INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Director's Office: LMSB

Taxpayer's Name:
Taxpayer's ID Number:
Taxpayer's Address:

Tax Year Ended:
Date of Conference:

LEGEND:

Corp A =

B Network =

Location C =

Year 1 =

ISSUES:

1) If Corp A barters advertising time on its television station for the right to broadcast a television series or feature films, under the accrual method of accounting, when must the advertising income be accrued?

2) If Corp A barters advertising time on its television station for the right to broadcast a television series or feature films, under the accrual method of accounting, when are the resulting deductions incurred and in what amount?

CONCLUSIONS:

1) If Corp A barters advertising time on its television station for the right to broadcast a television series or feature films, it must accrue advertising income as each episode in a series or each film is received.

2) If Corp A barters advertising time on its television station for the right to broadcast a television series or feature films, Corp A will have basis in the episodes of a series or in a feature film equal to the amount of income Corp A accrues with respect to the advertising time bartered for those episodes or films. Corp A may not take depreciation or other deductions except in relation to basis it has already established. Any remaining basis is deductible when the episodes or films are destroyed or returned to the distributor after broadcast.

FACTS:

Corp A owns and operates a television station, an affiliate of the B Network in Location C. Corp A uses the accrual method of accounting for book and tax purposes and has a calendar taxable year. The taxable year at issue is Year 1.

Corp A earns income from selling advertising time on its station. Sometimes, Corp A barters advertising time for property or services. Most commonly, advertising time is bartered for the rights to show a syndicated television series or feature films, that have been grouped together as a package.

Corp A obtains the rights to broadcast syndicated television series or feature film packages through program licensing agreements with unrelated distributors. The licensing agreements for a television series provide for the number of episodes, the number of times an episode may be broadcast, the length of the license, the time slot and the available commercial minutes. The order in which the episodes may be broadcast is determined by the distributor. The license agreement gives Corp A some rights to exclusivity in regard to being the only television station in its broadcasting area to carry a particular series during the licensing period.

Under the program license, the distributor delivers to Corp A a copy of each episode or film just before it is broadcast. The programs may be sent by satellite a few days before or by video diskette a few weeks before. Corp A has no right to broadcast an episode or film until the specified date and time, and cannot broadcast the episode or film without also broadcasting the advertising. Copies of the programs remain the property of the distributor and Corp A has no rights to the copies other than to broadcast them. After the broadcast, Corp A has to either return the copy to the distributor or destroy it and provide the distributor a certificate of destruction.

Corp A may pay for the licensing arrangement with cash or it may barter for all or part of the cost of the programs with the advertising time available during the broadcast of the programs. When Corp A barters, it sells the advertising time it has retained and the distributor sells the advertising time it has received in the transaction. Corp A receives the episode or film with the advertising the distributor has sold already encoded in it.

Income

Under section 61(a)(2) , gross income generally means income from whatever source derived including gross income derived from business.

Section 1.61-1(a) states that gross income includes income realized in any form, whether in money, property, or services.

Section 1.61-2(d)(1) provides that, except as otherwise provided in §1.61-1(d)(6)(i), if services are paid for in property, the fair market value of the property taken in payment must be included in income as compensation.

Section 1.61-2(d)(6) states that §1.61-2(d)(1) does not apply to the transfer of property (as defined in §1.83-3(e)), unless §1.83-8 (relating to the applicability of section 83) applies. Section 83 does not apply in this case.

Section 1.451-1(a) provides that, as a general rule, gains, profits, and income are includible in gross income for the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different year in accordance with the taxpayer's method of accounting. Under an accrual method of accounting, income is includible in gross income when all the events have occurred fixing the right to receive such income and the amount thereof can be determined with reasonable accuracy. See also Spring City Foundry Co. v. Commissioner, 292 U.S. 182, 184-185 (1934).

The right to receive income is fixed upon the earliest of (1) the taxpayer's receipt of the payment, (2) the contractual due date, or (3) the taxpayer's performance. Charles Schwab Corp. v. Commissioner, 107 T.C. 282, 292 (1996), aff'd 161 F.3d 1231 (9th Cir 1998), cert. denied 528 U.S. 822 (1999), citing Schlude v. Commissioner, 372 U.S. 128, 133, 137 (1963). In the present case, because the episode or film will always be received with the appropriate advertising in place before the broadcast, Corp A's performance for the right to broadcast the episode or film will always be after the due date and receipt of the episode or film. Thus, when Corp A exchanges advertising for the right to broadcast television series or feature film packages, it must report the fair market value of broadcasting each episode or each film when each is received.

The agent argues that Corp A has income at the beginning of the license period equal to the fair market value of all the rights Corp A receives under the licensing agreement. However, significantly, the licensing agreement is executory, that is, there has been no performance by either party. In this sense, the present case is distinguishable from Charles Schwab, supra, on which the agent relies. In Charles Schwab, a broker was found to have accrued commission fees on the trade date of the stock it sold for clients, because at that point the broker had performed all but ministerial functions. 107 T.C. at 293-294.

