. In contrast to the \textit{Automobile Club}\textsuperscript{47} case, the taxpayer presented extensive proof that its method of accounting whereby the membership dues were taken into income ratably over the twelve-month membership period did clearly reflect income. The Court noted that the record contained expert accounting testimony indicating that the system used was in accord with generally accepted accounting principles; that there was detailed proof of the cost of membership service; and that the correlation between that cost and the period of time over which the dues were credited as income was shown and justified by actual experience. But the Court pointed out that the holding of the \textit{Automobile Club} case (that the system of accounting was "purely artificial") was based on the finding that substantially all services were performed only upon a member's demand and the taxpayer's performance was not related to fixed dates after the tax year, and that this same fact was also present in the case under review. The Court held that while

\textsuperscript{46} The Supreme Court has never applied the claim of right doctrine as the rationale for the prepaid income rule. In \textit{Automobile Club} the court held for the Commissioner based on the discretion given to him by the Code to determine whether the taxpayer's method of accounting clearly reflects income. The court found that the Commissioner had not abused his discretion since the method used by the taxpayer was "artificial." The two other Supreme Court decisions, American Auto. Ass'n v. United States, 367 U.S. 687 (1961) and Schlude v. Commissioner, 372 U.S. 128 (1963), were both decided on the basis of the discretion rule of section 446 and the legislative intent behind the retroactive repeal of sections 452 and 462 of the 1954 Code. The dissenting opinions in all three of these cases specifically noted that the majority opinions were not based on the claim of right doctrine. See Alvin, \textit{supra} note 1, at 458-493 for a more detailed discussion.

The claim of right doctrine is far from dead, however, as a basis for applying the prepaid income rule. Several recent decisions from the lower federal courts indicate that the doctrine is currently being used to support the prepaid income rule. Although the courts do not always refer to the doctrine by name, use of terms such as "without restrictions" have obvious reference to the doctrine. See, e.g., Van Wagoner v. United States, 368 F.2d 95 (1st Cir. 1966); Parkchester Beach Club Corp. v. Commissioner, 335 F.2d 478 (2d Cir. 1964); Hagan Advertising Displays, Inc., 47 T.C. 139 (1966); William O. McMahon, Inc., 45 T.C. 221 (1965); Chester Farrara, 44 T.C. 189 (1965).

\textsuperscript{47} 367 U.S. 687 (1961).

\textsuperscript{47} 353 U.S. 180 (1957).
income recognition of the advances ratably over two taxable years, without regard to correspondingly fixed individual experience but consistent with overall experience, did present an accurate image of the total financial structure, such a method failed to respect the criteria of annual tax accounting and could be rejected by the Commissioner.\footnote{American Auto. Ass'n v. United States, 367 U.S. 687, 691 (1961).}

If the decision in \textit{American Automobile Association} was based solely on the finding that the "demand" aspect of the services caused the accounting system to be purely artificial and thus did not clearly reflect income, then it would appear that the door was still open for income deferral of advance payment where the taxpayer could show that the service was to be performed on a fixed date. But the Court's further reliance on their interpretation of the Congressional intent behind the retroactive repeal of sections 452 and 462 indicates conclusively that deferral of prepaid income from service contracts will not be permitted under any circumstances, regardless of the accounting system used by the taxpayer.\footnote{See E. Morris Cox, 43 T.C. 448, 455 (1965), where the prepaid income rule was applied to a taxpayer who performed services which were not dependent on the demand or request of its clients, but rather were performed by the taxpayer as a matter of course during the tax year.}

Just two years later, the prepaid income problem was again before the Supreme Court in the case of \textit{Schlude v. Commissioner}.\footnote{372 U.S. 128 (1963).} In that case, the taxpayer operated a number of dance studios in which students often paid for their lessons in advance by giving cash or negotiable notes due in installments. The Commissioner contended that the taxpayer's accrual method of accounting, which deferred the reporting of student advances as income until they had been earned through the performance of the related dance lessons or the lapse of the contract period, did not clearly reflect income within the meaning of section 446, and included the cash and the face value of the notes in gross income in the year received, as well as the contract installments due and payable. The Court held that \textit{Schlude} was squarely controlled by \textit{American Automobile Association} and that the Commissioner had not abused his discretion in rejecting the taxpayer's accrual accounting system. In so holding, the Court's rationale was again based on the Congressional intent behind the retroactive repeal of section 452 of the 1954 Code and on the fact that the services were rendered solely on demand of the students as in the \textit{American Automobile Association} and \textit{Automobile Club} cases.\footnote{\textit{Id.} at 136.}

