***Schlude v. Commissioner, 372 U.S. 128 (1963)***

Under the “claim of right” doctrine, advance payments for services must be included in gross income in the year of receipt, even if the services are to be performed in a later year, if the taxpayer’s right to the funds is unrestricted.

**Summary**

The Schlude case involved a dance studio that reported income on an accrual basis but included advance payments for lessons as deferred income. The IRS argued that these advance payments constituted income in the year received. The Supreme Court agreed, applying the “claim of right” doctrine. The Court held that, since the dance studio had unrestricted use of the funds, the advance payments were taxable in the year of receipt, regardless of the studio’s accounting method or the fact that some lessons might be performed later or refunds given. The Court also addressed the proper method for determining a capital gain on the sale of a partnership interest. The court held a contractual agreement was not equivalent to cash where the taxpayer was on a cash basis accounting method and the agreement did not have a readily ascertainable fair market value.

**Facts**

Arthur and Doris Schlude operated a dance studio. They received payments from customers in advance for dance lessons. The studio used an accrual method of accounting, initially recording these advance payments as deferred income. The IRS determined that the advance payments were income in the year received. The partnership was dissolved and Arthur Schlude sold his partnership interest. He received cash and a contractual agreement for additional payments. The IRS determined that the gain on the sale of his partnership interest was $81,813.19.

**Procedural History**

The Tax Court upheld the IRS’s determination. The Court of Appeals for the Eighth Circuit affirmed the Tax Court’s decision. The Supreme Court granted certiorari to resolve a conflict among the circuits regarding the tax treatment of advance payments.

**Issue(s)**

1. Whether the advance payments received by the dance studio for lessons to be given in subsequent years were includable in gross income in the year of receipt, even though the studio used an accrual method of accounting.

2. Whether the contractual agreement received by Arthur Schlude as part of the sale of his partnership interest had a readily ascertainable fair market value that should be included in the computation of the capital gain realized in the year of the sale of the partnership interest.

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## Holding

1. Yes, because the dance studio had unrestricted use of the funds, the advance payments were taxable in the year of receipt under the claim of right doctrine.

2. No, because the contractual agreement did not have a readily ascertainable fair market value, and thus was not included in the computation of the capital gain.

## Court's Reasoning

The Court relied heavily on the "claim of right" doctrine, which states that if a taxpayer receives funds under a claim of right and without restriction as to their disposition, they are taxable income in the year of receipt, even if the taxpayer might have to return the funds later. The Court found that the dance studio's accounting method of deferring the income until the services were rendered did not override this principle. The Court noted that the studio had unfettered control over the advance payments. The Court distinguished this case from situations where advance payments were made for a specific, completed transaction or for the sale of goods, rather than the provision of services.

The Court also cited policy considerations, stating: "the petitioner's system of accounting does not 'clearly reflect income' because income is not recognized until the year the services are provided." The Court stated that Congress recognized the issues and changed the law with respect to this issue in the Internal Revenue Code of 1954, but the 1939 code governed the relevant years in this case.

Regarding the sale of the partnership, because the taxpayer was on a cash basis accounting method and the contractual agreement did not have a readily ascertainable fair market value, it could not be included in the computation of the capital gain.

## Practical Implications

This case underscores the importance of the "claim of right" doctrine in tax law. It provides guidance on when advance payments constitute taxable income. Businesses receiving advance payments for services must recognize those payments as income in the year received if there are no restrictions on their use, regardless of their accounting method. This case is crucial for: businesses offering services, tax accountants and attorneys. Later cases have continued to apply the

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