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ABSTRACT

Prepaid income is the amount of income received in advance for services that are carried over to the next several taxable years, depending on the length of the services. Prepaid income may be excluded from the current taxable income if the accounting methods that taxpayers use properly reflect their income. Even then, the exclusion of prepaid income may not be guaranteed in the U.S. due to differences in the taxpayer's and the Internal Revenue Service's ("IRS") interpretation of how to properly reflect taxable income.

There are three major U.S. Supreme Court cases[2] covering tax treatment of prepaid income. In each of them, the Supreme Court held in favor of the IRS's taxable income calculation because the taxpayers' accounting methods did not clearly reflect their income.

Meanwhile, in *Hojin Zeiho*, the timing for recognizing income according to Japan's Corporation Tax Law is determined by accounting standards generally recognized as just and proper ("ASJP"), which is regulated by the Corporation Tax Law § 22(4). Japanese Generally Accepted Accounting Principles ("JGAAP") which is one of the most important ASJP, states that prepaid income should be excluded from the calculation of profits and losses for the current year. That is the difference between U.S. and Japanese tax treatment of prepaid income.

This article examines the crucial distinctions of methodology between the U.S. and the Japanese tax laws with respect to the timing for recognizing income. In addition, it studies the advantages and disadvantages of both tax treatment methods concerning prepaid income. As a result, it concludes that the advantages of Japanese tax law concerning prepaid income outweigh those of the American tax law. This article also suggests that U.S. tax law could borrow the Japanese mentality regarding the tax treatment of prepaid income.

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2. Auto. Club of Mich. v. Comm'r, 353 U.S. 180 (1957); Am. Auto. Ass'n v. United States, 367 U.S. 687 (1961); Schlude v. Comm'r, 372 U.S. 128 (1963).

I. INTRODUCTION

Prepaid income is the amount of income received in advance for services that are carried over to the next several taxable years, depending on the length of services.[3] The dispute concerning the tax treatment of prepaid income in the United States occurs when taxpayers use the accrual method of accounting.

There are two main methods regarding the timing for recognizing income. One is the cash receipts and disbursements method, and the other is the accrual method.[4] The cash receipts and disbursements method recognizes any cash received as income, whereas the accrual method recognizes earnings as income even when no cash has been received yet.[5]

The U.S. Internal Revenue Code ("IRC") permits taxpayers to choose either method.[6] However, C corporations, partnerships with a C corporation as a partner, and tax shelters cannot choose the cash receipts and disbursements method.[7] Most business taxpayers[8] in the United States are typically subject to the accrual method. Under the *Hojin Zeiho,* Japan's Corporation Tax Law § 22(4), the amount of corporation income shall be computed in accordance with accounting standards generally recognized as just and proper ("ASJP").[9] The accounting standards state that corporations are required to follow the accrual method.[10] Since both U.S. and Japanese tax law require most business taxpayers to follow the accrual method, it is assumed that the business taxpayers mentioned in this article have adopted the accrual method.

Under Japan's Corporation Tax Law, taxpayers only recognize the amounts received, excluding prepaid income, for services that they provide in the current taxable year as income when using the accrual method.[11] On the other hand, in the U.S. courts recognize any cash received as income even when using the accrual method.[12] This is the difference between U.S. tax law and Japanese tax law regarding the tax treatment of prepaid income. This article focuses on clarifying the advantages and disadvantages of U.S. and Japanese tax law concerning prepaid income,[13] and examines what ideas the U.S. tax law can borrow from Japanese tax law.[14]

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3. *See* JOSEPH BANKMAN, DANIEL N. SHAVIRO & KIRK J. STARK, FEDERAL INCOME TAXATION 221 (17th ed. 2017).

4. I.R.C. § 446(c) (2018).

5. *See* MICHAEL J. GRAETZ & DEBORAH H. SCHENK, FEDERAL INCOME TAXATION: PRINCIPLES & POLICIES 639 (7th ed. 2013).

6. I.R.C. § 446(c).

7. I.R.C. § 448(a).

8. Excluding S corporations.

9. Hōjinzeihō [Corporate Taxation Act], Law No. 22 art. 4, http://law.e-gov.go.jp/cgi-bin/idx-search.cgi (Japan).

10. JAPANESE GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (JGAAP)II・1A.

11. Hōjinzeihō [Corporate Taxation Act], Law No. 22 art. 4, http://law.e-gov.go.jp/cgi-bin/idx-search.cgi (Japan); JAPANESE GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (JGAAP)II・1A.

12. *See* Auto. Club of Mich. v. Comm'r, 353 U.S. 180 (1957); Am. Auto. Ass'n v. United States, 367 U.S. 687 (1961); Schlude v. Comm'r, 372 U.S. 128 (1963).

