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The Supreme Court, as early as 1926, in the *Anderson* case, 269 US 422, in describing the underlying basis for the accrual method of accounting, held that the accrual method enabled the taxpayer to make his tax return according to scientific accounting principles by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period.

This approach of matching income with expenses incurred or to be incurred to earn that income was not followed by the Court in its famous case of *North American Oil Consol.* v. *Burnet,* 286 US 417, which case established the "claim-of-right doctrine". Under this doctrine, the Court held that if a taxpayer "receives earnings under a claim of right and without restriction as to its disposition" he must report the earnings as taxable income in the year of receipt. In effect, the Court held that reporting of earnings could not be postponed beyond the point of realization.

Over the years there have been many cases dealing with the time for recognition of income in the prereceipt situation. In 1963, the Supreme Court considered the *Schlude* case, 372 US 128, which involved the status of receipts and contracts of a franchised Arthur Murray dance studio. The studio offered dancing lessons under either of two basic contracts.

Under the cash plan, a down payment in cash was required at the time the contract was executed with the balance due thereafter in installments. The other plan, the deferred payment contract, required that a portion of the down payment be paid in cash when the contract was executed, with the remainder of the down payment due in stated installments, and a negotiable note covering the balance of the contract price.

All of the contracts provided that the student should not be relieved of the obligation to pay the tuition; no refunds would be made; and the contract was irrevocable.

Cash payments received from students and amounts received when the student notes were discounted or were fully paid were deposited in the Studio's general bank account without segregation. When a contract was executed a "deferred income" account was credited for the total contract price. At the close of each fiscal period, the student record cards were analyzed, and the total number of taught hours was multiplied by the hourly rate designated in each contract. The resulting sum was deducted from the deferred income account and reported as earned income on the income tax return. If there had been no activity in a contract for over a year, an entry would be made cancelling the untaught portion of the contract, and recognizing gain to the extent that the deferred income exceeded the balance due on the contract. The balance of the deferred income account would be carried over to the next year.

The Commissioner included in gross income not only the advance payments received in cash but the full amounts of notes and contracts executed during those years. The Tax Court and the Eighth Circuit Court of Appeals upheld him.

The American Institute of Certified Public Accountants (in an amicus curiae brief) agreed that "the method of accrual accounting for advance receipts used by Schlude accurately and precisely matched revenues from services performed in each tax years with related costs of performance."

It was anticipated that the Supreme Court would clarify whether advance receipts must be reported as income by an accrual basis taxpayer in circumstances where both the fact and time of future offsetting expenses are definite. However, the anticipated clarification did not develop.

The Court apparently extended to the Commissioner the right to strike down all income deferred but it did state that should a situation be produced which accurately matches advance receipts with subsequent expenses, the deferral of income might be permitted. The Court apparently ignored the expert accounting treatment advanced by the Institute of Accountants and found that since at the end of any accounting period it was uncertain whether none, some or all of the remaining lessons would be rendered that the accrual method of accounting did not *clearly reflect income* as required under Section 446(b) of the Code.

As noted, the case concerned not only the receipt of a cash down payment but also the receipt of notes receivable and installment accounts receivable (not evidenced by a note) to become due in future periods. The taxpayer argued that even if the cash and negotiable notes were income when received that accounts receivable were not earned and could not be treated as income.

The majority of the Tax Court failed to recognize any significant difference between matured and executory accounts receivable and held that the taxpayer must include accounts receivable in income just the same as notes receivable.

The inequity of taxing unearned accounts receivable led the Government to concede that it was in error in including the accounts receivable in income.

Although the Supreme Court's opinion is not clear on the point, the Court would apparently draw a distinction between (1) receivables which are not due and for which services have not yet been rendered and, (2) receivables which are due even though services have not been rendered. In the latter situation, the Supreme Court appears to be saying that accrual is mandatory.

The case then would appear to recognize that there is a difference between the pre-receipt of a negotiable note and the similar pre-receipt of a non-negotiable note or account receivable. The former would be included in income, the latter not included.

