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A business that maintains its records according to an accrual method of accounting treats the right to receive income as income received, and the obligation to pay expenses as expenses paid, although the income may not, in fact, be received nor the expenses, in fact, be paid during the accounting year.[1] This method of accounting is distinguished from the cash method under which income and expenses are accounted for during the year the payment is received or made.[2] When the accrual method is used, an income tax problem arises as to the exact year in which prepaid income and estimated expenses[3] should be considered for income tax purposes. This Comment addresses itself to a discussion of this problem.

The Internal Revenue Code of 1954, in accordance with the previous statutes enacted periodically since 1916, indicates that income tax liability is properly computed upon the basis of the taxpayer's annual accounting period and in accordance with the method of accounting the taxpayer regularly uses, provided the method employed clearly reflects income.[4] The Code also provides that in arriving at the taxable income figure the taxpayer must report all gross income in the year in which it is received, "unless, under the method of accounting regularly used in computing taxable income, such amount is to be properly accounted for as of a different period."[5] From this gross income figure the taxpayer is permitted to deduct "all necessary expenses paid or incurred during the taxable year,"[6] including taxes "paid or accrued."[7] These deductions may be taken in the proper taxable year according to the method of accounting employed by the

1. Brown v. Helvering, 291 U.S. 193 (1934); FERST, BASIC ACCOUNTING FOR LAWYERS 15-16 (1950); KATZ, ACCOUNTING 43-46 (1954); PATON, ACCOUNTANTS' HANDBOOK 113-14 (3d ed. 1950); SHANNON, LEGAL ACCOUNTING 162 (1951).

2. FERST, BASIC ACCOUNTING FOR LAWYERS 15 (1950); KATZ, ACCOUNTING 46 (1954); PATON, ACCOUNTANTS' HANDBOOK 114-16 (3d ed. 1950); SHANNON, LEGAL ACCOUNTING 163 (1951).

3. For the purposes of this Comment, the term "prepaid income" means income which is attributable to an obligation to render services, or to furnish goods or other property beyond the close of the taxable year, and the term "estimated expense" means an expense which is attributable to the income of one year, but will not be completed until a subsequent year. See INT. REV. CODE OF 1954, §§ 452(e), 462(d), repealed by 69 STAT. 134 (1955).

4. INT. REV. CODE OF 1954, § 446.

5. *Id.* § 451.

6. *Id.* § 162.

7. *Id.* § 164.

taxpayer in computing taxable income.[8] These sections of the Internal Revenue Code of 1954 and the corresponding prior legislation clearly indicate that, in accordance with the taxpayer's method of accounting,[9] income and expenses may be considered in a year other than that of payment.[10]

When a taxpayer wishes to report income or deduct expenses in a year other than the one of payment, the clear reflection of income according to the method of accounting used determines the appropriate year.[11] The accounting experts are in agreement that the clear reflection of income rests upon two basic principles. First, income must be reported in the year of the earning process from which it arises; and, second, expenses must be deducted from the earning process to which they are attributable.[12] The writer has used these principles in evaluating the results of the judicial interpretations that have been placed upon the applicable legislation.

In examining the jurisprudence interpreting the relevant provisions of the Internal Revenue Code of 1954 and the corresponding provisions of previous statutes, no Supreme Court case could be found that dealt specifically with *prepaid income*. In view of this absence of a Supreme Court case directly in point, the lower courts could have given full effect to the existing legislation which would have afforded the flexibility necessary to permit the clear reflection of income. Unfortunately, however, the lower courts have chosen to rely upon decisions of the Supreme Court in which prepaid income was not a point in issue.[13] As a result the correct reflection of income according to the taxpayer's method of accounting has been ignored in favor of the so-called

8. *Id.* § 461.

