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A Critical Analysis of the Tax Treatment of Prepaid Income

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A CRITICAL ANALYSIS OF THE TAX TREATMENT OF PREPAID INCOME†

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The Internal Revenue Code of 1954 provides, as have previous Codes, that taxable income shall be computed in accordance with the method of accounting regularly employed by the taxpayer in keeping his books.[1] On its face this appears to be a quite clear provision, but its application over the years has been the source of considerable litigation. This article will cover one area of that litigation — the tax treatment of prepaid income by an accrual basis taxpayer.

The accounting profession has strenuously contended that accepted accounting procedures for handling prepaid income should be followed for tax purposes. However, the Internal Revenue Service has taken the position that such advanced payments represent income in the year of receipt and will be taxed in that year in spite of the method of accounting used. Through an analysis of legislative background and cases on the problem, an attempt will be made in this article to show that this position is legally unjustifiable and lacks sufficiently compelling reasons to justify its continuance.

This problem is still of particular importance today, for with the repeal of section 452 of the 1954 Code, dealing with prepaid income, the principles of law which would have been applicable if section 452 had never been passed, were reestablished. The Treasury Department has indicated that it would not consider the repeal of section 452 as any indication of Congressional intent as to the proper treatment of prepaid income items or as the acceptance or rejection of any judicial decision.[2]

I. LEGISLATIVE BACKGROUND

An examination of the revenue acts and their legislative history would seem to establish an adequate basis for the proposition that the method of handling prepaid income advocated by the accounting profession was the method provided for and intended.

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† ED. NOTE: See Automobile Club of Michigan v. Commissioner, 25 L. W. 4247 (U. S. Sup. Ct., April 22, 1957), appearing as this issue went to press.

[1] §446.

[2] Sec. 452 repealed June 15, 1953, C. 143, §1(a), 69 Stat. 134 [26 U. S. C. A. 23 (1956)]; H. R. Rep. No. 293, 84th Cong., 1st Sess. 5 (1955).

The first major act was the Revenue Act of 1913.[3] It was based wholly on the cash receipts and disbursements method and was quickly found to be completely inadequate for businesses of any complexity. As a result, Congress, in the Revenue Act of 1916,[4] provided for the use of the accrual method of accounting at the option of the taxpayer. The report of the Committee on Ways and Means stated:

> "As two systems of bookkeeping are in use in the United States, one based on the cash or receipts basis and the other on the accrual basis, it was deemed advisable to provide in the proposed measure that an individual or a corporation may make a return on either the cash or accrual basis, if the basis selected clearly reflects the income."[5]

This statement was given expression in sections 8(g) and 13(d) of the act, which provided for making returns on the same basis on which the taxpayer kept his accounts, and Regulation 33, Article 127,[6] recognized as acceptable bases all methods in accord with approved standard accounting practices. Here then, the basis was laid for the use of such standard practices, which, under the accrual method, meant the spreading of prepaid income over the period for which the services were to be rendered.

This adoption of approved standard accounting methods was given judicial recognition in the case of *United States v. Anderson*.[7] The Supreme Court, in commenting upon section 13(d) of the 1916 Act, stated that its purpose was to enable taxpayers to keep their books and make their returns according to scientific accounting principles.

The Revenue Act of 1918[8] continued the recognition of the accrual method, but made it mandatory for the taxpayer to compute income on the same basis on which his books were kept, provided such method clearly reflected

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[3] 38 Stat. 166.

[4] 39 Stat. 756; George O. May in his article *Accounting and the Accountant in the Administration of Income Taxation*, 47 Col. L. Rev. 377, 380-381 (1947), states that the change was also due to the report of a group of businessmen and economists who felt that the determination of income for a particular period was essentially an accounting problem and that accounting methods which had been adopted and consistently followed should be accepted as clearly reflecting income; and that these convictions were expressed in the Revenue Acts of 1916 and 1918 and the Regulations under them.

