Washington and Lee Law Review

Volume 24 | Issue 2 Article 7

9-1-1967

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Recommended Citation

Advance Payments and the Accrual Taxpayer, 24 Wash. & Lee L. Rev. 291 (1967), http://scholarlycommons.law.wlu.edu/wlulr/vol24/iss2/7

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ADVANCE PAYMENTS AND THE ACCRUAL TAXPAYER

General rules for the methods of accounting to be used in computing taxable income are provided under section 446 of the Internal Revenue Code of 1954. "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."[1] Both the accrual method and the cash basis method are specifically listed as acceptable, provided the method used clearly reflects income. The rules seem clear enough; but when an accrual basis taxpayer receives income before it is earned, that is, before it is accrued in the accounting sense, courts have been faced with the problem of whether it is immediately includable in taxable income or whether its taxability can be deferred. The problem has arisen mainly in the "services to be performed" cases.[2]

Recently, in *Hagen Advertising Displays, Inc.*,[3] the same problem arose in a different context. Hagen manufactures dealer-identification signs for national advertisers, who place blanket purchase orders of signs for later delivery to specific dealers as released by the purchaser. Hagen begins the manufacturing process when it receives orders, normally being in a position to start delivery of signs in about four weeks. A sign is not delivered until release orders are received from it customers specifying the dealer to whom a sign is to be shipped. At the end of a tax year Hagen has on hand signs in various stages of completion. Advance payments are received in two situations. One situation arises when a blanket order has been outstanding for an extended period of time, usually over twelve months, in which case Hagen may bill the customer to induce a release. The other arises when customers, on their own initiative, request a billing in advance of delivery. Hagen records such advance payments as a liability under accounts designated "advances from customers" but uses the funds without restriction.

Hagen keeps its books and reports its income on an accrual basis. It does not include in income such advances received from customers until actual delivery, at which time it recognizes the amounts as earned, crediting the sales account and making a corresponding adjustment in the "advances from customers" account.

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[1] INT. REV. CODE OF 1954, § 446.

[2] These cases involve reserves set up out of advance receipts which correspond to some service to be performed at a date beyond the taxable year.

[3] 47 T.C. No. 13 (Nov. 18, 1966).

Hagen determines its cost of goods sold by the use of inventories, following in this regard section 1.471-1 of the Income Tax Regulations, which provides:

> In order to reflect taxable income correctly, inventories at the beginning and end of each taxable year *are necessary* in every case in which the *production,* purchase, or sale of merchandise is an income-producing factor. The inventory should include all finished or partly finished goods.... 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.... A purchaser... should not include goods ordered for future delivery, transfer of title to which has not yet been effected.[4]

Pursuant to this regulation, Hagen included undelivered signs in closing inventory and so excluded from the year's cost of goods sold[5] costs incurred in the production of signs which had not yet been delivered but for which advance payments had been received.

The Commissioner rejected this treatment of advance payments and required inclusion of such advances as income in the year of actual receipt. No adjustment was made in the handling of inventories. The Tax Court, two judges dissenting, sustained the Commissioner's determination.

Under the accrual system of accounting items are includable in income when "earned," whether received before or after that time.[6] Expenses, or expired costs in the accounting sense, are recognized at the same time. Recognition of income as "earned" in the accounting sense usually comes upon the transfer of assets or upon the performance of a service. It is the consumation of the sale accompanied by a corresponding reduction in liability that is the key.[7] In the majority of instances involving a sale of goods accountants treat income as earned upon delivery of the goods. However, there is an exception: when goods are ordered to specification the manufacturer may *elect* to treat income as earned upon completion of the goods.[8] This election was available to Hagen but it chose to follow the more common procedure of treating income as earned upon delivery. It is important

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[4]TREAS. REG. § 1.471-1 (1966). (Emphasis added.)

[5]Cost of goods sold equals beginning inventory plus manufacturing costs, minus ending inventory.

[6]See generally AMORY & HARDEE, MATERIALS ON ACCOUNTING 89 (3d ed. 1959); KATZ, INTRODUCTION TO ACCOUNTING 43 (1954); SHUGARMAN, ACCOUNTING FOR LAWYERS 152 (1952).

[7]KATZ, INTRODUCTION TO ACCOUNTING § 38 (1954).

