INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Director

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Parent	=
Corp A	=
Corp B	=
LLC A	=
LLC B	=
Corp C	=
Corp D	=
State X	=
State Y	=
Month 1	=
Year 1	=
Year 2	=
State Act	=
Date 1	=
Date 2	=
Date 3	=
$p	=

$q =

ISSUES:

(1) Whether the prepayment made by Parent to LLC B was includible in the gross income of LLC B.

(2) If the prepayment was includible in the gross income of LLC B, whether LLC B's adoption of the method of accounting provided in Rev. Proc. 71-21, 1971-2 C.B. 549, was proper.

CONCLUSIONS:

(1) The prepayment made by Parent to LLC B was includible in the gross income of LLC B.

(2) LLC B's adoption of the method of accounting provided in Rev. Proc. 71-21 was not proper.

FACTS:

Parent is a publicly traded State X transportation company primarily engaged in hauling shipments of general commodities in both interstate and intrastate commerce. Parent owns a majority of the trucks it uses to haul merchandise from various locations throughout the United States. Parent also engages the services of independent contractors, who own and operate their own trucks, to haul merchandise throughout the United States. For federal income tax purposes, Parent files a consolidated income tax return on a calendar year basis and uses an overall accrual method of accounting.

In Month 1, Year 1, Parent altered its organizational structure. In this restructuring, Parent changed the entity form and legal domicile of two of its subsidiaries, Corp A and Corp B. Prior to the restructuring, Parent owned 100 percent of Corp A and Corp A owned 100 percent of Corp B. The restructuring is described in further detail below.

Corp A, a State X corporation, was a first-tier, wholly owned subsidiary of Parent. Corp A owned or leased a number of terminals and employed individuals who performed maintenance services on Parent's trucks and trailers. In Year 1, Corp A changed domiciles from State X to State Y and converted from a corporation to a single-member limited liability company. All of the operations, assets, and liabilities of Corp A transferred to the successor, LLC A. For federal income tax purposes, LLC A is treated as a division of Parent, as single member LLCs are disregarded entities. As such, all income and expense items of LLC A are combined with Parent's income for federal income tax purposes.

Corp C, a new State Y corporation, was formed during the restructuring. It is a first-tier subsidiary of LLC A. The sole asset of Corp C is a one percent (1%) interest in the capital and profits of LLC B.

Corp B, a State Y corporation, was a first-tier subsidiary of Corp A. It employed all of the drivers responsible for performing the freight driver services for Parent. Corp B's sole asset was its workforce. Parent compensated Corp B for its driver services through an intercompany service fee. Neither Parent, nor any affiliate of Parent, ever compensated Corp B through an advance payment for driver services expected to be rendered in the future. As a result, Corp B never received an advance payment for driver services prior to the restructuring.

As part of the Month 1, Year 1 restructuring, Corp B was converted to a two-member LLC, LLC B, pursuant to the State Act. Under the State Act, LLC B's existence was deemed to have commenced on the date Corp B commenced its existence and LLC B was deemed to be the same entity as Corp B for all purposes of the laws of the State Y. Thus, the operations, assets, and liabilities of Corp B remained vested in LLC B after the conversion. In addition, pursuant to advice from its tax advisor, LLC B retained Corp B's federal taxpayer identification number for payroll reporting purposes. For federal income tax purposes, however, Corp B and LLC B are separate organizations.

LLC B is treated as a partnership for federal income tax purposes and the membership interests of LLC B are owned 99% by LLC A and 1% by Corp C. LLC B operates on a calendar year basis and uses an overall accrual method of accounting. When Corp B was converted from a corporation to a limited liability corporation treated as a partnership, there was a deemed liquidation of the corporation's assets and liabilities under § 332, followed by a deemed contribution of those assets and liabilities to LLC B under § 721. Section 301.7701-3(g)(1)(ii) and (2).

On Date 1, Parent and LLC B entered into a receivables management agreement. This agreement provided that Parent may pay LLC B for services rendered with certain accounts receivable and that LLC B agreed to accept these receivables without recourse to Parent. Under the agreement, Corp D[1] is the designated agent responsible for collecting these receivables for a fee of 0.25 percent of the net trade receivables.