All three cases were split decisions, the latter two being decided by a one vote margin. Mr. Justice Stewart, in writing the dissenting opinions in both \textit{American Automobile Association} and \textit{Schlude}, forcefully argued that the majority opinion had misinterpreted the Congressional intent behind the retroactive repeal of section 452. He was of the opinion that the
only consideration behind the repeal was the expectation by the Treasury of an enormous loss of revenue, and that Congress intended that the repeal would simply re-establish the principles of law which would have been applicable if sections 452 and 462 had never been enacted. He further felt that the accounting systems used by the taxpayers in both cases did "clearly reflect income" and that the Commissioner had abused his discretion in rejecting them.

Subsequent to Schlude the lower courts have decided a number of cases involving taxpayers engaged in the performance of service contracts who have attempted to defer income recognition of advance receipts either by excluding them from gross income, or by taking a deduction for the estimated future expenses of performing the services. In each case, the courts have held for the Commissioner and required income recognition in the year of receipt. In answer to one taxpayer's attempt to distinguish its situation from the American Automobile Association and Schlude cases, the court stated that "there seems to be no escape from the no-deferral rule of Schlude v. Commissioner and American Automobile Association v. United States." Indeed, as previously noted, it is apparent that only legislation can change the law at this point.

3. THE "SALE OF GOODS" CASES

The first case which held that the prepaid income rule was applicable to the sale of goods was Fifth & York Co. v. United States. Here, an accrual basis automobile dealer made "two for one" agreements whereby purchasers of new cars at a price of about $400 higher than the regular sales price were permitted to receive in the following year a new car in even exchange, provided the buyer requested the exchange and that the older car had suffered only normal wear and tear. The $400 was placed in the taxpayer's bank account and used in the regular course of business. One-half of the gross profits from the "two for one" sales was included in income in the year when the exchange took place rather than the year when the cash was received. The court rejected the taxpayer's attempt to distinguish between the sale of services and goods and held that:

52. See notes 28-33 supra, and accompanying text.
53. E.g., Van Wagoner v. United States, 368 F.2d 95 (5th Cir. 1966) (insurance commissions); Parkchester Beach Club Corp. v. Commissioner, 335 F.2d 478 (2d Cir. 1964) (membership dues and locker fees); Decision Inc., 47 T.C. 5 (1966) (advertising fees); William O. McMahon, Inc., 45 T.C. 221 (1965) (subscription payments); E. Morris Cox, 43 T.C. 448 (1965) (management service fees). But see Gunderson Bros. Eng'g Corp., 42 T.C. 419 (1964) (finance charges on non-negotiable notes need not be included in income in the year received under the Schlude case).
56. See note 3, supra.
[I]nasmuch as Congress has not expressly provided for deferral of income from the sale of goods or personal property and in view of the expression of the Supreme Court in Schlude, it is concluded that the Commissioner properly exercised his discretion in allocating the entire profits from the "two for one" sales to the [year when they were received].

The taxpayer did not attempt to argue the "return of capital" concept which would have been applicable to the extent that no deduction was allowable for the additional net cost of the second automobile until it was determined whether the purchaser exercised his option in the following year.

In Chester Farrara the Tax Court followed Fifth & York in extending the prepaid income rule to the sale of goods. In Farrara the taxpayer formed "suit clubs" in which customers paid a fixed amount each week for an agreed period of weeks. At the end of each week there was a drawing under which one member would win a suit or other merchandise. At the end of a stipulated period of time, the non-winning members received a certificate which gave them the right to obtain merchandise equal in amount to what they had paid into the "club." Members were not entitled to cash refunds, and if payments were discontinued during the term of the agreement the member received a merchandise certificate in the amount of the payments he had made up to that time. In rejecting the attempted distinction between goods and services the court held that the theory underlying the American Automobile Association and Schlude cases was fully applicable, and that the payments must be included in income when received by the taxpayer without restriction as to their use.