[5] H. R. Rep. No. 922, 64th Cong., 1st Sess. 4 (1916).

[6] U. S. Treas. Reg. 33 (Revised), Art. 127 (1918).

[7] 269 U. S. 422, 440 (1926).

[8] §212(b), 40 Stat. 1064.

the income. This act appears to have considerably strengthened the proposition that the approach used by the accountants should be followed. Firstly, there was the continued recognition of approved methods of accounting and then the additional recognition that such methods clearly reflect income.[9] Secondly, there appeared to be specific authority for not including an item in income when received, provided the method of accounting in use provided for its inclusion as of a different period.[10] If there was any doubt under the Revenue Act of 1916 that by authorizing the accrual method the deferral of prepaid income was also authorized, it would certainly have seemed foreclosed in view of the specificity of the added provisions of the Revenue Act of 1918.

The language of the pertinent sections of the Revenue Act of 1918 and the regulations under it have been repeated almost verbatim in all the subsequent tax statutes including the Internal Revenue Code of 1954.[11] It would seem, therefore, that the accounting approach would have been the one used throughout this entire period, for nowhere in the law or regulations is there any indication that any other approach was intended. However, as will be seen from the cases discussed in the next section, a lack of understanding of the niceties of accounting concepts and a blanket of legal theories resulted in a complete divorce of prepaid income from the accepted accounting treatment.

II. Judicial Background

In analyzing the decisions in this area, it may be noted that they fall naturally into two periods with the dividing line at 1934. The cases prior to this date discussed the taxpayer's accounting method and the procedure for handling prepaid income under it, while the cases after 1934 ignored the question of the accounting method and based the decision on the "claim of right" doctrine. Although the courts generally refused to follow the accounting approach in both periods, it is only in the first period that one finds any expression by the courts or the Commissioner that the accounting approach might be permissible for tax purposes.

[9] U. S. Treas. Reg. 45, Art. 23 (1919), provided that standard methods of accounting will ordinarily be regarded as clearly reflecting income.

[10] §213(a), 40 Stat. 1057, provided for inclusion in the year of receipt unless under the method of accounting in use it was to be accounted for in a different period and U. S. Treas. Reg. 45, Art. 22 (1919), provided that the method of accounting in use was to be followed with respect to the time as of which items of income were to be accounted for.

[11] §§446, 451.

Afterwards, the claim of right doctrine became all powerful, and any contentions based on the taxpayer's accounting method were given little recognition. Thus, it is only through the cases prior to 1934 that any insight may be gotten as to the reason for the courts' refusal to follow the accounting approach, and the only apparent reason was a failure to understand accounting concepts.

A. *Period up to 1934.* The first major case in the pre-1934 period is that of *Automobile Underwriters, Inc.*[12] In this case one may observe a fine example of faulty reasoning resulting from a lack of understanding. The taxpayer kept its books on the accrual basis and claimed therefore that its advance subscriptions should be spread over the period covered by the membership. The court decided that the case was governed by Section 213 of the Revenue Acts of 1918 and 1921, but disallowed the deferral on the basis of Black's Law Dictionary definition of accruing. The court should have referred to the procedures for inclusion under the method of accounting in use, as was provided by section 213, rather than referring to a law dictionary definition which has nothing at all to do with accounting concepts. The court not only failed to understand accounting concepts, but also disregarded the statutory language which they had decided covered the case.

Another example of judicial blindness in this period is the opinion in *United States v. Boston & Providence R.R. Corporation,*[13] covering an advanced rental situation. The disallowance of deferral was based on the authority of the *O'Day Investment Co.*[14] case, in which the reason for requiring inclusion of an advanced rent payment as income in the year of receipt was the fact that the taxpayer accounted on the cash basis. To suppose that such a case is proper authority for the proposition that the tax statutes do not permit an accrual basis taxpayer to defer a prepaid item ignores both the distinction between the cash basis and the accrual basis and the statutory recognition of accrual accounting as an acceptable method of determining income.