On Date 2, Parent and LLC entered into a services agreement ("Services Contract"). The Services Contract, effective on Date 2, had a one-year term that was

[1] Corp D is a State X corporation also formed during the Month 1, Year 1 restructuring. It is a first-tier, wholly owned subsidiary of Parent. Corp D employs a significant number of administrative personnel who are responsible for providing most of the support services to Parent and its affiliates.

automatically renewable unless expressly terminated within 30 days of the end of the preceding one-year period. Pursuant to the Services Contract, LLC B agreed to provide to Parent, upon reasonable request and in sufficient numbers to meet the needs of Parent, over-the-road truck drivers holding valid commercial drivers' licenses and meeting applicable state Department of Transportation requirements. Pursuant to the Services Contract, LLC B agreed to provide transportation services in exchange for a payment on a per-mile basis for the cost of insurance, driver pay, and driver benefits. The Services Contract specified that the payment per mile is calculated based on: (1) the costs incurred by LLC B to provide the transportation services to Parent plus a five percent mark-up; and (2) dividing the sum computed in step 1 by the total miles driven. LLC B compensated its drivers based on the number of miles driven on a weekly basis and it provided its drivers with a competitive benefits package.

Payment generally was due under the Services Contract within fifteen days following the receipt of an invoice from LLC B; however, the Services Contract provided Parent the option to prepay up to three and one-half months (the Prepayment Period) worth of driver services that were reasonably expected to be rendered by LLC B within the Prepayment Period. The prepayment could be made in cash or cash equivalents such as trade receivables (accounts receivable). In addition, the Services Contract provided Parent with a prepayment discount equal to 130% of the short-term applicable federal rate in effect for the month in which the prepayment was made times the average period covered by the prepayment. Further, it specified the manner in which to determine the face amount of receivables needed to satisfy a prepayment. This amount was to equal the prepayment amount, less the prepayment discount, plus the product of the discounted prepayment amount times 100% of the short-term applicable federal rate in effect for the month in which the prepayment was made times the average period of time that the receivables remain outstanding. The Services Contract did not contain any refund provisions with regard to the prepayment.

On Date 2, Parent exercised its prepayment option in the amount of $p according to the terms and conditions of the Services Contract. After applying the prepayment discount in accordance with the Services Contract, Parent transferred $q of accounts receivable to LLC B on December 31, Year 1 (the Advance Payment) as a prepayment for the driver services that it expected LLC B to render during the period January 1, Year 2 through March 31, Year 2.[2]

For the period from Date 3 to December 31, Year 1, the partnership return of LLC B showed zero gross receipts, zero total deductions, and zero ordinary income. Schedule L of LLC B's partnership return reflected the receipt of the accounts receivable with a corresponding credit to a miscellaneous current liability account,

[2] Although the Services Contract authorized a prepayment up to 3 ½ months' worth of driver services that were reasonably expected to be rendered by LLC B within the Prepayment Period, the $p prepayment here actually represented driver services that were reasonably expected to be rendered during a 3 month period, not a 3 ½ month period.

Unearned Revenue. LLC B adopted a deferral method of accounting for advance payments of driver services. LLC B did not report the receipt of the Advance Payment in income for federal income tax purposes for the taxable year ending December 31, Year 1. LLC B also did not report the receipt of the Advance Payment in income for book purposes for the year ending December 31, Year 1.

LAW AND ANALYSIS:

ISSUE (1)

Section 61 of the Internal Revenue Code defines gross income as all income from whatever source derived. Section 451 provides that the amount of any item of gross income is included in gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, the amount is to be properly accounted for as of a different period. Section 1.451-1(a) provides that, under an accrual method of accounting, income is includible in gross income when all the events have occurred that fix the right to receive the income and the amount can be determined with reasonable accuracy. All the events that fix the right to receive income generally occur when (1) the payment is earned through performance, (2) payment is due to the taxpayer, or (3) payment is received by the taxpayer, whichever happens earliest. *See*, *e.g.*, Rev. Rul. 84-31, 1984-1 C.B. 127. Therefore, an advance payment of income generally is includible in gross income in the taxable year received. *See also Schlude v. Commissioner*, 372 U.S. 128 (1963), *American Automobile Assn. v. United States*, 367 U.S. 687 (1961); *Automobile Club of Michigan v. Commissioner*, 353 U.S. 203 (1957).