The *Schlude* decision has other widespread significance due to the fact that the Court refused to accept the expert testimony of the American Institute of Certified Public Accountants on the question as to whether the taxpayer's method of accounting clearly reflected income under generally accepted accounting principles.

The Commissioner in his regulations under Section 446 is more liberal in holding that "a method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income."

The Seventh Circuit Court of Appeals in *Consolidated-Hammer Dry Plate & Film Co.,* 317 F 2d 829, refused to extend the rationale of the prepaid income result in services cases to situations dealing with goods. In the *Consolidated case,* the taxpayer, on the accrual basis, entered into a number of government contracts for construction of specified photographic equipment. The contracts authorized the government to make partial payment for work in progress prior to acceptance by the government. Upon partial payment, title vested in the government to all materials, inventories and work in process theretofore acquired or produced. The Tax Court, sustaining the Commissioner, held that the partial payments constituted income when received. The Court of Appeals, in reversing, held that the partial payments are accrued income only when the products are delivered and accepted. The provision for granting title to the government was held by the Court to be a mere security device employed by a creditor who makes advancements.

The Seventh Circuit Court of Appeals, in the *Roy C. Demmon* case, 321 F. 2d 203, considered the accrual of corporate income taxes. The Court held that in determining earnings and profits for dividend purposes that corporate income taxes accrue against corporate income regardless of whether the corporation is on a cash or accrual basis. Two other circuit courts, the Sixth and Eighth, have followed the same logic in excluding corporate taxes from earnings available for distribution as dividends.

On December 27, 1958 taxpayer (*Susie K. Ackerman,* 318 F. 2d

402) sold certain real etstate for $13,000, receiving a mortgage note for the full amont. No payments were received thereon until January 2, 1959. Taxpayer failed to report the sale and to elect the installment method in her 1958 return; but did so in her 1959 return. The Tenth Circuit affirmed the District Court's decision that taxpayer may not report the gain on the sale in 1959 on the installment basis.

Regulations Section 1.453-8(b) (1) require that a taxpayer who elects to report a sale on the installment basis *must* report *for the year of sale* the computation of gross profit on the sale. The Regulation became effective on December 17, 1958. Prior to that date the Tax Court had held that it was necessary to elect only in the year when gain was to be reported. *Nathan C. Spivey,* 40 TC 115.

The taxpayer (*Andrew A. Monaghan,* 40 TC 680) sold his retail liquor store, a sole proprietorship, for $150,000, receiving $43,500 and a $106,500 mortgage. Under a separate agreement, the purchaser paid $21,305 for the inventory.

The Commissioner argued that a sale of an entire business could not be fragmentized. The Court upheld the taxpayer noting that the sale of a going business operated as a proprietorship has long been considered as a sale of the separate business assets in determining capital gain and ordinary income. Moreover, the Court noted that Section 453(b) excludes inventory from the privilege of installment reporting.

The *American Can Co.* case, 317 F. 2d 604, and *Dorr-Oliver, Inc.,* 40 TC 50, held that a change from cash to accrual method for vacation pay constituted a change in accounting method requiring consent of Commissioner. These cases affirm the Commissioner's position adopted in his regulations prior to 1958 that the change in reporting of a material item constitutes a change in accounting method. This position has served to tie the Commissioner's hands in his effective use of Section 481. As you will recall, under Section 481 dealing with adjustments required by changes in accounting methods, the Commissioner is required to exclude adjustments relating back to December 31, 1953, if a change in accounting method is initiated by the Commissioner. Prior to 1958, Section 481 provided that the adjustments were required whether the change in accounting method were initiated by the taxpayer or by the Commissioner. The Commissioner was able to persuade Congress to change Section 481 to provide that the adjustments would be required only if the change were initiated by the Commissioner. Prior to obtaining the favorable change in Section 481, the Commissioner, to restrict changes made by taxpayer in handling various items of deductions and income, had strongly taken the position that a change in a material item constituted a change in accounting method. The Regulations under Section 446 adopted on December 24, 1957 took this position. Now the position renders less effective the Commissioner's rights under Section 481 to effect changes in reporting items of income and deductions.