In *Creasey Corporation v. Helburn,*[15] the court simply misstated the accrual method of accounting. The taxpayer had received payments on contracts under which he was obligated to perform services for periods from ten to fifty

[12] 19 B. T. A. 1160 (1930).
[13] 37 F. 2d 670 (1st Cir., 1930).
[14] 13 B. T. A. 1230 (1928).
[15] 57 F. 2d 204 (W. D. Ky., 1932).

years and he contended that they should not be included in income as they represented capital investments. The Commissioner required the payments to be included in income, and, recognizing that the taxpayer was on the accrual basis, authorized these advance payments to be spread over the respective terms of the contracts. The court agreed that these payments were income, but declared that the Commissioner had no authority to permit a deferral: "I have never understood that, under the accrual method of keeping books, income actually received in one year may be, in part, projected into and allotted to future years."[16] It is difficult to imagine a more complete ignorance of the accrual accounting concept that an item is included in income in the period when earned, not when received.

Thus far we have seen a consistent refusal by the courts to allow a deferral of prepaid income. This refusal, however, has been based on the clearly erroneous reasoning that the accrual method did not encompass deferrals, with no reference to the issue of whether deferrals are permissible for tax purposes. It would seem, however, that the deferral of prepaid income would be held permissible for tax purposes as soon as the courts realized that such deferrals are basic to the accrual method, since they did recognize the propriety of use of the accrual method as such. Several courts, recognizing these fundamentals, would have allowed the taxpayer to spread the receipt were it not for other factors. In *Bradstreet Company of Maine*,[17] the taxpayer received subscription fees for services to be rendered over a period of years. The court disallowed the deferral because the company's books were kept so inadequately that they could not tell what method of accounting it followed or what portion of the receipts, if any, should be deferred. The court, however, expressing an understanding of the accrual method said:

> "We agree that if a proper portion of the total subscriptions could be deferred, income would be more clearly reflected . . . [but] In order to give the petitioner any relief, some method of accounting which would enable a proper allocation to be made or would at least be an improvement upon the method used in keeping its books and adopted by the Commissioner would have to be devised."[18]

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[16] *Ibid*, 206.
[17] 23 B. T. A. 1093 (1931).
[18] *Ibid*, 1099, 1102.

A case of similar import is *Jennings & Co. v. Commissioner of Internal Revenue.*[19] The taxpayer here received a lump sum payment on a lease which stated that the payment should not be applied on rent to be paid in the future and that it is fully earned by the lessor on execution. The court required this receipt to be included in income in the year of execution even though the taxpayer kept his books on the accrual method. This result was based on the wording of the lease, but the important part of the decision for our purposes is the consideration by the court as to the procedure that would have been allowable in the absence of such wording. They indicated that, in the absence of such wording, the petitioner's contention that the lump sum be spread over the term of the lease would have been entitled to consideration in light of section 213 of the Revenue Act of 1921 and that the payments might well be regarded in view of approved standard methods of accounting as prepaid rentals which are properly apportionable to the respective years to which such payments by the terms of the lease are related.

These two cases go several steps beyond the previous group. They recognize the deferral of prepaid income as part of the accrual method, and further, they indicate that such a deferral would generally be permissible for tax purposes.

As of 1934 then, the state of the law was somewhat uncertain. All the decisions had recognized the accrual method of accounting as permissible for income determination, but the issue of whether a taxpayer on the accrual method could defer income to periods other than the year of receipt was not unalterably settled.