13. *See* HIROSHI NOGUCHI, THE TREATMENT OF CORPORATION TAX CONCERNING PREPAID INCOME 76:3 (Sangyo Keiri 36 2016).

14. The following contents of this article will focus on tax treatment of prepaid income in terms of providing services. Therefore, tax treatment of prepaid income for selling assets will be out of the scope of this article.

II. THE TAX TREATMENT OF PREPAID INCOME IN THE UNITED STATES[15]

A. The Relation Between Tax Law and Accounting

I.R.C. § 446 states a general rule about the relationship between tax law and accounting. The rule says that "taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books."[16] An exception to this rule is "[i]f the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income."[17] I.R.C. § 446(b) prevents taxpayers from using different methods of accounting, such as combining both the cash and accrual methods.[18] Therefore, this statute acts as a safety valve for the Secretary.[19] This article will discuss three major U.S. Supreme Court cases that disputed the tax treatment of prepaid income.

Before discussing the three cases, it is important to understand the legislation and abolition of I.R.C. § 452. Section 452 of the I.R.C. permitted taxpayers to exclude the calculated amount of prepaid income from their current taxable income without any exceptions.[20] However, § 452 was abolished in in 1954 because of a decrease in tax revenue.[21]

B. Three Major U.S. Supreme Court Cases Concerning Prepaid Income

i. Automobile Club of Michigan v. Commissioner

The first of the three major U.S. Supreme Court cases that deals with prepaid income is *Automobile Club of Michigan v. Commissioner*.[22] When the Automobile Club of Michigan received an annual membership fee, the club did not recognize the entire amount as income.[23] However, the Commissioner of IRS claimed that the club should recognize the entire amount as income on the basis of the claim of right doctrine.[24] The claim of right doctrine was mentioned by the Supreme Court in *North American Oil Consolidated v. Burnet*[25]:

> if a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain

15. *See* Minoru Nakazato, *Systeme Juridique de la Determination du Benefice Imposable de l'Entreprise (3)*, 100:5 HOGAKU KYOKAI ZASSHI 935, 954–67 (1983).
16. I.R.C. § 446(a) (2018).
17. I.R.C. § 446(b).
18. *Id.*
19. *See* Maurice Austin, Stanley S. Surrey, William C. Warren & Robert M. Winokur, *The Internal Revenue Code of 1954: Tax Accounting*, 68 HARV. L. REV. 257, 260 (1955).
20. I.R.C. § 452.
21. *See* George E. Lent, *Accounting Principles and Taxable Income*, 37 ACCT. REV. 479, 482 (1962).
22. Auto. Club of Mich. v. Comm'r, 353 U.S. 180 (1957).
23. *Id.* at 181.
24. *Id.*
25. N. Am. Oil Consol. v. Burnet, 286 U.S. 417 (1932).

> the money, and even though he may still be adjudged liable to restore its equivalent.[26]

The club sued the Commissioner because its accounting method clearly reflected income.[27]

The Supreme Court held in favor of the Commissioner and stated "the pro rata allocation of the membership dues in monthly amounts is purely artificial and bears no relation to the services which petitioner may in fact be called upon to render for the member."[28] Justice Harlan dissented:

> The Commissioner seeks to justify that course under the 'claim of right' doctrine announced in *North American Oil* v. *Burnet* . . . . However, that doctrine, it seems to me, comes into play only in determining whether the treatment of an item of income should be influenced by the fact that the right to receive or keep it is in dispute; it does not relate to the entirely different question whether items that admittedly belong to the taxpayer may be attributed to a taxable year other than that of receipt in accordance with principles of accrual accounting.[29]

In addition, Justice Harlan stated "the Commissioner does not deny — as, indeed, he could not — that the method of accounting used by the taxpayer reflects its net earnings with considerably greater accuracy than the method he proposes."[30] Justice Harlan mentioned the Commissioner did not give any explanations justifying the denial of the deferral of prepaid income.[31]

ii. American Automobile Association v. United States

The second Supreme Court case dealing with prepaid income is *American Automobile Association v. United States*.[32] The Association filed a tax return, which followed Generally Accepted Accounting Practices ("GAAP") and deferred its prepaid income.[33] However, the Commissioner did not allow the Association to defer the income.[34] The Commissioner ignored the fact that the Association followed GAAP, and argued instead that "the annual accounting requirement demands that neither income nor deduction items may be accelerated or postponed from one taxable year to another in order to reflect the long-term economic result of a particular