The most recent and by far most significant case that has held the prepaid income rule applicable to the sale of goods is Hagen Advertising Displays, Inc. The taxpayer, a manufacturer of advertising signs, received advance payments from some of its larger customers under "blanket orders" for a certain number of signs to be delivered at the direction of each customer. Due to the system of accounting employed by the taxpayer, there was no accurate way of determining from its books the cost of the signs to be delivered in future years for which the advances had been received. Being on the accrual basis of accounting, the taxpayer properly did not include the advance payments in gross income until the year in which the signs were actually delivered. At that time, a deduction for the cost of the signs sold was also taken.

58. Id. at 423.
59. 44 T.C. 189 (1965).
60. The court was apparently referring to the claim of right doctrine. See note 45, supra.
62. The deduction would be automatically taken by excluding the signs sold from ending inventory.
The significance of the decision lies in the fact that for the first time, a taxpayer argued the distinction between gross receipts and gross income. In an attempt to escape the no-deferral rule of Schlude and American Automobile Association, the taxpayer contended that under section 61(a), the advance payments constituted gross receipts, but there could be no gross income under that section until the cost of goods sold had been determined and deducted from the amounts received. In short, the taxpayer took the position that the amounts received did not constitute gross income under section 61(a) until the year in which the signs were delivered and a deduction for their actual cost taken.\textsuperscript{63}

In supporting the Commissioner's contention that the advance payments were includible in gross income in the year of receipt, the court never directly answered the ultimate question posed by the taxpayer as to whether or not the income tax could be applied to gross receipts under section 61(a) of the Code. The court concluded that the prepaid income rule was applicable since tax accounting is required to be on an annual basis, not a transactional basis, and there was nothing in the regulations which required that an attempt be made to match the cost of a particular purchase with the receipt from its sale.\textsuperscript{64} In addition, the court concluded that the Supreme Court rule in Schlude and American Automobile Association applies likewise in cases such as this one involving contracts to sell property. In answer to the taxpayer's final contention that because its accounting method clearly reflected income the Commissioner was not justified in changing it, the court held the Commissioner's exercise of the broad discretion granted him under section 446 was not unsound in light of the many cases which have sustained his rulings requiring accrual basis taxpayers to include advances in income in the year of receipt.

In effect the court treated the question involved as one arising under section 446(b) as to whether income may be deferred, instead of one arising under section 61(a) as to whether the amounts received even constituted gross income in the first instance. Thus, the real holding of the case is not clear. For example, does the case stand for the proposition that there is no distinction between gross receipts and gross income, and

\textsuperscript{63} The taxpayer cited Consolidated-Hammer Dry Plate & Film Co. v. Commissioner, 317 F.2d 829 (7th Cir. 1963); Watkins v. United States, 287 F.2d 932 (1st Cir. 1961); Woodlawn Park Cemetery Co., 16 T.C. 1067 (1951); and Veenstra & DeHaan Coal Co., 11 T.C. 964 (1948), in support of his contention. The court distinguished the instant case by pointing out that the cases relied on by the taxpayer involved "mere loans or restricted deposits." It is noteworthy that neither the Watkins case nor the Woodlawn Park Cemetery case were decided on that point, but rather on the basis that the contracts involved there were executory contingent contracts to sell and thus constituted uncompleted transactions. The important distinction between these cases and the Hagen case is that the advance payments in Hagen were non-returnable in contrast to those in Watkins and Woodlawn Park Cemetery which were returnable in the event the contracts were cancelled.