B. *Period from 1934 to present.* In the period after 1934, the courts switched to an entirely different basis for their decisions on prepaid income. This change was brought about by the development of the claim of right doctrine in 1932 in the case of *North American Oil v. Burnet*[20] and from that date forward this doctrine has been used as the basis for the decisions in the majority, if not all, of the cases involving prepaid income. The *North American* case was concerned with the proper year for reporting the net profits of a business on the accrual basis, when the taxpayer's right to these net profits was involved in litigation. The Supreme Court held that the net profits were includible in income in the year the taxpayer first received

[19] 59 F. 2d 32 (9th Cir., 1932).
[20] 286 U. S. 417 (1932).

them by virtue of a District Court decision in its favor, though such decision was open to possible reversal on appeal. The basis of this holding was the claim of right doctrine which was stated as follows:

> "If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent."[21]

The *North American* case did not itself involve a prepaid income situation, but the doctrine of the case was used just two years later in *Brown v. Helvering*,[22] a case which has been consistently cited as the authority for applying the claim of right doctrine to prepaid income situations. Here the taxpayer had received overriding commissions on insurance policies which were to run for a period of years, and the Commissioner had required their inclusion in income in the year of receipt. The taxpayer made two contentions: first, that he should be allowed a deduction from the commissions received, as his experience indicated that a certain portion of these receipts would have to be returned in later years due to cancellation of some of the policies; second, that if such a deduction is not permissible, the commissions should be prorated over the life of the policy and reported as earned. The court rejected both of these contentions, but for our purposes the second is more important. The reasons given by the court for rejecting this contention were that this method of accounting for the commissions had never been used by the taxpayer, and that there was no proof that the commissions contained any element of compensation for service to be rendered in future years. Nowhere in the court's consideration of this second contention is there any mention or even an indication that the basis for rejection was the claim of right doctrine. The true basis of the rejection was that the commissions were not really prepaid income, and therefore, there was no reason to allow their deferral to later years.

It was only in the rejection of the first contention that the court used the claim of right doctrine. Here, as in the *North American* case, the taxpayer had received funds with a possibility that some part of the funds may have to be

[21] *Ibid*, 424.
[22] 291 U. S. 193 (1934).

given up, and therefore, the court used the doctrine as the basis for denying any deduction. This is just an illustration of a different application of the claim of right doctrine and goes no further than the decision in the *North American* case. It should, however, have no effect on the right of a taxpayer to allocate this receipt which the court has determined to be income. This is borne out by the fact that the court considered the right to allocate as a separate and distinct problem. If the factor of future services had no bearing under the claim of right doctrine, there would have been no reason for the court to deal with the point. Factual proof would have been unimportant, since it would not have been controling. Therefore, any citation of the *Brown* case as authority for the proposition that the claim of right doctrine precludes the deferral of prepaid income or that deferral of prepaid income is not permissible for tax purposes would appear to be incorrect.

Nevertheless, the cases since 1934 have consistently cited the claim of right doctrine and the *Brown* case as authority for denying the deferral of prepaid income.[23] If one accepts the *Brown* case as being an inadequate authority, then it would follow that all relying upon the *Brown* case, have been incorrectly decided. However, in view of the great number of these decisions, it is necessary to determine as an independent proposition whether the claim of right doctrine is a correct basis for denying deferrals of prepaid income. An examination of the major claim of right cases clearly leads to a negative answer.

Firstly, the claim of right doctrine was meant to apply only where earnings and net profits[24] were involved. In the *North American* case the court was concerned with the net profits of a business. The only issue involved was the determination of the time when these net profits had reached the status of income to the business. Further, the wording of the claim of right doctrine is in terms of earnings — if a taxpayer receives *earnings* under a claim of right. Coupling this with the fact that the court was dealing with net profits and that in citing the doctrine they referred to the case of *Board v. Commissioner of Internal*

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[23] See South Dade Farms, Inc. v. Commissioner of Internal Revenue, 138 F. 2d 818 (5th Cir., 1943); National Airlines, Inc., 9 T. C. 159 (1947); Your Health Club, Inc., 4 T. C. 385 (1944); Automobile Club of Michigan, 20 T. C. 1033 (1953).

[24] Earnings and profits are used here in the accounting sense, that is, arising when all the services connected with the sum of money have already been rendered. Under this view a prepayment is not earnings or profits.

Revenue[25] where the amounts in issue were net profits, this contention becomes very strong.