A deposit, however, is not includible in gross income when received. *Commissioner v. Indianapolis Power & Light Co.*, 493 U.S. 203 (1990). In *Indianapolis Power & Light*, the Supreme Court considered whether deposits received by an electric utility company (IPL) should be treated as taxable advance payments or nontaxable deposits. IPL required customers with suspect credit to make deposits to insure prompt payment of future utility bills. The customer was entitled to a refund of the deposit after making timely payments for several months or satisfying a credit test. The customer could choose to take the refund by cash or check or to apply the refund against future bills. The deposits were commingled with other receipts and at all times were subject to the IPL's unfettered use and control. The Service argued the deposits were advance payments immediately includable in income; IPL argued they were analogous to loans and as such not taxable.

In its analysis, the Supreme Court noted that the distinction between advance payments and deposits was one of degree rather than kind. *Id.* at 208. While both bestow economic benefits to the recipient, economic benefits qualify as income only if they are undeniable accessions to wealth, clearly realized, and over which the taxpayer has complete dominion. *Id*. at 209, citing *Commissioner v. Glenshaw Glass Co*., 348

U.S. 426, 431 (1955). The key to determining whether a taxpayer enjoys "complete dominion" over a given sum is whether the taxpayer has some guarantee that it will be allowed to keep the money. *Indianapolis Power & Light*, 493 U.S. at 210. The proper focus is on the rights and obligations of the parties at the time the payment was made. *Id*. at 209. With respect to distinguishing between taxable advance payments and nontaxable deposits, the Supreme Court further explained:

> An advance payment, like the deposits at issue here, concededly protects the seller against the risk that it would be unable to collect money owed it after it has furnished goods or services. But an advance payment does much more: it protects against the risk that the purchaser will back out of the deal before the seller performs. From the moment an advance payment is made, the seller is assured that, so long as it fulfills its contractual obligation, the money is its to keep. Here, in contrast, a customer submitting a deposit made no commitment to purchase a specified quantity of electricity, or indeed to purchase any electricity at all. IPL's right to keep the money depends upon the customer's purchase of electricity, and upon his later decision to have the deposit applied to future bills, not merely upon the utility's adherence to its contractual duties.

Id. at 210-211 (footnote reference omitted). Because IPL's customers controlled the ultimate disposition of the deposit and had not committed to purchasing any electricity at the time the deposit was made, the Court found that IPL had no guarantee that it would be allowed to keep the money and held that the deposit amount was not income.

In the instant case, it could be argued that LLC B did not control the ultimate disposition of the Advance Payment because Parent had not committed to purchasing any services at the time the Advance Payment was made. However, the Services Contract does not indicate that Parent could obtain a refund of the Advance Payment in any event, even if Parent never requested services from LLC B.[3] Under the provisions of the Services Contract, Parent had no right to request a refund and thus, had no control over the disposition of the Advance Payment after it was made to LLC B. *See Michaelis Nursery, Inc. v. Commissioner*, T.C. Memo 1995-143 (taxpayer's contractual obligation to refund advance payments for goods only if taxpayer defaulted on obligation to deliver goods was not enough to defeat taxpayer's complete dominion over the payments, even though taxpayer's practice was to authorize refunds upon request). From the moment the Advance Payment was made, the money belonged to LCC B under any circumstance, and regardless of whether it provided any services to Parent. LLC B, and not Parent, controlled the ultimate disposition of the Advance Payment. Thus, the Advance Payment is includible in the gross income of LLC B.

[3] We recognize that Parent and LLC B are related parties and that the Services Contract may not have contained all the terms and conditions that would have been included in a contract between unrelated parties. However, the fact remains that Parent had no right under the Services Contract to request a refund of the Advance Payment.

ISSUE (2)

Having determined that the Advance Payment is includible in the gross income of LLC B, the next issue is whether LLC B properly adopted the deferral method of accounting provided in Rev. Proc. 71-21, 1971-2 C.B. 549. As noted in the discussion of Issue (1), advance payments generally are includible in gross income when received. However, for the year at issue, Rev. Proc. 71-21 was effective and set forth procedures under which accrual basis taxpayers could defer the inclusion in income of payments received (or amounts due and payable) in one taxable year for services to be performed in the next succeeding taxable year. No issue has been raised regarding the substantive propriety of LLC B's deferral method; the only issue raised is with regard to whether LLC B was required to obtain the Commissioner's consent to use the deferral method under Rev. Proc. 71-21, which it admittedly did not obtain.