\textsuperscript{64} 47 T.C. 139 (1966). The court also stated that "the advance payments received by petitioner from its customers were without restriction as to use or disposition and were in fact used . . . in its normal business operations" (emphasis added). By the use of this language, the court was apparently referring to the claim of right doctrine. See note 45, supra.
therefore that one's capital investment is now subject to income taxation? Or does it stand for the proposition that the burden of proving the amount of capital return is on the taxpayer, and upon a failure to sustain this burden, he may then be subjected to taxation on his gross receipts and thus his capital? Although the second interpretation is certainly a more plausible one, this still would not help in situations where the cost of the item could not be either accurately ascertained or reasonably estimated. In this latter situation must the taxpayer then be permitted to defer income recognition until the cost (or return of capital) can be determined and a deduction taken?

It is submitted that the question as to whether a taxpayer, who is required to include an advance payment in gross income in the year of receipt, must also be permitted to recover his capital investment by taking a deduction for his cost of goods sold or else be permitted to defer income recognition of the entire amount until a subsequent period is not controlled by the Schlude or American Automobile Association cases. Those cases dealt only with the question of whether, under section 61(a), gross receipts for personal services to be rendered represents gross income immediately upon receipt, and there was no question that involved a return of capital. The amounts received there were unquestionably items of gross income in the year of receipt, and the only question involved was whether such amounts could properly be deferred to subsequent periods under sections 446 and 451 of the Code. In both cases it was held that the deferral of such gross income did not "clearly reflect income." This provides no authority, however, for determining whether amounts which represent a partial or perhaps even an entire return of capital constitute gross income under section 61(a) of the Code or "income" within the context of the sixteenth amendment.

III. CONSTITUTIONAL CONSIDERATIONS

The return of capital rule, although not specifically provided for by either the sixteenth amendment or the Code, has long been recognized by the courts as an essential aspect of calculating the gross income derived from the sale of goods or property. This concept was first established by the Supreme Court in the case of Doyle v. Mitchell Bros. where the Court was confronted with the problem of defining "income" under the Revenue Act. In answer to the Commissioner's argument that gross income was equivalent to gross receipts, the Court stated that:

There is no express provision that even allows a merchant to deduct the cost of goods that he sells, yet it is plain that by the true

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65. The court noted that the taxpayer made no argument that either its cost of goods sold or inventories were incorrectly computed.
66. 247 U.S. 179 (1918).
67. The court was construing the definition of income in the Excise Tax Act of 1909. In South Pacific Co. v. Lowe, 247 U.S. 330 (1918), it was held that the term "income" under the Excise Tax Act of 1909 was the same as "income" under the Income Tax Act of 1913.
intent and meaning of the act, the entire proceeds of a mere conversion of capital assets were not to be treated as income. . . . In order to determine whether there has been gain or loss, and the amount of gain, if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value [of the property].

The Court went on to state that the definition of income imports "something entirely distinct from principal or capital either as a subject of taxation or as a measure of tax."

While the regulations specifically recognize the return of capital concept by providing for a deduction for cost of goods in arriving at gross income, the Commissioner has argued to the contrary on several occasions. In each case the courts were unanimous in holding that under the Code the taxpayer must be allowed to deduct his cost of goods sold and thereby recover his capital investment. For example, in Lela Sullenger, the Tax Court held that:

Section 23 [corresponding to section 61(a) of the 1954 Code] makes no provision for the cost of goods sold, but the Commissioner has always recognized, as indeed he must to stay within the Constitution, that the cost of goods sold must be deducted from gross receipts to arrive at gross income. No more than gross income can be subjected to income tax upon any theory.

A. The Hagen Decision Reexamined

While many cases have held that the definition of income under the Code means gross income rather than gross receipts, thereby recognizing the return of capital concept, no case has directly held that to be the definition of "income" under the sixteenth amendment. There is authority, however, to the effect that the definition of income under the sixteenth amendment likewise means gross income rather than gross receipts. Therefore, an attempt to levy the income tax on gross receipts would not