The other claim of right cases follow this pattern. The decisions of the various circuits[26] prior to the *Brown* case applied the doctrine only to receipts for which nothing further remained to be done by the taxpayer, and when citing the doctrine always used the terms profits, income, or earnings, and not receipts. The later Supreme court cases are of similar import. *Brown v. Helvering* has already been discussed. The others[27] all involved the question of whether the receipt has reached a sufficient degree of ownership so as to be considered income and all the receipts involved were already earnings or net profits.

Then too, there is a considerable distinction between the issue involved in the claim of right cases and the issue involved in the prepaid income cases. In the claim of right cases the question was whether the disability connected with the receipt, such as the possibility of its having to be returned, was enough to prevent the receipt from being considered income. In other words, was the taxpayer's ownership of the receipt substantial enough to have it considered income to him. In the prepaid income cases, there is no dispute as to the taxpayer's ownership of the receipt and the only question is whether the inclusion in income can be deferred. If there is no dispute as to the fact that the receipt is income, then there is no reason to apply the claim of right doctrine, for it does not answer the question of whether the receipt can be deferred.

Thirdly, is it correct to say in a prepaid income situation that the taxpayer has received a payment without any restriction as to its disposition? For a company just starting business this is certainly not correct. The funds received will be needed to cover the expenses incurred in performing its obligation, so it can not use the funds as it pleases. The well established firms may also be under a restriction as to the use of these receipts. The firm must keep a fixed amount of funds available in order to be able to perform and thus may have to set aside some of these receipts to meet this requirement. Further, in the prepaid income situation there is a stronger restriction attached to

[25] 51 F. 2d 73 (6th Cir., 1931).

[26] See Commissioner of Internal Revenue v. R. J. Darnell, Inc., 60 F. 2d 82 (6th Cir., 1932); Commissioner of Internal Revenue v. Brooklyn Union Gas Co., 62 F. 2d 505 (2d Cir., 1933); Blum v. Helvering, 74 F. 2d 482 (C. A. D. C., 1934).

[27] United States v. Lewis, 340 U. S. 590 (1951); Healy v. Commissioner, 345 U. S. 278 (1953).

the receipt, for the taxpayer becomes subject to a fixed and certain liability immediately on receipt, while in the other claim of right cases the liability was at best contingent.

Therefore, it would seem that the claim of right doctrine would not be a correct basis for these decisions. If we accept this proposition and the fact that the *Brown* case is an inadequate authority, it becomes apparent that the whole line of prepaid income cases is incorrectly decided and entitled to little weight. Here, as in the pre-1934 period, the courts used a clearly erroneous basis to preclude deferrals but it can no longer be said that from a practical standpoint, there is any lack of clarity as to how prepaid income may be treated, tax-wise.

III. ANALYSIS OF COURT AND TREASURY TREATMENT

Thus far the analysis has been limited to a discussion of the reasoning advanced by the courts as the basis for their decisions. The discussion in this section will carry the analysis beyond that point and will consider the ramification of these decisions and further criticisms.

The refusal of the Treasury Department to adopt the accounting approach produces many unfair and distorted results. Perhaps the most blatant arises when the tax treatment of prepaid income is combined with tax treatment of prepaid expenses. The case of *Renwick v. United States*[28] is a particularly good illustration. Although the taxpayer here was on the cash basis, the same result would have been reached for an accrual basis taxpayer. The taxpayer had received an advance payment on a ninety-nine year lease, and in the same year had paid a commission to the broker for securing the lease. The court in accordance with standard tax practice held that the commission could not be deducted in the year paid, but had to be spread equally over the entire term of the lease, and at the same time held that the advance rental had to be included in income that year, despite the admitted unfairness and distortion which this produced.