[8]See PATON, ADVANCED ACCOUNTING 453 (1941).

to note that Hagen followed this method consistently. "For most types of business, a satisfactory determination of periodic income involves the accounting techniques of accrual and deferment. Without the use of these techniques, the recognition of revenue and expense... would result in an 'income' amount of little significance."[9] The goal behind accrual and deferral techniques is a clear reflection of income.[10]

Over the past thirty years the Internal Revenue Service has sought to persuade the courts that the accountants' method of handling advance receipts of the accrual basis taxpayer should not be followed as a matter of federal income tax law. Yet, the language of the federal income tax statutes do not seem to require a method different from that used as a matter of sound accounting practice. As one commentator has said:

> 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.[11]

Section 446 of the Internal Revenue Code of 1954 specifically requires the use of the same accounting method for tax purposes as is used in keeping one's books as long as this method clearly reflects income. Nevertheless, the Commissioner seems to have consistently disallowed the deferral of advance receipts, unless some restriction is placed on the use of the money. The Tax Court has been consistently persuaded by the Commissioner's arguments.

While recognizing the accrual method as an acceptable one and while even going so far as to recognize deferral of prepaid income as a part of this method, the early cases disallowed deferral for other reasons.[12]

In 1932 the United State Supreme Court developed a "claim of right" doctrine in *North American Oil Consol. v. Burnet.*[13] The case

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[9]KATZ, INTRODUCTION TO ACCOUNTING § 37, at 43 (1954).

[10]See AMORY & HARDEE, MATERIALS ON ACCOUNTING 89 (3d ed. 1959).

[11]Rothaus, *A Critical Analysis of the Tax Treatment of Prepaid Income*, 17 MD. L. REV. 121 (1957). The Revenue Act of 1913 was based wholly on the cash receipts method of accounting, while the later act of 1916 provided for use of the accrual method. The Revenue Act of 1918 continued to recognize the accrual method but made it mandatory to compute income on the basis on which books were kept. Rothaus, *supra* at 122.

[12]*E.g.*, Jennings & Co. v. Commissioner, 59 F.2d 32 (9th Cir. 1932); United States v. Boston & P.R.R., 37 F.2d. 670 (1st Cir. 1930); Creasey Corp. v. Helburn, 57 F.2d 204 (W.D. Ky., 1932); Bradstreet Co., 23 B.T.A. 1093 (1931); Automobile Underwriters, Inc., 19 B.T.A. 1160 (1930); O'Day Inv. Co., 13 B.T.A. 1230 (1928).

[13]286 U.S. 417 (1932).

involved an item which was admittedly net income but the right to which was being contested. The Court said that the amount was income and that its taxability as such could not hinge on the outcome of the pending suit. It was sufficient that the amount was held under a "claim of right." The case had nothing to do with deferral of advance receipts[14] but the Tax Court soon extended the doctrine to include this problem.

Beginning with *Beacon Publishing Co.*[15] "the Commissioner dredged up the 'claim of right' doctrine, persuaded the Tax Court to apply it to a situation for which it was not designed... and from then on nearly all the Tax Court decisions relied on 'claim of right.' "[16]

The petitioner in *Hagen*, therefore, faced a long line of Tax Court decisions against deferral of advance receipts in the "services to be performed" cases.[17]

Unfortunately, for purposes of analysis, the transactions in *Hagen* giving rise to the tax problem involved a spectrum of transactions rather than a single, well-defined type. Advance payments were received both as the result of Hagen's billings and of the customers' initiative for their own convenience. Furthermore, the signs involved were in all stages of completion.

Viewed as a case involving advance payments for signs only partially constructed so that substantial costs were yet to be incurred, a strong case for deferral of income reporting can be made. Viewed *solely* as a case involving advance payments for completed signs, for which all costs, except those involved in making delivery, have been incurred, the case for deferral is weaker.

When the transactions are interpreted as presenting the strongest case for deferral, the situation presented is essentially the same as in the "services to be performed" cases, there being substantial costs yet to be incurred. As so viewed, the Commissioner's argument basically turns out to be the "claim of right" doctrine. The majority said:

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[14]Brown v. Helvering, 291 U.S. 193 (1934), is consistently cited as the case in which the claim of right doctrine was applied to deferral of advanced receipts. However, the case contained two issues and the doctrine was not applied to the advance receipts issue.

[15]21 T.C. 610 (1954), *rev'd*, 218 F.2d 697 (10th Cir. 1955).

[16]Costigan, *Accrual Accounting in the Court of Appeals*, 38 TAXES 339, 342 (1960).

[17]Must taxpayers score a grand slam before the Commissioner and the Tax Court give up? "[T]he courts of appeals for seven different circuits, (Second Circuit, Third Circuit, Fourth Circuit, Fifth Circuit, Sixth Circuit, Ninth Circuit, and Tenth Circuit) have reversed the Tax Court in this area." Costigan, *supra* at 339, 342.