26. *Id.* at 424.
27. *Auto. Club of Mich.*, 353 U.S. at 189.
28. *Id.* (however, the Court did not mention the claim of right doctrine that the Commissioner of Internal Revenue claimed).
29. *Id.* at 191–92.
30. *Id.* at 193.
31. *Id.* at 190–93.
32. Am. Auto. Ass'n v. United States, 367 U.S. 687 (1961).
33. *Id.* at 688.
34. *Id.*

transaction or group of transactions."[35] The Association sued the Commissioner because it did follow GAAP,[36] and argued that the correspondence between the membership dues and expenses were clear and accurate.[37]

The Supreme Court stated, "[i]t is admitted that for its purposes the method used is in accord with generally accepted commercial accounting principles."[38] However, at the same time, the Court mentioned that the correspondence between the membership dues and expenses was vague, like in *Automobile Club of Michigan v. Commissioner*, because the Association did not know when it would provide services to its customers.[39] The Court also mentioned the abolition of I.R.C. § 452 and stated, "[t]his repeal, we believe, confirms our view that the method used by the Association could be rejected by the Commissioner."[40]

Justice Stewart, along with three other Justices, dissented from the Court's decision and stated the following:

> [i]n *Automobile Club of Michigan* the Court pointed out that the method of accounting employed by the taxpayer was 'purely artificial,' so far as the record there showed.[41] Here, by contrast, the petitioner proved, and the Court of Claims found, that the method of accounting employed by the petitioner during the years in issue was in accord with [GAAP] and practice, was customarily employed by similar taxpayers, and, in the opinion of qualified experts in the accounting field, clearly reflected the petitioner's net income.[42]

Justice Stewart also argued that the abolition of I.R.C.§452 is not a reason for the denial of deferral of prepaid income.[43]

iii. Schlude v. Commissioner

The third major Supreme Court case looking at prepaid income is *Schlude v. Commissioner*.[44] In this case, taxpayers received several years worth of dance lesson fees from students.[45] Taxpayers deferred the fees corresponding to the number of the lessons they had not yet taught.[46] But the Commissioner claimed all the fees should be included as income despite the fact there were contracts that obligated taxpayers to render performance in the following years.[47]

The Supreme Court admitted that, for its purposes, the method used was in accord with GAAP.[48] However, the Court held the taxpayers should recognize all

35. *Id.* at 701 (unlike the case of *Automobile Club of Michigan v. Commissioner*, the Commissioner did not insist the claim of right doctrine in this case).
36. *Id.* at 691.
37. *Id.*
38. *Id.* at 690.
39. *Id.* 690–91 (the Court did not adopt the doctrine that the Commissioner claimed).
40. *Id.* at 695.
41. *Id.* at 698 (citing Auto. Club of Mich. v. Comm'r, 353 U.S. 180, 189 (1957)).
42. *Id.*
43. *Id.* at 703–10. *SEE* BANKMAN, SHAVIRO & STARK, *supra* note 3, at 319–20.
44. Schlude v. Comm'r, 372 U.S. 128 (1963).
45. *Id.* at 131–33.
46. *Id.* at 131–32.
47. *Id.* at 132–33.
48. *Id.* at 132–34.

the fees they received as income in that taxable year, citing to *American Automobile Association v. United States*.[49] The dissent argued, "[t]he Court's decision can be justified, then, only upon the basis that the system of accrual accounting used by the taxpayers in this case did not 'clearly reflect income'. . . ."[50]

Although the Supreme Court admitted the taxpayer's method of accounting was correct from the business's perspective, the Court believed that the accounting method used did not clearly reflect income because taxpayers did not know when to provide services to their customers,[51] similar to *American Automobile Association v. United States*.[52]

iv. Other Cases

There is another case, 45 T.C. 221 (1965), similar to the three Supreme Court cases above. The case disputed whether the taxpayer could defer prepaid income or not when he received cash for his indeterminate service.[53] The Court stated that "[t]he repeal of § 452 . . . clearly establish[es] the general rule that prepaid income may not be deferred."[54] However, if taxpayers know precisely when to provide services to their customers, there is a different outcome, as shown in the following two cases.

The two cases are *Artnell Co. v. Commissioner*[55] and *Tampa Bay Devil Rays, Ltd. v. Commissioner*.[56] In the former, the Seventh Circuit Court of Appeals permitted taxpayers to defer prepaid income from prepaid baseball tickets to the next year.[57] The Court stated that "the deferred income was allocable to games which were to be played on a fixed schedule. Except for rain dates, there was certainty. We would have no difficulty distinguishing the instant case in this respect."[58] These two cases showed that the schedule of services provided by taxpayers was fixed, unlike the three above Supreme Court cases.[59] It can be inferred that other courts would allow taxpayers to defer prepaid income when the schedule of services to be provided is fixed. On the other hand, when it is not fixed, the courts will not allow a deferral.