Even though there may not be a combination of prepaid income and prepaid expense in one transaction as above, the different tax treatment of these two items seems clearly inconsistent. The reason advanced for requiring the spread of prepaid expenses is that to allow the taxpayer to deduct the full amount in one year may result in the distortion of

[28] 87 F. 2d 123 (7th Cir., 1936).

his income and cause a payment of either more or less taxes than proper.[29] Prepaid income is just the other side of the coin, and this sort of reasoning seems just as applicable to it. An inclusion of the full amount of the receipt in one year can bring about the same distorted result. Then too, this difference in treatment violates any consistency in the tax structure. At present the party making the payment must prorate the amount over the period covered while the party receiving the payment must include the full amount in income in the year received. A more balanced rule is to have the parties on both sides of the transaction receive the same treatment.

Another indication of the unfairness of the present tax treatment arises from a consideration of the undue tax burden imposed thereby. Since the taxpayer must report the income in the year of receipt without being able to claim the benefit of related deductible expenses, if in the later years the revenues are small, as may very likely be the case since he has already received a large part of the money due him, he will not be able to get full tax advantage of these related deductions. Also, by bunching the receipts in one taxable year, the taxpayer may be pushed into a higher tax bracket and thereby be required to pay an aggregate tax that is greater than if he had reported the income as it was earned. However, even though there is no increase in the aggregate taxes, by imposing the tax on advance receipts, the taxpayer is deprived during the intervening period of the amount of taxes attributable to the related deductible expenses. It has been suggested that this latter result has been partially responsible for the failure of certain businesses.[30]

Analysis of the post-1934 decisions indicates that the courts have ignored the "unless" clause of section 451(a)[31] which provides that an item of gross income can be ac-

[29] Security Mills Co. v. Comm'r., 321 U. S. 281, 285 (1944).

[30] Prepaid Income and Reserves for Estimated Expenses, Hearings Before Committee on Ways and Means of the House, 84th Cong., 1st Sess. 140 (1955); This was the statement of Frank J. Moch on the television and electronic service companies. To illustrate the effect of the present law he referred to the year 1950 when the service business was good, and the companies therefore assumed larger contract obligations on a prepaid basis. This large income placed the companies in a higher tax bracket and they paid taxes on the full amount received. Thus when 1951 turned out to be a poor year, these companies found themselves saddled with large contract obligations and no funds. The Government had taken its share in advance which deprived them of some funds, and being firms of limited capital, they had no reserves on which to draw. Thus, they found themselves unable to perform and were forced out of business.

[31] Int. Rev. Code of 1954.

counted for in a period other than the year of receipt. Although by its terms this clause covers the prepaid income situation perfectly, the courts have not taken it directly into consideration in determining the appropriate tax treatment. The allowance of a deferral under this clause would not seem to violate the overall requirement of clearly reflecting income,[32] and thus make the clause inapplicable, but rather, in view of the fact that approved standard methods of accounting are ordinarily regarded as clearly reflecting income, and the deferral of prepaid income is such an approved method, and the fact that only by deferring the receipt can a matching of revenues and expenses be brought about, it would seem that any other treatment would distort income. The courts in deciding the prepaid income cases have not really examined this point as an independent proposition. The decisions that a deferral did not clearly reflect income, have been based solely on the previous conclusion that a prepayment is required to be included in income in the year of receipt.[33] That is, once they had decided that a prepayment is required to be reported in the year of receipt, it followed that no other method of reporting would clearly reflect income. Thus, if it were decided that the "unless" clause did sanction the deferral of prepaid income the issue of whether this method of reporting clearly reflected income would be an open question.

Looking at the problem another way, the judicial requirement of inclusion in income in the year of receipt puts the taxpayer on a cash basis as to this item and thereby creates a hybrid system of accounting. Prior to the 1954 Code, the statutes did not sanction the use of hybrid systems,[34] so it can be argued that the courts have been flouting statutory language, as well as the professionally desirable element of consistency. Once the taxpayer has adopted a method of accounting, he is required to be consistent in his use of the method. As long as the taxpayer is held to this standard, it would be appropriate for the courts to require the commissioner to be consistent in his treatment of the method used.