68. 247 U.S. at 184.
69. Id. at 185.
70. Treas. Reg. § 1.61-3(a) (1957):
In a manufacturing, merchandising, or mining business, gross income means the total sales, less the cost of goods . . . The cost of goods sold should be determined in accordance with the method of accounting consistently used by the taxpayer.
71. E.g., Burnett v. Logan, 283 U.S. 404 (1931); Merchant's Loan & Trust Co. v. Smietanka, 255 U.S. 509 (1921); Doyle v. Mitchell Bros. Co., 247 U.S. 179 (1918); Commissioner v. Weisman, 197 F.2d 221 (1st Cir. 1952); Rayburn E. Hahn, 30 T.C. 195 (1958), aff'd per curiam, 211 F.2d 739 (5th Cir. 1959); Ray Edenfield, 19 T.C. 13 (1952); Joseph W. Scales, 18 T.C. 1263 (1952); Lela Sullenger, 11 T.C. 1076 (1948). See also J. MERTENS, supra note 18, at §§ 4.07, 5.03, 5.06, 5.10.
72. 11 T.C. 1076 (1948).
73. Id. at 1077.
74. See authorities cited note 71, supra.
75. E.g., Commissioner v. Guminski, 198 F.2d 265 (5th Cir. 1952); Commissioner v. Weisman, 197 F.2d 221 (1st Cir. 1952); Hofferbert v. Anderson Olds, Inc., 197 F.2d 504 (4th
be sustainable under the sixteenth amendment. The fact that a tax on gross receipts, if found to be an *excise* rather than an unapportioned direct tax, might be sanctioned by article I, section 8 of the original Constitution is, of course, irrelevant in determining whether an *income* tax can be imposed upon gross receipts representing at least a partial return of capital. When the *Hagen* decision is viewed in this light, the ultimate scope of its holding becomes clearer. Because of judicial interpretations which have limited the definition of income to "gross" income, in both the sixteenth amendment and the Code, the holding of the case cannot properly be interpreted to mean that a taxpayer who receives an advance payment for the sale of goods may in *all* cases be taxed on the gross amount of the receipt without taking into consideration the portion that represents a return of capital. In view of the fact that the taxpayer in *Hagen* made no attempt to prove what portion of the advance payment constituted a return of capital and demanded no deduction for it, the only reasonable interpretation of the decision is that the taxpayer has the initial burden of proving what portion of the advance payment constitutes a return of capital, and upon a failure to carry that burden, the taxpayer may then be taxed on his gross receipts notwithstanding the fact that part of it may actually represent a return of capital. Therefore, where the taxpayer can prove with reasonable certainty his cost of goods sold with respect to the advance payment under consideration, he should be allowed to deduct it, thereby subjecting him to taxation only upon his gross income. It should be noted that the prepaid income rule still applies here since the *income* portion of the advance payment is being taxed in the year of receipt; only the *extent* of its application is being limited.

B. The Logan Doctrine

As to the problem where the taxpayer cannot possibly determine what portion of the advance payment represents a return of capital, the Supreme Court has already indirectly established the applicable rule. In *Burnet v. Logan* the taxpayer sold her stock in a mining company to a steel manufacturer who made a cash payment and agreed to pay her

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Cir. 1952); *Jones v. Herber*, 198 F.2d 544 (10th Cir. 1952); *Lela Sullenger*, 11 T.C. 1076 (1948); *R. Magill, Taxable Income*, 347-368 (rev. ed. 1945); *J. Mertens*, supra note 18, at § 4.07.

This principle is succinctly set out in *J. Mertens, Code Commentary*, § 61-121:1:

A return of capital or of an investment is not income in the constitutional sense, and, until the capital element has been returned or some provision made for its recovery, generally no income is realized. Consequently, gross receipts, prior to an allowance for cost of goods sold, are not taxable, although the amount which results after such allowance—gross income—represents income which constitutionally may be taxable without the deductions allowable therefrom by legislative grace.


77. See notes 71 and 75, supra.

78. See note 65, supra.

79. 283 U.S. 404 (1931).
annually thereafter a specified amount for each ton of ore received. The Commissioner assigned a market value to the future obligations and apportioned the initial and all subsequent payments between capital and income. The taxpayer argued that none of the payments to her constituted gross income until she had recovered her capital investment in the property sold. The Court found that the value assigned to the future payments by the Commissioner was based on pure conjecture and that the market value of these payments was actually unascertainable. In holding that the taxpayer had "properly demanded the return of her capital investment before assessment of any taxable profit based on pure conjecture," the Court restated the principle espoused in Doyle v. Mitchell Bros. that the taxpayer must be allowed to recover his capital before there can be any income upon which to levy the tax.