Section 446(e) and the regulation thereunder provide rules for determining how a taxpayer changes a method of accounting. Section 446(e) states that except as otherwise expressly provided in this chapter, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary. Section 1.446-1(e)(1) of the Income Tax Regulations provides that a taxpayer filing his first return may adopt any permissible method of accounting in computing taxable income for the taxable year covered by such return.

In the instant case, LLC B adopted the deferral method of accounting provided under Rev. Proc. 71-21 for the first year in which it filed a return. That adoption generally would not constitute a change in accounting method for which consent is required. However, Rev. Proc. 71-21 contains a special rule for related parties. Section 5.01 of Rev Proc. 71-21 provides:

> Any change by a taxpayer from his present method of including amounts in gross income to the method prescribed in section 3.02 of this Revenue Procedure is a change in method of accounting to which section 446 and section 481 of the Code apply. In addition, the adoption of the method prescribed in section 3.02 for payments received by a taxpayer will be treated in the same manner as a change in method of accounting subject to the consent requirements of section 446(e) of the Code if the payments are for services of a type which were performed by a related person as defined in section 3.10 (or a predecessor thereof) within any of the five taxable years of such person (or predecessor) preceding the taxable year of the adoption.

LLC B adopted the deferral method under Rev. Proc. 71-21 for the Advance Payment, which payment was for services of a type that were previously performed by Corp B. Thus, the only issue is whether Corp B is a related person, as defined in section 3.10 of Rev. Proc. 71-21, to LLC B.[4] Section 3.10 provides that, for purposes of section 5.01, a person is related to the taxpayer if the taxpayer and such other person are owned or controlled directly or indirectly by the same interests within the meaning of § 482 and § 1.482-1(a) (1968).

LLC B and Corp B were owned or controlled directly or indirectly by the same interests within the meaning of § 482 and § 1.482-1(a) (1968). LLC B and Corp B were both indirectly owned by Parent. Parent owned and controlled LLC B through LLC A. Parent also owned and controlled Corp B through its wholly owned subsidiary, Corp A. It is irrelevant that LLC B and Corp B are considered to be the same entity for state law purposes. LLC B and Corp B are separate organizations because, for federal income tax purposes, LLC B is a separate and distinct entity from Corp B. Thus, LLC B and Corp B were owned or controlled by the same interests under § 482. Accordingly, LLC B and Corp B are related persons within the meaning of section 3.10 of Rev. Proc. 71-21.

Parent argues that, because LLC B and Corp B are the same entity, there were never two or more taxpayers to which § 482 applies. The fact that LLC B and Corp B are considered to be the same entity for state law purposes does not preclude the conclusion that § 482 may apply to them. Section 482 applies only to cases where two or more organizations, trades, or businesses are owned or controlled directly or indirectly by the same interests. LLC B and Corp B are two separate organizations, trades, or businesses. Even though LLC B and Corp B are deemed to be the same entity for state law purposes, for federal income tax purposes, they are separate organizations. When the corporation, Corp B, converted into a limited liability corporation treated as a partnership, the corporation is deemed to liquidate and distribute all of its assets and liabilities to its shareholders under § 332. The corporation, therefore, goes out of existence. Immediately thereafter, the shareholders are deemed to contribute all the distributed assets and liabilities to LLC B under § 721. Thus, a new and distinct organization is formed. Section 301.7701-3(g)(1)(ii) and (2).

