Taxation - Accounting for Prepaid Income

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Repository Citation
W. Bernard Kramer, Taxation - Accounting for Prepaid Income, 18 La. L. Rev. (1957)
Available at: https://digitalcommons.law.lsu.edu/lalrev/vol18/iss1/45

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Under this provision of the proposed code a plaintiff is not restricted to the relief specifically prayed for; in this manner the same result would be achieved without imposing an unnecessary delay on the judicial recognition of plaintiff's substantive rights.

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TAXATION — ACCOUNTING FOR PREPAID INCOME

The Automobile Club of Michigan furnishes road and map services to its members in accordance with one-year membership contracts, the dues for which are paid in advance. When received, the dues are credited to a liability account entitled “Unearned Membership Dues,” and monthly thereafter one-twelfth of this amount is transferred to an income account designated “Membership Income.” The Commissioner rejected the taxpayer's method of accounting and held that all membership dues are taxable in the year received.\(^1\) The Tax Court sustained the Commissioner on the grounds that the dues must be reported in the year received in order to reflect income clearly.\(^2\) On appeal to the Court of Appeals for the Sixth Circuit, \textit{held}, affirmed because money received under a “claim of right” is taxable income in the year received.\(^3\) On certiorari to the Supreme Court, \textit{held}, affirmed. The taxpayer’s method of accounting failed to reflect income clearly. \textit{Automobile Club of Michigan v. Commissioner}, 1 L. Ed. 746 (U.S. 1957).

It is within the intendment of the income tax laws that each taxpayer should compute his tax liability in accordance with the method of accounting which he regularly employs.\(^4\) Section 42 of the Internal Revenue Code of 1939 expressly states that in

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1. Acting in 1945 the Commissioner revoked his 1934 and 1938 rulings which had exempted the taxpayer from federal income taxes and applied the revocation retroactively to the years 1943 and 1944.
2. Automobile Club of Michigan, 20 T.C. 1033, 1047 (1953) : “Since the entire amount of membership dues was income for the year in which received and since the petitioner’s method of accounting for income did not take cognizance of the full amount thereof in such year, it is apparent that the petitioner’s method of accounting did not clearly reflect its income.”
4. Int. Rev. Code of 1939, § 41; U.S. Treas. Reg. 118, § 39.41-43: “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 to his purposes.”
accordance with the method of accounting regularly employed gross income may be reported in a year other than the year of receipt, provided there is a clear reflection of income. This language has been thought to refer to a clear reflection of income in accordance with accepted accounting practices, and therefore to mean earned income. Generally, earned income is income received less the cost incurred as an incident of such receipt.

The Tax Court and some circuits of the court of appeals have adopted the "claim of right" rule to determine the year in which prepaid income is taxable. Under this rule all income received by the taxpayer for his free and unrestricted use, including the present right to receive payment, 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 will be performed. This rule was first enunciated in North American Oil Co. Consolidated v. Burnet. In that case the Supreme Court held that income received by the taxpayer under a "claim of right" and without any restriction as to its use is taxable in the year that the income is received, although there is litigation in progress contesting the taxpayer's right to the money.

The instant case marks the first time that the Supreme Court has rendered a decision determining the year in which prepaid income should be reported.

5. This section is now Int. Rev. Code of 1954, § 451: "The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period."

6. 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."

7. Clay Sewer Pipe Ass'n v. Commissioner, 139 F.2d 130 (3d Cir. 1943); South Dade Farms, Inc. v. Commissioner, 135 F.2d 518 (5th Cir. 1943); Renwick 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 (1954); 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). But see Beacon Publishing Co. v. Commissioner, 218 F.2d 697 (10th Cir. 1955), where the court expressly rejected the rule because its application presented a distorted taxable income figure.


9. See cases cited note 7 supra.

income is taxable. The majority opinion failed to pass upon the propriety of using the "claim of right" rule to determine the year in which prepaid income is taxable. In view of the disagreement among the several circuits of the courts of appeals concerning this matter, a definitive opinion would have been desirable.\(^\text{11}\) Justice Harlan in his dissent pointed out that the Supreme Court instituted the rule in *North American Oil Co. Consolidated v. Burnet*\(^\text{12}\) as a test to determine what income is taxable, not in what year it is taxable; therefore, any application of the rule for the latter purpose is a misapplication.

Having passed the question of the "claim of right" rule almost without comment, the majority seemed to concede *arguendo* that income may be reported in a year other than the one in which it is received, provided there is a clear reflection of income. But the Court found that "the pro rata allocation of the membership dues is purely artificial and bears no relation to the services which the petitioner may in fact be called upon to render for the membership." Consequently, there was no clear reflection of income which would warrant holding that the Commissioner had abused his discretion by requiring the income to be reported as taxable in the year it was received. While it is true that the taxpayer could not know what would be the actual cost of the services which it might be called upon to render, it is also true that it did know exactly how much it was being paid each month to render the services. The taxpayer was not attempting to estimate the cost of fulfilling its contractual obligations; it was attempting to defer its unearned income to the month in which it would be earned. This practice is clearly approved in Section 42 of the Internal Revenue Code of 1939, and is separate and distinct from the practice of deducting estimated expenses which is provided for in Section 43.\(^\text{13}\) The difference in the two practices is that the taxpayer who is deferring prepaid income is postponing the income to the year or month in which he will

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11. 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. 1955); Fourth Avenue Amusement Co. v. Glen, 201 F.2d 800 (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).


13. Int. Rev. Code of 1939, § 43; for a more complete discussion of the tax law pertaining to prepaid income and estimated expenses, see Comment, 17 Louisiana Law Review 628 (1957).
"earn" it. The taxpayer who is deducting estimated expenses is accelerating the estimated cost of fulfilling his contractual obligations to the year or month in which he receives payment under a particular contract. Viewed in this light, it would appear that the method of bookkeeping employed by the taxpayer clearly reflected its income within the meaning of the Internal Revenue Code of 1939, and that the Court's disapproval of the method employed is attributable to a failure to distinguish between the closely related, but absolutely different problems of accounting for accrued estimated and for prepaid income.

In the present case the Court directed the greater part of its efforts to an exposition of the law on the question of the Commissioner's retroactive application of his new ruling that the petitioner is not a tax exempt club under Section 101(9).\textsuperscript{14} The decision as it relates to prepaid income seems to have been decided incidentally to that question. Since no thorough examination of the law as it concerns prepaid income was made in the case, the question of what year prepaid income is taxable will remain unsettled until the Supreme Court considers the matter more thoroughly in a later decision.

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\textsuperscript{14} Int. Rev. Code of 1939, § 101(9).