Finally there are several policy considerations that should be pointed out. There appears to have been but one exception to the Internal Revenue Service's policy of re-

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[32] *Ibid*, §446.

[33] See South Tacoma Motor Co., 3 T. C. 411 (1944); Automobile Club of Michigan, 20 T. C. 1033 (1953).

[34] Security Mills Co. v. Comm'r., *supra*. n. 29. 285.

quiring the whole payment to be included in the year of receipt. This is IT 3369[35] which permits publishing concerns to prorate their subscriptions for each year over the period of the subscription. Limiting this favorable treatment to just one type of business concern is highly discriminatory. There are many other types of concerns having the same sort of income problems, and the Internal Revenue Service has not offered any justification for the limited scope of this exception.

The administration of the income tax program depends largely, if not entirely, on accounting practices, and in fact it may be said that without accounting a workable administration would be impossible. Further, business practices and policies are guided and determined to a large extent by accounting practices, and when the tax rules follow these practices they are understood and accepted. A divergence causes considerable difficulty and necessitates such things as double sets of books and elaborate reconciliations. It is recognized, however, that in certain areas there must be a divergence for policy or administrative reasons; but as will be brought out in the following section, there appears to be no adequate justification in the prepaid income area.

IV. Justification Of The Court And Treasury Treatment

Several reasons have been advanced as justification for the present tax handling of prepaid income, but none appears adequate.

The first of these may be labelled as the concern for the security of the revenue. By levying the tax as soon as the taxpayer has the funds, the Government has no need to worry about insolvency or bankruptcy preventing tax collection as it may if the inclusion in income is deferred to later years. Although this by itself is a justifiable motive, the problems of collection and enforcement should be matters entirely distinct from the issue of what is income. Further, the application of such a policy to all taxpayers seems unrealistic in that, as a practical matter, the larger portion of prepayments is received by the more reliable business concerns, organizations beyond the worry of insolvency. Even if a bankruptcy occurs, the Government is a priority creditor.[36] If the Commissioner in a particular case feels that the taxpayer may be unable to pay his taxes,

[35] 1940 Cum. Bull. 46.

[36] The Bankruptcy Act §64, 30 Stat. 563 (1898), 11 U. S. C. A. §104 (1953).

bonds and jeopardy assessments provide means for protecting the revenue. Aside from such irregularities, taxation is a continuing process which will eventually catch all income.

Another reason advanced in support of the Treasury position is that, by allowing the deferral of prepaid income, tax liability would depend on a matter of judgment which might be influenced by the amount of taxes to be paid. There would be considerable merit to this contention, were it not for the fact that the accounting theory and practices concerning prepaid income are so well developed. To a certain extent the allocation is based on estimates or judgment, but the practice is so uniform and consistent that the differences in result would be of little consequence. Then, too, once the judgment has been exercised, the taxpayer would be bound to follow it, so that over a period of years everything would balance out. A large income in one year would be offset by a smaller income in a later year. Further, all that has happened as a result of this unsatisfactory treatment is to have the taxpayer exercise his judgment at a different point of time. The taxpayer will control the timing of the receipts or set up various kinds of arrangements and will accomplish the same result as if the Treasury had allowed the deferral in the first place. A resort to such devices compels the transactions to be set up in a manner which is highly undesirable and inconvenient from an economic viewpoint.

A third basis for the Treasury's position is that it simplifies the administrative process. No one will dispute this; but carrying it to its natural conclusion it becomes hard to justify the adoption of the accrual method as an acceptable basis, for the cash method is certainly the best from the viewpoint of ease of administration. Further, this type of contention should not really be determinative. In fact we have seen that the Treasury itself requires the deferral of items, such as prepaid expenses, illustrating that the primary concern is not administrative ease, when a clear reflection of income is involved. In addition to this, various sections of the 1954 Code such as 1301, 1302, 1303, 1341 and 1342, evidence that there is much less concern today over the individuality of each tax period.