Consistent with Schlude, supra, Corp A need not report in income the value of all the rights due to it under the executory agreements when entered. Schlude involved the correct timing of income received by a dance studio for dance lessons under contract. The contracts were noncancellable and no refunds were available. The students made down payments and paid the balance due in installments or with negotiable notes. Although the contracts designated the period during which the lessons had to be taken, there was no schedule of specific dates for lessons. The taxpayer deferred income from amounts paid under the contracts until the dance lessons to which the payments were attributable were performed. The Supreme Court instead held that the taxpayer had to include in income the amounts representing cash receipts, notes receivable, and contract installments due and payable.

Significantly, the government had successfully argued in both the Tax Court and the Eighth Circuit in Schlude that the taxpayer had to include in income all amounts due under the contract when the contract was entered. However, the government conceded in the Supreme Court that future payments that are neither due nor matured by the performance of related services were not currently includible in income. Schlude, 372 U.S. at 133 n.6. Because of the government's concession, the Supreme Court reversed the portion of the lower court's decision that had accrued amounts for services not performed or otherwise due or payable. 372 U.S. at 137. See Travis v. Commissioner, 406 F.2d 987, 990 (6th Cir. 1969), following Schlude on similar facts.

As a result, income generally accrues under an executory contract, that is, one that has not been performed, as the payments under the contract are due or are paid and not when the rights under the contract are initially received. Thus, in Cox v. Commissioner, 43 T.C. 448, 456 (1965), acq. 1965-2 C.B. 4, and nonacq. on another issue 1965-2 C.B. 7, the taxpayer had deferred reporting investment fees income it had not yet earned. The Tax Court held that the taxpayer had to report currently amounts actually received or billed, but could defer amounts not yet billed by the end of the tax year. Similarly, Decision, Inc. v. Commissioner, 47 T.C. 58 (1966), acq. on another issue 1967-2 C.B. 2, held that the taxpayer was not taxable on noncancellable executory contracts for its advertising services in the year they were obtained, but in the subsequent year when the billing date and payment occurred.

This position is also consistent with T.F.H. Publications, Inc. v. Commissioner, 72 T.C. 623 (1979), aff'd without opinion, 622 F.2d 579 (3d Cir. 1980), cert. denied 449 U.S. 921 (1980), upon which the agent also relies. There, the taxpayer had current taxable gain when it traded future advertising for the immediate receipt of tangible property.

The receipt of a contract can result in income, or at least gain in certain circumstances, if its fair market value can be determined or if it is the equivalent of cash. See Estate of Silverman v. Commissioner, 98 T.C. 54, 61-62 (1992). However, executory contracts to make future payments in money have been considered to not have a fair market value. See, e.g., Bedell v. Commissioner, 30 F.2d 622 (2d Cir. 1929); C.W. Titus, Inc v. Commissioner, 33 B.T.A. 928 (1936). In addition, to be the equivalent of cash the contract must, among other things, be unconditionally assignable and of a kind that is frequently transferred to lenders or investors at a discount. See Cowden v. Commissioner, 289 F.2d 20, 24 (5th Cir. 1961); Estate of Silverman, 98 T.C. at 61. The license agreements involved in the present case do not meet this criteria.

Deduction

Section 162(a) allows a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business.

Generally, under section 461(a), the amount of deduction allowed shall be taken for the taxable year that is the proper taxable year under the method of accounting used in computing taxable income.

Section 1.461-1(a)(2) provides that 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 liability can be determined with reasonable accuracy, and economic performance as provided in section 461(h) has occurred with respect to the liability.

Under section 461(h)(2)(A)(iii) and §1.461-4(d)(3)(i), if the liability of a taxpayer arises out of the taxpayer's use of the property, economic performance occurs ratably over the period of time the taxpayer is entitled to the use of the property.

Section 1.461-4(d)(4)(ii) defines "economic performance" under section 461(h) for barter transactions. The regulations state that, if the liability of a taxpayer requires the taxpayer to provide services, property, or the use of property, and arises out of the use of property by the taxpayer or out of the provision of services or property to the taxpayer by another person, economic performance occurs to the extent of the lesser of (A) the cumulative extent to which the taxpayer incurs costs (within the meaning of §1.446-1(c)(1)(ii)) in connection with its liability to provide the services or property; or (B) the cumulative extent to which the services or property is provided to the taxpayer.

When a taxpayer engages in a barter transaction, the transaction should be treated as if the taxpayer sold its own product or services at fair market value and then paid fair market value for the product or services of the other party. United States v. General Shoe Corp., 282 F.2d 9, 12 (6th Cir. 1960), cert. denied 365 U.S. 843 (1961); Estate of Wood v. Commissioner, 39 T.C. 1, 7 (1962). As indicated earlier, the taxpayer should take into account the fair market value of what it has received in the barter transaction. Section 1.61-2(d); FX Systems Corp. v. Commissioner, 79 T.C. 957, 963 (1982). The fair market value of what is provided by each side of the barter transaction is equal or presumed to be equal. United States v. Davis, 370 U.S. 65, 72 (1962); Tasty Baking Co. v. United States, 393 F.2d 992, 995 (Ct. Cl. 1968).