C. The Current Rules of Prepaid Income in the United States

There have been many disputes between taxpayers' and the IRS's interpretation of how to properly calculate taxable income. Therefore, the IRS announced its interpretation concerning the deferral of prepaid income, which "generally allows [an] accrual method taxpayer to defer [recognizing] advance payments [received] for goods[, services, or a mixture of goods and services as income] until the taxable

49. *Id.* at 135 (citing Am. Auto. Ass'n v. United States, 367 U.S. 687 (1961)).
50. *Id.* at 140.
51. *Id.* at 135–36.
52. *See Am. Auto. Ass'n*, 367 U.S. at 690.
53. William O. McMahon, Inc. v. Comm'r, 45 T.C. 221, 222 (1965).
54. *Id.* at 230.
55. Artnell Co. v. Comm'r, 400 F.2d 981 (7th Cir. 1968).
56. Tampa Bay Devil Rays, Ltd. v. Comm'r, 84 T.C.M. (CCH) 394 (2002).
57. *Artnell Co.*, 400 F.2d at 984.
58. *Id.*
59. *See* Laurie L. Malman, *Treatment of Prepaid Income—Clear Reflection of Income or Muddied Waters*, 37 TAX L. REV. 103, 121–22 (1981).

year [the taxpayer recognizes the advance payments] in revenue under the taxpayer's method of accounting for financial reporting purposes."[60] However, § 5.02(1)(a)(ii) of Rev. Proc. 2004-34 limits the deferral to the end of the next succeeding taxable year following the year the taxpayer receives the payments.[61] This interpretation means if the services provided carry over to the end of the next succeeding taxable year following the year the taxpayer receives the payments, the taxpayer should recognize all the amount as income when he or she receives the payments.

A Japanese textbook by Kimiya Ito, *The U.S. Federal Taxation*, shows several good examples of the IRS's interpretation.[62] One example involves a taxpayer who has a January 1st through December 31st taxable year and runs a dancing school.[63] The taxpayer received $1,200 of lesson fees for one year (December of 2016 to November of 2017) in December of 2016, which means she will finish providing all her lessons before the end of 2017.[64] Therefore, the taxpayer can defer $1,100 for 11 months as income to the next taxable year.[65] Whereas, when the taxpayer received $2,400 of lesson fees for two years (December of 2016 to November of 2018) in December of 2016, she will not finish providing all her lessons before the end of 2017.[66] Therefore, the taxpayer must recognize the entire amount as income when she received the $2,400.[67]

Congress allows for specific types of prepaid income to be defferrable. I.R.C. § 455 "permits the deferral of prepaid subscriptions for magazines and other periodicals"; the rule was amended with I.R.C. § 456, allowing "the postponement of prepaid dues received by membership organizations such as automobile clubs."[68] I.R.C. § 456 states the following:

> [t]he term "prepaid dues income" means any amount (includible in gross income) which is received by a membership organization in connection with, and is directly attributable to, a liability to render services or make available membership privileges over a period of time which extends beyond the close of the taxable year in which such amount is received.[69]

I.R.C. § 456(e)(2) specifies that "[t]he term 'liability' means a liability to render services or make available membership privileges over a period of time which does not exceed 36 months."[70] Subject to the condition of I.R.C. § 456(e)(2), taxpayers can defer prepaid income for the taxable years during the liability.[71]

On the other hand, there are other cases in which taxpayers cannot defer prepaid income, such as rentals received in advance.[72] Therefore, it may be difficult

60. Rev. Proc. 2004-34, 2004-1 C.B. 991.
61. Rev. Proc. 2004-34, 5.02(1)(a)(ii), 2004-1 C.B. 991.
62. *See* KIMIYA ITO, AMERICA RENPOU ZEIHO THE U.S. FEDERAL TAXATION 29-30 (5th ed. 2013).
63. *Id.* at 30.
64. *Id.*
65. *Id.*
66. *Id.*
67. *Id.*
68. *See* MARVIN A. CHIRELSTEIN & LAWRENCE ZELENAK, FEDERAL INCOME TAXATION 338 (13th ed. 2015).
69. I.R.C. § 456(e)(1) (2018).
70. I.R.C. § 456(e)(2).
71. I.R.C. § 456(a).
72. Treas. Reg. §1.61-8(b) (2004).

for taxpayers to understand their tax treatment because there are too many different cases of when deferrals concerning prepaid income are allowed under U.S. tax law.

III. THE TAX TREATMENT OF PREPAID INCOME IN JAPAN

A. The Relation Between Tax Law and Accounting

In Japan, the accounting of corporate taxable income should follow Corporation Tax Law § 22(4), unless otherwise provided.[73] The article states that taxable income "shall be computed in accordance with accounting standards generally recognized as just and proper".[74] Section 22(4) was added as an amendment to the Corporation Tax Law in 1967.[75] There has been a long-disputed question of whether ASJP is equivalent to JGAAP or not.

