

word "shall" in the cancellation provision of section 15(b) imposes no mandatory duty, but rather, allows discretionary policing action by the Commission.

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Taxation—Deferral of Prepaid Receipts by Accrual Basis Taxpayer.—*American Automobile Association v. United States.*¹—The taxpayer, a non-stock membership corporation, kept its books on an accrual basis and paid taxes on a calendar year basis. Its receipts consisted mainly of prepaid annual membership dues, payment of which entitled a member to the availability of certain automobile services. Under customary accounting procedure the taxpayer reported as gross income in the year of receipt only that portion of the total prepaid dues actually received which ratably corresponded with the number of membership months covered by the dues occurring within the same taxable calendar year. In auditing the taxpayer's returns for the years 1952 through 1954 the Commissioner of the Internal Revenue, in the exercise of his discretion under section 41 of the Internal Revenue Code of 1939,² rejected the taxpayer's system of accounting as not clearly reflecting income. The Commissioner adjusted the gross income for the years in question so as to recognize receipt of dues as income in the years actually received. Consequently, a net operating loss claim for 1954 and corresponding carry-back reductions were greatly reduced, and tax deficiencies were assessed for 1952 and 1953. In a suit to recover the deficiencies paid, the Court of Claims sustained the Commissioner³ in the face of detailed "expert testimony" to the effect that the taxpayer's treatment of prepaid receipts comported with sound commercial accounting practices. By reason of a conflict between the decision below and that in *Bressner Radio Inc. v. the Commissioner*,⁴ the United States Supreme Court granted certiorari. HELD (5-4): The Commissioner was not wrong in requiring the prepaid annual membership dues received by such a club to be included as income in the calendar year of its actual receipt.

The Court concluded that even assuming petitioner's treatment of prepaid dues to be in accord with sound accounting practice, the case of *Automobile Club of Michigan v. Commissioner*⁵ is still persuasive authority for

¹ 367 U.S. 687 (1961).

² A taxpayer's "net income shall be computed . . . in accordance with the method of accounting regularly employed in keeping the books . . . but . . . if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income . . ." Int. Rev. Code of 1939, ch. 1, § 41, 53 Stat. 24, 26 U.S.C. § 41 (1952). See similar provision in Int. Rev. Code of 1954, § 446.

³ 181 F. Supp. 255 (Ct. Cl. 1960).

⁴ 267 F.2d 520 (2d Cir. 1959). In this case the taxpayer, a retail television dealer, long employing the accrual method of accounting, was permitted to defer inclusion of income of prepaid revenue on twelve month television servicing contracts over a twelve month period subsequent to date of receipt, since the method employed was not shown to misrepresent income.

⁵ 353 U.S. 180 (1957).

the Commissioner's position. It was there decided that, for income tax purposes, an accounting practice substantially identical to that of petitioner was purely artificial in that the services extended were not related to fixed dates after the taxable year, but were performed only upon a member's demand. Aside from the *Michigan* decision, the majority also found that the enactment and subsequent repeal by Congress of the only law incontestably permitting the practice upon which the Association depends⁶ constitutes a legislative mandate that deferral of such income was not acceptable for tax purposes.

The rationale, if not the decision, is surprising. The *Michigan* case was as noteworthy for its dearth of expert testimony favoring the taxpayer's accounting system⁷ as is the instant case for its abundance thereof.⁸ Most comments on the *Michigan* case evinced a belief that the Court would approve a realistic deferral of prepaid income if taxpayer's income clearly were reflected.⁹ Furthermore, the argument from Congressional intent seems to overlook the fact that Congress repealed sections 452 and 462 out of concern for diminished revenue in the year of transition. For all taxpayers changing to the accrual method under section 452 there would be a "double deduction" during the first year in which receipts are deferred, since they would also be entitled to deductions for present expenses. The instant case, of course, involves no question of "double deduction."

A petition for re-hearing was filed,¹⁰ the decision on which has become moot due to an enactment of Congress adding section 456 to the Internal Revenue Code of 1954.¹¹ This section permits "certain membership organizations"¹² on the accrual basis to elect (in a manner to be prescribed by regulations) to include prepaid dues income in gross income for the taxable

⁶ Int. Rev. Code of 1954 § 452 provided that an accrual basis taxpayer might defer "prepaid income" to a taxable period in which it is earned. Under this section, a taxpayer could shift to the accrual method without the customary consent of the Commissioner. Int. Rev. Code of 1954, ch. 143, § 1(a), 69 Stat. 134. Int. Rev. Code of 1954 § 462 provided that an accrual basis taxpayer might deduct a reasonable addition to a reserve account for estimated expenses. Estimated expense is defined as "a deduction . . . part or all of which would (but for this Section) be required to be taken into account for a subsequent tax year. . . ." Int. Rev. Code of 1954, ch. 143, § 1(b), 69 Stat. 134.