9. U.S. Treas. Reg. 118, § 39.41-3: "It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited for his purposes."

10. INT. REV. CODE OF 1954, §§ 451, 461. But for cases in which the courts indicate that accepted accounting principles are foreign to the computation of income tax liability, see Security Flour Mills Co. v. Commissioner, 321 U.S. 281 (1944); Lucas v. American Code Co., 280 U.S. 445 (1930); Weiss v. Wiener, 279 U.S. 333 (1929); Capital Warehouse Co. v. Commissioner, 171 F.2d 395 (8th Cir. 1948); Vang v. Lewellyn, 35 F.2d 283 (3d Cir. 1929).

11. *Cf.* INT. REV. CODE OF 1954, §§ 451, 461.

12. FINNEY & OLDBERG, LAWYERS' GUIDE TO ACCOUNTING 79-81 (1955); KATZ, ACCOUNTING 43-46 (1954); PATON, ACCOUNTANTS HANDBOOK, 113, 114, 125 (3d ed. 1950); SHUGERMAN, ACCOUNTING FOR LAWYERS 152-55 (1952).

13. Hort v. Commissioner, 313 U.S. 28 (1941); North American Oil Consolidated v. Burnet, 286 U.S. 417 (1932); Continental Tie and Lumber Co. v. United States, 286 U.S. 290 (1932).

"claim of right" rule.[14] Under this rule any income received by the taxpayer for his free and unrestricted use, including the present right to such receipt,[15] is considered as taxable income in the year that it is received, regardless of what future obligations the taxpayer incurs by receiving the money or in what year these obligations are to be discharged.[16]

In applying the "claim of right" rule to cases involving prepaid income the lower courts rely largely upon the Supreme Court case of *North American Oil Consolidated v. Burnet*,[17] which held that money received into the possession of the taxpayer under a "claim of right" and without any restriction as to its use must be reported as income received, although there is litigation in process contesting the taxpayer's right to the money. The courts have overlooked the fact that in the *North American Oil* case the taxpayer by receiving the money did not obligate itself to perform any future acts; therefore, the money was not in the nature of prepaid income. The application of the "claim of right" rule to determine the year in which prepaid income should be reported requires the income to be considered as taxable income before it is ever earned because it is not reported in the year of the earning process from which it is derived.[18] The result is an unwarranted income tax burden upon a taxpayer who contracts his services or products for the future.

In an early case dealing with *unpaid expenses, United States v. Anderson*,[19] the Supreme Court held that a manufacturer should take deductions in 1916 for munitions taxes on munitions manufactured in that year, although no legal liability to pay actually existed at the expiration of the year. The Court reasoned: "In a technical legal sense it may be argued that a tax does not accrue until it is assessed and becomes due; but it is also true that in advance of the assessment of a tax, all the events may occur which fix the amount of a tax and determine

14. Clay Sewer Pipe Ass'n v. Commissioner, 139 F.2d 130 (3d Cir. 1943); South Dade Farms, Inc. v. Commissioner, 138 F.2d 818 (5th Cir. 1943); Renwich v. United States, 87 F.2d 123 (7th Cir. 1937); Wallace A. Moritz, 21 T.C. 622 (1954); Your Health Club, Inc., 4 T.C. 385 (1944); South Tacoma Motor Co., 3 T.C. 411 (1944). See also Pioneer Automobile Service Co., 36 B.T.A. 213 (1937); Automobile Underwriters Inc., 19 B.T.A. 1160 (1930).

15. Your Health Club, Inc., 4 T.C. 385 (1944).

16. See cases cited note 14 *supra*.

17. 286 U.S. 417 (1932).