Masasuke Takeda, an Emeritus Professor at Seikei University, believes ASJP are perfectly equivalent to JGAAP.[76] Takeda mentioned the point of Corporation Tax Law § 22(4) was to simplify the taxation system.[77] He also noted the Tax Commission of 1966 said that "[t]axable income is established by not only tax law but also concepts and principles of accounting practices. Therefore, tax law should exclude the rule regarding accounting standards."[78] Similarly, Professor Setsuo Taniguchi of Osaka University, states that ASJP are perfectly equivalent to JGAAP. He also states that if ASJP are not perfectly equivalent to those accounting standards, then the Japanese National Tax Agency can arbitrarily make its own interpretation of ASJP without passing the bill through Congress.[79]

On the other hand, Hiroshi Kaneko, an Emeritus Professor at Tokyo University, states that ASJP are not perfectly equivalent to those accounting standards.[80] He explains JGAAP are not always just and proper and should be continually examined.[81] Kaneko also states that JGAAP are not comprehensive, therefore Revenue Rulings announced by the Japanese National Tax Agency should cover their accounting standards.[82]

Professor Yoshihiro Masui of Tokyo University, argues that JGAAP should be examined to identify whether they work to regulate calculating taxable income.[83] Similarly, Professor Hidetoshi Masuda of Senshu University, believes that JGAAP would not be equivalent to ASJP if they cannot meet the requirement of equitability of taxation.[84] The equitability of taxation is established by the Japanese Constituiton

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73. Hōjinzeihō [Corporate Taxation Act], Law No. 22 art. 4, http://law.e-gov.go.jp/cgi-bin/idx-search.cgi (Japan).
74. *Id.*
75. *See* MASASUKE TAKEDA, DHC KOMMENTAR HOJIN ZEIHO [THE EXPLICATION OF CORPORATE TAX LAW] 1146 (2017).
76. *Id.*
77. *Id.*
78. OKURA ZAIMU KYOKAI, KAISEI ZEIHOU NO SUBETE [THE EXPLANATION OF 1966 TAX REFORM] (1966).
79. *See* SETSUO TANIGUCHI, ZEIHO KIHON KOGI [BASIC LECTURE ON TAX LAW] 403 (5th ed. 2016).
80. *See* HIROSHI KANEKO, SOZEIHO (TAX LAW) 322 (21st ed. 2016).
81. *Id.*
82. *Id.* at 333.
83. *See* YOSHIHIRO MASUI, SOZEIHO NYUUMON [INTRODUCTION TO TAX LAW] 204 (2014).
84. *See* HIDETOSHI MASUDA, LEGAL MIND SOZEIHO [LEGAL MIND ON TAX LAW] 141 (4th ed. 2013).

article 14[85]. Article 14 states that all citizens are equivalent under the law and there shall be no discrimination in political, economic or social relations because of race, creed, sex, social status, or family origin.

B. Cases Related to Hojin Zeiho, Japan's Corporation Tax Law § 22(4)

In this section, the article will provide an overview of cases related to Corporation Tax Law § 22(4). The first case is about a company that extended its fiscal year by five extra days, an act which is not accepted by the articles of association.[86] The taxpayer and Japanese National Tax Agency litigated over whether the extension followed ASJP or not.[87] The court stated, "ASJP should be defined by socially accepted ideas. Taxpayers can extend or shorten their fiscal year by several days on the basis of socially accepted ideas because it is difficult for taxpayers to precisely arrange all the transactions by the end of the fixed fiscal year."[88] According to Daijisen, a famous Japanese dictionary, a "socially accepted idea" is defined as common sense shared within the society, which can be used as an interpretation of a law.[89] However, this definition is vague. As a result, more cases disputed the interpretation of ASJP following this case.

One of these cases pertains to how a Tokyo District Court judged ASJP as perfectly equivalent to JGAAP.[90] In this Administrative Case *"U"* No. 597, 2005, the court stated the Accounting Regulation for the Electricity Business, which is a part of JGAAP should be equivalent to ASJP.[91] In another Administrative Case *"Ko"* No. 466, 2012, the Tokyo High Court held that the Practical Guidance for Accounting for Financial Instruments, an accounting standard that aligns with JGAAP, is also equivalent to ASJP.[92]

On the other hand, there are cases where courts have stated that ASJP's are not perfectly equivalent to JGAAP, Practical Guidance for Accounting for Financial Instruments, and Accounting Regulation for the Electricity Business. In one Administrative Case, *"Ko"* No. 94, 2001, the Tokyo High Court stated, "whether a company's calculation of revenue and expenses follow ASJP or not depends on whether the calculation meets the requirement of equitability of taxation or not."[93] There is another Administrative Case, *"U"* No. 13, 1998 in which the Japanese National Tax Agency did not accept the taxpayer's decision to classify a transaction as a lease transaction.[94] The calculation followed the Accounting Standard for

85. *See* MASUI, *supra* note 83, at 12.