The Tax Court in the *Harris W. Bradley* case, 39 TC 652, overruled its long standing decision in the *Otto Sorg Schairer* case, 9 TC 549. The *Schairer* case held that amounts received from the employer to reimburse an employee for loss on the sale of his home when the employee was transferred to another location was part of the sales proceeds upon the sale of the home. The Tax Court overruled its *Schairer* decision and held the loss reimbursement constituted compensation income to the employee. The Fourth Circuit Court of Appeals upheld the Bradley decision.

The *Mendel* case, 41 TC 44, finds the Tax Court in an unusually generous position of holding that taxpayer is entitled to deduct moving expenses in excess of amount for which reimbursement was received but not included in reportable income.

The taxpayer, a doctor, was transferred by the Veterans Administration from Newark, N. J. to McGuire Veterans Hospital in Richmond in the interest of the Government. The Tax Court felt that it "is an inherent assumption that reasonable amounts expended by a permanent employee in moving his family and personal effects in a transfer from one permanent post of duty to another are not personal expenses. If such amounts constituted personal expenses, amounts received in reimbursement therefore would be includible in the income of the taxpayer."

A District Court in Tennessee held that expenses incurred by a taxpayer in acquiring a construction permit and an initial television license could be amortized over the 3 year term of the license, *WDEF Broadcasting Company* v. *U. S.,* 215 F. Supp. 818. The Court said, "it ill behooves the Government to serve its regulatory ends by granting licenses of a definite, limited duration, reserving the power to grant or refuse renewal, and at the same time to contend for tax purposes that the specified definite duration of such licenses should be disregarded."

In an interesting case, the taxpayers were held not to realize taxable income upon receipt of additional common stock in satisfaction of accrued salaries when both before and after the receipt of the stock the individuals each owned 50% of the corporation's outstanding stock, *Fender Sales, Inc.,* 22 TCM 550. The Court followed *Eisner* v. *MaComber,* 252 US 189, and *DeLoss E. Daggitt* v. *Comm.,* 23 TC 31. In the *Daggitt* case the corporation took a deduction in 1947 and issued stock in 1948. The Court in that case held that stock distributed to two stockholders substantially in proportion to their stock holding purportedly in payment of salary was not taxable income.

In Motor Fuel Carriers, Inc., 322 F. 2d 576, the taxpayer failed to prove that accumulations of earnings were justified by plans to construct a truck terminal, where the facts showed that the plans were not definite when the earnings were accumulated, even though a terminal was subsequently constructed. The taxpayer did not show that it was entitled to a cash reserve sufficient to cover one year's operating expense, since it had no inventories, no doubtful receivables, and if business had declined its expenses would also have declined. The case was remanded, however, for consideration of the question of whether the taxpayer had proved that a part of the accumulation was reasonable, since failure to prove that the entire accumulation was reasonable does not require a finding that no part was reasonable.

The taxpaper cited the *Sterling Distributors* case, 313 F. 2d 803, but the Court noted that in the *Sterling* case there was an imperative need for a new warehouse for which funds were accumulated, and a fixed intention during the tax year involved to go forward with the construction of such a warehouse.

In *Duke Laboratories, Inc.,* 222 F. Supp. 400, the jury found that the corporation had accumulated earnings beyond the reasonable needs of the business but that there had been no purpose to avoid the imposition of tax on the stockholders.

The Court charged the jury that if it found accumulations unreasonable, then it must determine whether accumulations were made for the purpose of avoiding the surtax on plaintiff's stockholders. The Court noted that the mere fact that shareholders of a corporate taxpayer would have paid more taxes on their income if earnings and profits had been distributed, does not alone establish that the purpose of the unreasonable accumulation was to avoid the surtax.

To the contrary, a District Court in Tennessee instructed the jury that if earnings were unreasonably accumulated, a finding of a purpose to avoid taxes on the shareholders was mandatory. *Fischer Lime & Cement Co.,* 63-2 USTC ¶9664.

The Tax Court in *James R. Bair,* TCM 1963-223, found that residential properties sold by the taxpayer during 1955-1958 were used in his trade or business, and allowed full depreciation in year of sale.