18. See note 12 *supra*.

19. United States v. Anderson, 269 U.S. 422 (1926).

the liability of the taxpayer to pay it."[20] Permitting this deduction before the actual existence of a liability is easily understandable in this case since the act which was to create the liability, i.e., assessment, was only a formality and was relatively certain to occur. Also, the application of the "all events" test to this particular type of business expense permitted the 1916 munitions taxes to be deducted from the 1916 earning process and resulted in the clear reflection of income.[21]

While the Court in the *Anderson* case[22] applied the "all events" test as described above, it also noticed that where there exists an *actual liability* a deduction may be taken, although the exact amount of the liability is not known as of the expiration of the taxable year and although the amount is subject to change so long as it is susceptible of a reasonably accurate approximation. In making this observation the Court evidently had in mind such a situation as the one that existed in *Schuessler v. Commissioner*,[23] where the taxpayer had sold furnaces under an agreement whereby he obligated himself to turn them on and off for five years. In the *Schuessler* case[24] the court of appeals found that there was no doubt as to the substantial accuracy of the estimated cost of fulfilling the obligations and held the estimated expenses to be deductible in the year that the sale of the furnaces occurred. It should be noticed that this interpretation permits the desired correlation between income process and expense deductions necessary to the clear reflection of income.[25]

20. *Id.* at 441.

21. *Id.* at 440: "The Appellee's true income for the year 1916 could not have been determined without deducting from its gross income for the year the total cost and expenses attributable to the production of that income during the year." See also American National Co. v. United States, 274 U.S. 99 (1927); note 12 *supra*.

22. United States v. Anderson, 269 U.S. 422, 437 (1926). In this case Mr. Justice Stone quoted at length from T.D. 2433, 19 TREAS. DEC. INT. REV. 5-6 (1917), the pertinent part of which reads as follows: "[It] will be permissible for corporations which accrue on their books monthly or at other stated period amounts sufficient to meet fixed annual or other charges to deduct from their gross income the amounts so accrued, provided such accruals approximate as nearly as possible the actual liabilities for which the accruals are made. . . . In cases wherein, pursuant to the consistent practice of accounting . . . corporations set up and maintain reserves to meet liabilities, the amount of which and the date of payment or maturity of which is not definitely determined or determinable at the time the liability is incurred, it will be permissible . . . to deduct . . . the amount so credited . . ., provided [those amounts deducted] shall approximate as nearly as can be determined the actual amounts which experience has demonstrated would be necessary to discharge the liabilities incurred." And then added: "We think the statute was correctly interpreted by the Commissioner."

23. 230 F.2d 722 (5th Cir. 1956).

24. *Ibid.*

25. See note 12 *supra*.

The Tax Court and some circuit courts of appeals in construing the *Anderson* case[26] have failed to make the distinction between the situation that existed in that case and the situation in the *Schuessler* case.[27] As a result the "all events" test has usually been applied to *all* business expenses whether or not a liability existed at the expiration of the taxable year.[28] It has been held that a deduction for a business expense may not be taken unless "all events" fixing both the liability and its amount occur before the expiration of the taxable year.[29] Since it is impossible for all the events which fix the amount of a liability to perform services in a subsequent year to occur until the services are actually performed, such a liability as existed in the *Schuessler* case[30] would never be deductible in the year the liability is incurred.[31] The result has been that the taxpayer is required to compute his income tax liability from a distorted income figure because he is required to postpone deductions that were attributable to the income process of one year to a subsequent year.[32]

When the Internal Revenue Code of 1954 was enacted, it contained sections 452[33] and 462,[34] neither of which had any counterpart in any of the earlier legislation. The purpose of these two sections was to permit income tax liability to be computed in accordance with accepted accounting principles and to preclude future judicial interpretation which might hold otherwise.[35] Sec-