Although there are factual distinctions between our problem and the Logan case in that the former involves a situation where the total proceeds are known but the cost is unascertainable, and the latter involves a reverse situation; the net result is identical since the amount received is not apportionable between capital and income in either case. Therefore, the same rule should apply in both situations. There is authority to the effect that it does. For example, in the analogous situation where a mixed aggregate of assets is acquired for a lump sum in one transaction and subsequently disposed of a portion at a time, the rule is now well settled that an allocation of the cost or other basis of the several units need not be made where apportionment would be wholly impracticable or impossible and the taxpayer is permitted to fully recover his capital investment before gross income will arise. It is said that "this principle is based upon the equitable doctrine that a taxpayer should not be charged with gain on pure conjecture unsupported by reasonably ascertainable facts." Likewise, where the taxpayer cannot reasonably ascertain what portion of an advance payment constitutes a return of capital, he should be permitted to defer taking it into gross income until such time as a reasonable determination can be made. Here, the prepaid income rule should have absolutely no application.

IV. PRACTICAL CONSIDERATIONS

A. Use of Accounting Systems and Estimates

Since the burden is on the taxpayer to prove what portion of an advance payment represents a return of capital, this section will be devoted to exploring the various methods of carrying this burden. Whether

80. Id. at 413.
81. 247 U.S. 179 (1918).
82. E.g., Warren v. Commissioner, 193 F.2d 996 (1st Cir. 1952); Raytheon Prod. Corp. v. Commissioner, 144 F.2d 110 (1st Cir. 1944), cert. denied, 323 U.S. 779 (1944); Kirkland v. Burnet, 57 F.2d 608 (D.C. Cir. 1932); Inaja Land Co., 9 T.C. 727 (1947); Nathan Blum, 5 T.C. 702 (1945); William T. Piper, 5 T.C. 1104 (1945).
83. J. MERTZ, supra note 18, at § 38.25. The author notes that it is only the exceptional situation where an allocation of the cost price cannot be made.
any accounting system can be successfully used to accurately determine his cost of goods sold depends on the particular circumstances of the taxpayer. It is obvious that a fairly simple system would be appropriate where the taxpayer purchases ready-made goods for resale. In contrast, a far more sophisticated cost system would be needed where the taxpayer himself manufactures the goods. This is because there are various elements of raw material, labor, and overhead to account for in calculating the total costs involved. As a practical matter, whether any system could be devised and effectively used depends to a great extent upon the state of physical completion of the merchandise at the end of the taxable year. For example, where the items for which the advance payment was received are fully completed, there is no question that some accounting method could be developed to accurately determine their cost. However, where the items are only partially completed or perhaps not even yet in existence, only a standard cost accounting system could be used to directly ascertain their cost upon completion. Because of the large expense involved, a standard cost system may not be feasible in many cases. This does not mean that the use of accounting must be entirely ruled out in this situation because if an adequate (although non-standard) system is in use for cost accounting purposes it could also be used to indirectly determine the cost of these items by means of an estimate. Thus, the completed cost of the goods could be determined with a high degree of accuracy by comparing them to identical or very similar goods whose cost has already been developed by the accounting system.

Another situation in which an estimate could be used to prove the cost of goods sold is where the taxpayer's gross profit (or gross margin) on his sales remains fairly constant from year to year. In this case, the average gross profit percentage for a given number of prior years could be applied to the advance payment to determine the portion representing a return of capital. For example:

The X Company's gross profit percentage (sales minus cost of goods sold divided by sales) for the past five years has been 50%. They receive a $100,000 advance payment from the Y Company for goods to be delivered in the following tax year, and the Commissioner seeks to include the entire $100,000 in gross income in the year of receipt. The taxpayer should be allowed to prove that only $50,000 ($100,000 \times 50\%) is includible in gross income, since the remaining $50,000 represents a return of capital.