> The advance payments received by petitioner from its customers were without restriction as to use or disposition and were in fact used by petitioner in its normal business operations.... Insofar as this record shows, under no circumstances would petitioner be required to return any portion of the advance payments....[18]

In support of its holding on this point, the Tax Court cited *Automobile Club of New York, Inc.*[19] In that case the Tax Court also relied on "the claim of right" doctrine without so labeling it.[20] It is significant to note the similarity in the words used.

> [W]here there is actual receipt and the funds are at the unrestricted disposal of the taxpayer, as is the case here, all the events have already occurred which call for accrual.[21]

This argument would seem to hold little weight in light of the fact that in two recent deferral cases decided by the Supreme Court *Schlude v. Commissioner*[22] and *AAA v. United States*,[23] the Court finally rejected the claim of right approach as inapplicable. *AAA* involved a service organization which deferred membership dues to related periods of service based on their overall cost experience. The Court said "as four circuits have correctly held, the claim of right doctrine furnishes no support for the Government's position."[24] The Government shifted its argument to the position that incomes and expenses could not be deferred so as to reflect the long-term result of a particular transaction. The Court also found this argument inapplicable. *Schlude* involved a dance studio which deferred payments for dance lessons until the period in which the lessons were actually taught. The dissent said:

> Apparently the Court agrees that neither the annual accounting requirement nor the claim-of-right doctrine has any relevance or applicability to the question involved in this case. For the Court does not base its decision on either theory, but rather, as in two previous cases, upon the ground that the system of accrual accounting used by these particular taxpayers does not 'clearly reflect income'....[25]

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[18] 47 T.C. No. 13, at 103.
[19] 32 T.C. 906 (1959).
[20] The dissent suggests that the decision is "an application of the so-called 'claim of right' doctrine to the accrual method of accounting–although it was not here, as it was in several of the cited cases, so *labeled.*" Automobile Club of New York, Inc., 32 T.C. 906, 919 (1959).
[21] Automobile Club of New York, Inc., 32 T.C. 906, 913 (1959).
[22] 372 U.S. 128 (1963).
[23] 367 U.S. 687 (1961).
[24] *Id.* at 700.
[25] 372 U.S. 128, 139 (1963) (Footnotes omitted.)

The decisions in these cases indicate that the Court does not want to place a *final* stamp of validity or invalidity on the deferral of prepaid income. Instead it disallowed deferral based on artificiality in the method of correlating advance payments and future costs.[26]

Both *Schlude* and *AAA* relied on *Automobile Club of Michigan, Inc.*[27] in holding that the taxpayer's method of deferral was artificial and did not clearly reflect income. In disallowing deferral on this basis, the Court in *Automobile Club of Michigan, Inc.* indicated that a more specific determination would be acceptable. Such determinations have been held acceptable in a number of cases.

Beacon Publishing Co. v. Commissioner,[28] decided by the Tenth Circuit the year before *Automobile Club of Michigan, Inc.* held that in the case of prepaid newspaper subscriptions such a realistic deferral was acceptable. Congress has since given statutory recognition to these deferrals in section 455 of the Internal Revenue Code of 1954. Cases since *Beacon* have allowed realistic deferrals in other types of "services to be performed" cases. *Schuessler v. Commissioner*[29] involved a reserve set up by a furnace dealer to offset the cost of future maintenance service which he was required to perform under contracts of sale. The reserve was allowed, on the principles of *Beacon*, as clearly reflecting income. In *Bressner Radio, Inc. v. Commissioner*[30] the taxpayer was in the business of selling radios. To induce sales Bressner entered into twelve-month repair contracts with each sale. A portion of the amount received from each sale was set aside to cover possible future obligations under the contracts. In reporting income, it did not include such amounts as earned when received but rather pro-rated the same over the life of the contract, resulting in the amounts being included in income in subsequent years. The Second Circuit sustained the taxpayer's treatment. *Automobile Club of Michigan, Inc.* which it distinguished, the court said:

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[26]The court also based its decision on the fact that Congress repealed sections 452 and 462 of the Internal Revenue Code of 1954 which gave statutory sanction to such deferrals. This argument seems invalid in light of the fact that "the Secretary of the Treasury, who proposed the repeal of these sections made explicitly clear that no inference of disapproval of accrual accounting principles was to be drawn from the repeal of the sections. So did the Senate Report. The repeal of these sections was occasioned soley by the fear of temporary revenue losses which would result from the taking of 'double deductions' during the year of transition by taxpayers who had not previously maintained their books on an accrual basis." 372 U.S. 128, 140 (1963) (Footnotes omitted.)