26. United States v. Anderson, 269 U.S. 422 (1926).
27. Schuessler v. Commissioner, 230 F.2d 722 (5th Cir. 1956).
28. See Fourth Avenue Amusement Co. v. Glenn, 201 F.2d 600 (6th Cir. 1953); Capital Warehouse Co. v. Commissioner, 171 F.2d 395 (8th Cir. 1948); Spencer, White & Prentis, Inc. v. Commissioner, 144 F.2d 45 (2d Cir. 1944); Vang v. Lewellyn, 35 F.2d 283 (1929); Pacific Grape Products Co., 17 T.C. 1097 (1952); Paul C. Harrold, 16 T.C. 134 (1951); W. J. Scholl Co., 30 B.T.A. 993 (1934); Atlas Mixed Mortar Co., 23 B.T.A. 245 (1931).
29. See cases cited note 28 *supra.*
30. Schuessler v. Commissioner, 230 F.2d 722 (5th Cir. 1956).
31. *Ibid.*
32. See note 12 *supra.*
33. INT. REV. CODE OF 1954, § 452, repealed by 69 STAT. 134 (1955).
34. *Id.* § 462, repealed by 69 STAT. 134 (1955).
35. S. Rep. No. 1622, 83d Cong., 2d Sess. 62 (1954); H.R. Rep. No. 1337, 83d Cong., 2d Sess. 48 (1954): "Present law provides that the net income of a taxpayer shall be computed in accordance with the method of accounting regularly employed by the taxpayer, if such method clearly reflects the income. Nevertheless, as a result of court decisions and rulings, there have developed many divergencies between the computation of income for tax purposes and income for business purposes as computed under generally accepted accounting principles. The areas of difference are confined almost entirely to questions of when certain types of revenue and expenses should be taken into account in arriving at net income. The changes . . . are designed to bring income-tax provisions of the law into harmony with generally accepted accounting principles."

tion 452[36] provided for the deferment of prepaid income, together with the details of when and for how long such deferments could be made. This section probably allowed nothing that should not have been allowable under the previous legislation. However, Section 462,[37] dealing with the deduction of estimated expenses, made a material change in the law. This section permitted deductions to be taken for *future liabilities* which are subject to a reasonably accurate approximation.[38] Under the prior statutes as interpreted by *United States v. Anderson,*[39] although present liabilites of amounts that are not determined but may be approximated could be deducted, *future liabilities* were not deductible unless "all events" had transpired which would fix the amount of the liability. Unfortunately, both sections were repealed retroactively in 1955.[40]

A casual interpretation of this repeal could result in the conclusion that Congress by so acting tacitly approved the judicial interpretations which had recently been placed upon the Internal Revenue Code of 1939. An examination of the legislative history reveals that no such approval existed. The repeal resulted from the belief that Section 462[41] was subject to a much broader interpretation than had been intended and from the fear that the government would sustain an excessive loss of tax revenue in the inceptive years of the statute because Section 462(e)[42] would allow a taxpayer to deduct, in addition to the estimated expenses properly attributable to current income, expenses attributable to income of prior years when deductions for estimated expenses had not been allowed.[43] Section 452[44] was repealed with Section 462[45] because the two sections were complementary to each other and because Section 452 was thought susceptible of use to accomplish purposes denied by the repeal of Section 462.[46] By attempting to correct what it thought to be erroneous interpretations of the Internal Revenue Code of 1939, Congress has clearly announced the proper interpretation to be placed on correspond-

36. INT. REV. CODE OF 1954, § 452, repealed by 69 STAT. 134 (1955).
37. *Id.* § 462, repealed by 69 STAT. 134 (1955).
38. S. Rep. No. 1622, 83d Cong., 2d Sess. 306 (1954); H.R. Rep. No. 1337, 83d Cong., 2d Sess. A 162 (1954).
39. United States v. Anderson, 269 U.S. 422 (1926).
40. See 69 STAT. 134 (1955).
41. INT. REV. CODE OF 1954, § 462, repealed by 69 STAT. 134 (1955).
42. *Ibid.*
43. S. Rep. No. 372, 84th Cong., 1st Sess. (1955).
44. INT. REV. CODE OF 1954, § 452, repealed by 69 STAT. 134 (1955).
45. *Id.* § 462, repealed by 69 STAT. 134 (1955).
46. S. Rep. No. 372, 84th Cong., Ist Sess. (1955).