84. A standard cost accounting system is one that establishes the cost of goods in advance of production by means of scientific fact finding which utilizes both past experience and controlled experiment. Through the use of standards, it is possible to determine not only how much a product costs but how much it should cost, and the causes of excess costs. See WIXON & KELL, ACCOUNTANT'S HANDBOOK, §§ 6.10-6.14 (4th ed. 1962). A standard cost accounting system could be used to predetermine the cost of goods sold with a high degree of accuracy.
The use of a reasonable estimate should not be objectionable for lack of preciseness since many deductions provided for by the Code are also based on estimates. Specific examples include depreciation,85 unstated interest,86 and bad debt deductions,87 to name but a few.88 While the courts have been reluctant to permit deductions for future estimated expenses except in certain limited circumstances,89 this should not be determinative of whether a deduction for cost of goods sold should be allowed based on an estimate. In fact, one taxpayer was allowed a deduction for cost of goods sold computed by an estimate based on the then existing Cohan Rule.90 Of course, if an estimate would be purely arbitrary, or based on surmise or speculation, the taxpayer should then be allowed to defer income recognition of the entire advance payment.91

A technical discussion of the various accounting methods available is beyond the scope of this paper. The point is, however, that the taxpayer should seek the aid of a competent accountant to help design and put into effect an adequate accounting system which will enable him to carry the burden of proving what portion of any advance payment constitutes a return of capital.

**B. Avoiding the Prepaid Income Rule**

There are certain situations where the taxpayer, by means of some advance tax planning, may avoid the prepaid income rule altogether. One possibility would be to have the advance payment take the form of a loan or financing agreement. In this situation, the courts have held that the advance does not constitute gross income under section 61(a) and

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87. *Int. Rev. Code* of 1954, § 166(c). This section allows as a deduction for bad debts a “reasonable addition to a reserve for bad debts.”
88. Any computation based on “fair market value” is nothing more than an estimate of the true value. Basing the deduction for cost of goods sold on an estimate is really no different than the problem involved where an aggregate of assets is purchased for a lump sum in one transaction and subsequently disposed of a portion at a time. In the latter situation, an allocation of the total cost or other basis is made to the several units sold where such apportionment is possible, and the taxpayer is taxed in the year of sale rather than when the entire capital investment is recovered. See note 82, *supra* and accompanying text. It is obvious that the allocation is a mere estimate in most cases.
89. *Compare* Denise Coal Co. v. Commissioner, 271 F.2d 930 (3d Cir. 1959); Hilinski v. Commissioner, 237 F.2d 703 (6th Cir. 1956); Schuessler v. Commissioner, 230 F.2d 722 (5th Cir. 1956); Pacific Grape Prod. Co. v. Commissioner, 219 F.2d 862 (9th Cir. 1955); Harrold v. Commissioner, 192 F.2d 1002 (4th Cir. 1951), all allowing the deduction, *with* Milwaukee & Suburban Transp. Corp., 357 U.S. 906 (1961), *on remand*, 293 F.2d 628 (1961), and Ralph Patch, 19 T.C. 189, *aff’d*, 208 F.2d 532 (3rd Cir. 1953), which denied the deduction. *See also* J. MERTENS, *supra* note 18, at §§ 12.61, 12.118.
90. Nathan Goldsmith, 31 T.C. 56 (1958). The Commissioner had included receipts from unrecorded sales in gross income. Although the exact cost of the goods sold could not be determined, the court allowed an offsetting adjustment for cost of goods sold determined under the Cohan Rule.
91. *See notes* 79-83, *supra* and accompanying text.
hence is not subject to taxation in the year received. A caveat is in order here since such a plan might be subject to a "substance over form" argument by the Commissioner. In this area, the Consolidated-Hammer\textsuperscript{93} and Summit Coal\textsuperscript{94} cases should be carefully analyzed.