⁷ Brief for Petitioner, p. 39, *Automobile Club of Michigan v. Commissioner*, supra note 4.

⁸ Record, pp. 18, 19, 26, 66, *American Automobile Association v. United States*, supra note 1.

⁹ See Behren, *Prepaid Income Accounting Concepts and the Tax Law*, 15 Tax L. Rev. 344, 359 (1960); Note, 67 Yale L.J. 1425, 1440 (1958); Note, 59 Colum. L. Rev. 942, 944 (1959); Note, 1960 Duke L.J. 127, 131-134.

¹⁰ Letter from Fleming Bomar, Esq., Counsel for Petitioner, to the B.C. Ind. & Comm. L. Rev., July 15, 1961.

¹¹ 75 Stat. 222 (1961).

¹² "(3) Membership organization.—The term 'membership organization' means a corporation, association, federation, or other organization—

"(A) organized without capital stock of any kind, and

"(B) no part of the net earnings of which is distributable to any member." Int. Rev. Code of 1954, § 456(e)(3).

year to which a liability is directly attributable to making services available. Thus, the new statute avoids one pitfall of section 452, that of cash basis taxpayers changing to an accrual basis and receiving a "double deduction" in the year of transition. To allay further the difficulty, a special transitional rule is provided by section 456. After an inclusion and deductions according to formula, the taxpayer is whole again at the end of five years.¹³ Thus, for those taxpayers coming within the definition of "membership organization" in section 456, Congress has vindicated generally accepted commercial accounting practices for tax purposes where the courts have failed. However, it appears that there are businesses, not "membership organizations," which will continue to be bound by the decision in the present case. Thus, the U.S. Court of Appeals for the Eighth Circuit had held that an accrual-basis dance studio's receipts from instruction contracts could be spread over the tax years covered by the contract according to the number of lessons taught in each year where the student had executed a noncancelable contract and installment note. Also, the Seventh Circuit had held that an accrual-basis transit company could deduct each year its estimates of probable liability on unsettled, self-insured accident claims arising during the year. In light of its holding in the instant case, the Supreme Court by per curiam orders vacated and remanded in both cases.¹⁴ Presumably neither these cases nor others of a similar nature are affected by section 456.

BRIAN E. CONCANNON

Trade Regulation—Sherman Act—Rule of Reason Applied to Division of Territories.—*United States v. Pan American World Airways*.¹— Shortly after the first air mail contracts for South American service were

¹³ "d) Transitional Rule.—

"(1) AMOUNT INCLUDIBLE IN GROSS INCOME FOR ELECTION YEARS.

—If a taxpayer makes an election under this section with respect to prepaid dues income, such taxpayer shall include in gross income, for each taxable year to which such election applies, not only that portion of prepaid dues income received in such year otherwise includible in gross income for such year an additional amount equal to the amount of prepaid dues income received in the 3 taxable years preceding the first taxable year to which such election applies which would have been included in gross income in the taxable year had the election been effective 3 years earlier.

"(2) DEDUCTIONS OF AMOUNTS INCLUDED IN INCOME MORE THAN ONCE.—A taxpayer who makes an election with respect to prepaid dues income, and who includes in gross income for any taxable year to which the election applies an additional amount computed under paragraph (1), shall be permitted to deduct, for such taxable year and for each of the 4 succeeding taxable years, an amount equal to one-fifth of such additional amount, but only to the extent that such additional amount was also included in the taxpayer's gross income during any of the 3 taxable years preceding the first taxable year to which election applies." *Supra* note 11.

¹⁴ *Comr. v. Schlude*, 367 U.S. 911 (1961), reported below in 283 F.2d 234 (8th Cir. 1960); *Comr. v. Milwaukee & Suburban Transport Corp.*, 367 U.S. 906 (1961), reported below in 283 F.2d 279 (7th Cir. 1960).

¹ 193 F. Supp. 18 (S.D.N.Y. 1961).