ing sections of the Internal Revenue Code of 1954,[47] notwithstanding the subsequent repeal of Sections 452 and 462[48] for reasons other than a change of original purpose.[49]

Although the several circuits of the courts of appeals are not in agreement as to when prepaid income should be properly reported or when deductions may be properly taken for unpaid estimated expenses,[50] the more recent decisions have endeavored to reflect accurately income in accordance with accepted accounting principles. In a 1955 decision[51] in which the Court of Appeals for the Tenth Circuit was interpreting the Internal Revenue Code of 1939, the "claim of right" rule as used to determine the year in which prepaid income is reportable was repudiated, and the prepaid income was permitted to be deferred until actually earned.

In three recent cases[52] dealing with estimated expenses the "all events" test was not applied when there was a liability in existence at the expiration of the taxable year. In two of these cases[53] a deciding factor was the deduction of the expenses from the earning process to which they were attributable. While these decisions do not announce principles as broad as would have been allowable under Section 462,[54] they are consistent with the intent of Congress[55] and the conclusion reached in United States v. Anderson.[56]

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47. See note 35 *supra*.
48. INT. REV. CODE OF 1954, §§ 452, 462, repealed by 69 STAT. 134 (1955).
49. S. Rep. No. 372, 84th Cong., 1st Sess. (1955).
50. See Schuessler v. Commissioner, 230 F.2d 722 (5th Cir. 1956); Pacific Grape Products Co. v. Commissioner, 219 F.2d 862 (9th Cir. 1955); Beacon Publishing Co. v. Commissioner, 218 F.2d 697 (10th Cir. 1955); Patsch v. Commissioner, 208 F.2d 532 (3d Cir. 1953); Fourth Avenue Amusement Co. v. Glenn, 201 F.2d 600 (6th Cir. 1953); Harrold v. Commissioner, 192 F.2d 1002 (4th Cir. 1951); Capital Warehouse Co. v. Commissioner, 171 F.2d 395 (8th Cir. 1948); Spencer, White & Prentis, Inc. v. Commissioner, 144 F.2d 45 (2d Cir. 1944); South Dade Farms Inc. v. Commissioner, 138 F.2d 818 (5th Cir. 1943); Vang v. Lewellyn, 35 F.2d 283 (3d Cir. 1929).
51. Beacon Publishing Co. v. Commissioner, 218 F.2d 697 (10th Cir. 1955).
52. Schuessler v. Commissioner, 230 F.2d 722 (5th Cir. 1956); Pacific Grape Products Co. v. Commissioner, 219 F.2d 862 (9th Cir. 1955); Harrold v. Commissioner, 192 F.2d 1002 (4th Cir. 1951). See also Patsch v. Commissioner, 208 F.2d 532 (3d Cir. 1953).
53. Pacific Grape Products Co. v. Commissioner, 219 F.2d 862 (9th Cir. 1955); Harrold v. Commissioner, 192 F.2d 1002 (4th Cir. 1951): "This procedure does not violate the principle that income taxes must be calculated on an accrual basis, but, on the contrary, allocates to each year the proper income and expense, and prevents distortion of the taxpayer's financial condition in the tax year.
54. INT. REV. CODE OF 1954, § 462, repealed by 69 STAT. 134 (1955).
55. See note 35 *supra*.
56. 269 U.S. 422 (1926).

The writer submits that since the Revenue Act of 1916 the legislation has contemplated the computation of income tax liability according to acceptable accounting principles. Nevertheless, many judicial decisions have reached results which are at variance with these principles. These divergencies have been the results of attempts by the courts to adopt workable rules which will apply to all situations. These attempts have led to the adoption of the "claim of right" rule for prepaid income and the "all events" test for estimated expenses. Since these rules do not permit the flexibility required to reflect clearly income in accordance with accepted accounting principles, the results of their application have often been unsatisfactory.

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