[27]353 U.S. 180 (1956).

[28]218 F.2d 697 (10th Cir. 1955).

[29]230 F.2d 722 (5th Cir. 1956).

[30]267 F.2d 520 (2d Cir. 1959).

> It is apparent from the decision of the majority that at least for purposes of the decision of the case it assumed that realistic deferral would have been permissible, and found only that no realistic deferral was made.[31]

In *Beacon, Schuessler* and *Automobile Club of Michigan,* the amount of prepaid income deferred was held realistic if it "bore a carefully estimated relationship to the services petitioner would be called upon to render."[32] The estimates were based on past cost experience in providing such a service. In other words deferral was allowed if it bore a realistic relationship to estimated future expenses and, thus, clearly reflected income.

However, these cases involved the performance of services and not the manufacture of goods, and so the accounting technique used was different from that used by Hagen. *Hagen* involves the use of inventories.

The majority in *Hagen* recognized that section 1.471-1 of the Income Tax Regulation provides for the use of inventories wherever production of merchandise is an income-producing factor. It also recognized that only items to which title is vested in the taxpayer should be included in inventory.[33] The majority further pointed out that it was not in issue whether Hagen *could* have done something to the signs so that title would have passed to the customers. "Petitioner, as the facts show, did not do this."[34]

On the other hand, the dissent said:

> While it might be argued that this problem could be overcome by excluding from year-end inventories (and *in*cluding in cost of goods sold) the costs allocable to goods on hand (finished or in process) for which advance payment has been received, such adjustments would be contrary to sec. 1.471-1, Income Tax Regs, would force manufacturers to adopt burdensome and costly job-cost accounting systems, and would produce such a breakdown of fundamental principles of cost of goods sold accounting as would virtually nullify the integrity of any accounting system....[35]

The dissent approaches the problem from the "cost end." Since

[31] *Id.* at 526.

[32] *Id.* at 529.

[33] "Section 471 of the Code and section 1.471-1 of the Commissioner's regulations deal with what items are generally included in inventory. These regulations provide for inclusion in inventory only of items to which title is vested in the taxpayer...." 47 T.C. No. 13, at 104.

[34] 47 T.C. No. 13, at 104. If Hagen did not so set apart the signs to have title pass, title necessarily must remain in him.

[35] 47 T.C. No. 13, at 111 n.4.

Hagen's method of handling inventories, which deferred recognition of expenses, is in accord with the Treasury Regulation, the taxpayer should likewise be entitled to defer recognition of income to secure a matching of income and expenses in the same year. As to uncompleted signs, for which substantial costs are yet to be incurred, it would seem that *Hagen* presents a strong case for deferral in light of the *Beacon-Schuessler-Automobile Club of Michigan, Inc.* line of cases and the analysis of the dissent.

On the other hand, the majority approaches the problem from the "revenue end." Since Hagen has received payments for its unrestricted use, it could recognize income as earned at that time. Under the accrual system of accounting it would have to recognize expenses at the same time. Whether or not it could do so, according to the majority, was not an issue in the case so the question was left unresolved. In light of this approach the case for deferral, viewed only as to completed signs, appears weaker. The majority pointed out that under section 446 of the Internal Revenue Code of 1954 the Commissioner has the right to require a change in accounting method if he thinks income is not being clearly reflected. Requiring advance receipts to be treated as earned in the year of receipt would be an acceptable accounting procedure as to signs completed in that year. As shown earlier this would qualify as the exception to the accrual accounting procedure of treating income as earned on delivery.

The error in *Hagen,* apparently overlooked by the majority, is that requiring such a change in accounting method *only* as to completed signs results in an inconsistency in accounting methods which is clearly unsound.[36] Requiring Hagen to treat income as earned upon completion of a sign as to signs for which advances have been received, while allowing it to treat income as earned upon delivery of a sign as to signs for which advances have not been received is clearly inconsistent.

Consequently, in light of the wide range of transactions involved in *Hagen,* the case can serve as a springboard for arguing, as the judges of the Tax Court did, more than one position. The United States Supreme Court and the Courts of Appeal have repeatedly held that realistic deferrals of advance payments must be permitted under

[36]Consistency is one of the most fundamental principles of accounting. "Wherever two or more methods ... are permitted by custom or convention, the principle of consistency requires that one of these methods be adopted and used consistently." OEHLER, LAWYER'S ACCOUNTING HANDBOOK 41 (1952). See FINNEY & MILLER, PRINCIPLES OF ACCOUNTING 144 (6th ed. 1965).