86. Tōkyō Chihō Saibansho [Tokyo Dist. Ct.] December 26, 1977, 909 HANREI JIHO [HANTA] 110 (Japan).

87. *Id.*

88. Same judicial decision as Tōkyō Chihō Saibansho [Tokyo Dist. Ct.] September 19, 1979, 414 HANREI TIMES [HANTA] 138 (Japan); Kōbe Chihō Saibansho [Kobe Dist. Ct.] September 12, 2002, 50:3 SHOMU GEPPO 1096 (Japan).

89. DAIJISEN (2nd ed. 2012) (socially accepted idea "Ippan Shakai Tuunen").

90. Tōkyō Chihō Saibansho [Tokyo Dist. Ct.] January 31, 2007, 257 ZEIMU SOSHO SHIRYO 10623 (Japan).

91. *Id.*

92. Tōkyō Kōtō Saibansho [Tokyo High Ct.] August 29, 2014, 1475 JURIST 8 (Japan).

93. Tōkyō Kōtō Saibansho [Tokyo High Ct.] March 14, 2002, 49:5 SHOMU GEPPO 1571 (Japan).

94. Fukuoka-shi Chihō Saibansho [Fukuoka Dist. Ct.] December 21, 1999, 245 ZEIMU SOSHO SHIRYO 991 (Japan).

Lease, one of the accounting standards mentioned earlier set by the Accounting Standards Committee — the predecessor to the Accounting Standards Board of Japan.[95] At that time, Fukuoka District Court stated that the Accounting Standard for Lease was not equivalent to ASJP. This is because the standard had only been in existence for three years and has not spread widely into Japanese society.[96]

In another Administrative Case, *"Tsu"* No. 45, 1992, the Japanese Supreme Court also stated, "as long as the company's income calculated by accounting principles meets the requirement of equitability of taxation, the calculated income should be admitted as ASJP, which is regulated by Corporation Tax Law § 22(4)."[97] In other words, if the company's income, regardless of the accounting principles the company follows, does not meet the requirement of equitability of taxation, the calculated income should not be accepted as ASJP.

C. The Current Rules for Prepaid Income in Japan.

Hojin Zeiho, Japan's Corporation Tax Law, has two specific articles regarding timing for recognizing income. One article is § 63, which regulates the accounting period to which revenues and expenses from long-term installment sales belong.[98] The other article is § 64, which regulates the accounting period to which revenues and expenses from construction work contracts belong.[99] If neither article is applicable to a transaction, the timing of recognition of income is determined by ASJP, which is regulated by the Corporation Tax Law § 22(4).[100]

The timing for recognizing prepaid income is not regulated by any specific articles. Therefore, the timing is determined by ASJP. JGAAP, which is one of the most important Japanese accounting standards, states "prepaid expenses and prepaid income for the next several fiscal years should be excluded from the calculation of profits and losses of the current year."[101] Based on this rule, prepaid income for the next several taxable years should be excluded from the current taxable year.

There are three reasons why prepaid income should be excluded from the current year's income in Japan. First, JGAAP was announced in 1949, thus it takes deep root in Japanese accounting and tax practices.[102] Therefore, it is conceivable that JGAAP has more predictable accounting and tax practices than the Accounting

95. ACCOUNTING STANDARDS BOARD OF JAPAN, RIISU TORIHIKI NI KANSURU KAIKEI KIJUN [THE ACCOUNTING STANDARD FOR LEASE] (2007).

96. Fukuoka-shi Chihō Saibansho [Fukuoka Dist. Ct.] December 21, 1999, 245 ZEIMU SOSHO SHIRYO 991 (Japan).

97. Saikō Saibansho [Sup. Ct.] November 25, 1993, 47:9 MINSHU 5278. The Osaka District Court also came to the same conclusion as the Supreme Court. Ōsaka Chihō Saibansho [Osaka Dist. Ct.] February 25, 2013, 60:5 SHOMU GEPPO 1103.