The line of cases holding that advance payments for the sale of goods on executory or contingent contracts to sell do not constitute gross income in the year of receipt are still good law.\textsuperscript{95} Thus, if acceptance of the goods is conditioned upon satisfactory inspection by the buyer, it would appear that any advance payment for them could be deferred until actual inspection and acceptance had taken place. A similar result should obtain where the contract specifically allows either party to rescind and back out of the deal.\textsuperscript{96}

There are also many practical factors to be considered. For instance, the relative bargaining power of the taxpayer with respect to contract terms and his willingness to accept the financial risks inherent in placing contingencies in the contract are both crucial aspects that cannot be overlooked in tax planning.

Another planning device, while not avoiding the prepaid income rule, would limit the extent of its application to gross income by guaranteeing a deduction for cost of goods sold. This would be to have title to the goods pass to the seller upon entering into the contract of sale. The regulations\textsuperscript{97} specifically provide that:

Merchandise should be included in the inventory only if title thereto is vested in the taxpayer. Accordingly, the seller should include in his inventory goods under contract for sale but not yet segregated and applied to the contract... but should exclude from inventory goods sold... title to which has passed to the purchaser.

Thus, even though the taxpayer would have to include the advance payment in gross income in the year of receipt, he would be allowed a

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\item \textsuperscript{92} J. Mertens, \textit{supra} note 18, at § 5.12.
\item \textsuperscript{93} Consolidated-Hammer Dry Plate & Film Co. v. Commissioner, 317 F.2d 829 (7th Cir. 1963).
\item \textsuperscript{94} Summit Coal Co. v. Commissioner, 18 B.T.A. 983 (1930).
\item \textsuperscript{95} See cases cited note 41, \textit{supra}.
\item \textsuperscript{96} J. Mertens, \textit{supra} note 18, at § 12.125:
\textit{The execution of a sales contract which definitely fixes the liabilities of the parties generally determines the time when a sale is made. But a sale premised upon satisfactory tests in operation by the purchaser will not be considered consummated until the property is accepted after the tests or expiration of the test period. Where amounts are paid to a vendor in advance of a sale to be applied on the purchase price, contingent upon the consummation of the sale, the gain on the sale is taxable in the year the sale is completed and not in the earlier year when the contract is made and the advance payments received.}
\item \textsuperscript{97} Treas. Reg. § 1.471-1 (1958).
\end{enumerate}
corresponding deduction for his cost of goods sold by virtue of the fact that these goods would be excluded from his ending inventory.

V. CONCLUSION

Notwithstanding the three decisions\(^9\) which have held that the prepaid income rule as set out in *Schlude* and *American Automobile Association* is equally applicable to the sale of goods, it is submitted that such an application is severely limited by the return of capital concept. Any application of the rule that completely ignores this concept would appear extremely tenuous in view of the constitutional and statutory considerations which, hopefully, this paper has brought to light. This writer is of the opinion that the Supreme Court would also take this position if and when they are confronted with the question. Of course, there is always the possibility that Congress will take the initiative in this area by again passing legislation similar to that contained in section 452 of the 1954 Code to allow all taxpayers to defer income recognition of advance payments.\(^9\) In the meantime, taxpayers may deal with the problem by either planning to avoid it completely, or by at least limiting the application of the rule to gross income by being prepared to prove what portion of the advance payment constitutes a return of capital. Until Congress passes appropriate legislation, however, even taxpayers engaged in the sale of goods cannot completely escape the prepaid income rule except where it appears that there is no possible way of ascertaining the portion that represents a return of capital. In this situation, the *Logan*\(^10\) doctrine would appear to require that the taxpayer be permitted to defer income recognition until a subsequent period when the portion constituting a return of capital can be determined and a deduction for it taken.

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\(^9\) In *S. REP. No. 372*, 84th Cong., 1st Sess., 3 (1955), the Senate Committee on Finance, in recommending the retroactive repeal of sections 452 and 462 of the 1954 Code, stated that: "The present status, where some taxpayers are able to defer prepaid income which others are not, is inequitable and should not be allowed to continue. In order to eliminate this uncertainty and discrimination, definite rules must be written into the income tax law. For these reasons your committee plans to begin studies in the near future to devise proper substitutes for the sections now being repealed."

Unfortunately, the "near future" has turned out to be 12 years with no end in sight.

\(^10\) See notes 79-83, *supra* and accompanying text.