But even if the sides are not equal, giving the taxpayer a basis equal to the amount taken into income prevents the inequities of no tax being paid to the extent the basis is more than the income and of double taxation to the extent the basis is less. Philadelphia Park Amusement Co. v. United States, 126 F.Supp. 184, 188-89 (Ct. Cl. 1954). Thus, the recognition of income gives the taxpayer a cost basis in the services or product received equal to the amount of income recognized. Strong v. Commissioner, 91 T.C. 627, 639 (1988); Stahl v. Commissioner, T.C. Memo. 1987-323; Conversely, it has been held that if no income is reported upon receipt of the property, the taxpayer has no basis in the property. See Borg v. Commissioner, 50 T.C. 257 (1968); Bellows v. Commissioner; T.C. Memo. 1967-199.

The Service's published position is consistent with the court cases cited above. For example, Rev. Rul. 73-13, 1973-1 C.B. 42, applies the basis rule to services received. It holds that executives, who had to include in income $3000 of financial services provided to them by their employer, could deduct the $3000 to the extent the costs were allowable under section 212. Rev. Rul. 83-130, 1983-2 C.B. 148, applies the basis rule to property, holding that a taxpayer has a basis in a house won in a raffle equal to its fair market value taken into income minus the cost of the raffle ticket. Similarly, Rev. Rul. 84-67, 1984-1 C.B. 28, holds that, where there was an election to exclude or include in income certain forestry incentive payments, the taxpayer's basis in reforestation is increased to the extent the payments are included in income. Relying on Rev. Rul. 73-13, Notice 89-55, 1989-1 C.B. 696, held that a farmer should include in income the difference between the amount paid for feed and the fair market value of the feed received and is allowed a deduction for the fair market value of the feed. Notice 89-55 also relied upon Rev. Rul. 84-67 to find that "[i]f payments are not excluded from gross income..., a taxpayer is treated as paying or incurring a cost equal in amount to the payment and may recover this cost through deduction, or ... amortization." 1989-1 C.B. at 697. See also Rev. Rul. 92-16, 1992-16 C.B. 15, holding that, if the receipt of property does not result in income, the property's basis is not measured by a reference to its fair market value.

The agent argues that §1.461-4(d)(4)(ii)(A) operates to limit Corp A's deduction with respect to the barter exchange to the cost incurred in broadcasting the distributor's advertising. However, since Corp A already deducts operating costs, the agent concludes that there is no additional cost associated with the barter exchange and Corp A's deduction is $-0-.

We do not think that the economic performance regulations change the established precedent regarding the amount of deduction or basis to which a taxpayer is ultimately entitled. Rather, the barter rule only applies to postpone costs incurred by a taxpayer in performing its side of the barter exchange. Interpreting §1.461-4(d)(4)(ii) to preclude basis resulting from the recognition of income would result in the taxpayer having a different deduction depending on whether the taxpayer received cash or barter. Section 461 affects the timing of a deduction, not its amount. See H.R. Rep. No. 432, Pt. 2, 98th Cong., 2d Sess. 1234 (1984), stating that the reason for enactment of section 461(h) was that the time for the accrual of a deduction should be changed to take into account the time value of money. See also H.R. Rep. No. 861, 98th Cong., 2d Sess. 873 (1984). Thus, we conclude that Corp A has basis in episodes and films equal to the amount of advertising income it accrues with respect to the barter for those episodes or films and obtains that basis when the income is accrued. Corp A may not take depreciation or other deductions except in relation to basis it has already established. Any remaining basis is deductible when the episodes or films are destroyed or returned to the distributor after broadcast.

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Other Property Received

Corp A also trades advertising time on its station for other property and services. In all the agreements covering such transactions, Corp A's performance was completed by the end of the calendar year following the tax year at issue.

Under the principles discussed above, Corp A must also include in income the fair market value of other property or services traded for its advertising. However, Rev. Proc. 71-21, 1971-1 C.B. 549, allows deferral of advance payments in certain circumstances where the taxpayer's performance of services is completed by the end of the tax year following the one at issue. Advertising is considered to be services for the purposes of Rev. Proc. 71-21. T.F.H. Publications, 72 T.C. at 623. Thus, if the requirements of Rev. Proc. 71-21 are met, Corp A may defer reporting income until it is earned through Corp A's performance.

When Corp A receives other property or services, it will have basis in the property or services equal to the amount of income it has accrued in the barter transaction. Because income is deferred under Rev. Proc. 71-21, Corp A's basis in the property or services will be built up over time. Again, Corp A may not take depreciation or other deductions except in relation to basis it has already established.