The Commissioner contended that such properties failed to qualify for the depreciation deduction because their salvage or market values in the year of sale of each of them was in excess of their depreciated cost. The Court said that the properties did not constitute the "type of asset, where the experience of the taxpayers clearly indicated a utilization of the asset for a substantially shorter period than its full economic life." The Court noted that depreciation should be based upon the number of years the asset is expected to function properly in use. Based on the evidence in the case the useful life of all the properties except for two, was 33⅓ years. The other two properties had useful lives of 45 years.

In *S & A Company,* 218 F. Supp. 677, the taxpayer sold all of its operating assets used in its business of manufacturing and selling outboard motors. In its return the taxpayer deducted depreciation for the period up to the date of sale. The Commissioner disallowed the deduction.

The District Court held for the taxpayer. The government contended that the sale price received for the property conclusively determined its salvage value and since such sales price was in excess of the cost, less depreciation, at the beginning of the year, the depreciation was not allowable. The Court disagreed. The Court noted that the two factors involved in the computation of depreciation are the useful life and the salvage value of the property. These are estimated figures and are made at the time of acquisition of the various assets. The taxpayer expected to use the assets in its business for their full economic lives and thus the estimate of their useful lives was not subject to redetermination merely because the assets were sold. The Court further noted that salvage value once it is determined may not be redetermined without showing a need for redetermining the useful life. The sale merely reflected a probable interim appreciation or depreciation in the value of property due to many factors.

The taxpaper owned 37% of "Indiana's" outstanding stock; Campbell owned the remainder. *William A. Green,* 22 TCM 1241. Campbell, who was in poor health and responsible for Indiana's management, informed taxpayer that he wished to sell his stock and retire. Taxpayer negotiated with Campbell to purchase his stock. At that time taxpayer knew that Indiana's surplus was insufficient to enable it to purchase Campbell's stock outright.

Taxpayer and Campbell entered into an agreement which provided that taxpayer agreed to purchase Campbell's stock by part payment of cash and the balance by payments in ten annual installments. No promissory note was given. No personal obligation was imposed by the agreement.

Two months later, Indiana accepted assignment of the agreement and made the downpayment. The Commissioner contended that amounts paid by Indiana to Campbell constituted constructive dividends under Section 302(b) of the Code.

The Judge rejected Commissioner's contention. Taxpayer was acting on behalf of corporation and when a corporation obligates itself to purchase shares of stock, there is no constructive dividend to other stockholders.

After acquisitions made in 1946, taxpayer owned 99% of "Corporation's" shares. *Henry C. Goss,* 22 TCM 1219. Taxpayer borrowed money on his interest-bearing installment notes from a third party to make the acquisitions. Because taxpayer could not pay the first note, he transferred 60% of his shares to the third party in cancellation of all the notes. Thereafter the Corporation acquired all of the third party's stock. The Commissioner determined that the amount paid by the Corporation to the third party constituted a dividend to the taxpayer.

The Judge held that the Corporation was simply redeeming all of the stock of a shareholder and therefore the payment cannot be considered a dividend to anyone.

On somewhat similar facts, the Tax Court (affirmed by the Eighth Circuit) held opposite to this case in *Idol* v. *Comm.,* 38 TC 444.

In the first clear cut decision on the point, the Tax Court in *Aylsworth,* 22 TCM 1111, held that advances by controlled corporation to another controlled corporation were dividends to the stockholder. In substance, the transaction was held to be the same as if stockholder personally received a dividend and reinvested money in other controlled corporation.

In two recent decisions the Supreme Court defined the rules for determining whether expenses are incurred for the conservation of income-producing property, so as to be an allowable deduction. *U. S.* v. *Patrick,* 372 US 53, and *U. S.* v. *Gilmore,* 372 US 39. The Court said that the test is not whether the consequences of a claim affect income-producing property, but whether the claim originated in connection with the taxpayer's profit-seeking activity. In so doing the Court has for all practical purposes wiped out the possibility of deducting a portion of legal costs incurred in connection with divorce actions.