It must be conceded that each of the above contentions has some merit; but in view of the inequities of the present tax treatment, together they should not be considered strong enough to uphold the present treatment or to preclude a change.

V. Present Status And Expectations

Although reason demands a reversal of the present law by the courts, there is considerable doubt whether such a change will be effected by judicial decision. The case law is frozen and the courts will undoubtedly be reluctant to overrule all this precedent. A ray of hope appeared in *Beacon Publishing Co. v. Commissioner of Internal Rev.*,[37] which not only allowed the taxpayer to defer prepaid income, but also indicated that such a deferral is generally proper. However, the effect of the decision may be considerably weakened by the fact that section 452 of the 1954 Code was in effect at this time. Although that section did not cover the years involved in this decision, the court may have used the policy of the section as evidence of what has always been the Congressional intent as to prepaid income in deciding the case. In addition, two subsequent tax court cases[38] refused to accept the *Beacon* case as a change of tide precedent. In both of these cases the *Beason* case was referred to and not followed, on the basis that it was clearly contrary to settled law. There is one certain result of the *Beacon* case, though. It has produced a sound reason for Supreme Court review of the problem on certiorari, since there is now a conflict in the decisions of the circuit courts.

Congress in the 1954 Code attempted to correct the situation by the addition of Section 452 which with certain limitations permitted accrual basis taxpayers to defer prepaid income. However, at the insistence of the Secretary of the Treasury this section was retroactively repealed in June 1955.[39] There was considerable doubt whether the repeal of this section was justifiable,[40] but Congress nevertheless bowed to the Secretary's fears. But the issue is not dead. Congress has now definitely taken the position that the deferral of prepaid income should be allowed. Both the House and Senate Committees indicated in their reports that new legislation on this problem would be taken under consideration, and the House in fact adopted a resolution requesting further study on the problem with an eye to new legislation as soon as possible.[41]

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[37] 218 F. 2d 697 (10th Cir., 1955); certiorari not applied for.

[38] Curtis R. Andrews, 23 T. C. 1026 (1955); E. W. Schuessler, 24 T. C. 247 (1955).

[39] Pub. L. No. 74, 84th Cong., 1st Sess. §1(a), (b) (June, 1955).

[40] See Prepaid Income and Reserves for Estimated Expenses, Hearings Before Committee on Finance of the Senate, 84th Cong., 1st Sess. 37, 72, 77 (1955).

[41] H. R. Rep. No. 293 and S. Rep. No. 372, 84th Cong., 1st Sess. (1955).

It can be expected that when Congress adopts new legislation, it will follow fairly closely the wording and intent of section 452 of the 1954 Code. Allowing the Internal Revenue Service to amend the regulations so as to permit deferrals would not be satisfactory. Perhaps the most serious drawback is that such would give the taxpayer a free hand in an area with which the Service has had no experience and thereby create a considerable number of administrative problems. From the viewpoint of security of the revenue, this approach is certainly not acceptable. Taxpayers would be able to defer the reporting of income for a number of years and the Treasury would have to share the risk of insolvency or bankruptcy throughout the whole period. Although the courts would be able to fill in this flexibility somewhat, it would still be a considerable length of time before any definite practice became established.

As a result of these objections, the approach that most likely will be taken is the adoption of a specific section similar to section 452. This section probably would have adequately served the needs of both the Treasury and the taxpayer. The limitation to five years served as a protective device for the Treasury, as it cut down the period over which income could be deferred and thereby the possible loss of revenue. Also, the section established a definite method of handling so that too many administrative problems could not arise. For the taxpayer, the limitation to five years probably was not too serious as the majority of prepayments probably do not exceed five years. Further, if there was a transaction requiring different treatment, the taxpayer could always appeal to the Secretary for consent to a different handling.

It appears then that there is adequate basis for assuming that Congress will adopt a specific statutory section alleviating the problem as soon as possible. Although the taxpayer is today still faced with the same problem, the future may bring the relief long overdue.