98. Hōjinzeihō [Corporate Taxation Act], Law No. 63, http://law.e-gov.go.jp/cgi-bin/idxsearch.cgi (Japan).

99. Hōjinzeihō [Corporate Taxation Act], Law No. 64, http://law.e-gov.go.jp/cgi-bin/idxsearch.cgi (Japan).

100. Hōjinzeihō [Corporate Taxation Act], Law No. 22 art. 4, http://law.e-gov.go.jp/cgi-bin/idxsearch.cgi (Japan).

101. JAPANESE GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (JGAAP)II・1A.

102. *See* HISAKATSU SAKURAI, ZAIMUKAIKEI KOUGI [LECTURE ON FINANCIAL ACCOUNTING] 50 (18th ed. 2017).

Standard for Lease, mentioned above. Secondly, JGAAP and ASJP treat taxes similarly.[103] Finally, in Japan, there is no disagreement among legal scholars that prepaid income should be excluded from the current taxable year. Due to these reasons, it can be concluded that this accounting treatment in which prepaid income should be excluded from the current year's income may be based on JGAAP meeting ASJP's requirement of equitability of taxation.

IV. COMPARING THE ADVANTAGES AND DISADVANTAGES OF U.S. TAX LAW AND JAPANESE TAX LAW CONCERNING PREPAID INCOME

This section will examine the advantages and disadvantages of U.S. tax law concerning prepaid income.[104] First, the U.S. government has no need to worry about insolvency or bankruptcy preventing tax collection, as the U.S. government can levy the tax as soon as the taxpayer has the funds.[105] Second, the total amount treated as income can simplify the administrative process because the government and taxpayers do not need to divide income for tax calculation.[106] The U.S. applies the methodology of Kanri-Shihai-Kijun as a general rule regarding the recognition of prepaid income.[107] Kanri-Shihai-Kijun is the principle that any money made is considered income once it is under the control of the taxpayer.[108]

When comparing the two governments' risk and the allocation income, the above-mentioned principle has clear advantages. Since Japan does not follow the Kanri-Shihai-Kijun principle with regard to prepaid income, its government is at risk of being unable to collect income tax when a company files for bankruptcy. Another disadvantage for the Japanese government and taxpayers is the fact that they are required to divide income for the appropriate taxable year.[109]

In comparison to the aforementioned U.S. tax law advantages, there are two advantages in Japanese tax law. One advantage is the simplicity of tax treatment of prepaid income.[110] There are no exceptions to the deferral of prepaid income in Japan. As long as taxpayers follow JGAAP to calculate prepaid income, prepaid income can be deferred without any complications. The U.S. tax law, conversely,

103. *See* Hideo Narimichi, *Zeikaikei Shori Kijun*, 68:1 KIGYO KAIKEI 59, 64 (2016) (standards of accounting disposition generally recognized as just and proper).

104. *See* Murray H. Rothaus, *A Critical Analysis of the Tax Treatment of Prepaid Income*, 17 MD. L. REV. 121, 133–34 (1957).

105. *Id.* at 133.

106. *Id.* at 134.

107. I.R.C. § 451(a) (2018).

108. *See* TANIGUCHI, *supra* note 79, at 340.

109. Hōjinzeihō [Corporate Taxation Act], Law No. 22 art. 4, http://law.e-gov.go.jp/cgi-bin/idx-search.cgi (Japan); JAPANESE GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (JGAAP)II・1A.

110. As mentioned above, the current U.S. tax law allow taxpayers to defer prepaid income only when they receive prepaid income for subscriptions of magazines and other periodicals, prepaid income of certain membership organizations, or when the taxpayers use an accrual method to defer recognizing advance payments received for goods, services, or a mixture of goods and services as income until the taxable year the taxpayer recognizes the advance payments in revenue under the taxpayer's method of accounting for financial reporting purposes. However, Rev. Proc. 2004-34, 5.02(1)(a)(ii), 2004-1 C.B. 991 limits the deferral to the end of the next succeeding taxable year following the year the taxpayer receives the payments. Taxpayers are sometimes permitted the deferral of prepaid income as shown in the case of Artnell Co. v. Comm'r. On the other hand, taxpayers cannot defer rentals received in advance. Therefore, it may be difficult for taxpayers to understand the tax treatments because there is a mixture of allowing deferral and not allowing deferral concerning prepaid income in American tax law.

has exceptions that make calculating prepaid income more difficult than necessary.[111]

In contrast to the U.S., Japan applies the methodology of Kenri-Kakutei-Kijun as a general rule regarding the recognition of all income.[112] Kenri-Kakutei-Kijun is the principle in which taxpayers recognize their income when they receive consideration upon providing goods or services.[113] Taxpayers generally obtain the right to said consideration when they provide those goods and services.[114] Since prepaid income is consideration that has been received before taxpayers have provided any goods or services, they do not obtain the right to receive consideration, even though they are in possession of the payment. As such, prepaid income is not recognized as income in Japan.[115] This way of thinking by the Japanese tax law corresponds with GAAP.