Further, § 482 applies even though LLC B and Corp B did not exist simultaneously. *See Central Cuba Sugar Co. v. Commissioner*, 198 F.2d 214, (2d Cir. 1952) (holding that the application of § 45 of the 1939 Code (§ 482 of the 1954 Code) was proper to reallocate expense deductions taken by a predecessor corporation to its successor corporation that reported the income attributable to those expenses even

[4] LLC B argues that section 5.01 of Rev. Proc. 71-21 was intended to apply only when the related person not only performed services of a type performed by the taxpayer, but also established a method of accounting under which advance payments for those services were included in income when received. In this case, because Corp B had never received an advance payment, LLC B argues that section 5.01 should not apply. We recognize that section 5.01 has never been interpreted by the courts or by the Service in any published guidance. However, LLC B's interpretation would require us to read additional requirements into the language of section 5.01. We think the language of section 5.01 is clear on its face. The language certainly put LLC B on notice that, assuming Corp B was a related person, LLC B was required to obtain consent to use the deferral method under Rev. Proc. 71-21.

though the Commissioner found no tax avoidance motive); *see also Rooney v. United States*, 305 F.2d 681 (9th Cir. 1962) (holding that § 482 was properly applied to reallocate expenses incurred by an individual business in planting a crop to a corporation to which the individuals transferred the crop and other assets of their farm even though the corporation was formed after the expenses were accrued). Thus, LLC B and Corp B are related persons and LLC B was required under section 5.01 of Rev. Proc. 71-21 to obtain the consent of the Commissioner to adopt the deferral method of accounting for the Advance Payment. Because LLC B failed to obtain consent, LLC B did not properly adopt the deferral method of accounting provided in Rev. Proc. 71-21.

LLC B argues that, regardless of whether it was required to obtain consent under section 5.01 of Rev. Proc. 71-21, it was permitted to defer the Advance Payment under *Artnell Co. v. Commissioner*, 400 F.2d 981 (7th Cir. 1968) and its progeny. In *Artnell*, the court allowed a professional baseball franchise to defer advance payments for season tickets, radio and television rights, and season parking passes for games to be played in the following taxable year. The court distinguished the trilogy of Supreme Court cases holding that advance payments must be included in gross income when received because in those cases, the time and extent of the performance of future services were uncertain. *See Schlude*, 372 U.S. 128, *American Automobile Assn.*, 367 U.S. 687; *Automobile Club of Michigan*, 353 U.S. 203. The court noted that income received by the sports franchise was allocable to games on a fixed schedule. The court stated that "there must be situations where the deferral technique will so clearly reflect income that the court will find an abuse of discretion if the commissioner rejects it." *Artnell*, *400* F.2d at 985.[5] *See also Tampa Bay Devil Rays v. Commissioner*, T.C. Memo 2002-248; *Morgan Guaranty Trust Co. v. United States*, 585 F.2d 988 (Ct. Cl. 1978); *Boise Cascade Corp. v. United States*, 530 F.2d 1367 (Ct. Cl. 1976)[6] (holding that the taxpayer in each case was entitled to defer recognition of income for services to be performed on fixed dates).

In the instant case, LLC B argues that the deferral of the Advance Payment clearly reflects income and, therefore, any attempt to reject that deferral would be an abuse of the Commissioner's discretion under § 446(e). LLC B states that its method clearly reflects income because its provision of driver services to Parent, and indirectly to Parent's customers, involved a fixed schedule of driver services. LLC B's position is that, because Parent enters into arrangements with the majority of its customers and has established long-term, service-based relationships, LLC B necessarily provides a fixed schedule of driver services. We disagree. First, the Services Contract between LLC B and Parent is the relevant document for determining whether services in this

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5 The Commissioner acquiesced to *Artnell* in result only (1970 AOD Lexis 372 (Sept. 17, 1970)), and has stated that it will not follow *Artnell* to the extent the rules for deferral could be deemed to be broader than those contained in Rev. Proc. 71-21. *See* 1971 AOD Lexis 77 (July 27, 1971).

6 The Commissioner does not agree with the decision in *Boise Cascade*. *See* AOD CC-1986-014 (Feb. 19, 1986).

case are provided on a fixed schedule. Any arrangement that Parent has with its own customers, which arrangement is not incorporated in the Services Contract, is not determinative with regard to the services that LLC B provides to Parent under the Services Contract.

Second, the Services Contract provides only that LLC B agrees to provide truck drivers to Parent, upon reasonable request and in sufficient numbers to meet the needs of Parent. Thus, the time and extent of the performance of future services were uncertain. Unlike the fixed schedule of services provided in *Artnell* and its progeny, in this case there are no fixed dates for performance in the Services Contract. Therefore, it is not an abuse of the Commissioner's discretion to reject LLC B's deferral of the Advance Payment.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to LLC B. Section 6110(k)(3) provides that it may not be used or cited as precedent.