The purpose of the Japanese tax law is different than the purpose of Japanese accounting standards.[116] For this reason, tax treatment does not need to correspond with that of accounting. According to Robert A. Behren, an attorney and a certified public accountant, "tax treatment of prepaid income should not be bound by the conservatism of GAAP. This doctrine of conservatism, according to this view, while encouraging prudent management and protecting the interests of creditors, investors, and the public, should not be determinative of tax consequences."[117] However, Behren does not suggest that tax treatment should be completely independent of how accounting treats prepaid income. Furthermore, § 74 of Japan's Corporation Tax Law requires that a domestic corporation file its tax return based on the final settlement of accounting.[118] This means that the computation of taxable income should follow GAAP as much as possible. Therefore, tax treatment should correspond with accounting principles if there is no justifiable reason not to match both treatments.

The other advantage is that the tax treatments of prepaid income and expenses are similar in Japanese tax law.[119] The treatments are similar because both prepaid income and expenses can be deferred without any complications. Therefore, Japanese tax law does not provide many disadvantages to either its taxpayers or the Japanese government.

The tax situation in the U.S. is far more complicated. American taxpayers are essentially prohibited from deferring their prepaid income.[120] While there are some exceptions, they are far and few between, and taxpayers wishing to defer prepaid income must rely on complex rules and past cases. To further illustrate this point, Treasury Reg. § 1.461-1(a)(2)(i) states the following:

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111. *See* Rev. Proc. 2004-34, 2004-1 C.B. 991.
112. *See* KANEKO, *supra* note 80, at 327.
113. *See* TANIGUCHI, *supra* note 79, at 340.
114. *Id.* at 341.
115. *Id.* at 342–43.
116. *See* MASUI, *supra* note 83, at 205.
117. Robert A. Behren, *Prepaid Income—Accounting Concepts and the Tax Law*, 15 TAX L. REV. 343, 364 (1960).
118. Hōjinzeihō [Corporate Taxation Act], Law No. 74, http://law.e-gov.go.jp/cgi-bin/idxsearch.cgi (Japan).
119. Prepaid expense is the amount of payment sent in advance for services that are carried over to the next several taxable years depending on the length of the services.
120. I.R.C. § 451(a) (2018).

> Under an accrual method of accounting, a liability is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.[121]

Japanese tax law has the same regulation.[122] Therefore, under both U.S. and Japanese tax laws, taxpayers may not deduct the total amount paid, including the prepaid expense, for the current taxable year because economic performance has not occurred with respect to the liability for prepaid expense.[123] As a result, the tax treatments of prepaid income and prepaid expenses are similar in the Japanese tax system, whereas U.S. tax treatment of prepaid income and expenses are not.[124]

IV. CONCLUSION

This article examined the disparate treatment of prepaid income under U.S. and Japanese tax law. As a result, it clarified that prepaid income is guaranteed to be excluded from current taxable income under Japanese tax law if prepaid income is calculated correctly under JGAAP. It also explained that Japanese tax law will not provide much of a disadvantage to taxpayers since the tax treatments of prepaid income and prepaid expenses are similar in Japanese tax law.

It is argued that these advantages of the Japanese tax law concerning prepaid income outweigh those of the American tax law. Although the American government has no need to worry about insolvency or bankruptcy preventing tax collection, the U.S. tax law gives a disproportionate advantage only to its government. Moreover, Japanese taxpayers can reduce the cost of deskwork by using computer software, while the U.S. cannot. The latest accounting software can easily let the government and taxpayers divide prepaid income for the appropriate taxable year, which renders the time-saving advantage enjoyed by the U.S. irrelevant.

All of the above things considered, the U.S. tax law should borrow from the Japanese mentality regarding its tax treatment of prepaid income. In this way, U.S. taxpayers can predict how their prepaid income will be treated come tax season. In addition, the improved U.S. tax law will not provide much of a disadvantage to taxpayers since the tax treatments of prepaid income and prepaid expenses would be similar.

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121. Treas. Reg. § 1.461-1(a)(2)(i) (1999).

122. Hōjinzeihō [Corporate Taxation Act], Law No. 22 art. 3, http://law.e-gov.go.jp/cgi-bin/idxsearch.cgi (Japan).

123. Treas. Reg. § 1.461-1(a)(2)(i); Hōjinzeihō [Corporate Taxation Act], Law No. 22 art. 4, http://law.e-gov.go.jp/cgi-bin/idxsearch.cgi (Japan); JAPANESE GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (JGAAP)II・1A.

124. *See* Jacquin D. Bierman & Richard S. Helstein, *Accounting for Prepaid Income and Estimated Expenses Under the Internal Revenue Code of 1954*, 10 TAX L. REV. 83, 87 (1954).